In last year’s Annual Report, I began this column by noting that for “many Americans, 2007 was a difficult year.” Unfortunately, 2008 was even more difficult. The U.S. economy spent the entire year in recession and by the fourth quarter, economic activity was falling dramatically. In fact, we now find ourselves in the most severe contraction in more than a generation.

At first, the recession appeared to be fairly mild. Over the first eight months of 2008, about 700,000 jobs were lost. But in September, the downturn intensified. In the final four months of the year, we lost 1.9 million jobs, including more than 500,000 in December alone. And if you look at other measures of economic performance, almost all appear similarly dismal.

The Federal Reserve responded aggressively to the slowdown, cutting the target for the federal funds rate to a range of 0 to 0.25 percent in December. In addition, the Fed initiated a number of credit programs aimed at providing liquidity to selected sectors of the economy. While I have raised questions about many of the latter policies — in my opinion, it would be preferable if the Federal Reserve expanded the monetary base by purchasing Treasury securities rather than creating targeted credit programs — they have had the effect of providing an additional monetary stimulus at a time when that is needed. Eventually, however, the Fed will need to find a way to effectively “unwind” those programs, an issue discussed in the essay of this year’s Annual Report.

In general, I am hopeful that we will see the economy begin to grow again in late 2009. We already have seen a few encouraging signs. For instance, retail sales of goods and services to consumers have increased recently, and there are indications that many housing markets may be bottoming out. Having said that, it bears emphasizing that uncertainty about the
economic outlook is particularly acute right now, and while there are signs consistent with the emergence of stronger performance by the end of 2009, we are likely to see some negative economic reports in the meantime.

Which brings me to this question: What caused the financial crisis of 2008? It’s too early to know for certain. Indeed, financial economists will spend many years examining this episode. But it is possible to offer informed thoughts on the question. Some commentators have argued that the crisis was a result of fundamental defects with the market system. Before we jump to such conclusions, however, it’s worthwhile to understand the environment in which financial market participants operated.

The financial sector was not unregulated prior to the crisis. Indeed, there were substantial regulations on the books, some necessary and wise, and some more questionable. More importantly, in my view, there was an enormous federal financial safety net that protected market participants from bearing the full brunt of potential losses, thus undermining the incentives of creditors to monitor the risks taken on by institutions that were viewed as “too big to fail.” The safety net, of course, has grown even larger since the onset of the crisis. In my view, this has been a mistake. Instead of expanding the safety net — which, as I have argued, contributed significantly to the crisis — we should work instead to place tighter and more transparent limits around it. Capitalism is a system of both profit and loss, and market participants should not be shielded from the losses they may incur because of poor business strategies or excessive risk-taking.

Anyone who questions government intervention risks being called a Pollyanna, an unskeptical believer in free markets and an apologist for financial fat cats. Let me be clear: I do not believe that markets are perfect, and I do believe that some government actions are essential to the health and well-being of our market economy. But the outcomes that result from market interactions can be difficult to improve upon, and government policies can at times cause more harm than good. As we strive to fully understand the financial boom and bust we have just been through, I believe we should pay particular attention to the distortions that fundamentally altered the incentives faced by firms and individuals.

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President