
Gilles Saint-Paul


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This book is a vivid account of the unraveling of the financial crisis since its inception in 2008. The first part of the book describes the events to a great detail, from the housing bubble to the liquidity crisis during the summer of 2008, the Lehman bankruptcy, followed by the recession in the real economy, the stimulus package and quantitative easing. The operation of the financial system, with the introduction of new instruments following deregulation and the associated moral hazard problems, is also discussed.

The second part of the book draws the main lessons from the crisis. These can be organized under three headings. First, the rediscovery of Keynesian economics and the renewed belief that a capitalist economy left to itself is unstable. Second, the skepticism about financial deregulation and the increased legitimacy of regulation as a tool to prevent excess risk taking and a legitimate counterpart to the implicit insurance that repeated government bailouts provide to the financial sector. Third, the disappointment with mainstream macroeconomics and the apparent incapacity of standard models to account for, let alone predict, sharp financial crises.

The last part of the book goes through a number of policy proposals and it is telling that they are remarkably low key and uncontroversial. It illustrates, in my view, how policy makers and analysts are baffled by the crisis. The proposals are as follows:

1. Establish an executive commission to study the causes of the crisis and suggest reforms
2. Consider limited legal reforms (here prof. Posner suggests an amendment to the bankruptcy code, which does not address the crisis itself but instead some shortcomings of the policy response to the crisis)
3. Rotate staff of financial regulatory agencies

*Paris School of Economics-ENS, PSL, NYU Abu Dhabi
4. Consider changing the financing of financial regulatory agencies
5. Establish a financial intelligence agency
6. Regulate off-balance sheet contingent liabilities. Here one can make a few comments: In Part I professor Posner convincingly established that despite not having to do so, banks were eager to provide guarantees on their off-balance sheet liabilities in order to defend their reputation and that this played a role in the spreading of the crisis. So it is not obvious that these liabilities would be associated with more risk-taking than the on-balance sheet ones.
7. Reform credit rating
8. Tie capital requirements to the business cycle. This is a popular proposal, which is intended to address the issue that the market value of assets falls during recessions. With mark-to-market regulation, banks have to de-leverage during recessions in order to meet their capital requirements, which makes the recession even deeper. While that is unfortunate from a Keynesian perspective, shouldn’t we take seriously the fact that indeed during recessions banks are naturally more exposed and that it makes sense for them to increase their capital? After all, the cycle is supposed to be taken care of by fiscal and monetary policy, so it is unclear why bank regulation should have such concerns.
9. Return to the Glass-Steagall act. This is also a popular proposal—the idea is to insulate deposits from any losses incurred when doing proprietary trading.

After reading the book, it is difficult to see where Professor Posner stands. On the one hand, he seems (surprisingly, to me) to endorse the new orthodoxy. On the other hand, he seems reluctant to expand government power significantly in order to prevent further crises, because of doubts he has over the government’s ability to do so. As a result it is difficult to see why any of the measures proposed could prevent the rise of a new asset bubble or the potential macroeconomic consequences of a crash. Perhaps these measures would reduce contagion. But if one believes that the key issues are the government’s promiscuity with the financial sector, and its unwillingness to pay the price (in terms of economic activity) of a downward correction in credit flows and asset prices, these problems are not addressed by the proposed reforms.