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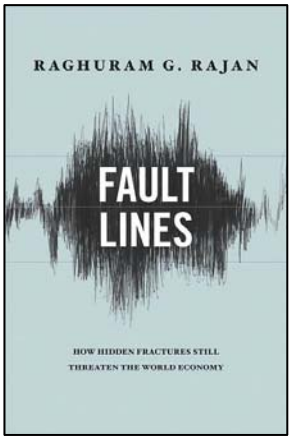

Fault Lines:
How Hidden Fractures Still Threaten the World Economy

Author: Raghuram G. Rajan
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About The Author:
Raghuram G. Rajan teaches economics at the University of Chicago. Formerly, he was chief economist at the International Monetary Fund. He is also the co-author of *Saving Capitalism from the Capitalists* and a recipient of the Fisher Black Prize in economics.

General Overview:
As the world struggles to recover from the global financial crisis, it's tempting to blame the crisis 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 he warns that a potentially more devastating crisis awaits us if these flaws aren't fixed. Rajan asserts that the individual choices that collectively brought about the economic meltdown 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 shows how inequalities in U.S. incomes, education, and health care are putting all of us into deeper financial peril. Rajan also outlines sensible reforms to ensure a more stable world economy and to restore lasting prosperity.

**** Please Note:*** This political book summary does ***not*** offer judgment or opinion on the book's content. The ideas, viewpoints and arguments are presented just as the book's ***author*** has intended.

Introduction
The financial collapse of 2007 and the subsequent recession left many economists with a black eye. While some financial experts saw the crisis coming, most financial prognosticators were caught flat-footed by events. Not surprisingly, the public's faith in economists and financial professionals was greatly shaken.

The financial crisis was precipitated by fault lines in the global economy. In simple terms, the global economic system had unsustainable imbalances. In particular, China's manufacturing growth depended on America's over-consumption (which was fueled by cheap credit). Chinese savings were lent to over-extended American consumers so that they could continue to afford Chinese exports. The artificially low value of the Chinese currency helped Americans maintain their spendthrift ways, while also contributing to the housing bubble.

Unsustainable processes eventually come to an end.

In recent years, America has been experiencing increasing levels of income inequality. The gap between the haves and the have-nots has much to do with increasing educational disparities. Politicians, however, have generally taken the easy way out when it comes to income inequality. In order to diffuse the animus of the underclass, our politicians pursued policies that extended cheap credit to segments of the population that were getting left behind. Policies by both the Clinton and Bush administration's to encourage sub-prime borrowing were a case in point.

The world needs a more balanced economy. Americans need to save more and the Chinese need to consume more. In the long-run, China will benefit by allowing its currency to appreciate and by pursuing a more balanced economy. Unfortunately, there are many vested interests that want to maintain the status quo.

The financial crisis did not represent the failure of capitalism. Rather, the government, the financial sector, and the consumers all bear some responsibility for the meltdown. In particular, government agencies – the Fed, Fannie Mae, and Freddie Mac – sent messages to market participants that the government would indemnify the losses of institutions deemed too big to fail. Concomitantly, financial institutions were incentivized to take on maximum risk in order to garner maximum rewards. Finally, consumers were proffered with cheap credit in order to maintain the illusion of wealth. In short, the discipline of free markets – where inefficient or badly run organizations are allowed to fail – was short-circuited.

Progressives blame greedy bankers for causing the financial crisis. On the other hand, conservatives blame government housing policies and the Federal Reserve. In fact, the government, the financial sector, and the consumers all bear some responsibility for the financial meltdown.
We need to fix the fault lines and imbalances that created the crisis in the first place. In particular, "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 government needs to send the message to the financial sector that taxpayer dollars will not be used for financial sector bailouts in the future. Government has a role to play in helping its citizen pursue opportunities in the marketplace, but government also needs to step back and allow the marketplace to function. Otherwise, financial firms and other businesses will game the system at the taxpayers' expense. "This crisis has resulted from confusion about the appropriate roles of government and the market. We need to find the right balance again."

Let Them Eat Credit

Technology has revolutionized the workplace. Technology confers many benefits over the long term, but it also displaces workers. Today, workers need to constantly upgrade their skills in order to adapt to the fast-changing economic environment.

College-educated and highly-skilled workers are in demand, but seven out of 10 Americans lack a college degree. Low-skill and poorly-educated Americans have seen their incomes stagnate and fall.

Inequality is rising in America. Some blame a dysfunctional public education system. Others believe that America has ceased to be a land of unlimited opportunity and upward mobility. Politicians have responded to rising economic inequality by "facilitating the flow of easy credit to those left behind by growth and technological progress."

Education is essential for both individual and national success. The United States cannot be a world economic leader if it fails to improve its human capital. When more and more Americans recognize that they do not have the skills to thrive in the global workplace, their self-confidence suffers. Stagnant wages, income inequality, lower social mobility, and seemingly diminished opportunities have left a significant segment of Americans anxious and resentful.

Since the 1980s, politicians have responded to the anxieties of America's underclass with policies aimed at extending easy credit. As far as politicians are concerned, cheap credit has many virtues: it promotes home ownership, pushes up housing prices, encourages consumption, and it creates more jobs in the financial, real estate, and construction sectors. Best of all, of course, cheap credit creates benefits in the present while pushing off costs into the future.

Improving education and other far-sighted reforms might help American workers in the long run, but such benefits could take decades to materialize. Promoting home ownership among low-income Americans by encouraging banks to extend easy credit to risky borrowers, however, seemed like a quick way for politicians to reward constituencies and curry favor with key voting blocks.

The Clinton and Bush administrations both pushed policies aimed at promoting low-income housing. In particular, Fannie Mae and Freddie Mac, hybrid organizations that were both private and public, were effectively put in the business of purchasing high-risk (i.e., subprime) loans.

The intentions behind the affordable housing initiatives were good. Unfortunately, Fannie Mae and Freddie Mac were being asked to take on significant risk. Fannie and Freddie had private shareholders, but they were perceived as quasi-public entities that would be backed by the full faith and credit of the federal government in the event of a crisis. Private financial institutions would exploit this fact.

For instance, private sector lenders recognized that Fannie and Freddie's involvement in the subprime mortgage market would help insure that the market for subprime mortgages remained liquid. In other words, private institutions assumed that Freddie and Fannie's involvement in the subprime market would make the business of high-risk loans a sure bet.

As long as easy credit flowed, housing prices rose. And as long as housing prices rose, everybody felt rich. However, the whole house of cards came tumbling down once the Fed was forced to raise interest rates.

Exporting to Grow

Developed countries are wealthy because they grew steadily over time. By and large, government intervention in the earliest phases of a country's development is a prerequisite for success. This relationship, where government intervenes and partners with private industry, is known as managed capitalism. Developing economies, of course, also focus on exports. In fact, "the export-led managed-growth strategy, when implemented well, has been the primary path out of poverty in the post-war era."

Escaping poverty is not easy. Poor countries invariably lack the organizational capacities to deploy resources efficiently.

In developing countries, nascent industries and businesses need nurturing. But over the long term, permanent protectionism will induce complacency, thus undermining growth.

Governments in developing countries have generally encouraged their firms to aim their products at global markets. In addition, households in developing economies tend to be savers rather than consumers. With developed countries, however, just the opposite is true. For instance, in the United States, the savings rate of the typical household approached zero in the new millennium.

Developed countries tend to absorb the exports of developing economies. At the same time, developing countries like China have lent their accumulated trade surpluses back to the developed countries so that first-world consumers can afford their exports. As a result, the world economy has become seriously imbalanced.

The developing countries like China need more balanced economies. That is, they need to consume more.

Flighty Foreign Financing

Countries that rely on large amounts of foreign financing tend to make wasteful spending decisions. In general, foreign financing usually involves arm's length transactions. That is, foreign lenders do not maintain close relationships with their borrowers. As a result, foreign lenders are predisposed to pulling their money out of developing countries at the first sign of trouble. Further, foreign lenders often take advantage of the fact that private enterprises in developing countries are intertwined with the government. In other words, favored firms with political connections will not be allowed to fail, which means that taxpayers will end up footing the bill by bailing out foreign investors.

The crisis in Mexico (1994) and East Asia (1998) exemplify the pitfalls of the boom and bust cycle. "It is a fool's game to succumb to the temptation of cheap goods and easy money; rapid debt-fueled spending invariably ends in tears."

In fact, the export-oriented countries believed their trade surpluses were necessary for internal stability. However, this strategy created vulnerabilities in the rest of the world's economic system. After all, the strategy relied on exporting to countries that consumed more than they produced. The United States fit this bill. In fact, the United States effectively became the consumer of last resort. However, debt-fueled consumption and growing economic inequality in the United States were fault lines upon which this precarious system rested.

A Weak Safety Net

Following the dot-com bubble, the Fed pursued expansionary fiscal and monetary policies for a sustained period. Basically, low interest rates and cheap credit stoked demand as the U.S. absorbed surplus goods produced abroad.

The Fed's policies served several purposes. First, it assured that America's consumers would be the buyers of last resort. But cheap credit served another purpose; namely, it helped cushion American consumers reeling from recessions and increasingly jobless recoveries. Indeed, the Fed's loose monetary policy seemed designed to compensate for the fact that America has a weak social safety net.

In the future, recoveries following recessions are likely to be jobless recoveries. Unfortunately, "the United States, with its weak safety net, is singularly unprepared for them."

Unemployment benefits have both advantages and disadvantages. European countries, which have generous welfare and unemployment benefits, have generally not been as economically nimble and innovative as the United States. However, the absence of a strong safety net, coupled with jobless recoveries, will put enormous pressure on politicians to apply fiscal stimulus (tax cuts and spending increases) in order to deal with the dislocations caused by downturns. Discretionary fiscal stimulus, however, can easily lend itself to political abuse.

Fiscal stimulus done under duress invariably contains much that is unwise. Many countries recognize and take advantage of the fact that the United States relies so much on fiscal stimulus.

The lack of a stronger social safety net poses dangers to both the American economy and the global economy.

From Bubble to Bubble

When the world economy is in a downturn, developing countries look to the United States to pick up the slack and absorb excess supply. At the same time, the U.S. government has found it convenient to stimulate consumption as a way of ameliorating the plight of those left behind. All this encouraged an explosion in lending.

Unfortunately, there were many incentives that encouraged lenders to overlook the creditworthiness of borrowers. As a result, this system could not be sustained.

The Fed's loose monetary policy has had the effect of increasing risk-taking and inflating asset-price bubbles. Over time, these policies have undermined America's economic health. Relying on cheap credit to stimulate consumption will not lead to sustained job growth. Instead, the Fed's loose monetary and fiscal policies will engender one bubble after another.

When Money is the Measure of all Worth

In the financial sector, money is the measure of all worth. The financial world is an extremely competitive arena that is driven by self-interest. While allocating capital is an extremely important function, it is often very difficult (particularly when arm's length transactions are involved) to know whether a product, service, or business being financed is socially useful.

Financiers, by and large, are not thinking about social utility or the big financial picture. Rather, they are thinking in terms of the bottom line and competitive advantage. This does not absolve the financial class of blame for the financial crisis. Rather, the financial class was playing the role it believed it was supposed to play: investing client money and managing risk in order to generate profits for themselves and shareholders.

Deep-pocketed investors, arm's length transactions, and a highly self-interested financial sector create a particularly risky combination.

For example, in the recent crisis, the Fed's loose monetary policy gave U.S. consumers access to cheap credit, which consumers used to purchase exports. Dollar inflows into developing countries were recycled by foreign banks as they invested heavily in the U.S. subprime market. These investments were perceived as low-risk because of the involvement of Fannie Mae and Freddie Mac.

Essentially, foreign investors were counting on the U.S. government to organize a taxpayer-financed bailout if their investments went bad. Ironically, this pattern was virtually identical to the emerging market meltdown in Mexico (1994) and East Asia (1998).

Betting the Bank

"The problem of tail risk taking is particularly acute in the modern financial system, where bankers are under tremendous pressure to produce risk-adjusted performance."

Put simply, tail risk taking involves making huge bets that pay off most of the time, but which pose catastrophic risks in unlikely circumstances. Taking on tail risk can make pedestrian fund managers seem like superstars, until the bottom falls out.

In principle, the market should reward good risk management and punish shoddy risk management. However, tail risks are, by their nature, exceedingly hard to predict. After all, tail risks are essentially "black swans" – events few see coming. Unfortunately, the prospect of government bailouts actually encourages tail risk taking.

Incentives in our present society encourage bankers to take huge risks. When these bets go bad, the failures of the financial sector threaten to drown the rest of society. Understandably, a civilized government wants to mitigate the economic pain of its citizens. As a result, the government directs taxpayer money to finance bailouts of the housing market and banking system. However, these bailouts encourage the kind of risk-taking that will lead to the next crisis.

Reforming Finance

We want to encourage financial innovation but discourage excessive risk.

Much of the problem lies in the interface between government and the financial sector as the financial sector has exploited the implicit guarantees the government has made in the housing and banking sectors.

To remedy this, the government must convince the financial sector that no institution or sector is too big, important, or enmeshed to fail. Only then will the financial sector value risk properly again. Beyond this, transparency and publicity are the best measures to prevent and weed out abuses.

Improving Access to Opportunity in America

Politicians, in response to growing income inequality and economic insecurity, have encouraged debt-driven overconsumption. However, lax credit policies have only exacerbated excesses in the financial sector.

The government needs to improve education and strengthen the social safety net. Americans need to improve their skills and develop their human capital. Government can and should help in this area. In particular, early schooling, job training, and college aid can help reduce inequality and improve opportunity. Universal healthcare, encouraging the portability of pension plans, and encouraging Americans to save more are reforms that will make for a less anxious and more productive work force.

These are reforms the government should undertake. However, the government must get its fiscal house in order too. In all likelihood, we will need to cut spending and raise taxes (particularly by adding a national sales tax) in order to create a more just and prosperous society.

Conclusion

Recently, the United States has financed its consumption by tapping the excess savings of Europe, Asia, and the developing world. Politicians and the Fed have relied on cheap credit to mitigate the pain of America's underclass. Profligate spending was seen to be the path out of recession.

This pattern provided benefits for producers (i.e., developing countries) and consumers (the developed countries). Ultimately, the imbalances in the pattern made it unsustainable. Today, the consequences of over-relying on credit are clear; "indebted U.S. households, weighed down by houses that are worth less than the mortgages," have been forced to save more.

Because consumers could not continue to spend as they once did, the government has been forced to stimulate the economy. However, there are limits as to how much even the U.S. government can spend without doing harm to the nation's long-term fiscal solvency. Both consumers and the U.S. government will have to live within their means.

The global imbalances that precipitated the current crisis need to be addressed.

China will have to depend less on global demand and become a more balanced economy that consumes more. In particular, China's undervalued currency effectively subsidizes its domestic exporters. However, in the long term an undervalued Chinese currency is inimical to China's interests. After all, subsidized industries invariably lose their competitive edge and grow stagnant. More importantly, China's artificially undervalued currency is creating distortions in both the Chinese economy and the world economy.

The fault lines in the world's economic system are deep. We need multilateral organizations and agreements for addressing these imbalances.

At the same time, ordinary citizens in China, the United States, and elsewhere in the world need to be educated about the pernicious effects of trade surpluses and structural deficits. Informed opinion can help encourage more constructive relationships between governments and markets.

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