BOOK REVIEW

“FAULT LINES” BY RAGHURAM G. RAJAN

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ABSTRACT: This book review presents a summary of “Fault Lines: How Hidden Fractures Still Threaten the World Economy” by Raghuram Rajan, who puts forward a clear and cogent account of the latest global financial crisis. With the historical perspective he adopts, Rajan digs in deeper than the shallow surface to reveal the growing economic stresses in both the United States and the rest of the world that were overlooked at the time but came together eventually to trigger the crisis that drifted world economies into prolonged recessions. While elucidating the roots of the crisis, the book insightfully explains how structural problems piled up, how households, banks, and politicians acted on self-interest ignoring rising risks, and how policy makers stayed reluctant to act. Rajan emphasizes the importance of drawing right lessons out of the crisis to ensure a more balanced world economy and restore lasting prosperity on a global scale.

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FAULT LINES ÜZERİNE BİR ELEŞTİRİ

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“The problem was not that no one warned about the dangers; it was that those who benefited from an overheated economy – which included a lot of people – had little incentive to listen.”

– Fault Lines, p.1

1. Introduction

The crisis that broke up in the United States’ housing sector in mid-2007 quickly spread to other sectors of the economy through ruined balance sheets of economic units and severely dampened household consumption. As it turned into a devastating global financial crisis affecting all world economies, closely tied by trade and financial linkages, the recession that followed was of great proportion, often compared to the Great Depression of 1929 in terms of scale. And many countries are yet to recover.

Once the crisis hit, the big question was why anybody did not see it coming. Professor Raghuram G. Rajan of the Booth School of Business of the University of Chicago was in fact one the few who gave an early warning of the risks that was building up in the financial sector before the crisis erupted. At the 2005 Jackson Hole Conference, as the chief economist of the International Monetary Fund, he presented a controversial paper drawing attention to the developments that caused the financial sector to become more exposed to risk and argued that disaster might loom, despite the buoyant atmosphere of the time (Rajan, 2005). Criticized fiercely then but proven to be right eventually, Rajan puts together a detailed account of the crisis in “Fault Lines: How Hidden Fractures Still Threaten the World Economy” after the risks materialized. He uses the geological metaphor of fault lines to refer to the structural economic problems in both the United States and the rest of the world, and offers clear and cogent explanations for the roots of the crisis.

Having won several awards, including 2010 Financial Times and Goldman Sachs Business Book of the Year and 2010 PROSE Award for Excellence in Economics, perhaps, what makes the book joyfully appraised by a large audience is the historical perspective it adopts while providing a brilliant diagnosis of the causes of the global crisis. In that respect, Rajan digs in deeper than the shallow surface to reveal the underlying stresses that were growing in the economy over a longer period. With a particular focus on the US economy, he insightfully explains how structural problems piled up, how households, banks, and politicians acted on self-interest ignoring rising risks, and how policy makers stayed reluctant to act in Fault Lines.

Rajan also puts forward broad policy recommendations to fix the serious flaws in the economy in order to avoid potential future crises. His emphasis is on the importance of drawing right lessons out of the crisis to ensure a
more balanced world economy and restore lasting prosperity on a global scale.

Rajan’s work differs from other popular books on economic crises such as This Time is Different: Eight Centuries of Financial Folly (Reinhart & Rogoff, 2009) and Crisis Economics: A Crash Course in the Future of Finance (Roubini & Mihm, 2010) which provide comparisons of the latest global financial crisis to previous ones, for its entire focus is on the most recent episode.

2. The Fault Lines

According to Rajan, the roots of the crisis lie in several structural economic fractures that existed long before the crisis erupted, but were either not properly dealt with or were intentionally ignored. Namely, these were (i) the unbalanced growth in the global economy; (ii) the rising income inequality in the United States and the populist policies that meant to fix it; (iii) the weak safety net; and (iv) the reckless credit growth coupled with the increasing risk taking behavior in the financial system. The essence of these fault lines are given below.

To support their investment and growth, developing countries initially relied on imports, running trade deficits to absorb the excess supply of rich industrialized exporters. But after their financial crisis in the late 1990s, a considerable share of East Asian economies realized that borrowing large amounts from developed countries to finance investment was a recipe for trouble. Hence, they took measures to increase savings and reduce reliance on imports. Likewise, countries like Brazil and India reformed their economies to achieve more stable and faster growth, reducing their dependency on foreign finance. And most notably, China became a net exporter itself. Meanwhile, Japan and Germany who had long depended on foreign demand for growth were already searching for new markets to sell their surplus output. In essence, income earned by these countries through exports were lent abroad to finance consumption in other countries. At the flip side of the coin, the export orientation in these large exporters was not only depressing domestic consumption and causing the nontradable sectors not to produce as efficiently as they should, but also was putting a burden on other countries to create demand to meet the excess supply put out in the global goods markets. When China was added to this league of export oriented economies, the imbalance in world trade became even more pronounced, yet the consequence of this unbalanced growth path meant larger trade deficits elsewhere. Hence, the rising burden of absorbing the

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1 Us Alioğlu (2012) provides a recent review of the book.
excesses fell on the over-stimulated US economy’s over-consuming households.

In the US, the center of the crisis was the unsustainable household debt. Rajan argues that the heart of the problem was the income inequality caused primarily by under-education and, to a lesser extent, immigration, changes in tax rates and decrease in unionization. The gap between the earnings of educated and under-educated individuals was constantly rising over time, which was difficult to eliminate. Thus, politicians came up with an easier solution to cope with it: providing cheap and easy credit to low income households. Instead of combating the income inequality problem directly, this populist strategy of facilitating credit had large, seemingly positive, immediate, and widely distributed benefits. However, the corresponding costs lied in the future. Supporting home ownership, especially among low-income households, became the main policy of the government. Low interest rates added to the incentives already provided by government support for low-income housing and fueled an extraordinary housing boom as well as increasing indebtedness. But the quality of loans deteriorated as lending to those with low credit ratings (sub-prime mortgages) increased. The government-backed mortgage agencies were pushed to support the expansion in mortgage lending. They bought subprime mortgages despite the significantly higher risks involved and issued asset-backed securities with high ratings. Growing sophistication of financial instruments concealed the actual risks that were associated with them. For a while, the problems were shadowed by booming construction sector, rising house prices, and low default rates.

In addition to the home ownership mandate to content those who were left behind, the jobless nature of the recovery after the dot-com bust and the weak safety net, forced the US government to push considerable fiscal and monetary stimulus to the economy. According to Rajan, unemployment benefits and health care systems proved to be weak safety nets, the former for its short duration and the latter for its high cost, during the recession following the dot-com bust that was more prolonged than the past ones. But because the case for increasing government spending beyond the automatic stabilizers was not strong, much of the task of stimulating the economy was left to monetary policy. The Federal Reserve felt the pressure to pursue an overly accommodative monetary policy to bring the economy back on track and create jobs that were still scarce. While keeping its policy rate low, the Fed assured the markets on its willingness to maintain easy credit conditions and step in to provide liquidity when financial markets get into trouble.

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2 See Krugman & Wells (2010) and the official blog of Fault Lines for a debate between Rajan and Krugman on the subject.
Rajan claims that the sustained easiness of monetary conditions increased the incentives for aggressive risk taking in the financial sector and inflated the housing prices that were already on the surge. The Fed’s monetary stance was defended on the grounds that there was no housing bubble and hence no need for action. Thus, the Fed’s reluctance to act against the housing bubble for its concern over the high unemployment rate resulted in important problems for financial stability.

The financial sector also bore responsibility in the formation of fault lines. As the book puts it, the very essence of the competitive market mechanism brings about the willingness to exploit any opportunity to increase profits. This coupled with the fact that bankers’ performance evaluations are based on the amount of money they make, encouraged the financial sector to invest in complex products that promise higher returns, without appropriately accounting for the risks associated. These, in turn, made the financial system more prone to unprecedented perils. At the start of the housing boom, when mortgage loans were profitable, credit creation looked like a worthy investment. But Rajan points out that the herd-like behavior of making more and more mortgage loans exaggerated investment trends and soon caused housing prices to move away from fundamentals. Besides, because the number of bankers in mortgage business was too large, it created a moral hazard problem: the bankers knew the government would not let all banks to fail. When it came to risk diversification and packaging subprime mortgage loans in creative ways to invent different asset-backed instruments, the financial system worked on the basis of an “arm’s-length” model instead of relying on long-term trustful customer relationships, so the parties mainly cared about the amount of fees they got out of transactions. Thus, the fault line in the financial sector lied beneath the way the competitive system worked, which pushed the financiers to the limits to seek for higher returns.

In summary, the book argues that the rising tensions along these fault lines that were often overlooked at the time came together in the end to trigger a devastating financial crisis.

3. The Highlights

While conformably identifying the causes of the crisis and providing insightful explanations for the disregarded failures in the economy, Rajan makes some important points that worth to be highlighted along the road.

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3 Other proponents of this view include Taylor (2007) who claims the Fed’s target for the federal-funds interest rate was below what the Taylor rule implied during 2002-2005.

4 Failing to recognize the bubble at the time, Bernanke (2005) argued that the rising housing prices largely reflected strong economic fundamentals. Nonetheless, while evaluating the housing bubble in retrospect in 2010, he argued that the price gains were too large to be explained by the stance of the monetary policy alone (Bernanke, 2010).
First, the book claims that although managed capitalism in the form of an export led growth strategy has proved enormously successful in its immediate objective of getting countries out of poverty, it is not an ever-sustainable strategy to implement. According to Rajan, countries should not pursue this kind of strategies longer than intended and make the switch to start a more open economy when domestic firms become mature enough to compete internationally. To this line, Rajan emphasizes the importance of organizational capital and institutional environment to flourish competition and innovation.

Secondly, Rajan argues that the tail risk taking behavior in the modern competitive financial system is not an easy problem to address. While the free market system should encourage good risk management and penalize excessive risk taking in theory, in practice things can get out of hand quite easily. Moreover, government intervention at those times can in fact reduce market discipline and even support such risk-taking behavior through creating a moral hazard problem. Rajan believes that transparency can be one remedy to rebuild the lost faith in the financial system, allowing public to monitor the practices of the financial institutions.

Thirdly, the improvement of the quality of education and the strengthening of the weak safety net are essential in the US. While investment in human capital needs to be increased in as many alternative ways as possible to overcome the rising inequality problem, unemployment benefits should be raised to sufficient levels that would allow workers to be more resilient in downturns. Besides, reforms that would deliver flexibility in the labor market should be undertaken.

Lastly, global coordination is the key to a more stable world economy and its gains are meant to be long-term. Since global imbalances arise from the policies that countries have been long pursuing, they are hard to be changed. At this point, multilateral agencies have a role to play in helping countries take the necessary steps to contribute to global balance and welfare.

Unfortunately, the roots of the crisis go deep and the global economy is still subject to the threats that they may further trigger. Yet, it is obvious to anyone that the solutions to the problems are not easy. Rajan aptly warns that drawing right lessons out of the crisis and addressing the flaws in the economy properly would matter enormously for the system not to repeat its mistakes.

4. Conclusion

As developing countries cut back on their import demand following the crises in the 90s and China joined the major exporters, the mounting global supply searched for countries that would reliably absorb the excess. The
over-saving world exporters were keen on financing those who were willing to consume more than they produced. Meanwhile, the United States was already infusing substantial fiscal and monetary stimulus in the face of a jobless recovery, a weak safety net and last but not least a mandate to provide cheap and easy credit to low-income households. The over-lending and over-consumption caused vulnerabilities to emerge in the financial sector, mainly due to excessive risk taking behavior. Eventually, the growing stresses underneath all these fault lines came together to trigger a global financial crisis that drifted world economies into prolonged recessions.

Rajan elucidates the roots of the 2008 global financial crisis exceptionally well in his book Fault Lines from a Chicago School viewpoint. His writing is clear and direct, making the economic concepts easy to understand and the linkages easy to follow. Chapters are self-contained and the short summaries and conclusions provided at the end of each are quite helpful for giving the essence of the subject matter. The book is indeed an essential reading for those who are particularly interested in the structure of the housing market in the US, the history of housing credit, the operation of government-supported mortgage associations, and the creation of financial products related to mortgages. Moreover, Rajan goes further than just focusing on the US economy in his search for the fault lines, but rather adopts a comprehensive global perspective. Overall, he defends his case convincingly and offers –reasonable and moral– guidelines to fix the problems in the economy. With an urge to increase the awareness for the importance of ensuring global balance and improving world welfare, his responsible way of thinking as an economist is impressive.

References


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