

## *Foreword*

A properly functioning financial system plays a central role in the process of achieving a better allocation of resources in a market economy. However, when the financial sector becomes impaired, the consequences are severe. Now that we are leaving behind the Great Financial Crisis, the worst financial crisis of the last 80 years, we have to deal with its side effects and consequences—high unemployment, heavy debt burden, modest prospects for medium term sustainable growth—and to work on controlling the excesses that facilitated the crisis. Although the causes of the crisis are still heavily debated, there is agreement that the set of factors that facilitated its occurrence include: the Asian economies' savings glut (an ex-ante excess of savings), China's currency policy and its excessive reserve accumulation, a period of low variability in growth and inflation or the so called Great Moderation, the sudden collapse of the heavy leveraged American housing market, agency problems brought about by executive compensation policies, easy monetary policy after the dot-com crisis of 2001-2002, excessively lax financial regulation, poor supervision, government interference in financial markets, the corrosive influence of greed, and a number of other similar factors.

Many of the mentioned factors are only symptoms, and many of the proposed culprits only victims. It is true, for instance, that the Great Moderation facilitated the development of the crisis by lulling regulators and risk managers into a false sense of security. But this is not very different from stating that busts unexpectedly follow booms, or that night follows day. An observation can be both true and not at all informative about the underlying processes that govern a system. Distinguishing the proper causes of the crisis is crucial if we are to draft more effective rules for economic policy.

This highly readable book by Askari and Mirakhor is a welcome addition to the study of the causes and consequences of financial crises. In their view the fragility of the financial system was the result of the “process of financialization and increased debt” that results from the pre-eminence of interest rate-based debt and the role of fractional reserve banking, which together facilitate high leverage and constitute the root cause of the financial boom before the crisis and the financial crisis that followed. To reduce the probability of financial crisis, they propose to move to a financial system that relies more heavily on risk-sharing contracts and equity finance coupled with a banking system that is closer to 100 percent reserve banking, as opposed to risk shifting and interest-based debt and the highly leveraged (fractional) reserve banking system that we have today.

The authors have advocated risk-sharing contracts for a number years. This, their latest contribution, is a very interesting and stimulating book that extends the recent risk-sharing proposal of Mian and Sufi from the financing of housing to most financial contracts in the economy.

Vittorio Corbo, Professor of Economics Pontificia Universidad Católica de Chile, Senior Research Associate of the Centro de Estudios Públicos (Santiago, Chile) and Former President of the Central Bank of Chile (2003-2007)