

# A conversation with Judge Richard Posner, Part I

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By Zach Carter



Judge Richard Posner

*Richard Posner is one of the leading conservative legal and economic intellectuals of the past century whose recent book, *A Failure of Capitalism: The Crisis of '08 and the Descent Into Depression*, is a robust critique of the deregulatory movement. Posner currently serves as a judge on the United States Court of Appeals for the Seventh Circuit, and his name was frequently circulated as a potential nominee for the Supreme Court under President George W. Bush. Part one of Judge Posner's two-part critique of President Barack*

*Obama's financial regulatory overhaul was recently published on Fin-Reg21.com, where Judge Posner is a regular contributor. SNL's Zach Carter recently spoke with him about the current economic situation. In Part I of the interview, Posner discusses ways to improve the financial regulatory landscape. In Part II, published separately, Posner considers broader public policy options to fight the economic downturn. What follows is an edited transcript of their conversation.*

**SNL Financial: The main thrust of your critique seems to be that the Obama plan neglects the degree to which regulators dropped the ball over the past decade. What can we do to make regulators better?**

I think for one thing, they will now be more alert to the problems than they were before. They were very slow to recognize that there was a housing bubble, and they didn't really see the connection between a housing bubble and the financial industry. It's a little odd, because everyone knows that houses are the product that is bought with debt, so the banking industry is always deeply involved in the housing industry. If one collapses, the other can go with it. There are many historical examples where that's happened.

But in addition to that awareness, it should be possible to create a financial intelligence capability in the government, something like the CIA for the financial industry. It would be people who are looking for signs of trouble, investigating and thinking of ways of preventing problems if they got serious and preparing contingency plans. One of the things that disturbs me about what happened last September when the banking industry collapsed and was saved by the Federal Reserve and the Treasury Department is that the government had no plans for what would happen in the event of a banking collapse. They improvised. We can be a little more systematic about trying to detect threats to financial stability, and that can be done without new legislation.

**You mentioned deregulation as a factor leading up to the collapse, but your paper generally shies away from structural regulator reforms. Why?**

It's a lot easier to deregulate than reregulate. When you deregulate, you end up with a very heterogeneous industry, and trying to figure out what to do with all the different pieces is very, very difficult. If money market funds had never been permitted, if we'd said, 'No, if you want a checkable account, you have to go to a bank,' then we wouldn't be worried about what to do with money market funds. Money market funds are regulated by the SEC, not the Federal Reserve, and they have all sorts of different rules and buy different assets and so on. And they're at risk, because they are functionally banks and can get into problems as the Reserve Primary Fund did last fall, because it took the depositors' money and put it into commercial paper issued by Lehman Brothers. That turned out to be a disaster.

But what do we want to do? Do we want to take the money market funds away from the SEC and put them under the Federal Reserve and say they're really banks? Or say money market funds will only be provided by banks? We've got a lot of hedge funds that are operating like banks. They borrow money and then they lend it. What do you do with them? These things didn't exist when the deregulation movement started.

**But we didn't have any financial crisis between 1933 and 1982. Is there a way to bring back the structural mechanisms that were put into place after the Great Depression?**

It can be done. And maybe it requires further consideration. What you could say is that banks should be free-standing; they shouldn't be affiliated with companies that engage in other activities like speculative trading. Any institution like a money market fund that provides very close substitutes for banking services would have to be organized as a bank. Then we wouldn't worry about the rest of the financial system, because we would have a safe banking sector that would be subject to all the old rules.

It's not a ridiculous idea, although I'm sure it's very, very difficult politically. Banks no longer are the principal providers of credit in the United States, but they're a very important backbone of the financial system. They only provide about 20% to 25% of all credit. Companies can finance their operations just by issuing commercial paper and their own promissory notes, but they always like to have standby lines of credit with banks. If something happens with the commercial paper market like it did last fall, they can go to the bank. It's very important to have a safe back-up. Banks also finance a lot of small businesses that can't finance themselves out of their retained earnings or by issuing commercial paper.

Also, the banks are really the vehicle by which, traditionally, the Federal Reserve regulates the money supply. They're almost like branches of the Federal Reserve, and as long as you have a healthy banking system in the narrow sense — the regulated banks — then the Federal Reserve can control the money supply. If the banks become unsafe, it doesn't work. Then they're afraid to lend even if the Federal Reserve will allow them to lend. That's what happened last fall.

**Our economy seems very bubble-prone of late. Is our financial system too big, and if so, are there appropriate ways to shrink it?**

It's too big in the following sense: Finance is inherently unstable, because essentially what finance involves is lending borrowed capital. That's just inherently risky. These companies borrow short-term because short-term interest rates are low, risk is less and you can get your money out quickly, but in order to make a profitable spread, they have to lend at a high interest rate, which involves taking risk. So bank assets — loans — are inherently risky. There's a very long history of banking collapses in the United States and abroad. Even during the stable period from World War II into the 1980s, there were no financial crises, but there were always plenty of bank failures. But the bigger the financial sector is, the more risk there is in the economy as a whole, because it's a risky sector.

It will shrink automatically if there is less capital available for lending. But as long as you have countries like China, Germany, Japan and the Middle Eastern oil countries that accumulate very large dollar balances, because they export much more than they import, you're going to have huge amounts of global capital available for borrowing, and that leads to a very large financial sector. I don't think that's likely to change. But it does mean we need more vigilance with regard to the risks that these financial companies are permitted to take.

**You're very critical of Alan Greenspan's monetary policy, but this is not the first time we've seen a big monetary policy failure in the United States. Should we be devising ways to make the Fed more transparent or accountable?**

I'm not sure that transparency or accountability would do much. Accountable to whom? Nobody has a very good understanding of the macro economy. The economists don't. They were completely surprised by what happened last fall. So I'm not sure the problem is accountability. And they operate with a degree of secrecy because these are very sensitive matters. Suppose you have a bank that has some problems. If you publicize those problems, the bank is likely to collapse because money moves around so easily that if investors see the Federal Reserve is raising questions about the solvency of a bank, they'll just pull out.

**But what about other areas like monetary policy? Can't we at least make the transcripts of the FOMC meetings available more quickly?**

What is the lag now? They do of course publish them now.

**It's five years.**

They do publish a summary every month of their FOMC meeting. They're guardedly worded because they don't want to cause some economic sensation. The problem is, economists have not done a good job. I don't think it's their fault, it's just too difficult. They haven't done a good job understanding how everything works together in the economy. How on the one hand you can avoid inflation and on the other avoid deflation and unemployment. So they just don't know much.

**But isn't the Federal Reserve system a little suspect? Private-sector banks themselves are shareholders of the Federal Reserve banks, bank executives sit on the boards of the regional Fed banks and then get to select the regional presidents who**

**serve on the FOMC. Isn't it strange to have a supposedly public agency so closely connected to the banking system?**

Yes. I don't think it makes any sense at all. As I understand it, the history is, there was such fear of a central bank that when they finally created the Federal Reserve in 1913, they decided they wouldn't have a central bank that actually had any money. Instead, they had these regional banks that would be privately owned and they would have the money. So the Federal Reserve calls the tune, but all their assets are actually held in these regional Federal Reserve banks. I don't know what sense that makes. I don't think other countries have regional central banks like that. And as you say, the presidents of the Federal Reserve Banks participate in the setting of monetary policy and I don't understand what sense that makes. Traditionally the chairman of the Federal Reserve has been almost a dictator. And maybe that's good, maybe that offsets the power of these regional presidents.

Long-term reform of the Federal Reserve could be a very good idea. The problem is that when you look around the world, you see a great variety of central bank structures. I don't think any other country has a set-up like ours, and our set-up seems goofy. But the other central banks don't seem to do any better than we do. The English central bank goes back hundreds of years. They're the founders of modern finance, and they don't do well. So the structure of the Federal Reserve is odd, but it may be that structure is not really tied to performance. What we really lack is not enough emphasis simply on financial intelligence.

There were a lot of signs of serious trouble in the housing market and the finance market for years. And I'm still puzzled why the Federal Reserve did not take these warnings seriously, even to the extent of studying the problem. Not necessarily even taking action, but at least studying them. I mean, you could read a local newspaper — they were talking about a housing bubble years ago, and somehow this never percolated up to Washington. It's very odd.

**Would the Fed really be the best place to house that, given its recent track-record?**

It could be there, it could be in the President's Council of Economic Advisors, it could be almost anywhere. The Fed may not have a good culture for that. They're very timid and reactive at the Federal Reserve. One of the problems is, the Federal Reserve is very concerned about maintaining its political independence. It doesn't have constitutional independence the way the federal courts do. The Congress could do anything it wants with the Federal Reserve. So to avoid getting into trouble, they tend to be very timid and very quiet.

In fact, I think Greenspan was explicit about the fact that he wasn't going to try to burst any bubbles, because if he did, he'd be blamed for the ensuing loss of value and that would jeopardize the Federal Reserve's independence. So it may not be the best organization to warn against bubbles. You know, when housing prices were rising, everybody was enthusiastic and thought it was great. Peoples' savings were increasing because their savings consisted largely of their homes. For someone to rain on that parade guarantees unpopularity and the Federal Reserve does not want to be unpopular. So where you would lodge some financial intelligence ability needs more thought, but I think that would be very important. *i*