ESADE

Ramon Llull University

ESADEgeo-CENTER
FOR GLOBAL ECONOMY
AND GEOPOLITICS

6 Book Reviews on global economy and geopolitical readings

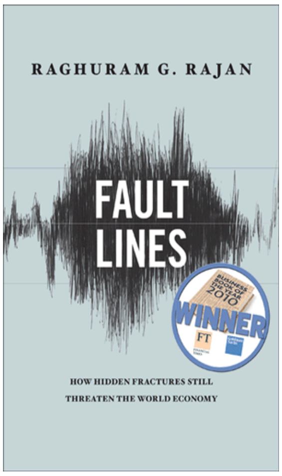
ESADEgeo, under the supervision of Professor Javier Solana and Professor Javier Santiso

Fundación REPSOL

Obra Social "la Caixa"

Fault lines: How Hidden Fractures Still Threaten the World Economy

Raghuram G. Rajan (2010) Princeton University Press



Financial markets and democratic governments are not incompatible… The role of government is to create a legal, regulatory and supervisory framework within which financial markets can operate. Democratic government, however, has other functions including the power to restrict the most unfair consequences of the market-driven economy by means of taxation, subsidies and safety nets. When a democratic government uses these other tools inadequately or tries to use modern financial markets for political purposes or becomes a player in the market instead of a regulator, then the sort of disaster we have just experienced happens …

Unless we reinstate government and the finance industry in their rightful roles and repair the imbalances between nations, what has happened may happen again.

Premise and opinion

According to Rajan, the reasons for the crisis that began in 2008 are seven structural problems in today's economic system that the author calls fractures and which he analyses with the utmost rigour. In this book, winner of the 2010 Financial Times award for the best business book of the year, Rajan proposes three major areas of reform to remedy the fractures.

The author

Raghuram G. Rajan is Professor of Economics at the University of Chicago Booth School of Business and former chief economist at the International Monetary Fund. He is also the co-author of Saving Capitalism from the Capitalists: Unleashing the Power of Financial Markets to Create Wealth and Spread Opportunity (Princeton University Press).

Fault lines

According to Rajan, the financial meltdown and ensuing recession that have shaken capitalism since 2008 were not only due to the factors mentioned most frequently since then, such as the skewed incentives for bankers that unbridled their seemingly irrational greed; or the lack of control by public regulators unable to foresee and deal promptly with an obvious systemic risk. “The real origins of the crisis we have undergone are not only more widespread but also more hidden.” They are the seven structural problems of today’s economic system that the author calls fractures and which he analyses in the course of this book, whilst suggesting three major areas for reform to remedy the current situation.

The fractures in the economic system

The widening income gap in the USA and government support for “easy credit” to remedy it

Between 1975 and 2005, the income gap between percentile 90 and percentile 10 climbed from 3/1 to 5/1. The main cause for this increase is the “college wage premium” caused by the gap between the supply and demand of individuals with higher education, due in turn to the unequal access to quality education by US citizens. In response to this growing inequality, the government increased the supply of credit, a populist measure designed to let people spend in a way not otherwise possible on their stagnant wages. Everything went well whilst house prices were on the up and up. “Easy credit, in general, is an extremely expensive way of redistributing”.

Export-driven growth

Late developer countries opted to let the government nurture a handful of private companies and transform them into “national heroes”. But this model has a drawback: it forces low wages to protect the profitability of the “national heroes” and in doing so, it depresses domestic consumption, thereby stripping these major companies of markets in which to sell. The solution has been to point these companies towards exporting. In this way, guided capitalism has been extremely successful in extricating countries from poverty. However, the shift from depending on exports towards becoming a balanced economy is not a smooth, painless process.

The clash between different financial systems

In guided-capitalism countries, because the government and the banks directed the financial flows, there is little public information. Information is jealously guarded by a stronghold of privileged banks, and the application of contractual demands depends on long-term business relations. But western foreign investors are wary of this system. Many developing countries do not access international money markets. As a result, in the late 90s, developing countries changed from being net importers to being net exporters of capital. But these trade and capital surpluses are a serious problem for the global economy. "The attempt made by those exporters to attain security", writes Rajan, "has increased the vulnerability of the rest of the world."

A frail safety net in the USA

Historically, the USA has been against high social security and unemployment benefits, unlike Europe. The USA system works well provided that an economic crisis is followed by fast recovery. But the 1991 recession marked the start of jobless recoveries. Under pressure from citizens and with no automatic stabilisers, governments used fiscal and monetary policies to kick-start their economies. The creation of a social safety net would be far more beneficial for the economy than the "persistent and politically-driven monetary stimulus" so dangerous for the finance industry.

A monetary policy that creates bubbles

Rajan points out the two main mistakes made by the Federal Reserve in recent decades. To combat jobless recoveries after 2001, the USA implemented a highly expansive monetary policy (extremely low interest rates) for a protracted period. The second mistake was Greenspan's put option (1996): a commitment through which the Federal Reserve opted to ignore asset prices, arguing that "it could not easily determine when asset prices were forming a bubble, (…) but would be prepared to intervene when the bubble burst", flooding the market with liquidity. This "gave bankers the impression that if they played along [with the bubble], the Federal Reserve would not restrict their profits but if their bets went sour, it would soften the consequences. (…) Leverage increased throughout the system."

The reasoning of the financial sector in contact with previous fractures

Greed, says Rajan, is a constant driving force in the financial sector and therefore cannot alone explain its ups and downs. Just a few mistaken incentives in "an amoral financial system with an eye for opportunities" can derail it, as happened in the recent crisis. These incentives came from the public support for sub-prime mortgages (1st fracture) and from foreign investors seeking somewhere to invest the huge currency reserves amassed thanks to their enormous trade surpluses (2nd fracture). The "enormous increase in the volume of money spent [on affordable housing]" meant that rating agencies "could not operate very thorough quality controls." The end purchasers of the securities were misled by erroneous ratings.

The banks' gamble on tail risks

Tail risks have three characteristics: they very rarely occur (they lie in the tail of the probability distribution); to be triggered off, adverse events must happen in the entire system; and when they happen, they are extremely expensive. Mortgage-backed securities were AAA rated because "the correlation between default [on the different mortgages packaged together in these securities] was low". This default risk was, therefore, a tail risk because in order to happen, mortgage defaults had to happen across the country. Furthermore, the characteristics of tail risks "guarantee they are ignored by banks and markets" because they know that "people are willing to pay a great deal to avoid the fallout" of such great damage if this happens. Because tail risks would only happen "if mortgage default happened across the country", it was obvious that the government would have to intervene if this unlikely possibility did occur.

Reforms needed to deal with these structural fractures

Reforms in the financial system

Rajan defends reforms "that limit the ability of finance to cause damage whilst taking advantage of its creative energy". He does not believe in reforms designed "to make finance boring". Likewise, he feels that most people should have access to finance and he believes in the democratisation of credit. "Our aim should be to make those in charge of [borrowing] decisions assume all the consequences of these decisions instead of preventing them from taking decisions." Hence the aim of the reform, assuming that finances and their profits are not reserved for a select, informed group, "should be to get the best out of finance for the greatest number of people whilst minimising the risk of instability." Rajan proposes a dozen specific lines of action.

Enhance the access to opportunities in the USA

"The USA must avoid an increase in actual and perceived social polarisation. (…) The best way to reduce unnecessary wage inequality is to reduce inequality in the access to better human capital. (…) If nothing is done, inequality will perpetuate itself."

Rajan believes it is essential to enhance the quality of human capital. To do so, he suggests preventing child poverty, ensuring universal, quality schooling and providing aid for universities. Furthermore, quality human capital can only be achieved by guaranteeing a system that provides social and physical protection and safeguards for all society, and by encouraging savings.

Put an end to the imbalances of the world economy

"In recent years, the USA (and other countries such as the United Kingdom and Spain) have consumed more than they produce or earn and have, therefore, been borrowing to finance the difference. Poor countries such as China and Vietnam have been doing the opposite". In the interests of macroeconomic prudence, countries with large deficits will have to save more. But if the aim is to stop the world economy slowing down, then exporting countries must spend more. To achieve these changes, new roles must be assigned to G-20 and, above all, to the IMF. It was easy for G-20 countries to agree on the initial response to the crisis: none had to pay anything for the coordinated stimulus policy. But putting an end to the imbalances of structural imbalances calls for politically painful economic reforms in each country, “reforms that seem to focus more on helping other countries in the short term than helping the reforming country itself.” “The reason why everyone blames other people is not because they don’t understand their own responsibility, but because none of them (…) can really commit themselves to taking the necessary measures” because of the short-term political and social costs, whilst the benefits of these measures will only be felt in the long run.

Today the IMF, the body responsible for international macroeconomic coordination, is in no position to force countries to undertake the necessary reforms. Unlike the WTO, it cannot impose penalties, nor will it be able to in the future. The only way to get the IMF to promote the reforms that the world economy needs - and avoid another crisis like this one – "is to increase its influence by appealing to the citizens of each country more directly." If the IMF is able to explain to a country’s citizens the multilateral, long-term benefits of reforms that have unilateral and short-term costs, then the governments of those countries will be more willing to carry them out. In keeping with this greater influence the IMF should recruit more staff from outside the USA in order to broaden its intellectual horizons.