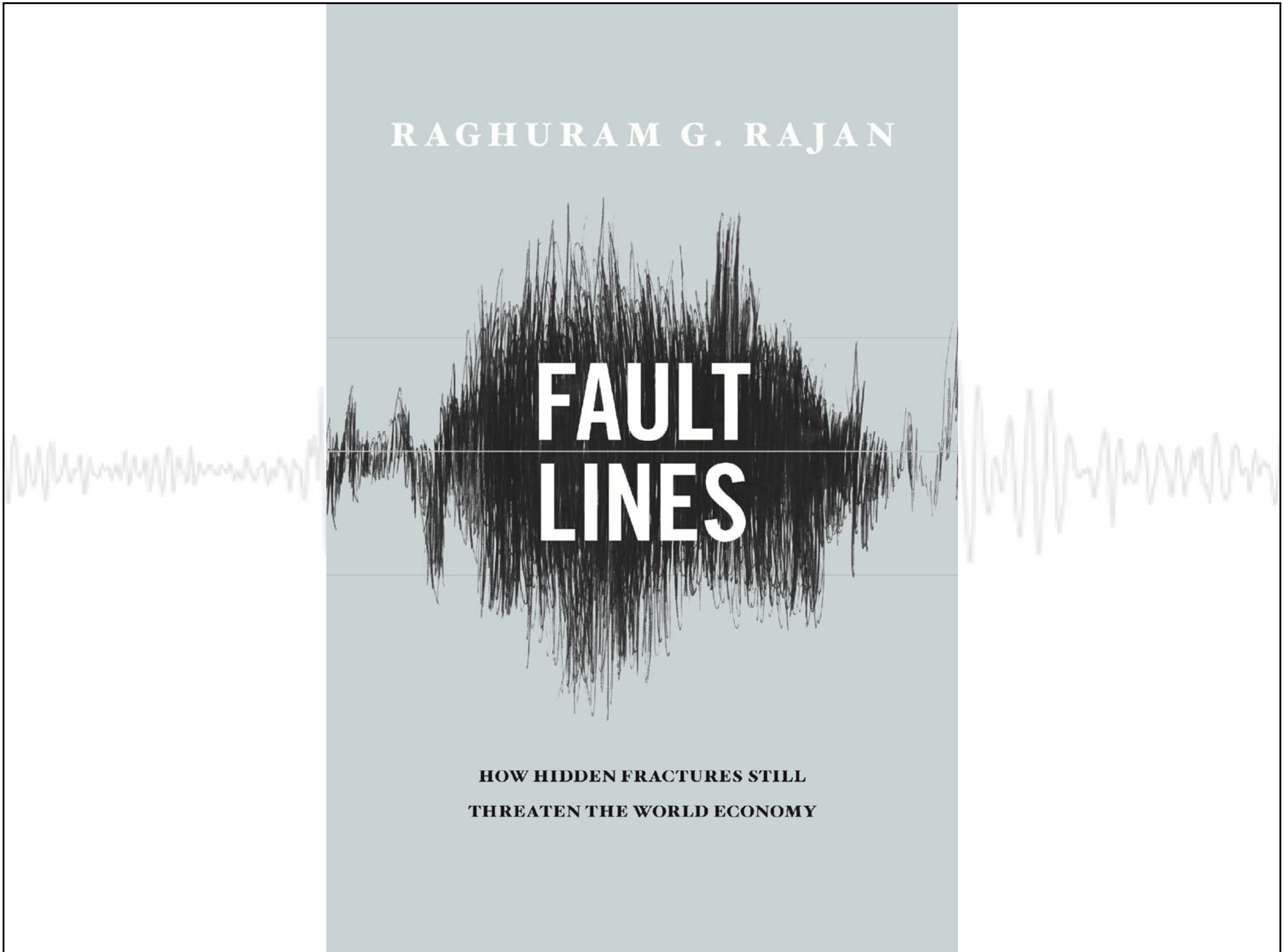

RAGHURAM G. RAJAN
FAULT LINES
HOW HIDDEN FRACTURES STILL
THREATEN THE WORLD ECONOMY

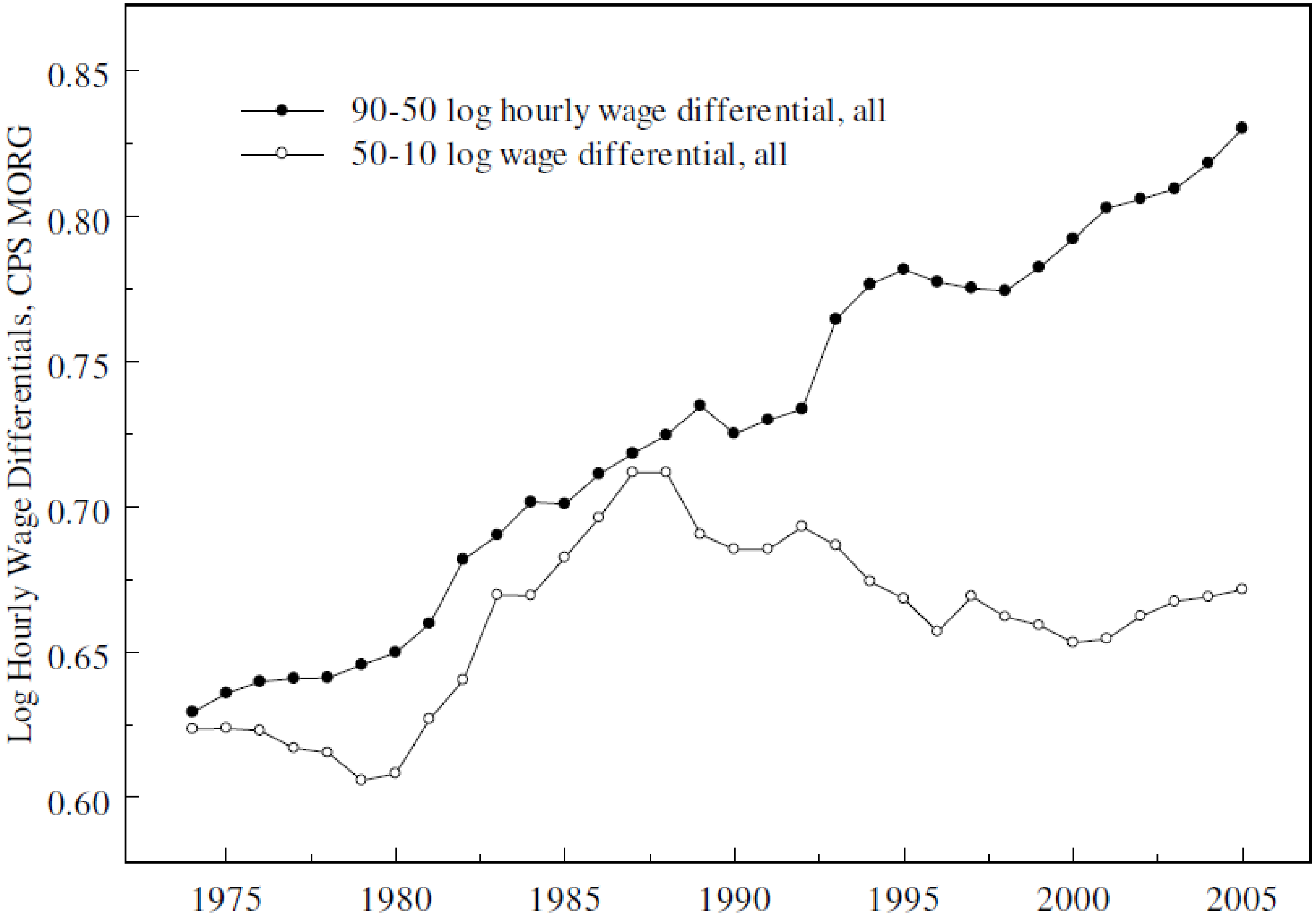
Why did the crisis happen?

- Greedy conflicted bankers, pliant regulators
  - Why now? Why in the most sophisticated financial system in the world?
  - Why sub prime?
- Why does the explanation matter? Because the solutions are different!
  - Shoot a few bankers
  - Stiffen regulatory backbones
- But what if the problem is deeper?

My explanation

- Serious fault lines in the U.S. and world economy
- Financial sector at the center of these fault lines
- Bankers were neither innocent nor victims but responded to implicit and explicit incentives
- Could it not happen again if we do not address the fault lines?

The first fault line – growing inequality in the United States



Source: Golden and Katz 2009

Reason for 90-50 inequality

- Is it technology and the demand for the highly skilled?
- No, it is largely supply. Education is losing in race between technology and education.
  - Stagnant high school graduation rates
  - College completion rates not different for cohorts born in 1970s from those for cohorts born in 1940s
  - Probably due to inadequacies in families, communities, pre-school preparation, and K-12 schooling experience.

Let them eat credit

- As more Americans left behind in perception if not in fact, increasing polarization.
- But education difficult to tackle
  - Redistribution? No political support + huge costs
  - But people care about consumption. So what if they don’t have income growth.
    - Consumption growth through credit growth
    - Better still, home ownership: stake in the future as well as means to borrow
- Affordable housing (Clinton), ownership society (Bush)
  - Instruments: CRA, FHA, Fannie, Freddie
- Fault line: Rising inequality and political pressure to do something.

Fault line 2: Under-spending exporters

- Post-war Germany and Japan, followed by Korea, Taiwan, ASEAN, and now China:
  - Government and bank intervention to create a bias towards producers and develop strong firms
  - Discriminate against households
- But
  - Small domestic market

=> Emphasize exports

- It worked!

But not in all ways

- Inefficient domestic sector – cartelized with the help of the government or banks
  - Haircuts in Japan
- Inadequate domestic growth in normal times, worse in downturns
  - Bridges to nowhere, Japan covered with concrete

=> Fault line: Export dependence and savings surpluses that have to be absorbed elsewhere, especially in global downturns

Fault Line 3: Jobless growth in the United States and an inadequate safety net

- Past recoveries
  - 2 quarters typically for growth
  - 8 months for recovering lost jobs
- Thin safety net – 6 months: Created for in and out recoveries incentive to search and match
- 1991: 3 quarters for growth, 23 months for jobs
- 2001: 1 quarter for growth, 38 months for jobs
- Safety net inadequate for jobless recoveries

Consequences

- Substantial government stimulus
  - But in the shadow of a crisis, opens the way for substantial excess
- ...and Fed stimulus
  - Which central banker would be brave enough to raise rates when unemployment is still high?
  - Greenspan Put
- Fault line: Jobless recoveries and inadequate safety net

What does all of this have to do with the crisis?

- Why were low-quality mortgage backed securities created?
- Why did banks hold on to much of the risk?

Why were mortgage backed securities created?

- Wall of money poured into sub-prime lending to fulfill congressional mandates
- Foreign money came in looking for higher yielding “safe” securities
- Together, they eliminated checks on quality.

More generally

- Bionicles
- Sophisticated arm's length financial sector does not directly see the consequences of its behavior.
  - Making money is both a signal of personal worth as well as social value – doing God's work
- Relies on price signals being right.
- When prices are wrong, can go enormously off-track.
  - What were the Countrywide brokers thinking?
- Wall of price-insensitive money distorts prices and behavior

Why did banks hold on to much of the risk?

- Problem not with government or financial sector, but at the interface.
- “...when easy money pushed by a deep-pocketed government comes into contact with the profit motive of a sophisticated, competitive, and amoral financial sector...”

Hard choices

- Financial sector – focus on getting market signals right
  - Role of government and Fed
  - Restore market discipline
- U.S.
  - Access vs redistribution
  - Flexibility and innovation vs safety net
    - Healthcare?
- Global:
  - How to deal with surplus countries?
    - Does Germany have responsibility for Greece?

THANK YOU