Fault Lines: How Hidden Fractures Still Threaten the World Economy

Archana Patro

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The financial collapse of 2007 and the Great Recession that followed left many economists to rethink and debate about the issue. Why didn't we see it coming? What happened to the usual regulatory checks and balances? What happened to the discipline imposed by markets? What happened to the private instinct for self-preservation? Is the free enterprise system fundamentally flawed? Why was the flood of money that came in from outside the United States used for financing subprime credit? Why was the United States, like any other economies such as Germany and Japan, unable to export its way out of 2001 recession? Why are poorer developing countries like the China financing and unsustainable consumption of rich countries like United States? Why did the Federal Reserve keep rates so low for so long?

Fault Lines is a perceptive, detailed look at where the answers to the questions that were raised during the recession may lie. In the analytical framework of Fault Lines, the crisis was not a pure accident and that more severe crises could arise in future unless the root causes are addressed sufficiently soon. Raghuram Rajan was one of the few economists who warned of the global financial crisis before it hit. Rajan is a professor of finance at the University of Chicago's Booth School of Business and a former chief economist at the International Monetary Fund.

The book acquired a lot of praise for itself after its publication, some of them I would like to include in my review-

"What if financial crash of 2008 was really caused by income inequality? Not greedy bankers, not reckless homeowners, but the ever-widening gulf between rich and poor? This is the startling new theory from Raghuram Rajan"-John Richardson, E Squire

"This is an ambitious project for a book of only 260 pages. It is clear, accessible, but not relaxing; or encouraging."- Clive Crook, Financial Times

"Deserves to be widely read"- The Economist

"Of the many books written in the wake of our recent economic meltdown, this is the one that gets it right" - George A. Akerlof, Nobel Laureate in Economics

The Title "fault line" has been used as a metaphor for the Financial crisis .The book describe the Fault lines that have emerged in the global economy and explains how these fault lines affect the financial sector. One set of fault line stems from the domestic political stresses, especially in the United States, second set of fault line emerges from trade imbalances between countries stemming from prior patterns of growth and the final set of fault line develops when different types of financial systems come into contact to finance the trade imbalances.

The book suggests that many - bankers, regulators, governments, households, and economists among others - share the blame for the crisis. The Author details the hard choices regarding understanding what happened in order to avoid repeating it face in the book.

The book presents two important government distortions in the global economy and their underlying causes. These are (i) the push for universal home ownership in the United States, and (ii) export-led growth in countries such as Germany and China. Together, these policies have led to massive "global imbalances".

The book is divided in to ten chapters. There has been growing income inequality in the United States, which combined with a relatively feeble safety net for the poor and unemployed, has created pressure on politicians to find quick ways to bridge the inequality. Instead of improving the long-run competitiveness of labor force for a global market with a changing mix of industries and required skills, governments have adopted the short-run option "let them eat credit" (the title of Chapter One).

The presence of government-sponsored financial firms in the United States (Fannie Mae and Freddie Mac, in particular) enabled exercising such an option readily through a push for priority lending to the low-income households (sub-prime mortgages).

In case of surplus countries, it has been the problem of "exporting to grow" (the title of Chapter Two).

Countries that had focused on export -led growth learned an important lesson. The temptation of cheap goods and easy money: rapid debt spending invariably ends in tears because managed capitalism is hard for foreign investors to understand and navigate, they respond by retaining the right to exit at short notice ''flighty foreign financing'' (title chapter3).

Central banks have tended to provide massive monetary stimulus to get the financial sector to push the household consumption and real sector investment harder and harder through greater lending and intermediation. Such stimulus, unfortunately, again serves to transfer rents from households to the financial sector (by keeping interest rates low) and produces mispriced risk. Thus, the economy moved "from bubble to bubble" (the title of Chapter Five).

In the later chapters the book explains why we had a crisis now rather than at some other points of time, proposes valuable reforms, focusing on all three issues: building a better safety net in the United States, reducing the global imbalances, and improving the regulation of the financial sector rather than governments and Central Banks passing on these costs to taxpayers.

The book also helps to understand why export-based Chinese and German growth, and their effective vendor financing of consumption in the US and Euro-zone countries, may ultimately face limits as consumption slows. These countries are now being forced to become the stimulators of growth and run the risk of planting seeds of bubbles in their own economies. These is how hidden fractures still threaten the world economy, as the book's subtitle goes. The book also leads one to consider that the slower growth of India compared to China is not entirely faultless. However it might be more balanced given its lack of extreme export reliance.

Besides the Ten chapters there is a special chapter on India (Afterwards what lies ahead for India)- which is possibly the most thought-provoking contribution by the author.

There is a lot of value addition one can get from this book .The content and facts are fully justified with simple examples and cases (even has a fascinating poem recounted in the chapter "The Fable of the Bees Replayed"). It is accessible to one and all. I found the language to be very simple and gives a feeling of reading a story book, i.e. the author has tried to make every possible effort so that while reading we may enjoy its flavor of understanding the complex issues in a simple way. If anyone have the anxiety of how the world economy works: interest rates, currency devaluation, credit spreads....and every other term in economics then he must read this book.

Archana Patro is a doctoral student in the area of Finance & Accounting at Indian Institute of Management Indore. She has about four years of teaching experience and has also worked with Bajaj Allianz Life Insurance. Her areas of interest include IFRS, Behavioral Finance, and Risk Management. During her teaching assignment she was also in-charge of the Faculty Development Programs and publication of Institutional journals.