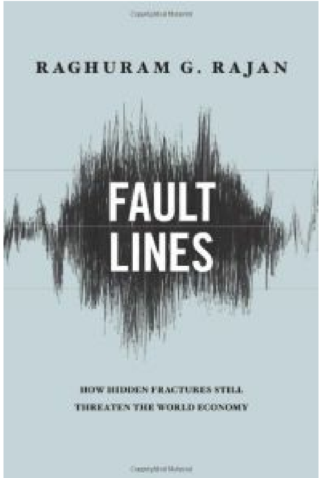

Book Fault Lines

How Hidden Fractures Still Threaten the World Economy

Raghuram G. Rajan
Princeton UP, 2010
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Recommendation

Dismissing the 2008 recession as an inevitable free market setback might seem simple, but economist Raghuram G. Rajan doesn't take the easy path. He makes a compelling case that the weak links in the global economy remain both visible and fixable. In a provocative analysis unhindered by ideological boundaries, Rajan argues against such government interventions as propping up the U.S. housing market. Yet he urges Americans to create a more generous safety net for unemployed workers facing a "jobless recovery." Rajan's more challenging suggestions, such as rebalancing the international economy or changing global monetary institutions, may not shift policy makers' actions, but he argues persuasively that failing to do so will mean deeper fault lines in the next crisis. *BooksInShort* recommends his book to those who want a clear-eyed economic analysis.

Take-Aways

- "Fault lines" mar the U.S. and world economies. These weak spots, or pitfalls, lie hidden below the surface in prosperous times, but become obvious during crises.
- The U.S. labor market's wage gap and its shortage of educated workers are fault lines.
- The export imbalance that mars the economies of China, Japan and Germany also constitutes a fault line.
- Export nations have high savings rates, but buyer nations suffer huge consumer debt.
- U.S. workers' jobless benefits are far stingier than those granted by European nations.
- Lack of a strong social safety net for the unemployed is a fault line that threatens U.S. economic growth.
- Propping up the housing market is a fault line that delays the inevitable correction.
- Cures for U.S. fault lines include reducing government support of housing and markets, and making higher education more available.
- Regulators should cut deposit insurance so banks don't become too big to fail.
- International fault line remedies include rebalancing spending, readjusting exports and reforming international governance agencies.

Summary

The Cracks Beneath the Global Economy

For all its sophistication and complexity, the world economy is filled with weak spots, or "fault lines," that are invisible in good times but become painfully obvious during a crash, such as the recession of 2007 to 2009. One such fault line is the United State's growing income disparity, as illustrated by top earners' widening share of annual earned income. In 1976, the top 1% of households "accounted for only 8.9% of income." That soared to "23.5% of the total income generated" in the U.S. by

2007. Incomes for median-wage earners, such as factory workers, have stagnated. High wages are not inherently wrong; they're a powerful economic incentive that pushes talented, enterprising people to take on valuable pursuits. Yet income stratification creates the danger that workers will begin to think that luck or connections, not work, lead to success.

> "Deep fault lines...have developed because in an integrated economy and in an integrated world, what is best for the individual actor or institution is not always best for the system."

Other U.S. fault lines include the weak safety net for the jobless and the government's insistence on propping up the housing market. These fault lines are more visible in a global, interconnected economy, where central bankers' decisions in Washington affect Japanese consumers and London markets, and can make or break African economies. The global economic landscape is marred with fault lines, such as China, Japan and Germany's reliance on exports for growth.

> "The consequences of the government's pressing an agile financial sector to act in certain ways are often unintended and...costly."

Now, policy makers face the challenge of fixing these fault lines, even if it is politically difficult. The fault lines aren't endemic to a global economy. They result from reversible policy decisions, though changing these rulings won't be easy or popular. For instance, the U.S. Federal Reserve softened the blow of the housing market's collapse based on the rationale that a softer landing would be less painful. But by slowing the pace of the correction, the U.S. is prolonging the recovery and creating inertia among homeowners, lenders and builders. The government also is signaling that profits can stay in private hands, but the public sector will share the losses. This sends a dangerous message that the Fed will ride to the rescue when investors take on too much risk.

America's Gaps in Incomes and Education

The U.S. education system, which leaves many workers unprepared for high tech jobs, is another fault line. The benefits of a higher education are clear. In 2008, the median wage of a worker with a high school diploma was $27,963, while a worker with a bachelor's degree made $48,097 and a worker with an advanced professional degree made $87,775. The "college premium" is obvious, yet the U.S. government hasn't responded by making it possible for more people to earn degrees. College graduation rates have stagnated, so the wage growth of the top 10% of earners has far outpaced that of the lower 50%. The idea that hard work earns rewards is embedded in the American dream, yet many workers are unready to compete in a market that demands fast-changing technological skills.

> "Cynical as it may seem, easy credit has been used as a palliative throughout history by governments that are unable to address the deeper anxieties of the middle class directly."

Politicians have not fixed the educational system or encouraged workers to learn more, both of which would require tough choices and hard work. Instead, policy makers flood the economy with cheap credit that lets low-income earners spend more. The embrace of easy credit crosses party lines. In the 1990s, President Bill Clinton made homeownership a priority. In the next decade, President George W. Bush also extolled homeownership and pushed government-backed lending. Homeownership soared as a sudden glut of subprime loans enabled low-income people to buy houses. But when the housing bubble burst, foreclosures surged, the supply of homes far outpaced demand and financial institutions took huge losses that taxpayers absorbed. Despite this fallout, easy credit maintains its dangerous role as a "political palliative."

The Dangers of Export-Led Growth

Another precarious fault line for the global economy intersects international trade. Exports drive growth in China, Japan and Germany. Consumers in the U.S., the United Kingdom and Spain – countries that tolerate and even encourage high consumer debt – snap up imported goods.

> "Many of today's wealthy nations are rich...because they grew steadily for a long time, not because they grew particularly fast."

In the 1800s, when the U.S. was an emerging market, per capita income grew at 1% a year. Industries and firms expanded gradually, over long periods. A century later, emerging economies grow much faster. The economies of South Korea and Japan went on a two-decade romp as per capita income soared 8% a year, and then they slowed. Such quick growth, which China later experienced as well, skews the economies of export-focused nations. In Japan, for instance, hotels still employ "elevator ladies" whose sole function is to point guests to the next available elevator. This small inefficiency illustrates larger problems in the Japanese economy. Instead of creating prosperity at home, export-led economies rely on growth elsewhere. Japan can't turn to domestic demand for growth. Instead, its culture of thrift and saving forces its factories to rely on foreign buyers. So while Japan is a global manufacturing leader, it lags in such domestic service industries as finance and retail. This imbalance has become clearer in recent decades. A long malaise followed Japan's 1980s asset bubble. Export growth didn't pick up until the U.S. stimulated Japan's economy after the 2001 dot-com bust.

> In "the export-oriented miracle economies...a superefficient manufacturing sector existed side by side with a moribund services sector."

These export-oriented economies have transformed themselves into oddities akin to "someone who exercises only the limbs on one side of the body." China has an even more asymmetrical economy. While its exports have skyrocketed, its consumers are misers, partly because its former government and social safety nets no longer exist. Public sector jobs with generous benefits have disappeared. Population controls mean Chinese elders cannot count on large families to support them, so consumers have a strong incentive to save rather than spend.

Contributing to the World's Oversupply

The lack of connection between developing countries that want to join the global economy and the nations they emulate is another fault line. In the U.S., transparency and arm's-length circumspection are the rule in investments and loans. But in developing nations, relationships reign supreme. When developed-world capital flows into a developing country that has a different business culture, painful corrections can follow. In the late 1990s, Indonesia suffered a 25% decline in GDP in a single year – just one of a number of developing countries that followed a policy of easy credit and heavy consumer spending on imports. Investments dried up during the fiscal crisis. Amid riots and political unrest, Indonesia had to ask the International Monetary Fund (IMF) for money at unfavorable terms. Similarly stung, many developing nations retooled from consumption to production, adding to "the global supply glut."

The Skimpy Safety Net in the U.S.

The U.S.'s lack of a substantial social safety net is also a fault line. The country has long seen itself as nimbler and more efficient than Europe, home to hefty unemployment assistance and health care benefits. By offering few such cushions, the U.S. motivates workers to stay employed, even if they have to move or learn new skills. Yet, as "jobless recoveries" (a recent economic phenomenon in the U.S.) become more common, the lack of a safety net casts many U.S. workers adrift. For the four decades leading up to 1990, U.S. economic recoveries were brisk. But since the 1990-91 recession, the U.S. has seen hiring recover more slowly than other economic activity. After the 2001 recession, U.S. economic output bounced back in three months, but hiring was so sluggish that it took more than three years to recreate lost jobs. Indeed, unemployment rose for two years after the recession ended. U.S. employers use recessions as opportunities to offload unproductive workers and boost productivity through technology rather than new hiring. These jobless recoveries have laid minefields for central bankers. After the 2001 downturn, the Federal Reserve kept priming the pump to encourage job creation and, in doing so, it created the conditions that led to the housing bubble and the subsequent financial meltdown.

> At IMF sessions, "The truth was that everyone contributed in some way to the problem, but no one wanted to be part of the solution."

The U.S. safety net is strikingly smaller than Europe's. While U.S. unemployment benefits typically end after six months, France extends such help for three years. Germany once paid indefinitely, but has set a term of 18 months. The U.S. system also pays, on average, a smaller amount, replacing half of a worker's wages, compared to 57% in France and 63% in Germany. Laid-off American workers face a double whammy: They lose their paychecks and their health insurance, which makes their lives particularly precarious.

> The nations "did not understand their own responsibility because no one...could really commit to the actions that were needed."

This situation may encourage U.S. workers to take their skills wherever they're needed, since they don't have the luxury of waiting around for job offers that suit them. The relative weakness of labor unions in the U.S. as compared to Europe is one explanation for such insufficient social benefits. The heterogeneity of U.S. society is another. Taxpayers are less willing to pay taxes to benefit people who are unlike themselves, such as minorities and immigrants. While this may suggest that Americans are hard-hearted and stingy, by other indications, they are quite generous. The average American gives 12 times as much to charity as the average European.

> "Indeed, these were decisions that even the head of government could not take. For instance, no U.S. president can commit to reining in the deficit: that is a decision that only Congress can take."

The U.S.'s weak social safety net creates unique challenges for the Federal Reserve, essentially the central bank not just for the U.S., but also for the world. Since high unemployment is politically untenable in tandem with a slim safety net, the Fed kept stimulating the economy well after the 2001 recession. If the Fed had been acting deliberately as the world's central bank, it would have begun raising interest rates in 2002. Instead, it cut rates well into 2003. This led directly to the 2008 downfall. The Fed is compounding its earlier mistake by supporting U.S. home prices with low interest rates and loans to the housing market. The Fed's benevolence exacerbated the boom and bust. Bankers and homeowners who knew that the Fed would contain a crisis had an incentive to embrace more risk than they would have without a government backup plan.

Repairing the Fault Lines

How can policy makers fix these fault lines? Here are some ideas for the U.S.:

- **Pay bankers' bonuses a little at a time** – Wall Street's compensation plans encouraged bankers to take big risks during the mortgage securitization boom. A banker could place a risky bet, collect his bonus at year's end and not worry about the outcome. Instead, banks should pay bonuses a bit at a time. Putting a bonus in escrow and reclaiming it if an investment tanks would give bankers an incentive to take risk responsibly, not recklessly.
- **Reduce government support of markets** – While Americans see themselves as scions of free market capitalism, government intervention plays a huge role in private markets. Government-backed lenders dominate the mortgage market, and tax policy favors home ownership. Government must not be a "soft touch" for foolish industries and institutions.
- **Rein in deposit insurance** – Keep insuring deposits at small and medium banks, but phase out deposit insurance at large banks to avoid creating too-big-to-fail institutions.
- **Increase unemployment compensation** – Amid jobless recoveries, paying job seekers more, for longer, makes sense. The formula for calculating benefits should consider the severity of job loss, the pace of job creation and the time span since the recession started.
- **Expand health coverage** – Congress passed a bill in 2010 to make health insurance available to all Americans, but opposition remains strong, some provisions don't take effect for years, and some states already question the plan's wisdom and even its legality.
- **Make professional certifications more mobile** – To encourage mobility, regulations should not force professionals to re-earn credentials when they move to another state.
- **Make college education a lifelong endeavor** – Offer education on demand.

> "Change, whether attempting to enforce global discipline with a stick or encouraging citizens to push for it from below, will not come easily for the multilateral organizations."

Ways to address international fault lines include:

- **Rebalance spending** – Countries with mounting deficits should spend less and save more; countries with "trade surpluses" should encourage spending.
- **Waste less, conserve more** – For economic and environmental sustainability, the world's population must lessen waste and practice conservation.
- **Readjust exports** – Major exporting countries, such as China, should "wean themselves off dependence on global demand," encourage domestic spending and import more. China and its cohorts should "move to a more balanced growth path."

- **Reform international agencies** – Countries must avoid dangerous, “opportunistic nationalism” and foster economic cooperation. That means changes in international structures, from the IMF to the G-20, to enable and nurture global economic cooperation.

About the Author

Raghuram G. Rajan teaches finance at the University of Chicago Booth School of Business. The former chief economist at the IMF, he won the 2003 Fischer Black Prize.