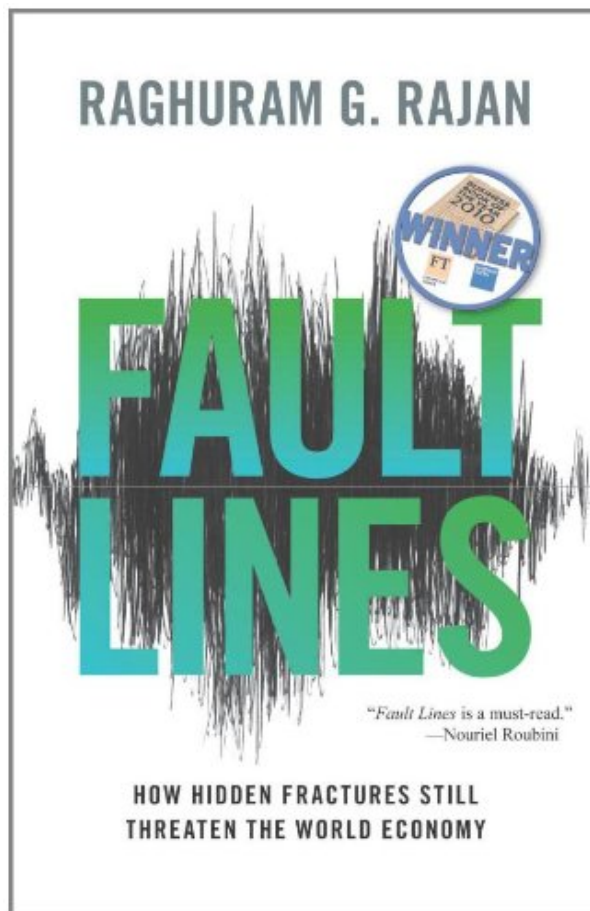


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Raghuram Rajan was one of the few economists who warned of the global financial crisis before it hit. Now, as the world struggles to recover, it's tempting to blame what happened on just a few greedy bankers who took irrational risks and left the rest of us to foot the bill. In *Fault Lines*, Rajan argues that serious flaws in the economy are also to blame, and warns that a potentially more devastating crisis awaits us if they aren't fixed.

Rajan shows how the individual choices that collectively brought about the economic meltdown--made by bankers, government officials, and ordinary homeowners--were rational responses to a flawed global financial order in which the incentives to take on risk are incredibly out of step with the dangers those risks pose. He traces the deepening fault lines in a world overly dependent on the indebted American consumer to power global economic growth and stave off global downturns. He exposes a system where America's growing inequality and thin social safety net create tremendous political pressure to encourage easy credit and keep job creation robust, no matter what the consequences to the economy's long-term health; and where the U.S. financial sector, with its skewed incentives, is the critical but unstable link between an overstimulated America and an underconsuming world.

In *Fault Lines*, Rajan demonstrates how unequal access to education and health care in the United States puts us all in deeper financial peril, even as the economic choices of countries like Germany, Japan, and China place an undue burden on America to get its policies right. He outlines the hard choices we need to make to ensure a more stable world economy and restore lasting prosperity.

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The most thought-provoking recent book.

By Viral Acharya

I found this book a highly stimulating read. It represents possibly the most thought-provoking contribution in the aftermath of the crisis that started in 2007 and that yet engulfs us. Let me first summarize some of the most salient points it makes, then talk about its strengths, and finally, why everyone should read it.

The epilogue of the book summarizes the book best - "The 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." The book presents two important government distortions - the push for universal home ownership in the United States and the push for export-led growth in some countries such as Germany and China that have left to massive "global imbalances", with some countries such as the United States, the United Kingdom and Spain persistently being in deficits and borrowing from the surplus, exporting nations. While pursuit for home ownership affordability and growth are nothing to complain about per se, the book makes sharp observations that they are occurring at the expense of something more, or as, important. In the United States, the book argues, there has been a growing income inequality, which combined with a relatively feeble safety net for the poor, has created pressure on politicians to bridge the inequality. Instead of improving the competitiveness of labor force in a global market with changing mix of industries and required skills, governments have adopted the option "let them eat credit" (Chapter One's title). The presence of government-sponsored agencies in the United States enabled exercising such an option readily through a push for priority lending to the low-income households (sub-prime mortgages). In case of surplus countries, the single-minded focus on exports has led governments to ignore the domestic sector, preventing sufficient redeployment of surplus for internal development and somewhat perversely, boosted domestic savings rates significantly due to lack of adequate safety nets (at least in case of China, if not in case of Germany). The savings have thus had no place to go but to outside

and ended up resulting in massive capital inflows that fueled the housing sector expansion in the US, the UK and Spain.

While these government "failures" are themselves pretty interesting to have observed and highlighted, what is fascinating is how they interacted with each other - and with the financial sector - in fueling the expansion to levels that can be called massive housing bubbles. The idea here is that the invisible hand operating through the price when the price is distorted can lead to massive distortions in allocation of capital also. The financial sector in developed world is so sophisticated and amoral (a great choice of word by the author) that its dispassionate pursuit of profits leads it to direct capital to wherever there is a relative mis-pricing. So if governments are subsidizing home ownership, efforts will be made to deploy pretty much all available free capital of the world to that sector. If some governments are finding it cheap to borrow because savings are seeking them out, the financial sector will grow at a sufficient rate to absorb and support expansion through the capital inflows. While clearly there are some incentive-based distortions, especially short-term nature of accounting-based compensation that ignores true long-term risks, the book takes the stand, and explains it well, that the bigger issue was that the imbalance of capital flows and the ease of pushing sub-prime home ownership - both due to government distortions - meant the financial sector was essentially the conduit to make happen what the rest of the world was seeking to achieve. In the process, it made a ton of bad loans (but the governments were happy with that till it all really blew up). And some parts of the financial sector pursued this role even more aggressively than one could have imagined due to the steady entrenchment of too-big-to-fail expectations --- large banks being repeatedly bailed out through government and regulatory forbearance and enjoying Central-Bank monetary stimulus each time markets turned south. In essence, one walks away with an explanation of what brought about the perfect storm.

Some may question the basis of this argument by saying - why did we see credit expansion across board and not just in low-income households. There are two important points the book makes. One, that once risk is mispriced for one investment (by governments for sub-prime lending), financial sector must demand similar return elsewhere. That is, there will be mispricing of risk across board. Second, the book focuses on a rather fascinating recent phenomenon that recent recoveries from recessions, especially in the United States, have remained "jobless" for extended periods of time. Perhaps as a subconscious response to this (or due to ideologies in other cases), Central Banks have tended to provide massive monetary stimulus to get the financial sector to push the real sector hard through greater lending and intermediation. Such stimulus, unfortunately, again serves to transfer rents from households to the financial sector (by keeping interest rates low) and produces mispriced risk and the economy moved "From Bubble to Bubble" (Chapter Five title), until the most recent bubble could not be mopped up by anyone, in spite of the efforts to do so.

Those who have read Raghuraj Rajan's earlier book and research would recognize that his writings are always cogent and based in sound set of facts. But this book is more special in the sense that here he paints on a much larger canvas, covering bases from distributional issues within income strata of society, to the persistent capital imbalances across large countries of the world, and the power and ruthless profit-maximizing incentives of modern market-based financial sector. The point of *Fault Lines* is that these are slow-moving tectonic plates, neither movement might seem dangerous by itself, but that when these plates come together and collide, global economy can get badly shaken. To most minds that are focused narrowly on their own positions, let alone the movements of the plate they stand on, the earthquake - like this crisis - may seem sudden. The beauty of the book is in explaining that when viewed carefully, the crisis was not a pure accident and that more may arise in future unless the root causes are addressed sufficiently soon.

While the book is worth it even just for its explanation of why we had a crisis now rather than at some other points of time in the past, it goes the extra mile and proposes valuable reforms - once again focusing on all three issues - building a better safety net in the United States (see in particular, the suggestions to improve

education access to all), reducing the global imbalances, and improving the regulation of the financial sector so that they (and their financiers) pay for mopping up of "bubbles" that they create, rather than governments and Central Banks passing on these costs to taxpayers.

As you can tell from this review, there is a lot going on here. But it is written with great examples and cases - almost allegorical at times (even has a fascinating poetry recounted in the chapter "The Fable of the Bees Replayed"), and should be accessible to one and all. Not all may find it easy to agree with every single point (as it will certainly question some long-held biases about different countries and societies), but it is hard to not take a deep breath and ponder once you have read it all. In many ways, it shows that when economic conditions so demand or induce, developed world behaves much the same way as developing world: they are both after all driven by choices of human beings and the book lays out some common patterns of global economic behavior - in households, markets and governments.

In summary, I recommend the book extremely highly and comment and thank Raghuram Rajan for putting together this brilliant painting of global economy and finance, surrounding the arena of the recently witnessed crisis.

- Viral Acharya, Professor of Finance, New York University Stern School of Business
([...])

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Rajan's Reply to Krugman Re: Fault Lines

By Suo Marte

In the Sept 2010 issue of the New York Review of Books, Paul Krugman & Karen Wells reviewed Fault Lines. Below is Rajan's reply to their review:

Paul Krugman and Robin Wells caricature my recent book Fault Lines in an article in the New York Review of Books.

First, Krugman starts with a diatribe on why so many economists are "asking how we got into this mess rather than telling us how to get out of it." Krugman apparently believes that his standard response of more stimulus applies regardless of the reasons why we are in the economic downturn. Yet it is precisely because I think the policy response to the last crisis contributed to getting us into this one that it is worthwhile examining how we got into this mess, and to resist the unreflective policies that Krugman advocates. The article, and their criticism, however, do have a lot to say about Krugman's policy views (for simplicity, I will say "Krugman" and "he" instead of "Krugman and Wells" and "they") which I have disagreed with in the past. Rather than focus on the innuendo about my motives and beliefs in the review, let me focus on differences of substance. I will return to why I believe Krugman writes the way he does only at the end.

My book emphasizes a number of related fault lines that led to our current predicament. Krugman discusses and dismisses two - the political push for easy housing credit in the United States and overly lax monetary policy in the years 2002-2005 - while favoring a third, the global trade imbalances (which he does not acknowledge are a central theme in my book). I will argue shortly, however, that focusing exclusively on the imbalances as Krugman does, while ignoring why the United States became a deficit country, gives us a grossly incomplete understanding of what happened. Finally, Krugman ignores an important factor I emphasize - the incentives of bankers and their willingness to seek out and take the tail risks that brought the system down.

Let me start with the political push to expand housing credit. I argue that in an attempt to offset the

consequences of rising income inequality, politicians on both sides of the aisle pushed easy housing credit through government units like the Federal Housing Administration, and by imposing increasingly rigorous mandates on government sponsored enterprises such as Fannie Mae and Freddie Mac. Interestingly, Krugman neither disputes my characterization of the incentives of politicians, nor the detailed documentation of government initiatives and mandates in this regard. What he disputes vehemently is whether government policy contributed to the housing bubble, and in particular, whether Fannie and Freddie were partly responsible.

In absolving Fannie and Freddie, Krugman has been consistent over time, though his explanations as to why Fannie and Freddie are not partially to blame have morphed as his errors have been pointed out. First, he argued that Fannie and Freddie could not participate in sub-prime financing. Then he argued that their share of financing was falling in the years mortgage loan quality deteriorated the most. Now he claims that if they indeed did it (and they did not), it was because of the profit motive and not to fulfill a social objective. Let me offer details.

In a July 14, 2008 op-ed in the New York Times, Krugman explained why Fannie and Freddie were blameless thus:

"Partly that's because regulators, responding to accounting scandals at the companies, placed temporary restraints on both Fannie and Freddie that curtailed their lending just as housing prices were really taking off. Also, they didn't do any subprime lending, because they can't: the definition of a subprime loan is precisely a loan that doesn't meet the requirement, imposed by law, that Fannie and Freddie buy only mortgages issued to borrowers who made substantial down payments and carefully documented their income. So whatever bad incentives the implicit federal guarantee creates have been offset by the fact that Fannie and Freddie were and are tightly regulated with regard to the risks they can take. You could say that the Fannie-Freddie experience shows that regulation works."

Critics were quick to point out that Krugman had his facts wrong. As Charles Calomiris, a professor at Columbia University and Peter Wallison at the American Enterprise Institute (and member of the financial crisis inquiry commission), "Here Krugman demonstrates confusion about the law (which did not prohibit subprime lending by the GSEs), misunderstands the regulatory regime under which they operated (which did not have the capacity to control their risk-taking), and mismeasures their actual subprime exposures (which he wrongly states were zero)."

So Krugman shifted his emphasis. In his blog critique of a Financial Times op-ed I wrote in June 2010, Krugman no longer argued that Fannie and Freddie could not buy sub-prime mortgages. Instead, he emphasized the slightly falling share of Fannie and Freddie's residential mortgage securitizations in the years 2004 to 2006 as the reason they were not responsible. Here again he presents a misleading picture. Not only did Fannie and Freddie purchase whole sub-prime loans that were not securitized (and are thus not counted in its share of securitizations), they also bought substantial amounts of private-label mortgage backed securities issued by others.

Of course, one could question this form of analysis. Asset prices and bubbles have momentum. Even if Fannie and Freddie had simply ignited the process, and not fueled it in the go-go years of 2004-2006, they would bear some responsibility. Krugman never considers this possibility. When these are taken into account, Fannie and Freddie's share of the sub-prime market financing did increase even in those years. In the current review piece, Krugman first quotes the book by Nouriel Roubini and Stephen Mihm:

"Clearly, Fannie and Freddie did not originate sub-prime mortgages directly - they are not equipped to do so.

But they fuelled the boom by buying or guaranteeing them. Indeed, Countrywide was one of their largest originators of sub-prime mortgages, according to work by Ed Pinto, a former chief credit officer of Fannie Mae: "The huge growth in the subprime market was primarily underwritten not by Fannie Mae and Freddie Mac but by private mortgage lenders like Countrywide. Moreover, the Community Reinvestment Act long predates the housing bubble.... Overblown claims that Fannie Mae and Freddie Mac single-handedly caused the subprime crisis are just plain wrong."

For instance, consider this press release from 1992, and participated from very early on in Fannie Mae's drive into affordable housing:

"Countrywide Funding Corporation and the Federal National Mortgage Association (Fannie Mae) announced today that they have signed a record commitment to finance \$8 billion in home mortgages. Fannie Mae said the agreement is the single largest commitment in its history...The \$8 billion agreement includes a previously announced \$1.25 billion of a variety of Fannie Mae's affordable home mortgages, including reduced down payment loans...

"We are delighted to participate in this historic event, and we are particularly proud that a substantial portion of the \$8 billion commitment will directly benefit lower income Americans," said Countrywide President Angelo Mozilo..."We look forward to the rapid fulfillment of this commitment so that Countrywide can sign another record-breaking agreement with Fannie Mae," Mozilo said.

"Countrywide's commitment will provide home financing for tens of thousands of home buyers, ranging from lower income Americans buying their first home to middle-income homeowners refinancing their mortgage at today's lower rates," said John H. Fulford, senior vice president in charge of Fannie Mae's Western Regional Office located here.

Of course, as Fannie and Freddie bought the garbage loans that lenders like Countrywide originated, they helped fuel the decline in lending standards. Also, while the Community Reinvestment Act was enacted in 1979, it was the more vigorous enforcement of the provisions of the Act in the early 1990s that gave the government a lever to push its low-income lending objectives, a fact the Department of Housing and Urban Development (HUD) was once proud of (see the HUD press releases below).

Perhaps more interesting is that after citing Roubini and Mihm, Krugman repeats his earlier claim; "As others have pointed out, Fannie and Freddie actually accounted for a sharply reduced share of the home lending market as a whole during the peak years of the bubble." Now he attributes the inaccurate claim that Fannie and Freddie accounted for a sharply reduced share of the home lending market to nameless "others". But that is just the prelude to changing his story once again; "To the extent that they did purchase dubious home loans, they were in pursuit of profit, not social objectives--in effect, they were trying to catch up with private lenders." In other words, if they did do it (and he denies they did), it was because of the profit motive.

Clearly, everything Fannie and Freddie did was because of the profit motive - after all, they were private corporations. But I don't know how we can tell without more careful examination how much of the lending they did was to meet government affordable housing mandates or to curry favor with Congress in order to preserve their profitable prime mortgage franchise, and how much was to increase the bottom line immediately. Perhaps Krugman can tell us how he determined their intent?

Interestingly, before the housing market collapsed, HUD proudly accepted its role in pushing low-income lending through the various levers that Krugman now denies were used. For instance, in 2000 when it announced that it was increasing Fannie and Freddie's affordable housing goals, it concluded:

"Lower-income and minority families have made major gains in access to the mortgage market in the 1990s. A variety of reasons have accounted for these gains, including improved housing affordability, enhanced enforcement of the Community Reinvestment Act, more flexible mortgage underwriting, and stepped-up enforcement of the Fair Housing Act. But most industry observers believe that one factor behind these gains has been the improved performance of Fannie Mae and Freddie Mac under HUD's affordable lending goals. HUD's recent increases in the goals for 2001-03 will encourage the GSEs to further step up their support for affordable lending."

And in 2004, when it announced yet higher goals it said:

"Over the past ten years, there has been a 'revolution in affordable lending' that has extended homeownership opportunities to historically underserved households. Fannie Mae and Freddie Mac have been a substantial part of this 'revolution in affordable lending'. During the mid-to-late 1990s, they added flexibility to their underwriting guidelines, introduced new low-downpayment products, and worked to expand the use of automated underwriting in evaluating the creditworthiness of loan applicants. HMDA data suggest that the industry and GSE initiatives are increasing the flow of credit to underserved borrowers. Between 1993 and 2003, conventional loans to low income and minority families increased at much faster rates than loans to upper-income and nonminority families."

If the government itself took credit for its then successes in expanding home ownership then, why is Krugman not willing to accept its contribution to the subsequent bust as too many lower middle-class families ended up in homes they could not afford? I agree there is room for legitimate differences of opinion on the quality of data, and the extent of government responsibility, but to argue that the government had no role in directing credit, or in the subsequent bust, is simply ideological myopia.

Let me move on to Krugman's second criticism of my diagnosis of the crisis. He argues that the Fed's very accommodative monetary policy over the period 2003 to 2005 was also not responsible for the crisis. Here Krugman is characteristically dismissive of alternative views. In his review, he says that there were good reasons for the Fed to keep rates low given the high unemployment rate. Although this may be a justification for the Fed's policy (as I argue in my book, it was precisely because the Fed was focused on a stubbornly high unemployment rate that it took its eye off the irrational exuberance building in housing markets and the financial sector), it in no way validates the claim that the policy did not contribute to the manic lending or housing bubble.

A second argument that Krugman makes is that Europe too had bubbles and the European Central Bank was less aggressive than the Federal Reserve, so monetary policy could not be responsible. It is true that the European Central Bank was less aggressive, but only slightly so; It brought its key refinancing rate down to only 2 percent while the Fed brought the Fed Funds rate down to 1 percent. Clearly, both rates were low by historical standards. More important, what Krugman does not point out is that different Euro area economies had differing inflation rates, so the real monetary policy rate was substantially different across the Euro area despite a common nominal policy rate. Countries that had strongly negative real policy rates - Ireland and Spain are primary exhibits - had a housing boom and bust, while countries like Germany with low inflation, and therefore higher real policy rates, did not. Indeed, a working paper by two ECB economists, Angela Maddaloni and José-Luis Peydró, indicates that the ultra-low rates by both the ECB and the Fed at this time had a strong causal effect in relaxing banks' commercial, mortgage, and retail lending standards over this period.

I admit that there is much less consensus on whether the Fed helped create the housing bubble and the banking crisis than on whether Fannie and Freddie were involved. Ben Bernanke, a monetary economist of

the highest caliber, denies it, while John Taylor, an equally respected monetary economist insists on it. Some Fed studies accept responsibility while others deny it. Krugman, of course, has an interest in defending the Fed and criticizing alternative viewpoints. He himself advocated the policies the Fed followed, and in fact, was critical of the Fed raising rates even when it belatedly did so in 2004.

Then, as he does now, Krugman emphasized the dangers from a Japanese-style deflation, as well as the slow progress in bringing back jobs.

Finally, if he denies a role for government housing policies or for monetary policy, or even warped banker incentives, then what does Krugman attribute the crisis to? His answer is over-saving foreigners. Put simply, trade surplus countries like Germany and China had to reinvest their financial surpluses in the United States, pushing down long term interest rates in the process, and igniting a housing bubble that eventually burst and led to the financial panic. But this is only a partial explanation, as I argue in my book. The United States did not have to run a large trade deficit and absorb the capital inflows - the claim that it had to sounds very much like that of the over-indulgent and over-indebted rake who blames his Then, as he does now, he advocated more stimulus. Then, as he does now, Krugman ignored the longer term adverse consequences of the policies he advocated.

creditors for being willing to finance him. The United States' policies encouraged over-consumption and over-borrowing, and unless we understand where these policies came from, we have no hope of addressing the causes of this crisis. Unfortunately, these are the policies that Krugman wants to push again. This is precisely why we have to understand the history of how we got here, and why Krugman wants nothing to do with that enterprise.

There is also a matter of detail suggesting why we cannot only blame the foreigners. The housing bubble, as Monika Piazzesi and Martin Schneider of Stanford University have argued, was focused in the lower income segments of the market, unlike in the typical U.S. housing boom. Why did foreign money gravitate to the low income segment of the housing market? Why did past episodes when the U.S. ran large current account deficits not result in similar housing booms and busts? Could the explanation lie in U.S. policies?

My book suggests that many - bankers, regulators, governments, households, and economists among others - share the blame for the crisis. Because there are so many, the blame game is not useful. Let us try and understand what happened in order to avoid repeating it. I detail the hard choices we face in the book. While it is important to alleviate the miserable conditions of the long-term unemployed today, we also need to offer them incentives and a pathway to building the skills that are required by the jobs that are being created. Simplistic mantras like "more stimulus" are the surest way to detract us from policies that generate sustainable growth.

Finally, a note on method. Perhaps Krugman believes that by labeling other economists as politically extreme, he can undercut their credibility. In criticizing my argument that politicians pushed easy housing credit in the years leading up to the crisis, he writes, "Although Rajan is careful not to name names and attributes the blame to generic "politicians," it is clear that Democrats are largely to blame in his worldview." Yet if he read the book carefully, he would have seen that I do name names, arguing both President Clinton with his "Affordable Housing Mandate" (see *Fault Lines*, page 35) as well as President Bush with his attempt to foster an "Ownership Society" (see *Fault Lines*, page 37) pushed very hard to expand housing credit to the less-well-off. Indeed, I do not fault the intent of that policy, only the unintended consequences of its execution. My criticism is bipartisan throughout the book, including on the fiscal policies followed by successive administrations. Errors of this kind by an economist of Krugman's stature are disappointing.

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It's easy to write a partisan manifesto outlining a left or ...

By Amazon Customer

In 2010 Raghuram Rajan set out to explain how structural instabilities in the global financial system led to the largest crisis in recent memory. With *Fault Lines: How Hidden Fractures Still Threaten the World Economy* he succeeded.

It's easy to write a partisan manifesto outlining a left or right wing perspective of "what happened" in 2008 someone with no background in economics can understand and enjoy. It's far trickier to write a balanced and accurate analysis for other economists. It's comparatively impossible to write a balanced and accurate analysis someone with no background can both understand and find engaging. Rajan knocks it out of the park.

By using simple yet illustrative anecdotes and explanations (carefully chosen to illustrate the given phenomenon!) as stand-ins for complex economic theory, the current Governor of the Reserve Bank of India and former IMF Chief Economist morphs models into stories, and analysis into narrative as he brings to life the "fault lines" in the global financial system he famously warned of in 2005. Maligned at the time by many policymakers and academics, his speech proved prescient, and is now outlined for a broader audience to understand after the fact what he saw before.

Further, it illuminates how these factors are still generating risk in the financial sector today. With policymakers still too focused on basic factors (such as unemployment and inflation) in economic policy – instead of financial factors that exhibit highly dynamic and critical behavior – we are applying the wrong tools to the wrong target. This is exacerbated by the continued institutional misalignment of incentives in markets and political systems. Tying the present and past versions of these problems into a compelling narrative, Rajan explains how the same weaknesses culminating in the crisis of 2008 may strike again – then outlines both a set of fixes, and the roadblocks we should expect in their implementation.

Rajan proposes the interaction of an eclectic cocktail of factors ranging from economics and political science to psychology and education when constructing his explanation. The first of these is a credit expansion generated by the combination of inequality and short-term political incentives, while the rest of the book discusses factors that grew this expansion into vast imbalances then the largest crisis in recent memory.

Inequality has risen for decades. Accelerating technological development increased the need for high productivity workers above the capacity of an inadequate educational system to supply them, all while markets expanded due to Globalization. This led to an outsized portion of gains from growth to be accrued to these skilled workers at the upper end of the income distribution. With increased redistribution politically and financially costly, policymakers used a combination of populist measures aimed at expanding lending to the poor, and subtle arm-twisting of the closely tied financial sector to allow those left behind in income to "keep up" in consumption through increased (risky!) borrowing – especially for mortgages. Credit issuance was forced up and risk evaluations were forced down in a myopic attempt at placating the poor, distorting financial activity enough a tipping point was passed - tilting this initial expansion into a bubble, which fed on itself until large enough to tank the global financial sector.

International Trade and Financial flows – and therefore their role in the crisis - cannot be looked at in isolation. As developing countries became a larger part of the global economy, their export-led model required increased industrial country spending while generating excessive savings. The U.S. picked up the slack – partially through demand from the credit bubble, while developing countries searched for a safe place to park these savings – given domestic financial underdevelopment ruled out keeping it home. They found

U.S. debt markets.

This insatiable appetite for safe U.S. debt by high-savings countries (emerging markets + Germany and Japan) was satisfied by turning these risky-mortgages into securities, as a misunderstanding of risk correlations in systemic events allowed them to be bundled and treated as “safe debt.” Flows into the U.S. from high foreign savings further eased already over-eased credit, increasing demand and strengthening the lethal combination of rising asset prices and falling risk assessments that builds into an irrational exuberance. Lowered risk brings inflows. Higher inflows increase asset (housing) values/credit issuance. Increased asset values and credit issuance often lowers risk evaluations through increased liquidity. Then lowered risk brings more inflows, and the cycle continues until it collapses.

This initial distortion may not have occurred were it not for idiosyncrasies within the U.S. political and economic system. Given the U.S.’s relatively weak safety net and cutthroat business environment, U.S. businesses and workers are (respectively) created/destroyed and hired/fired by the bundle relative to other countries. The result has been one of the world’s most flexible and innovative economic systems. In the recessions of the early 90s and 2000s this system sputtered, giving “jobless” recoveries to recessions. With the safety-net too weak to handle long-term unemployment (unlike European economies) the U.S. political system is highly sensitive to its presence. The Federal Reserve and Federal Government’s hands’ were forced.

A heavily stimulative monetary and fiscal response pushed interest rates down and deficits up. When financial markets have large credit growth or asset appreciation (present throughout this time), the resultant demand alone can encourage more risk-taking – begetting more credit growth, asset (housing) appreciation, and risk-taking that perpetuate the cycle. When outside factors such as large stimulus further increase demand, the vicious cycle accelerates. By dealing with unemployment instead of (well-masked) financial imbalances, policymakers piled on the growing bubble.

While mistakes by policymakers in generating, then failing to correct to, credit and asset imbalances bears the brunt of the blame in the early part of Rajan’s analysis, the financial sector itself is far from blameless. With earnings as the sole measure of professional success in the financial sector (unlike, say, teaching or engineering), maximizing self-worth, and therefore incentives (both monetary and non-monetary), purely centered on maximizing returns. This can be done by beating the market, or by taking on excessive risk then misevaluating it (knowingly or not) to masquerade as having beat the market. With risk related to large-scale movements manifesting rarely, it can be difficult to tell the two apart. Individual compensation mechanisms minimizing decision makers’ share in downside risk, and insufficient monitoring from deep-pocketed foreign investors made checks on reckless behavior minimal, and falling as the credit boom grew. After years of underrated systemic risk with losses pushed onto others, voices of moderation in the field were cast out as profit-killing pessimists. This culminated in mortgage companies pushing loans onto those completely unable to pay, which were bundled and sold as safe assets to investors unaware of their risk. The initial credit boom, already further inflated by other expansionary factors, was pushed beyond dangerous territory.

Given the linkage between financial markets and policy, it’s difficult to understand the behavior of financiers independent of the institutional structure they operated within. Low-rate policy put excessive pressure on financiers to generate returns by taking on high risk, while the implicit promise of bailouts from the government lowered the costs to doing so, eliminating the standard market mechanisms punishing those misevaluating risk. This combination acted as a taxpayer subsidy to the financial sector – money managers reaped the gains from risky investments knowing taxpayers were on the hook if the risk manifested. Corporate structure in the banking sector, misaligned to reward short-term benefits to shareholders over long-term benefits to society, exacerbated human fallibility associated with risk assessment by pushing

incentives away from socially optimal behavior.

Reforming these incentives tops the list in Rajan's proposed financial sector reforms. Human behavior is guided by incentives. Any attempt to change it must start there. Compensation structures focused on longer-term success, removing the implicit assumption of a bailout, and greater transparency of banks' balance sheets will all increase the cost, thereby reducing the presence, of excessive risk-taking. One promising "in vogue" option – a new Federal Reserve policy tool to shift leverage or equity requirements counter-cyclically is left out. Absent this tool, monetary policy must acknowledge financial cycles then raise rates between recoveries – even at the cost of higher unemployment. Preventing institutions from becoming systemically important, while building buffers for when the system is stressed, requires avoiding government guarantees that drive excessive risk but still ensuring liquidity is available when needed – a difficult mechanism to design. Focusing on linkages, rather than institution size, and requiring the selling of instruments undertaking debt to equity conversions when stress thresholds are surpassed is a strong start.

If inequality resulting from an inadequate education system – and the use of credit to cover it up – sowed the seeds of the pre-crisis boom, expanding access to education must be part of the solution. This goes deeper than increasing funding to education. Most ills in modern society will not be solved with merely an increase in funding. Gaps between the richer and poorer of society begin early; children of poorer parents often fall behind both cognitively and socially due to a variety of socioeconomic factors. When these gaps grow, they often last a lifetime. Early childhood and low-income family targeted measures are essential. Increasing worker retraining and mobility (reducing barriers to relocation such as worker certification) while restructuring the safety net account for the need for lengthened (in a rule based system) benefits – but only in serious downturns – will reduce the anxiety that forces heavy stimulus and drives bubbles. Counter-intuitively, these expansions of benefits may then be likely to strengthen the government's fiscal position by minimizing both the costly bust and fiscal response to it. Policy change of this nature though is easier said than done.

Higher hurdles stand in the way of international policy reform. Economists have always been aware the actions of countries are interconnected – in this case export-led high-savings countries flooded low-savings countries like the U.S. with liquidity, fueling credit booms then busts. However no mechanism exists to push net saving countries into increased spending to ease the burden of supplying global demand from industrial countries; indeed developing countries such as China and Vietnam argue a depreciated currency and export subsidies are necessary to grow in a world with built-in structural and first-mover advantages for industrial countries. Moderating capital flows presents even greater challenges; the integration of radically different financial cultures and institutions causes wires to cross with billions on the line. Investors seek to avoid this risk by using flighty short-term debt, allowing wild financial flows that generate these crises. Were a perfect solution available political actors are still hamstrung by domestic constituencies – at the cost of global financial stability. Pushing reforms constituents fear through a system from which entrenched interests benefit is a herculean task – and international institutions have little leverage. Rajan recounts his ill-fated pre-crisis series of globe trotting meetings to attempt just that as Chief Economist of the IMF.

Rajan illustrates how the complex interactions of politics and economics melded with institutional incentives and human nature to culminate in the Great Recession. By acknowledging the difficulty of policy reform amidst a nod to the validity of both partisan narratives, he avoids the blame game in favor of an even-keeled discussion of why the crisis happened with ideas to avoid the next. *Fault Lines: How Hidden Fractures Still Threaten the World Economy* deserves its award as the 2010 Financial Times/Goldman Sachs business book of the year.

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Review

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- Finalist for the 2010 Paul A. Samuelson Award, TIAA-CREF
- Finalist for the 2010 Book of the Year Award in Business and Economics, ForeWord Reviews
- One of strategy+business magazine's Best Business Books of the Year for 2010
- Best Crisis Book by an Economist and Named one of Bloomberg News's Thirty Business Books of the Year for 2010
- Finalist for the 2011 Estoril Global Issues Distinguished Book Prize
- One of Financial Times's Books of the Year in Business & Economics, Nonfiction Round-Up for 2010

"Fault Lines is a must-read."--Nouriel Roubini, Forbes.com

"[E]xcellent. . . . [Fault Lines] deserve[s] to be widely read in a time when the tendency to blame everything on catch-all terms like 'globalisation' is gaining ground."--Economist

"Like geological fault lines, the fissures in the world economic system are more hidden and widespread than many realize, he says. And they are potentially more destructive than other, more obvious culprits, like greedy bankers, sleepy regulators and irresponsible borrowers. Mr. Rajan . . . argues that the actions of these players (and others) unfolded on a larger world stage, that was (and is) subject to the imperatives of political economies. . . . [A] serious and thoughtful book."--New York Times

"A thought-provoking new book. . . . [Rajan's] voice is worth listening to."--Martin Wolf, Financial Times

"The book, published by Princeton University Press, saw off stiff competition from five others on the shortlist, to be chosen as 'the most compelling and enjoyable' business title of 2010. The final intense debate

among the seven judges came down to a choice between Fault Lines and Too Big to Fail, Andrew Ross Sorkin's acclaimed minute-by-minute analysis of the collapse of Lehman Brothers. The book identifies the flaws that helped cripple the world financial system, prescribes potential remedies, but also warns that unless policymakers push through painful reforms, the world could be plunged into renewed turmoil."--Financial Times

"Rajan is worth reading not just because he was correct when few were but also because his writing is clear as a bell, even to nonspecialists."--Christopher Caldwell, Weekly Standard

"The left has figured out who to blame for the financial crisis: Greedy Wall Street bankers, especially at Goldman Sachs. The right has figured it out, too: It was government's fault, especially Fannie Mae and Freddie Mac. Raghuram Rajan of the University of Chicago's Booth School of Business says it's more complicated: Fault lines along the tectonic plates of the global economy pushed big government and big finance to a financial earthquake. To him, this was a Greek tragedy in which traders and bankers, congressmen and subprime borrowers all played their parts until the drama reached the inevitably painful end. (Mr. Rajan plays Cassandra, of course.) But just when you're about to cast him as a University of Chicago free-market stereotype, he surprises by identifying the widening gap between rich and poor as a big cause of the calamity."--David Wessel, Wall Street Journal

"In a new book . . . entitled Fault Lines, Rajan argues that the initial causes of the breakdown were stagnant wages and rising inequality. With the purchasing power of many middle-class households lagging behind the cost of living, there was an urgent demand for credit. The financial industry, with encouragement from the government, responded by supplying home-equity loans, subprime mortgages, and auto loans. . . . The side effects of unrestrained credit growth turned out to be devastating--a possibility most economists had failed to consider."--John Cassidy, New Yorker

"[C]onvincing."--Christopher Caldwell, New York Times Magazine

"What if the financial crash of 2008 was really caused by income inequality? Not greedy bankers, not reckless homeowners, but the ever widening-gulf between the rich and the poor? And what if the lack of social services--like health care--made things much, much worse? This is the startling new theory from Raghuram Rajan. . . . [Fault Lines is] especially fascinating because it mixes free-market Chicago School economics with good-government ideas straight out of Obamaland."--John Richardson, Esquire.com

"A high-powered yet accessible analysis of the financial crisis and its aftermath, Fault Lines was awarded the FT/Goldman Sachs Business Book of the Year. Rajan . . . was one of the few who warned that the crisis was coming and his book fizzes with striking and thought-provoking ideas."--Financial Times (FT Critics Pick 2010)

"What caused the crisis? . . . There is an embarrassment of causes--especially embarrassing when you recall how few people saw where they might lead. Raghuram Rajan . . . was one of the few to sound an alarm before 2007. That gives his novel and sometimes surprising thesis added authority. He argues in his excellent new book that the roots of the calamity go wider and deeper still."--Clive Crook, Financial Times

"Few people were able to foresee the recent economic downturn. Raghuram Rajan . . . was one of them. This makes his new book, Fault Lines, worthy of consideration amidst the rampant speculation about the causes of the financial crisis. . . . Fault Lines is valuable primarily for its clear explanation of unintended economic consequences from well-meaning government intervention."--Washington Times

"Rajan's writing is clear and direct."--James Pressley, Bloomberg News

"Former IMF chief economist Raghuram G. Rajan . . . in his new book, *Fault Lines*, brings together and explains the diverse failings that contributed to the crisis--the fault lines, as he puts it, that were exposed by the events of the past several years. Rajan then puts forward broad policy recommendations to ward off a future problem. . . . Rajan's book takes a comprehensive look at what got us into the crisis and offers an intriguing approach to avoiding another one."--Phillip Swagel, Finance & Development

"I devoured Raghuram Rajan's *Fault Lines: How Hidden Fractures Still Threaten the World Economy* in a very short span of time last night. It's brief, well-written, and extremely interesting. I would definitely recommend adding it to your financial crisis reading list."--Matthew Yglesias, Yglesias blog

"The proposed global reforms that [Rajan] lists in *Fault Lines* run the gamut from the prosaic to grandiose. Along with revamping Wall Street's pay system, he offers innovative ideas on building capital buffers into the global credit system, obviating much of the need for bailouts of companies deemed too big or too enmeshed in the financial system to fail."--Barron's

"Economists who can challenge their peers while remaining accessible to the general reader are rare, but Rajan belongs to this elite group. No short summary can do justice to this well-written, insightful, and nuanced study."--Choice

"In 2007, then-chief IMF economist Raghuram G. Rajan delivered a stark warning to the world's top bankers: financial markets were headed for doom. They laughed it off. In the wake of the collapse that followed, Rajan has written a new book, *Fault Lines: How Hidden Fractures Still Threaten the World Economy*, that warns the system is doomed to repeat its mistakes. Like many defenders of the market, Rajan urges us not to demonize the bankers. But it's this fiscal conservative's focus on inequality that makes him stand out from the pack. The growing wage gap, he argues, is a hidden driver of financial instability, putting constant pressure on politicians to enact short-term fixes."--Toronto Star

"The critics are wrong: Raghuram Rajan's analysis of the global financial crisis remains highly relevant and deserves to be widely read. . . . The breadth of Rajan's explanatory framework--which is presented cogently and concisely within 230 pages of text--marks this book apart from many others that tackle the same themes."--Mark Hannam, Prospect

"Dozens of experts have explored the reasons behind the ongoing global economic turmoil, and Raghuram Rajan provides his own elegant and thoughtful analysis in *Fault Lines*."--BizEd

"With *Fault Lines*, Rajan has made an original diagnosis of the credit crisis, one that goes much further than those of greedy bankers or wasteful mortgage giants such as Fannie Mae and Freddie Mac."--Christophe De Rijcke, *De Tijd* (translated from the Dutch by K.C.L.)

"A book that should be the default choice of discerning finance professionals when they enter the store the next time."--D. Murali, Business Line

"Rajan's *Fault Lines* is . . . expansive and policy-focused and clearly destined to become a must-read on any list of books on the recent global crisis."--Jahangir Aziz, Business Standard

"Insightful, educative and incredibly gripping, if you want just one book to understand the ongoing global financial crisis and the way forward, *Fault Lines* it is."--Gautam Chikermane, Hindustan Times

"Best Crisis Book by an Economist (2010)."--James Pressley, Bloomberg News

"Fault Lines has a strong claim to be the economics book that best caught the spirit of 2010. Raghuram Rajan's receipt of the Financial Times and Goldman Sachs annual business book award only confirmed his book's widespread popularity. It is not hard to see why so many people liked it. Fault Lines eschews hyperbole for a lucid and balanced account of the crisis."--Fund Strategy

"Rajan . . . comes up with original and important long-term remedies. . . . Rajan's book is a bold enterprise in three ways: firstly it aims to explain the US financial crisis by looking at deep, decade-long fractures in economies and societies; secondly it suggests well-known but radical solutions that few dare put forward; and finally it supplies innovative answers to practical questions. . . . [T]he book will please any reader looking for an inquiry into the deepest causes of the recession and a consistent account of government's errors of omission and commission."--Natacha Postel-Vinay, British Politics and Policy

"In a well-written, well-organized study, he focuses on ten of the most important issues bedeviling a still shaky world economy. Neither too technical for laymen nor too glib for specialists, the book ought to be a significant contribution to policy-makers' discussions of where we go now."--Joel Campbell, International Affairs

"Just when you thought you had heard it all and that there is not much more that we can learn from the recent financial crises, here comes a brand-new assessment from another angle. . . . Written with clarity and persuasion."--Good Book Guide

"[T]his book is a must read for analysts, academics, politicians, economists, and the like."--Emilia Garcia-Appendini, Financial Markets and Portfolio Management

From the Back Cover

"Fault Lines provides an excellent analysis of the lessons to be learned from the financial crisis, and the difficult choices that lie ahead. Of the many books written in the wake of our recent economic meltdown, this is the one that gets it right."--George A. Akerlof, coauthor of *Animal Spirits* and *Identity Economics*

"Amidst the welter of books about our financial crisis, Rajan's book stands out for several reasons: the author's intellectual distinction, his academic and real-world involvement in the problems of finance and the macroeconomy, his global perspective, his search for the roots of the financial crisis in America's growing economic inequality, and also his prescience. In 2005, Rajan foresaw the coming financial collapse--and was fiercely criticized for his insight."--Richard A. Posner, author of *A Failure of Capitalism: The Crisis of '08 and the Descent into Depression*

"Beautifully clear, cogent, and highly readable. This is the best book out there on the global imbalances that gave us the last financial crisis and might well give us the next one."--Kenneth S. Rogoff, coauthor of *This Time Is Different: Eight Centuries of Financial Folly*

About the Author

Raghuram G. Rajan is the Eric J. Gleacher Distinguished Service 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).

Fault Lines: How Hidden Fractures Still Threaten The World Economy By Raghuram G. Rajan

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