"Fault Lines: How Hidden Fractures Still Threaten The World Economy" by Raghuram G. Rajan (Mr. Rajan is the Eric J. Gleacher Distinguished Professor of Finance at the University of Chicago Booth School of Business and former Chief Economist at the International Monetary Fund. He is the coauthor of Saving Capitalism from the Capitalists (Princeton), a fellow of the American Academy of Arts and Sciences, and in 2003 was the inaugural winner of the Fischer Black Prize given by the American Finance Association to the best financial economist under forty.)

"Although I believe that the basic ideas of the free-enterprise system are sound, the fault lines that precipitated this crisis are indeed systemic. They stem from more than just specific personalities or institutions. A much wider cast of characters are responsible for the crisis: it includes domestic politicians, foreign governments, economists like me, and people like you……Somewhat frighteningly, each one of us did what was sensible given the incentives we faced. Despite mounting evidence that things were going wrong, all of us clung to the hope that things would work out fine, for our interests lay in that outcome. Collectively, however, our actions took the world's economy to the brink of disaster, and they could do so again unless we recognize what went wrong and take the steps needed to correct it."

"In structuring reforms, we have to recognize that the only truly safe financial system is a system that does not take risks, that does not finance innovation or growth, that does not help draw people out of poverty, and that gives consumer little choice. It is a system that reinforces the incremental and thus the status quo. In the long run…..settling for the status quo may be the greatest risk of all, for it will make us unable to adapt to meet the coming challenges. We do not want to return to the bad old days and just make banking boring again: it is easy to forget that under a rigidly regulated system, consumer and firms had little choice. We want innovative, dynamic finance, but without excessive risk and the outrageous behavior. That will be hard to achieve, but it will be really worthwhile."

"With the benefit of hindsight, it is easy to suggest that the Fed made mistakes even in the traditional conduct of monetary policy: for instance, it may well have overestimated the risk of deflation. In some ways, the threat of deflation seemed to be a low-probability red herring, put forth to explain why the Fed kept rates on hold. The true problem was unemployment, which made raising rates politically impossible. In the past, when economic growth and job recovery coincided, this was not an issue. With jobless recoveries though, growth and jobs became somewhat divorced. The Fed would have to be on hold for a long time if it wanted to see jobs reappear."

"Low short-term interest rates pushed investors to take more risk, for a number of reasons. Some institutions, like insurance companies and pension funds, had contracted long-term liabilities. At the low interest rates available for safe assets, they had no hope of meeting those liabilities. Rather than falling short for sure, they preferred to move into longer-term riskier bonds, such as mortgage-backed securities, that paid higher interest rates. In addition, as long-term interest rates fell and the value of stocks, bonds, and housing rose, households felt wealthier and may have felt the confidence to take more risks."

"Indeed, instead of discouraging the development of bubbles, the Fed encouraged it through and implicit commitment, which might have done far more damage than any other Fed action. This commitment, the so-called 'Greenspan-put', essentially said that the Fed could not really tell when asset prices were building up into a bubble, and so instead the Fed would ignore asset prices but stand ready to pick up the pieces when the bubble burst. To understand why this commitment was made, we need to go back to 1996."

“In sum, the Fed’s conduct of monetary policy between 2002 and 2005, while roundly criticized by all but central bankers and monetary economists (with notable exceptions), had two important limitations. First, it was fixated on the high and persistent unemployment rate and did its best to bring it down by trying to encourage investment. It signaled that it would keep rates low for a sustained period and offered the Greenspan put if firms were still not convinced….This policy, however may have had a greater effect on credit growth and asset prices than on job creation outside the real estate industry: corporations were still working away excesses of the dot-com boom. Second, the dominant academic orthodoxy indicated that so long as inflation was quiescent, central bankers had nothing to worry about. Indeed to worry was to destroy the purity of the theoretical system that had been built, for that would admit of multiple objectives and lead to market confusion. Instead, central bankers should keep their eyes fixed on inflation (or the lack thereof) and let bank supervisors worry about risk taking. Unfortunately, the supervisors had been muzzled, this time on the ideological grounds that they would do more harm than good by restraining the private sector.”

“The danger is that monetary economists will try to wish away links between monetary policy, risk taking, and asset-price bubbles. Bernanke came close to doing so in his 2010 speech to the American Economic Association, where he argued that it was not the Fed’s defective monetary policy….which he considered entirely appropriate, given the Fed’s views on inflation…..but its inadequate supervision that helped trigger the crisis. He concluded: ‘Although the most rapid price increases occurred when short-term interest rates were at their lowest levels, the magnitude of the house price gains seem too large to be readily explained by the stance of monetary policy alone. Moreover, cross-country evidence shows no significant relationship between monetary policy and the pace of house price increases.’”

“Of course, no one claims that the Fed alone was responsible for the housing debacle. Government policies favoring low-income housing, as well as private-sector mistakes, contributed significantly. But to suggest that it had no role is disingenuous. Indeed, a detailed study published in the Federal Reserve Bank of St. Louis Review in 2008 presents evidence that ‘monetary policy has significant effects on housing investment and house prices and that easy monetary policy designed to stave off the perceived risks of deflation in 2002-2004 had contributed to a boom in the housing market in 2004 and 2005.’”

“Similarly, as we have seen, the Federal Reserve, though ostensibly independent, has a very difficult task. It is extremely hard to ensure rapid job growth in an integrated, innovative economy where firms use recessions to refocus on becoming more productive or strengthen their global supply chains, shifting jobs elsewhere. Moreover, the new technologies employed in hiring allow firms the luxury of waiting to fill positions. The sustained easy monetary policy that is maintained while jobs are still scarce has the effect of increasing risk-taking and inflating asset-price bubbles, which again weaken the fabric of the economy over the longer term. If the United States cannot tolerate longer bouts of unemployment, but those bouts are here to stay, we risk going from bubble to bubble as the Federal Reserve is pressured to do the impossible and create jobs where none are forthcoming.”

“Vibrant financial markets can provide the risk capital needed by the innovators across the world as well as the savings instruments needed by the aging and the currency-transfer facilities needed by migrants. But finance is in disrepute. Calls to shackle it are being heard from every quarter. More dangerous is the possibility that industrial countries, especially the United States, could lose faith in the financial system that has made them what they are. A misbegotten sense of the inadequacy of markets and competition is leading to ever more faith being placed in government. Although there are certain things government can (and must) do, leading dynamic change and innovation is not among them.”

“Some argue that it was laissez-faire ideology that led us to this pass: regulators became enamored of the ideal of the self-regulating market and stood on the sidelines as it self-destructed. They are only partly right. Although it ought to be the duty of regulators to lean against the prevailing winds of optimism (and sometimes pessimism), regulation in the United States was driven by the misplaced view that markets would take care of themselves, a view that time and time again makes the ideological Right play into the hands of the ideological Left. Yet the bulk of the damage was done as the sophisticated financial sector tried to seek an edge that the U.S. government, driven by political compulsions, was only too willing to provide.”

“Progressives in the United States blame the bankers, while conservatives blame the government and the Federal Reserve. The worrying reality is that both are to blame, but neither may have been fully cognizant of the fault lines guiding their actions……Unless we reestablish the proper role of the government and the financial sector, as well as fix the imbalances between nations, what happened may happen again.”

“….the past three decades have brought immense improvements to countries around the world, as they have harnessed the power of global markets and finance while obtaining economic freedom. Unfortunately, we have allowed political imbalances to develop within countries and economic imbalances to grow between countries. In many rich countries, insecurity and despair have replaced hope. We should not let what has gone wrong obscure all that can go right, or reverse the progress we have made. But to preserve and rebuild trust in the market system, we have to make fundamental changes. Governments have to do more to help their citizens build capabilities that will allow them to be productive. But they also have to step back in other areas to allow the market to function effectively. This crisis has resulted from a confusion about the appropriate roles of the government and the market. We need to find the right balance again, and I am hopeful we will.”