How to Understand the Disaster

By Robert M. Solow

A Failure of Capitalism: The Crisis of '08 and the Descent into Depression

by Richard A. Posner

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No one can possibly know how long the current recession will last or how deep it will go. That is because the dangerous combination of the "real" recession—the unemployment and idle productive capacity that come from lack of demand—and the financial breakdown, each being both cause and effect of the other, makes the situation more complex, more unstable, more vulnerable to psychological imponderables, and more distant from previous experience. Whenever the US economy returns to some sort of normality, or preferably before then, it will be necessary to improve and extend the oversight and regulation of the financial system. The main goal should be to make another such episode much less likely, and to limit the damage if one occurs.

To make progress in that direction requires some understanding of the origins of the current mess. I once saw a hospital discharge diagnosis that read "sepsis of unknown etiology"; that sort of thing will not help in this case. The need is not only for a clear picture of what happened but for an assessment of the motives and actions of the main players, the causes and consequences of what they did, and the ideas and institutions that encouraged, inhibited, and shaped the outcomes. Richard Posner's book is intended to fill that need, in clear and understandable language. I think it is at best a partial success; it gets some things right and some things wrong, and the items on both sides of the ledger are important.

More striking than what the book says is who says it. Posner is a judge of the US Court of Appeals for the Seventh Circuit, and so preeminently a lawyer. In addition, he is an apparently inexhaustible writer on nearly everything. To call him a polymath would be a gross understatement. A partial list of his publications in the past ten years alone includes How Judges Think; Law, Pragmatism and Democracy; Frontiers of Legal Theory; the seventh edition of his Economic Analysis of Law (first published in 1973); the third edition of Law and Literature; three volumes of essays on The Economic Structure of Law; and books on plagiarism, constitutional aspects of national emergencies, the election of 2000, the US domestic intelligence system, countering terrorism, public responses to the risk of catastrophe, the Clinton impeachment, dealing with the AIDS epidemic, and, significantly, Public Intellectuals: A Study of Decline. There is a prehistory of still more books, and many articles in legal and other periodicals.

Judge Posner evidently writes the way other men breathe. I have to say that the prose in this book often reads as if it were written, or maybe dictated, in a great hurry. There is some unnecessary repetition, and many paragraphs spend more time than they should on digressions that seem to have occurred to the author in mid-thought. If not exactly chiseled, the prose is nevertheless lively, readable, and plainspoken. The haste may have been justified by the pace of the events he aims to describe and explain. Posner has an extraordinarily sharp mind, and what I take to be a lawyerly skill in argument. But I also have to say that, in some respects, his grasp of economic ideas is precarious. In his book on public intellectuals, Posner blames the decline of the species on the universities and their encouragement of specialization. I may be acting out that conflict. Remember that even hair-splitting is not so bad if what is inside the hair turns out to be important.

The plain-spokenness I mentioned is what makes this book an event. There is no doubt that Posner has been an independent thinker, never a passive follower of a party line. Neither is there any doubt that his independent thoughts have usually led him to a position well to the right of the political economy spectrum. The Seventh Circuit is based in Chicago, and Posner has taught at the University of Chicago. Much of his thought exhibits an affinity to Chicago school economics: libertarian, monetarist, sensitive to even small matters of economic efficiency, dismissive of large matters of equity, and therefore protective of property rights even at the expense of larger and softer "human" rights.

But not this time, at least not at one central point, the main point of this book. Here is one of several statements he makes:

Some conservatives believe that the depression is the result of unwise government policies. I believe it is a market failure. The government's myopia, passivity, and blunders played a critical role in allowing the recession to balloon into a depression, and so have several fortuitous factors. But without any government regulation of the financial industry, the economy would still, in all likelihood, be in a depression; what we have learned from the depression has shown that we need a more active and intelligent government to keep our model of a capitalist economy from running off the rails. The movement to deregulate the financial industry went too far by exaggerating the resilience—the self-healing powers—of laissez-faire capitalism.

If I had written that, it would not be news. From Richard Posner, it is. The underlying argument—it is not novel but it is sound—goes something like this. A modern capitalist economy with a modern financial system can probably adapt to minor shocks—positive or negative—with just a little help from monetary policy and mostly automatic fiscal stabilizers: for example, the lower tax revenues and higher spending on unemployment insurance and social assistance that occur in a weakening economy without any need for deliberate action. It is easy to be lulled into the comfortable belief that the system can take care of itself if only do-gooders will leave it alone. But that same financial system has intrinsic characteristics that can make it self-destructively unstable when it meets a large shock. One such characteristic is asymmetric information: some market participants know things that others don't, and can turn that knowledge into profit. Another is the capacity of financial engineering to produce securities so complicated and opaque—for example, collateralized debt obligations and other exotic derivatives—that almost no one in the market can understand their implications. (Insiders still have an exploitable advantage.)

Yet another characteristic is the inevitability of market imperfections, so that what is essentially the same object can sell for two or more different prices; or so that some market prices can be manipulated by large, informed operators; or so that some markets take a long time to match supply and demand. And yet another is the
risk of greed, stupidity, and corruption.

Why did I do such a risky and, as it turned out, stupid thing? Well, it had worked in the past, and made a lot of money for many people. If I had backed off, others would probably have continued to make money for a while. I would have looked like a fool, and very likely an unemployed fool.

This sob story is just the beginning. Many highly leveraged financial institutions—banks, hedge funds, and insurance companies among them—have dug themselves into similar, interconnected holes. They have borrowed from other financial institutions to make complicated bets on risky assets, and they have lent to other leveraged financial institutions so that those institutions could make complicated, risky asset bets. These are the "toxic assets" that weigh down the balance sheets of banks. No one knows for sure what anyone else is worth: they own assets of uncertain value, including the debts of other institutions that own assets of uncertain value.

All those banks and others are now unwilling to lend to one another because they fear that the potential borrower is already broke and will be unable to repay. And so the credit markets freeze up and ordinary businesses that need credit for ordinary business purposes find that they cannot get it on any reasonable terms. This is what happened in September 2008 when the common commercial market—"the market for daily business borrowing"—ceased to work. The breakdown of the financial system exacerbates the recession; many who want to buy or build cannot get credit with which to do so. The recession then endangers the solvency of more financial and nonfinancial borrowers and worsens the state of the financial system.

I have deliberately kept this story stylized, omitting the juicy details about complicated derivative securities that seem to bear only the most tenuous connection to the everyday economic realities of production, employment, consumption, and so on. I have also ignored the even juicier details of greed, stupidity, and corruption. Posner does not ignore those things. They provide an irresistible target for amusement and contempt. I wanted instead to focus on the central role of leverage, because it is leverage that turns large banks and financial institutions into ninepins that cannot fall without knocking down others that cannot fall without knocking down still others. That seems to be the key to the potential instability of an unregulated financial system. It happens without any of the private actors violating the canons of self-interested rationality. Those canons would have been different if the SEC, the Fed, and other institutions charged with regulation had insisted both that all transactions be made public and that there be some limits on leverage.

It is a noteworthy intellectual event that Posner has come to this understanding and expressed it forcefully and fearlessly. This same understanding must then also be the key to designing regulations that can reduce the frequency of financial crises like the current one, and limit the collateral damage to the real economy that they entail. Regulations should require that the uses and amounts of leverage, still largely hidden, be made public and that limits be set on the amounts of leverage that financial institutions can bring into play.

Now let me turn to the recession itself. Posner prefers to label it a "depression"—see his subtitle—as if there is some unambiguous dividing line that has been crossed. He defines a depression as a "stark reduction in output that causes or threatens to cause deflation and creates widespread public anxiety and, among the political and economic elites, a sense of crisis that evokes extremely costly efforts at remediation." All sorts of obvious questions arise. How steep? How many prices must fall for the market for daily business borrowing to cease to work? What is the possibility that large financial institutions can raise large sums of credit, in amounts and ways that can affect the whole system, without anyone taking account of, or feeling responsible for, the systemwide effects.

In that kind of world, imagine a period of low interest rates. Once a set of profit opportunities is found, big operators will be tempted to borrow so that they can play with much more than their own capital, and thus make very large profits. This has come to be called "leverage." Suppose I have $100,000 of my own, and I see an opportunity to earn a 10 percent return. If it pans out, I make $10,000; if it earns nothing, I have my original stake. If it loses money, that comes out of my initial capital. But I have a shot at something bigger. I can borrow $900,000 at, say, 5 percent interest, and invest the whole million. If it earns the expected 10 percent, I have $1,100,000; I can pay off my debt, plus interest of $45,000, and have $155,000 left. I have earned 55 percent on my money. Only in America! Of course, if the investment earns zero, I must still pay back my borrowing, with interest, which leaves me with $55,000. I have lost almost half of my capital; and it could be worse. Risk cuts both ways. What I have just described is 10-to-1 leverage; the size of the total bet is ten times my equity.

What if I choose to borrow $900,000 at 5 percent interest, and invest the whole million in an asset that is worth, at the end of the year, exactly what I paid for it a year ago? In fact, there might be no takers at all. There is no way of knowing what the package of mortgages might be worth in a couple of years; when it comes to raising more cash to cover my debt, it is worth essentially nothing, i.e., it can neither be sold nor used as collateral. Whoever lent me the $3,045 million, including interest, has lost the whole thing.

In the past, 10-to-1 leverage would have been about par for a bank. More recently, during the housing bubble that preceded the current crisis, many large financial institutions, including now-defunct investment banks such as Bear Stearns and Lehman Brothers, reached for 30-to-1 leverage, sometimes even more. So suppose I borrow $2.9 million to go with my very own $100,000—leverage of 29 to 1. I can buy $3 million of whatever asset I fancy. If it earns 10 percent, I repay the $2.9 million plus $145,000 in interest and go home with $255,000, having earned a mere 155 percent on my own capital. But now, if the investment earns zero, I have an asset worth $3 million and liabilities of $3.045 million. I am, to coin a phrase, bankrupt. And this is when I have invested in an asset that is worth, at the end of the year, exactly what I paid for it at the beginning. If I had bought a piece of a complicated package of subprime mortgages, as many investors did, it might be worth less than I paid for it a year ago. In fact, there might be no takers at all. There is no way of knowing what the package of mortgages might be worth in a couple of years; when it comes to raising more cash to cover my debt, it is worth essentially nothing, i.e., it can neither be sold nor used as collateral. Whoever lent me the $3,045 million, including interest, has lost the whole thing.
boom. In fact, construction had already increased pretty sharply during the prosperous 1990s, in spite of generally unfavorable demographics, such as the aging of the population and the corresponding slowdown in family formation, both of which diminish the need for living space.

But there was certainly a further spurt. About 1.2 million private housing units were started in 1990, 1.6 million in 2000, and 2.1 million in 2005. Posner emphasizes the corresponding run-up in house prices, and he is right to do so. But the housing boom was not just a financial fact. By 2005 the country had clearly built many more houses, maybe two or three million more, than it could afford to occupy and finance. There would have been a housing slump in any case. We have had housing booms and slumps before, with consequences no worse than an interval of slow growth or a brief downturn, met with normal monetary policy and automatic fiscal stabilizers such as changes in tax rates or in public spending.

What made this housing boom different, of course, was the mix of low interest rates and the ability of the original lenders to package many thousands of mortgages into mortgage-backed securities that could be sold off to the broad capital markets, where the buyers could have no real grasp of how risky the underlying mortgages were. (The rating agencies that were supposed to figure it out for them were waist-deep in conflicts of interest. Moody's and Standard and Poor's were paid by the same institutions whose securities they were supposed to be judging.) As a result, trillions of dollars of mortgages were sold, unsparingly and deceptively, to buyers whose only chance of meeting their obligations was a continued rise in prices. (I remember a ubiquitous TV commercial for a mortgage finance company whose punch line was: "When others say No, Champion says Yes." I haven't seen it lately.)

So this housing boom was enhanced by riskier and more opaque financial products that entangled a wider variety of highly leveraged financial institutions. The word "bubble" is often misused; but there was a housing bubble. Rising house prices induced many people to buy houses simply because they expected prices to rise; those purchases drove prices still higher, and confirmed the expectation. Prices rose because they had been rising.

To make matters worse, the fever spread to other assets: stock prices doubled in the five years 2003–2007. When the implosion came in 2007, enormous amounts of what had been perceived as wealth—true, eventually spendable wealth—simply disappeared. According to data compiled by the Federal Reserve, household wealth in the US peaked at $64.4 trillion in mid-2007, and had plummeted to $51.5 trillion at the end of 2008. Something like $13 trillion of perceived wealth vanished in not much more than a year.

Nothing concrete had changed. Buildings still stood; factories were still just as capable of functioning; people had not lost their ability to work or their skills or their knowledge of technology. But a population that thought in 2007 that they had $64.4 trillion with which to plan their lives discovered in 2008 that they had lost 20 percent of that. A standard, empirically tested rule of thumb is that an additional dollar of wealth induces the average consumer to increase annual spending by an amount between four and six cents. So we are looking at a potential drop in consumer spending of something like $650 billion a year (5 percent of $13 trillion).

To see how big this is, remember that President Obama's stimulus package amounted to less than $800 billion, spread over two or more years. If every dollar of stimulus were translated into a dollar of spending, this particular consumer-spend gap would still not be filled. And not every dollar of stimulus will be spent; nor is the consumer-spending gap the only demand failure we have to worry about. But this is one very important route by which the financial collapse damages the real economy. Another, of course, is the paralysis of credit markets, limiting the ability of legitimate businesses and families to borrow and spend. Much the same thing seems to be happening in Europe and in Asia, with national differences in detail.

Judge Posner does not quite get the role of the consumer right. He says that among the "immediate causes of the depression were the confluence of risky lending with inadequate personal savings...so that people couldn't reallocate savings to consumption." He is referring to the fact that American families, who were saving 5 or 8 percent of their after-tax income not so long ago, had brought their saving rate down to less than 2 percent on average in the years between 2001 and 2008. If they had saved more they would find it easier to maintain their consumption spending in hard times.

But from the rational individual's point of view, the goal of saving is to add to one's wealth, to be used eventually in what Judge Posner is much too smart to expect the average household to see exactly how much of its available wealth is very unreliable, to put it mildly. Judge Posner is much too smart to expect the average household to see exactly how much of its apparent wealth was at risk in an unregulated, highly leveraged, deeply opaque, generally shortsighted financial system. Besides, there is plenty of evidence that many people rarely, if ever, alter their 401(k) allocations and, when they do, are very likely to alter them unwisely.

Most commentary, at large, in Posner's book, and in this review, has been about how the financial collapse damages the real economy. It might be thought that somehow fixing the financial mess would automatically fix the real economy. That is not so, for at least two reasons worth mentioning. In the first place, all that vanished wealth cannot be restored; much of it was fluff, as we now know. American families are not worth $64.4 trillion. When all that shakes itself out, both the real economy and the financial system will be different.

Secondly, the restoration of credit flows is not just a matter of clarifying and strengthening the balance sheets of banks and other lenders. It takes two to make a loan: a solvent and willing lender and a credible borrower. In a deep recession, there are not enough credible borrowers, meaning businesses and individuals with excellent prospects of being able to repay a loan on time, with interest. That is why direct stimulus has to accompany the necessary work of cleaning up the debris cluttering the financial system, by removing those toxic assets from the balance sheets of banks and replacing them with clean capital.

There are other weaknesses in Posner's remarks on the real economy. For example, more than once he says that the various antirecessionary measures—like fiscal stimulus, bailouts—are very "costly" and "may do long-term damage to the economy." He does not explain what these costs and damages are. Sometimes he seems to have budgetary costs in mind. But bailouts are mostly transfers from one group in society to another, for example from taxpayers to financial institutions and their owners. They are certainly not ethically satisfying transfers, but it is not clear how they do long-term damage to the economy. The components of a fiscal stimulus package are costs to the federal budget; but to the extent that they put otherwise unemployed labor and idle industrial capacity to work, they do not impoverish the economy; in fact, they enrich it. (Of course, one would prefer useful projects to wasteful ones.) If fiscal stimulus works, even imperfectly, there is no doubt which way the benefit–cost ratio goes.
Posner is on much firmer ground in worrying about the very large increases in the money supply and in the interest-bearing public debt that are left behind by antirecessionary policy. Even there, we do not know how skillful and lucky the Federal Reserve will be at mopping up excess liquidity when the economy recovers, whether by arranging repayment of loans it has made to the private sector, or by selling off the assets it has acquired along with Treasury debt. And if the economy can be restored to normal growth and sensible fiscal policy, the ratio of debt to GDP, which is what matters, can eventually be brought down. Without some analysis, this sort of talk does not spread light.

There is an even odder chapter called “A Silver Lining?” In it Posner flits with the idea that a recession, even a depression, has a good side. It weeds out inefficient firms and practices. This is a little like saying that a plague is not all bad: it cleans up the gene pool. No doubt there is some truth to this idea of a purifying effect. But the notion that it could possibly compensate for years of lost output and lost jobs seems wholly implausible. There is certainly no calculation of economic costs and benefits behind the thought of a “silver lining.” I think it is another example of overemphasis on minor gains in efficiency and neglect of first-order facts.

Posner's chapter on “The Way Forward” is all of sixteen pages long, and fairly disorganized pages at that. This means he does not seriously try to imagine what an effective regulatory regime for financial markets would look like or, above all, how it could be designed to protect the real economy as much as possible from damage inflicted by financial breakdown. Nevertheless he says some useful things; and it is especially significant that they come from a leading conservative (even if never a tamely doctrinaire one). Here is a representative statement:

Other regulatory changes might be desirable, such as limiting leverage; raising credit-rating standards and changing how credit-rating agencies are compensated; forbidding proprietary trading by banks (that is, trading of their equity capital, which puts that capital at risk); adjusting reserve requirements to take more realistic account of the riskiness of bank’s capital structures; requiring greater disclosure by hedge funds and private equity funds; requiring that credit-default swaps be traded on exchanges and fully collateralized; and even resurrecting usury laws.

In addition, he is clear that the enormous collection of federal and state agencies with various regulatory responsibilities over financial institutions has to be somehow consolidated and unified. Also, though he is unnecessarily ambiguous, a new streamlined regulatory apparatus has to apply to most of the financial sector, including hedge funds, not just the proper banks. If this is not done, new but just as dangerously risky and opaque practices will find their way between the cracks; and no agency will have the capacity or the responsibility to detect oncoming trouble.

Obviously that laundry list is not a blueprint for reform. It seems to me that effective limits on leverage, even if they have to be different for different classes of institutions, are basic to controlling the potential instability of the financial system. Even with more transparency, extreme leverage is what generates extreme uncertainty and systemic risk. And it also encourages the dangerous compensation practices that Posner pillories. Leverage allows a clever player to manage enormous sums; it is then irresistible to focus on the short run and skim off mind-boggling paychecks and bonuses before the opportunity goes away.

The Obama administration has been trying to inject enough clarity and capital into the balance sheets of banks so that they can resume providing credit for businesses and consumers. The job of regulatory reform has had to wait. The hints we have had suggest that the administration understands the need to include the unregulated institutions, and to set up at least an early warning system to detect major risks before they arrive. But there is no way yet to know what form the new system will take. One would like to establish some principles before we forget how bad it can get.

The financial system does have a useful social function to perform, and that is to make the real economy operate more efficiently. Some human institution has to collect a nation's savings and put them at the disposal of those who have productive ways to use them. Risks arise in the everyday business of economic life, and some human institution has to transfer them to those who are most willing to bear them. When it goes much beyond that, the financial system is likely to cause more trouble than it averts. I find it hard to believe, and I suspect that Judge Posner shares my disbelief, that our overgrown, largely unregulated financial sector was actually fully engaged in improving the allocation of real economic resources. It was using modern financial technology to create fresh risks, to borrow more money, and to gamble it away.

Posner writes:

As far as I know, no one has a clear sense of the social value of our deregulated financial industry, with its free-wheeling banks and hedge funds and private equity funds and all the rest.

That is already a hint that he thinks its social value is limited. As Posner sees it, talk about greed and foolhardiness is comforting but not useful. Greed and foolhardiness were not invented just recently. The problem is rather that Panglossian ideas about “free markets” encouraged, on one hand, lax regulation, or no regulation, of a potentially unstable financial apparatus and, on the other, the elaboration of compensation mechanisms that positively encouraged risk-taking and short-term opportunism. When the environment was right, as it eventually would be, the disaster hit.

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We've shown you how to prepare for a disaster before, and you should bookmark the Federal Emergency Management Agency's disaster preparedness site, Ready.gov, but here are some stand-out tips: How to Prepare for and Survive a Disaster. The earthquake and tsunami in Japan, followed by tsunami warnings in Hawaii and across much of theâ€¦ Read more. Advertisement. The previously mentioned disaster kit from 72hours.org is a must-have. After the unexpected earthquake in Japan, you should seek shelter immediately. Read Understand Insurance’s guide on how to prepare for risk.Â Once you have identified the disasters you are exposed to, itâ€™s important to review your insurance policies and confirm your cover against various events. If you don’t have insurance, consider the types of policies you may require and the risks you need them to cover. If you live in a flood or bushfire zone, it would be wise to insure your property accordingly. How to be prepared for natural disaster: explanations from professionals and complete guide how to survive natural disaster. What are the types of disasters and what to do when nature strikes.â€”Don’t forget to include your family in the creation of the plan, this way they will better understand the risks and how to avoid being caught unprepared. Don’t ignore disasters that happen rarely, for all you know one of those might strike before the one that is most likely to happen. Mother Nature is full of surprises and she loves playing with all 4 elements. The complete guide on how to survive. The three main things you need to do in order to be prepared for surviving natural disasters are the following.