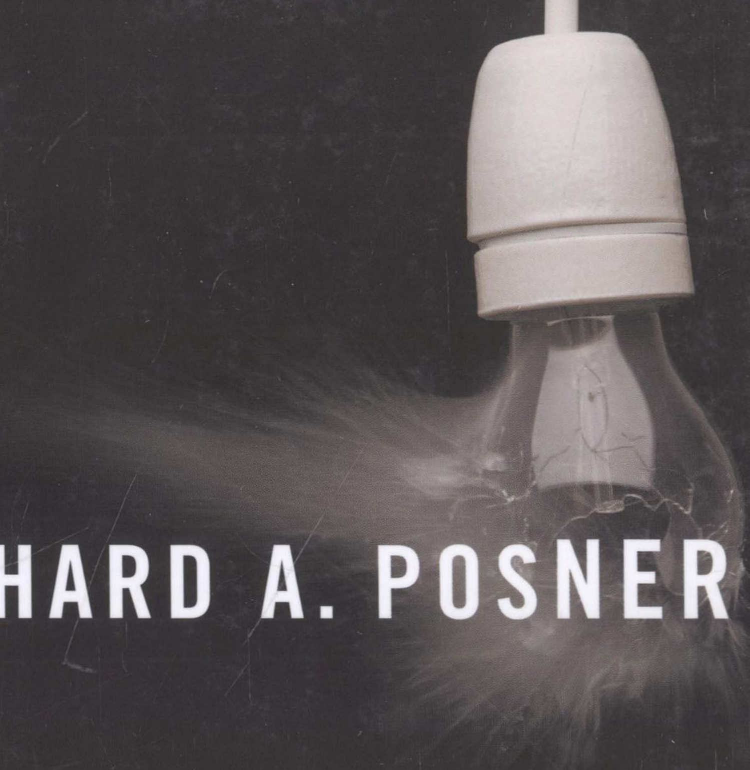

RICHARD A. POSNER

THE CRISIS OF CAPITALIST DEMOCRACY

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INTRODUCTION

At this writing, it is more than two years since the beginning of a recession that turned into a depression in the fall of 2008, following the financial crisis in mid-September of that year. The financial circuits had become overloaded; the banking industry collapsed like the light bulb, shattered by an electrical overload, on the cover of this book. The first really frightening and dangerous economic crisis since the Great Depression of the 1930s, this depression already has had profound economic, political, institutional, and intellectual consequences, and the consequences may continue to be felt for many years to come. I am emphatic in regarding the economic downturn as a "depression." The issue is more than semantic, but to explain why would take up too much space here; I defer it to chapter 6.

I first analyzed the crisis in my book *A Failure of Capitalism: The Crisis of '08 and the Descent into Depression* (2009), which took the story up to February 2, 2009. The title alarmed some readers, who thought I meant that capitalism has failed us and we need something different. That was not my intention. I believe in capitalism. But capitalism is not a synonym for free markets. It is the name given to a complex economic system with many moving parts. The buying and selling and investing and borrowing and other activities carried on in private markets are only some of those moving parts. Others include a system of laws for protecting property and facilitating transactions, institutions for enforcing those laws, and regulations designed to align private incentives with the goal of achieving widespread prosperity. If the regulatory framework is defective, it must be changed, because competition will not permit businessmen to subordinate profit maximization to concern for the welfare of society as a whole, and ethics can't take the place of regulation.

One of the key regulatory institutions is a central bank, which in the United States is the Federal Reserve. The component of capitalism that consists of a private banking system is unstable and can fail, and if it fails can bring down much of the rest of the economy with it. That is one reason a capitalist system cannot consist just of free markets. A central bank has a key role to play in keeping a nation's banking system working, as do the government agencies involved in the regulation of banking, which include the Federal Reserve; indeed it is the most powerful of the bank regulatory agencies. A combination of unsound monetary policy and regulatory inattention brought on the banking collapse of September 2008.

The Federal Reserve was not created until 1913, and before then central banking in the United States was intermittent. An economic literature advocates returning to "free banking" (that is, no government creation or regulation of the money supply). And a return to the gold standard, for which there are more advocates, would curtail the power of the Federal Reserve. But realistically there is no alternative to a modern central banking system as typified by the Federal Reserve System.

The inherent instability of a capitalist economy is a fact, not a criticism. The average growth of the U.S. economy has long been about 3 percent a year, which is good and has made us the world's wealthiest large nation, as well as the world's most powerful nation. But the actual growth from year to year oscillates around that trend line—often dipping into negative territory—in an irregular, unpredictable fashion. This oscillation is the "business cycle," though the word "cycle" is misleading because it suggests a smooth wavelike motion, like a pendulum; the real motion is anything but.

One reason for the oscillation, perhaps the main reason, is feedback effects. There is an analogy to climate, another inherently unstable system. Carbon dioxide in the atmosphere raises surface temperatures by trapping heat radiated from the earth; the higher temperatures, among their other effects, melt the Alaskan and Siberian permafrost, releasing methane, another "greenhouse gas," which leads to a further increase in surface temperatures. Similarly, an asset-price bubble can form and then burst and in bursting trigger a recession that can feed on itself until it grows into a depression: demand falls, so output falls, so unemployment rises, so incomes fall, so there is a further reduction in demand as a result of which output declines further and unemployment rises further. Eventually, as inventories shrink and durables wear out and cash hoarding by businesses afraid to invest and consumers afraid to spend produces a savings glut, spending will increase, and the downward spiral will stop and then reverse. In either direction, feedback effects will amplify what initially may have been only a small change in economic behavior. Those effects can get out of hand. They did in the 1930s and again in the fall of 2008 and the winter and spring of 2009. To prevent them from getting out of hand requires active and intelligent government. Government has been active since the crash of 2008; how intelligent is another question.

February 2, 2009, did not end my interest in the crisis; nor did the economy and government obligingly stand still. Since then I have written on the crisis in my blog (sponsored by the *Atlantic Monthly*) called "A Failure of Capitalism" (http://correspondents.theatlantic.com/richard_posner/), in my separate blog with the economist Gary Becker ("The Becker-Posner Blog," recently moved to http://uchicagolaw.typepad.com/beckerposner/, formerly at www.becker-posner-blog.com/), and in the following published writings:

"Shorting Reason" (review of George A. Akerlof and Robert J. Shiller, *Animal Spirits: How Human Psychology Drives the Economy, and Why It Matters for Global Capitalism* [2009]), New Republic, Apr. 15, 2009, p. 30;
"Capitalism in Crisis," *Wall Street Journal,* May 7, 2009, p. A17;
"Reply to Akerlof and Shiller," *New Republic,* May 8, 2009, www.tnr.com/article/politics/disputations-case-misrepresentation;
"Our Crisis of Regulation," *New York Times,* June 23, 2009, p. A23;
"The President's Blueprint for Reforming Financial Regulation: A Critique—Part I," *FinReg21,* July 20, 2009, www.finreg21.com/lombard-street/the-president%E2%80%99s-blueprint-reforming-financial-regulation-a-critique-part-i;
"Treating Financial Consumers as Consenting Adults," *Wall Street Journal,* July 23, 2009, p. A15;
"The President's Blueprint for Reforming Financial Regulation: A Critique—Part II," *FinReg21,* Aug. 3, 2009, www.finreg21.com/lombard-street/the-president%E2%80%99s-blueprint-reforming-financial-regulation-a-critique-part-ii;
"Uncertainty Aversion and Economic Depressions," *Challenge,* Sept.-Oct. 2009, p. 25;
"How I Became a Keynesian," *New Republic,* Sept. 23, 2009, p. 34; and
"Financial Regulatory Reform: The Politics of Denial," *The Economists' Voice,*" Nov. 2009, www.bepress.com/ev.

I draw on these writings in this book, though on much else besides.

The book is not a sequel, picking up where the first one left off, though it does bring the story of the crisis up to date. Rather, it is an effort to deal in greater depth, and from a longer perspective, with a crisis that has continued to evolve, to elicit new response measures and new proposals for regulatory reform, to engender new concerns about the future and spawn new controversies about the past. More is known now about the background, causes, and course of the crisis; a richer narrative and fuller analysis are therefore possible. Current and former government officials who played an unwitting causal role in the economic collapse, such as Alan Greenspan and Ben Bernanke, have weighed in with their excuses. Academic economists, emerging from the shell shock that I described in my first book, have begun grappling with the profound economic issues presented by the crisis and the efforts to resolve it. I have joined the fray, and in the process amplified and sharpened the economic approach sketched in the first book.

That book was completed twelve days after Barack Obama's inauguration ushered in new efforts to contain the crisis. This book zeroes in on those efforts, and on the measures that have been proposed and in some instances adopted to prevent a repetition of the crisis. It is now possible to assess the success of the Obama Administration in responding to the crisis, and to evaluate proposals for financial regulatory reform, coming both from within and outside the government, that have acquired texture, that are not merely vague concepts. The politics of depression and recovery, and the practicalities of regulatory reform, have thus come into sharper focus. As recovery begins, moreover, careful scrutiny is required of the prospects for the recovery's continuing without interruption despite soaring deficits, which may be setting the stage for a painful depression aftershock, and perhaps even for a long-term deterioration of the American economy. Critics of the Administration are beginning to argue that the cure for the depression may turn out to be worse than the disease—and they may have a point.

Between the end of 2001, when the Federal Reserve pushed the federal funds rate (a benchmark short-term interest rate) way down, and the middle of September 2008, when the Fed and the

Treasury allowed Lehman Brothers to collapse, the government's management of the economy was miserable. Beginning in October and continuing through the enactment of the $787 billion stimulus package in February 2009 (and thus straddling the outgoing and incoming Administrations), the government's economic management was as good as could realistically have been expected. Since then, however, the government has stumbled again, as we shall see throughout the book, and in ways and for reasons that raise the question whether the American political system can preserve the nation's prosperity in the challenging conditions in which the economy now finds itself. Whether America is governable—whether its political institutions are still adapted to the challenges that the economic crisis has both highlighted and magnified—has been brought into question. The American polity is a fusion of a capitalist economic system with a democratic political system in which modern techniques of political manipulation overlie an eighteenth-century constitution. The economic downturn that began in 2007 and turned critical in September 2008 has acted as a stressor that has brought the resilience of our capitalist democracy into question. Hence the title of this book.

A depression raises complicated issues typically discussed, whether by economists or by journalists, in an esoteric business and economics jargon garnished with charts and statistics. One aim of my first book was to explain to the educated but nonexpert public, clearly and simply—stripping out all irrelevant detail—the economics of the business cycle and of finance, the causes and course of the crisis, the initial responses, and the dangers ahead. This book takes a further step. Different from its predecessor, it is more detailed, more wide-ranging, and requires greater involvement and attention from the reader. I want still to be understood by the nonexpert reader (formerly called the "general reader") who seeks understanding of a complex phenomenon that affects everyone. But I want to reach experts as well, especially a certain class of experts. The economic crisis caught unawares many persons who are professionally engaged with issues involving the crisis yet who are unfamiliar with the relevant macroeconomics, finance theory, and financial instruments and practices. This book seeks to equip them with the background knowledge they need in order to engage—whether as lawyers, accountants, congressional staffers, civil servants in the economic branches of government, or businessmen who buy rather than sell financial products or services—with the issues thrown up by the crisis. Even finance professionals, specialists all, may learn a little from seeing their field placed in a broader intellectual context.

As the crisis has evolved, as analyses have proliferated, as proposals for reform have become detailed and concrete, the challenge of lucid explanation has grown. And so, because intelligibility remains my overarching goal, I have had to decide whether to present essential background material (definitions, the operation of the Federal Reserve, the rival economic theories, and so forth) in a lump at the beginning of the book or to weave it into a narrative of the crisis. The first approach, though simpler to execute, would have bored the experts yet have been difficult for the nonexpert reader to digest. So rather than laying out all at once the essentials of business-cycle theory, the theory of money and banking, the structure of financial regulation, and the financial instruments that have figured largely in the crisis, I introduce these concepts, institutions, practices, and instruments as they become relevant to a chronological narrative that covers the run-up to the crisis, the crisis itself, how government and the market have responded, what reforms aimed at preventing a repetition of the crisis have been adopted or proposed, and what may lie ahead for the economy. I criticize several aspects of the government's response to the crisis, including the Obama Administration's program of financial regulatory reform, which seems to me premature, overly ambitious, too political, too interventionist.

That is the project of Part I of the book. Part II discusses lessons that we should bring away from the crisis and the responses. There is some repetition, but I think it will be helpful for readers to encounter key concepts first in a narrative context and second in a theoretical one. The central theoretical chapters are chapters 7 through 9; the concepts emphasized there, such as hoarding and uncertainty, will by then be familiar to the reader from the earlier chapters.

I argue that we need to understand the inherent fragility of a banking system and the danger therefore of slack regulation, including a loose monetary policy. And we need fresh economic thinking about the business cycle, but thinking that builds on the original ideas of John Maynard Keynes, as distinct from their revision by practitioners of the "New Keynesian Economics." Those ideas centrally include the importance of uncertainty as distinct from calculable risk in shaping economic behavior, the separation of savings from productive investment, and the role of confidence and optimism in shaping the business cycle. I extend the criticisms I made of present-day economists in the first book, emphasizing now not just their failure to anticipate the crisis, which was my emphasis in that book, but also failures of understanding that can be summarized as forgetfulness of Keynes.

Part III considers life after the depression. I canvass regulatory reforms that should be receiving serious considerations; generally these are not the reforms proposed by the Administration and under active consideration in Congress. I also discuss how the role of the United States in the world economy is being altered, probably for the worse and perhaps for a very long time, by the depression and its aftermath. It is not that the economic challenges that we face are insurmountable but that we may lack the governmental structures and political culture requisite for meeting them. I do not attempt to offer a theory of political failure, but I offer plenty of evidence of it.

The world will not stand still while I write a book and my publisher publishes it. I had thought when I began that by the beginning of the new year the economic and political outlook would be much clearer. It is not. It seems reasonably clear that the core of the proposals for financial regulatory reform that the Treasury Department made in June will be enacted by Congress in the first quarter of 2010, but the details of the legislation will be critical and they cannot be predicted. Economic recovery has begun, but how fast it will proceed cannot be predicted either; nor can its aftermath be foreseen. I can hope only to provide a lens through which to view with sharpened perception an economy in troubled transition.

Three simplifications in my presentation should be kept in mind. I use "Federal Reserve" to denote interchangeably the two principal organs of the Federal Reserve System, the Board of Governors and the Federal Open Market Committee. They can be regarded interchangeably because both are dominated by their chairman, who is the same person. Second, unless otherwise indicated explicitly or by context, I use "bank," "banking industry," "banking system," and other cognates of "bank" to refer to any financial intermediary—that is, any entity that lends borrowed capital, whether or not it is a commercial bank regulated by banking regulators. Third, I use "subprime" to refer to any home mortgage that would be considered unsafe under traditional banking principles because the mortgagor (the borrower) had little or no equity in the house, lacked an income adequate to assure his ability to make the monthly mortgage payments, was allowed to defer the making of monthly payments for several years, had a poor credit record, or had been given a mortgage without having to document his financial situation.

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AN ANALYTIC NARRATIVE OF THE CRISIS

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