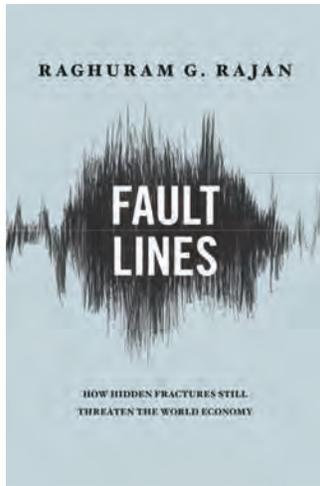


Book Review



Fault Lines: How Hidden Fractures Still Threaten the World Economy

by Raghuram G. Rajan
Princeton University Press 2010



Reviewed by
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Recently in the *New York Times Book Review*, historian and journalism professor David Greenberg lamented a recurrent feature of the social criticism genre—the disappointing ending. That’s when authors lay out a fantastically intricate explanation of what went wrong, only to fall short in suggesting a fix.

Maybe Greenberg hadn’t come across *Fault Lines: How Hidden Fractures Still Threaten the World Economy*. Raghuram G. Rajan, a professor at the University of Chicago and former chief economist at the International Monetary Fund, proves the exception to Greenberg’s

rule of unsatisfactory endings. Where others have delved into the personalities and perverse systems that led to the financial crisis and then summed up with a half-baked list of policy ideas, Rajan puts a premium on policy. In fact, nearly half of *Fault Lines* is dedicated to policy choices that Rajan believes are not only realistically achievable but likely to be quite effective. He makes a good case.

Rajan writes with the authority of his credentials: He is both a top-flight economist and one of the few skeptics who raised frequent and grave concerns about the world’s overleveraged financial system in the years building up to the crisis. His recollection of the 2005 Jackson Hole Conference, where he delivered a stern warning about mounting financial risks to an audience of disbelievers, is both amusing and disturbing: “I exaggerate only a bit when I say I felt like an early Christian who had wandered into a convention of half-starved lions.”

For the most part, however, *Fault Lines* is not a behind-the-curtain look at the personalities behind the financial crisis. Rajan sees the financial crisis through an economist's prism: He follows the incentives. There are no villains, per se; just systems, and institutions, and us. "Somewhat frighteningly," he writes, "each one of us did what was sensible given the incentives we faced."

So the first half of *Fault Lines* proceeds with a sequence of head-slappers. Rajan notes that on-the-job happiness tends to be associated with the ability of people to see tangible results from their work. For a house builder, the satisfaction comes from the house. But what of the banker? His satisfaction comes chiefly from making money, and lots of it.

When subprime lending looked like a stream of unending profits, everybody jumped in. Meanwhile, widening income inequality brought pressure to boost middle-class consumption with easy access to credit. How else would Americans be able to afford their proverbial flat-screen TVs and SUVs? That the Federal Reserve kept interest rates low for so long leading up to the crisis was no coincidence, by Rajan's way of thinking. After all, it was just trying to fulfill its dual mandate of achieving price stability and maximum employment.

It should be noted that the Federal Reserve comes under quite an attack in *Fault Lines*, at one point likened to a gigantic hedge fund. In Rajan's story, the Federal Reserve joined with the private sector to drive subprime lending toward "its disastrous conclusion."

Scores of other financial crisis analysts have more or less stopped their stories right there. Rajan takes the trouble not only to explain what's wrong with the system, but to describe some fundamental ways to change it for the better. Chief among these are ways to ensure that market players fully appreciate the tail risks they are taking—that is, risks whose consequences don't manifest themselves immediately and aren't apparent to others in the short term. Tail risks may be quite unlikely, but if they come true can be devastating. Investors know that if everybody fails, nobody fails because the government will bail everybody out. As Rajan puts it, "failing in a herd rarely has adverse consequences."

What gives Rajan's recommendations force is their place in a coherent, overarching strategy. "Clawbacks" would force bankers to give up some of their earlier earnings—or have a lot of income deferred—until the tail risks had faded. Continuous sharing of financial information with supervisors would fit better with today's fast-moving financial markets. Beefed-up capital cushions would keep institutions safer.

Between these policy recommendations and detailed observations about the problems in our global economy, Rajan takes time to outline the biggest problems—the fault lines. These are indeed wide and dangerous. The fault lines include the housing crisis, widening income inequality, trade imbalances, and the way these imbalances are financed across national borders. Any story that identifies such gaping chasms must of course offer remedies, and that's where *Fault Lines* stands out.

Rajan is careful not to demonize the financial sector. After all, finance provides substantial benefits—think credit cards and money market accounts. Some innovations may not provide much value. The only safe financial system doesn't take risks, and then it ceases to be a financial system at all. The risks go away, but so do the benefits.

This is a wholly expected premise from a Chicago School economist, the kind that will have progressives complaining that Rajan's book is just more of the same. But how to account for Rajan's call for universal healthcare? Or early childhood education? It's clear that Rajan is interested in being intellectually consistent. If you identify income inequality as a fault line, you can't very well ignore it. An honest approach has to take into account the need for both advancing opportunities so that incomes are less widely dispersed, and then acknowledging that the financial system requires us to build a stronger safety net for those who find themselves victims.

Fault Lines was published almost a year ago. While it received its share of accolades, I don't recall much of a buzz around it at the time, though it did win a number of awards. Its critique and policy suggestions remain powerful today.

So to Rajan's list of recommendations toward a better world, I add another: Read *Fault Lines*. And make sure to stick around for the ending. ■