Summary of Interview with Raghuram Rajan regarding the book Fault lines
Full Interview Available at http://docshare01.docshare.tips/files/23285/232850935.pdf
(to be used as additional reading for Unit 5 last chapter)

The book, *Fault Lines*, is basically taking the standard explanations for the crisis and asking, are these sufficient?

What are the standard explanations?

To caricature them, we have greedy, conflicted bankers—when you talk about conflicts of interest, when there's no conflict, there's no interest; that's the banker's view—and pliant regulators. These two were at the center of the crisis. It was because of them. And what we need to do is fix the bankers, make them less greedy, *change incentive systems*, et cetera, and fix the regulators. Give them a lot more regulations to implement, forgetting that they didn't implement the old regulations in the first place. Then we fix the system, and we're done. We can go ahead and do everything we did before.

This is *extremely simplistic and worrisome*. **We have to ask why there was a crisis in the most sophisticated financial system in the world and why regulators, who seem to have avoided previous crises**—why is an industrial country's system different from an emerging market? Because, we believe, the institutions are stronger. **Why did the institutions break down this time? What happened? What was driving all this?** If, in fact, there are some deeper forces, **how do we know those forces won't act up again and, even now, aren't acting up?**

My argument is, yes, there are what I call serious fault lines in the U.S. and the world economy, and the financial sector was at the center of those fault lines. [The problems are more systemic in nature]

This is not to absolve the bankers. This is not a defense of what the bankers did. They were neither innocent nor victims. But they did respond to implicit and explicit incentives that the system created. Therefore, we must make sure that those incentives aren't created again, as we would suffer.

I think an equally simplistic view of the regulators is that they were driven by laissez-faire ideology. This was, "The market works." Yes, there was some of that. But also I think they had a deeper and in many ways appropriate agenda, which interfered with the regulatory system. In a sense, we had the perfect storm, with everybody following what were in many ways reasonable courses of action when taken alone but, when taken together, were calamitous.

Three fault lines emphasised and consequences for Financial sector

1. Growing inequality, not just in the United States—though I emphasize the United States in the book—but elsewhere also.

There is 90-50 hourly wage differential. What does that mean? Take somebody at the 90th percentile of the wage distribution in the United States, compare their wage with the 50th percentile wage, and plot that over time. You see that the 90th percentile wage earner, who is typically a manager in a store, is walking away quite fast from the person at the 50th percentile, who is usually an office assistant or a factory worker. You see that difference is not between the 50th and the 10th percentiles. That's the second line there. The 50th to 10th percentile is fairly flat. It is the 90th to 50th percentile.

This, to my mind, is a profound source of concern. What's driving this? Why the 90-50 inequality? I think the best answer is given by two professors at Harvard University, Larry Katz and Claudia Goldin. They basically argue that it's not technology. Most people argue that technology is running away from us and that's why we need more and more skilled, educated people.

In truth, technology has been on gallop throughout the century. We talk about Facebook and Internet and so on. At the beginning of the 20th century, it was chemical plants, large, integrated chemical plants, which hadn't been seen before. They were as much of a leap for people moving from the farms as the Facebook and Internet and so on are for people moving with a high-school degree into the cities. *Technology has been on a gallop throughout recent history.*

What has happened is that *the supply of highly educated people has fallen behind*. To give you a couple of examples, high-school graduation rates in the United States have been stagnant, stagnant since the 1970s. You can get a little more action if you add in graduate equivalency diplomas, but those aren't really worth the paper they are written on. In truth, America is falling behind as far as high-school graduates go.

But we don't just need a high-school graduate nowadays. The 90-50 differential reflects a college-to-high school differential. We need people with a college education. That's extremely worrisome. The graduation rates for males for cohorts born in the 1970s are no different from the graduation rates for males born in the 1940s. So we haven't increased the number of male graduates. Female graduates have moved up. That's sort of positive. But for male graduates, there has been no difference.

This is a massive problem. Really, the roots are complex but lie in some combination of families breaking up, communities becoming more dysfunctional, inadequate preschool preparation, and inadequate K-12 experience. Every president, of the last so many, has said, "This is a major problem which I want to address."

But it's a difficult problem. It involves massive transformation, which is difficult.

My argument in the book is that often, if you look at every emerging market, bad policy emerges from inequality. Why? Take what happened with the subprime prices. As more Americans were left behind, in perception if not in reality, you had increasing polarization. It's well known that Congress has become more polarized over time. There are studies of this. But it also makes these issues of inequality harder to tackle. There is no political support for redistribution. Of course, it entails massive incentive costs and so on.

One of the judgments implicit that many politicians may well have made over this time is, what do people care about? If we can't give them incomes, perhaps we can give them consumption. How do we give them consumption? Credit growth often—and again I appeal to emerging markets—eases the way you expand consumption.

How do you get credit growth? The tool that the government had either directly under it or that it could influence was housing credit. So you had this massive push towards housing credit, both from the Clinton Administration and the Bush Administration. This was a bipartisan effort. It was a bipartisan effort which had no opposition from the Democrats, because clearly it was sending money towards their preferred constituency and creating homes. Who could object against homes and wider homeownership? For the Republicans, they felt they were building new constituents, property owners, homeowners. Of course, homeownership is a good thing in society.

The one thing that *The Village Voice* suggests that the Clinton Administration and the Bush Administration agreed on was homeownership, and they pushed it massively, with massive infusions of money. But there were other instruments that were used. Interestingly, many of these instruments were created to deal with the mess in the Depression and gave the government the entryway into housing. The Community Reinvestment Act was applied and enforced for the first time in the 1990s, except, of course, the 1970s act, which wasn't enforced. The Federal Housing Administration reduced its lending standards, sent more money. A wall of money went towards low-income housing.

This is important. It's hard to imagine that the private sector suddenly woke up one day and had a social conscience and said, "We have to finance low-income housing." Why did that happen? Why so much money went that way was because this was fundamentally good intentions on the part of the government—we want more homeownership—but done in a way which actually created massive distortions in the financial sector.

So the fault line here is rising inequality and the political pressure to do something, typically, across countries.

2. **<u>The second fault line is an international fault line</u> <u>– Export-led Growth and dependency</u>**

Post-war Germany and Japan were flat on their backs, capital stock largely destroyed, people very poor as a result of the world. How did they grow? They basically latched onto an export-led growth strategy, because there was no domestic demand. Their banks and governments basically focused on creating strong producers who could service the foreign demand, create domestic jobs, and help these countries grow out of the poverty created by the war.

This was an extremely successful strategy. There is no period in history, other than through conquest, where a country has grown faster than Japan grew between 1950 and 1973—per-capita growth rates of 8 percent a year. Never before in history has that been seen. We have seen that since with China, but never before had you seen it, when Japan came on the world stage.

There were a bunch of things which helped it. They focused on exports to a hungry world. In many ways, it set the example for the East Asian economies, for economies like Korea, Taiwan, eventually Chile, and now China.

What is central to the strategy is that you help the producers, typically by discriminating against the households, and you keep the producers honest by forcing them to export, because then they are forced to compete in the world economy and that keeps them relatively efficient. And it worked. In many ways, for a development economist, when you look at this, this is probably the only strategy which has worked in terms of pulling countries out of poverty quickly. I think India has perhaps one alternative strategy which is not export-led growth, but we can talk about the ways India's is different a little later.

However, <u>there is a deep flaw in this strategy</u> - **while you can get your export sector to be very disciplined, very competitive, the strong intervention that is entailed in this kind of growth strategy means that many domestic-oriented producers tend to use the government to make their industries uncompetitive. So these countries have very strong export sectors, very weak domestic-oriented producing sectors, very inefficient producing sectors.**

The broader point is, we have a bunch of exporters in the world who don't have strong sources of domestic demand who are pumping goods into the world economy. Those goods are looking for buyers. That creates a deep problem, because it wants countries to overspend to buy those goods. If I tell you that in the 1990s, the countries that overspent were the emerging markets, in the 2000s, the countries that overspent—it sounds like a rogues' gallery of countries that are now in trouble—the United States, the U.K., Greece, Portugal, Spain, to some extent Italy, but not that much. Who are the countries in trouble now? Many of the countries that spent beyond their means.

The point I'm trying to make is that the second fault line is that you have export-dependent countries that now are unable to pull back. ***That strategy was very good in taking them to growth, but now it's very hard, because they are surplus countries and are forced to look for other countries to overspend—in a sense, others to take the counterpart. In a sense, they are looking for the weakest countries in the world, and that's a problem.***

3. <u>The third fault line is that the nature of U.S. recessions has changed</u>

U.S. recessions used to be in and out. You went in, you came out. Why? Because firms cut jobs, in the auto industry, for example. As soon as demand started coming back, they went quickly to rehire. Typically, it took two quarters for growth to come back, eight months to recover all the lost jobs—not just for job growth to be positive, but to recover all the lost jobs from the depth of the recession. That's why the thin U.S. safety net—you get unemployment benefits for six months—seemed to work reasonably well. You had enough while you were looking for a job and typically the jobs came back.

Something changed starting in 1990-1991. In 1991, it took three quarters for growth to come back to the levels that it was before, but it took 23 months for jobs. In 2001, it took one quarter for growth to come back, but it took 38 months, three and a quarter years, for jobs to come back. What do we know about the current recession? For us to recover the jobs that were lost in this recession, by most economists' count, will take about four more years.

That's the kind of unemployment we are now seeing. **The question we have to ask is, is the safety net adequate for the kinds of recovery we have seen?** Why do I say this is important? Because policy is often driven by politics, and politics is driven by public anxiety, and public anxiety is driven by the fears of unemployment, not just from those who are actually unemployed, but those who prospectively could get unemployed. What we have seen again and again as far as **government policy goes is that policy driven by a crisis is not good policy.** But more than the fiscal stimulus I want to point to is the monetary stimulus, which, to my mind, is even more problematic.

People say Greenspan was asleep on the job. Why didn't he raise interest rates? Why didn't Greenspan take a more active role in regulation? I want to argue that no central banker would be brave enough to raise interest rates when unemployment is where it is. If jobs aren't coming back, nobody is going to raise rates. That was true of Greenspan. It is true of Bernanke right now. In fact, Greenspan went further and said, "Look, you guys are worried about investing. I'm assuring you, if there is a double dip, I will come in and pour more money into the economy." This was a famous Greenspan quote, saying, "I will plug the economy with liquidity if, in fact, you have a problem."

These kinds of government policies are a response to the political inadequacies of the safety net to some extent. But they create incentive distortions in the financial sector. As you often say, the road to hell is paved with good intentions.

These kinds of fault lines, in some sense, create the underlying incentive structures for the financial sector. Lets focus on one. <u>Why were low-quality mortgage-backed securities created? What does all this have to say about it?</u>

The explanation is actually quite a simple one. There was a wall of money which was pouring into subprime lending to fulfill these congressional mandates. There is documented evidence from former employees of Fannie and Freddie on how much went into these areas every year. There was an accompanying wall of money coming from outside from the surplus countries which were trying to sell to the United States. These guys were looking for high-yield safe securities, the triple-A mortgages that became infamous during this crisis.

With the tremendous amount of money flowing into the financial sector, for noneconomic reasons, from outside—much of it was being sent by central banks that wanted to, in a sense, preserve the value of their currency against the dollar and maintain competitiveness. From inside, it was to fulfill the congressional mandates, not so much from a profit perspective. Given that all this money was not that focused on pricing, it distorted prices in the sector. The financial sector, when it knew that you could sell these mortgage-backed securities to people who didn't ask questions, went out and created a whole lot of rotten mortgages which then were financed.

What is it in the financial sector that makes it focus only on prices and not on whether you are getting a grandmother who can't afford the house into the house? **I want to argue that the nature of the financial sector is such that it makes you focus on whether you are making money or not. That, in many ways, is a good thing, except when the prices get distorted.**

A quick example. Most people care about whether their work has value. I think the financial sector is no exception. So when we say "greedy bankers," why did they suddenly become greedy and without social conscience?

The point is that we care about the effects of our work. We want to see these things, and the more we see it, the more we want to build good things. *The problem with the financial sector, to some extent, is that it has become an arm's-length transaction-oriented financial sector. In many ways, this is a good thing. It allows risk to be spread. It allows us to do things that enhance value,* ***provided the market prices are right.***

For example, a short seller who is selling Enron because he thinks the accounting is flawed, and makes a ton of money doing that, is providing a service to society, because he is putting Enron out of business, and Enron wasted tremendous amounts of resources in this society which could have been better utilized elsewhere. But if he looked at Enron and saw the people going to work every day, saw the people who would lose their jobs, he would be a little less motivated to sell the shares short. Compassion would be a bad thing in this case. The fact that he is at an arm's length is a good thing.

But it depends very much on the prices eventually being right, that Enron would collapse in price and he would make a ton of money. If every stock that he sold short collapsed in price, there would be an incentive to distort the economy.

Similarly here, if people were willing to buy any garbage that you sold—think about the broker there who is talking to a client. You know you are not going to see this client ever again. You know that out there people are waiting to buy any mortgage that you can put out, because they are packing it and selling it to German banks that don't ask any questions. When you have that kind of structure, immediately you lose all sense of anchoring, because the prices are telling you, "Do more of it. Do more of it." And they did more of it—Countrywide, First Century. The rogues' gallery there is pretty strong.

But you don't have to portray these guys as evil. They're like us. They're probably here. It's the incentive structure which, when distorted—when prices get distorted, the modern, sophisticated financial system can go a long way.

Bottom line: I started by saying, can we blame the bankers? Can we blame the regulators? Yes, they do deserve blame. But in many ways, you can well imagine that there is some truth to Lloyd Blankfein's statement that they thought they were doing God's work. The prices were telling them they were doing God's work. We need to go back and ask why the prices were distorted. Why did things go haywire?

I think, for that, we have to step back and ask a fundamental question about our society: Are we too unequal? Should we improve access in the society? How can we improve access? Can we do the right things, instead of doing the palliatives and the wrong things which take us off course? Similarly, do we need a stronger safety net? We have to trade off. The U.S. has always had a flexible economy, which has been a source of innovation. If we increase safety nets to the level that they are in Europe, maybe we will lose some of the innovation. How do we make this tradeoff? What are the right metrics we should think about in doing this?

Those, to my mind, are the serious questions we have to ask, in addition to, of course, how much we regulate, how we restructure the financial system. There are key questions there. For example, we have got to a point where too many institutions are too big to fail. We have got to the point where the standard response to anything is, "Bail it out." Of course, anticipating we'll be bailed out, we have lots of strange incentives.

One of the things I have left out in all this discussion is, why did the bankers, who knew the garbage that was in the mortgages, buy the stuff and hold them on the books? That's for you to read in the book, if you ever get to that. But the point is, the problem is not the government. The problem is not the financial sector. The problem is the interface between the two, which is driven by some of these larger considerations that I talked about—the fault lines, so to speak—which create a perverse interface and create the kinds of problems that led to the most sophisticated financial system in the world behaving exactly like an emerging market. To get away from this, we need to fix those underlying problems. And that, to my mind, is a much bigger agenda than what anybody is talking about.