OBSERVARE
Universidade Autónoma de Lisboa

ISSN: 1647-7251
Vol. 2, n.º 1 (Spring 2011), pp. 151-155

JANUS.NET
e-journal of International Relations

Critical Review

Rajan, Raghuram G. (2011). *Linhas de Fractura – As fracturas escondidas que ameaçam a economia mundial* (*Fault Lines: How Hidden* Fractures *Still Threaten the World Economy*). Lisbon: Babel: 429 pp. ISBN 978-972-22-3024-7 (Translated by Carla Pedro)

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This is the Portuguese edition of a book about, according to the first words written on it[1], "the financial collapse of 2007 and the "Great Depression" that followed". In other words, this is a book about the newly enshrined word, the "crisis" which shook the financial world in the U.S. and Europe, and which, due to the configuration of the world economy, impacted on virtually all sectors of society worldwide, something we are still experiencing.

It is a very compelling book, essential for anyone wishing to know more about this issue. The author has a PhD in economics from MIT, and he has been the IMF's chief economist, professor of finance at the University of Chicago and contributor to the Indian government as an adviser and chairman of the committee for the regulation of the financial sector. Such a curriculum, in addition to winning the Fischer Black Prize awarded by the American Finance Association, leaves him particularly well placed to deal with this topic.

However, this is also due to the fact that he was one of the economists who predicted this crisis. The episode of his participation in the 2005 meeting of the Jackson Hole conference is often cited. This conference annually brings together the governors of main central banks, and experts in the fields of economics and finance are invited to submit their contributions. The work he presented at this meeting - titled "Has financial development made the world riskier?" – advanced that prediction and had a visible impact on the audience because, as the author writes in his Introduction, "it was not in tune with the general tone" which, at the time, marked the discussions on issues relating to the financial industry.

What makes this book indispensable is the recognition it attained, having been considered the best business book of 2010 and awarded the Financial Times/ Goldman Sachs Prize.

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[1] The original book is Rajan, Raghuram G. (2010). *Fault Lines: How Hidden Fractures Still Threaten the World Economy*, Princeton University Press. The edition from which the translation into Portuguese was made is not mentioned.

The book was written for an audience broader than just specialists in this area, and focuses on the economy of the United States[2], the home of what is deemed to be the most sophisticated financial system in the world. Accordingly, the main question that occurred to me when I was asked to make a presentation for janus.net, was to know whether a book that was just written in February 2010, when the crisis is not yet over, and centred on the North American reality, could be of interest to Portuguese speaking readers who are not specialists in this field, because, should that be the case, they would have already read the English version. And I also wondered about the contribution the book could make to readers who are experiencing the crisis from a Portuguese and European perspective.

Portuguese readers who are aware of the news and debates in the general media, are exposed to the social environment, have seen the film "Inside Job", and read the references and jokes circulating on the internet[3], not to mention the Memorandum of Understanding agreed between Portugal and the "Troika"[4], will not find that the topics exposed in the book or even the language used constitute big news. However, I think readers will benefit from the reflections that may arise from reading the book, and from the comparisons they will be able to make between events described in the book and those currently experienced in Portugal and elsewhere in Europe. Nevertheless, readers should not stop being critical, because both the arguments used and the theses are not irrefutable[5].

The book focuses on the forewarnings resulting from the crisis and proposes a set of reasons for explaining it, putting them in context and analyzing them. This analysis is the starting point from which the author presents what he believes to be the difficult political choices that will fight the real causes of this and potential future crises.

The approach method the author uses is based on the concept of 'fault lines', i.e., sets of interacting forces which cause huge tensions which, in turn, generate crises, like the fault lines created by the contact or collision of tectonic plates on the Earth's surface, which result in earthquakes. He believes that these fault lines are in fact systemic, and he moves away from the explanation he classifies as simplistic, according to which the crisis could be explained only by the behaviour of individuals or specific institutions.

Besides an "Introduction" and an "Epilogue", the book is divided into ten chapters. In the first seven, the author explains all three sets of fault lines he has examined. The last three chapters are dedicated to reforms and other proposed policy measures. These three sets of fault lines are the result of the contact (i) between politics and financial markets, (ii) between countries, especially among the economies that consume too much, like the United States, and those that do not consume enough, such as Germany and Japan and, increasingly, China; and (iii) between different types

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2 A useful book with a non-American perspective of the financial system, based on the experience of European countries, is: Dewatripont, Mathias; Rochet, Jean-Charles and Tirole, Jean (2010). *Balancing the bank: global lessons from the financial crisis*, Princeton University Press.

3 *Subprime Crisis* by Bird and Fortune (http://www.youtube.com/watch?v=mzJmTCYmo9g) is quite an interesting example.

4 On this, see the commentary on Collaterized Debt Obligations and on the *European* Financial Stability Facility (EFSF) by Zingales, Luigi, published in *Negócios Online* (Online Businesses), on 7 January 2011, titled *A alquimia financeira da Europa (The financial alchemy of Europe).* (http://www.jornaldenegocios.pt/home.php?template=SHOWNEWS_V2&id=461849)

5 On this it is interesting to read Paul Krugmam's critiques of some of the theses and arguments advanced by Rajan in his book (http://www.nybooks.com/articles/archives/2000/sep/30/slump-goes-why/) and also Rajan's actual reply (http://forums.chicagobooth.edu/faultlines?entry=24).

of world financial systems, specifically between transparent and non-favoured financial systems – like in the U.S. and in the UK - and less transparent financial systems that exist in most part of the world, given that they operate based on different principles and are subject to different forms of government intervention, which means they tend to distort the functioning of each other whenever they finance each other.

The most important example of the first type of fracture line is the one that results from rising income inequality in the United States – which the author attributes to the insufficient results of undifferentiated socialization of education and learning in general, which has been generating deficits in the human capital that the U.S. economy needs - and the political pressure that was created to facilitate credit giving.

In this situation, the political response to rising inequality was to use credit as a stopgap: consumption not supported by a low income may be supported by affordable credit. "The benefits - increased consumption and more jobs - were immediate, postponing the payment of the bill into the future" (p. 24). In particular, the author discusses the controversial policy to promote wider access to home ownership.

Another example of fracture resulting from contact between politics and financial markets, to which the author gives great importance for its harmful effects, is precisely how the U.S. monetary policy is influenced by political considerations, along the same lines of credit facilitation, in order to respond to a situation where economic recovery is done without an increase in jobs, in a country where the duration of unemployment benefits is short and medical care benefits are not available to the unemployed. Hence, a policy of low interest rates stimulates job creation, but in a deregulated financial market, it turns out to have adverse effects by causing the price increase of raw materials, the price of assets that are not remunerated by interest, the tendency for the financial sector to take more risks and make credit more easily available.

Going beyond mere economic logic, "the economic recovery has everything to do with jobs, not with production, and politicians are prepared to offer fiscal and monetary incentives to the economy until jobs start to reappear" (p. 34). The second series of fault lines emanates from the contact between economies with high levels of consumption and economies with relatively lower levels of consumption. In the first case, we have the United States, which, according to the book and as a result of their relative scarcity of savings, funded "... their expenditure in 2006 by borrowing about 70% of the world's surplus savings" (p. 363). In the second case, the author refers in particular to Germany, Japan and China, countries that have based their growth on exports. This means they had surplus production capacity with regard to their domestic consumption, which enabled them, in the late 1990s and in the 2000s, to meet an important part of U.S. demand. In this context, the author finds a second fault line: the excessive dependence of countries with growth based on exports vis-à-vis foreign consumers, which undermines the global economy for the pressure that these countries exert on importing countries to maintain their pace consumption, since their protected and inefficient domestic markets are unable, by themselves, to promote the growth of their own economies.

The last set of fault lines was brought about by the contact between different types of financial systems. On this topic, three main sets of considerations stand out in the book. The first deals with "the flighty unpredictable foreign funding”, putting emphasis on the reasons why, in the process of "developing countries" seeking financing, the tensions and confrontation between the consequences of their "less transparent financial systems", which is the result of assistance given by banks and governments - and the "more transparent" financial systems of the lenders, contributed to those countries becoming net exporters, and thus cease to contribute to the absorption of global oversupply.

The second set of considerations exposes one of the weaknesses of "transparent and non-favoured" financial systems: the fact that investors trust, without much scrutiny, their safety, in addition to the ratings they attribute to assets traded in these systems, as well as the market prices that are formed therein, leaving them unprepared when something does not work that well.

Finally, the author examines the explanations advanced for the behaviour of financial agents who helped trigger the crisis, leading them to exaggerate their risk taking.

The policy measures the author proposes to remedy and especially prevent future crises, presented in Chapters 8, 9 and 10, leave, somehow, a feeling of dissatisfaction. Let us examine how they are presented right in the "Introduction":

"There are no miracle solutions. The reforms will require careful analysis and sometimes a tedious attention to detail. I shall examine this topic (...) by focusing on more comprehensive approaches. My proposals, if implemented, could substantially transform the world we live in and make it leave the path of deepening crisis for a path of greater economic and political stability and cooperation. (...).Reforms will require societies to change their way of life, how they grow and how they make choices. They will involve a significant short-term pain, but, in exchange, we will attain enormous and widespread long-term gains. These reforms are always difficult to sell to the public, so they are not very attractive to politicians. But the cost of doing nothing is perhaps a worsening of the turbulence we experienced recently, because the fault lines, if not identified, only tend to deepen even more"(p. 42).

When we read these proposals, some seem superficially presented, and some side effects appear to have been neglected; and those steps that appear necessary to make are few and far between, especially those outside the scope of strictly monetary and financial matters. This is further aggravated by the fact that some have not been implemented and others were so skewed that fail to guarantee that, as originally worded, they would have been effective.

Chapter 8 is about reforming the financial sector, and considers that the main issue is to make the private sector re-evaluate risk properly, without assuming that the government will intervene. "Transparency will need to be encouraged to make people interested in monitoring the relationship between the government - or the regulator - and the financial sector. Much of what I propose falls short of the expectations of those who want drastic solutions" (p. 326).

The author then presents a list of measures that are certainly not alien to the reader and which were in general widely referenced in the media, whose implementation has been attempted or achieved. These measures are related to salaries and incentives for managers of financial firms, to the distortions in assessing risk, managing the expectations of government intervention, the end of government subsidies and privileges to financial institutions, the introduction of a type of regulatory mechanism that is cycle-proof, comprehensive, non-discriminative, and cost-effective, and also to measures related to competition and innovation...

It is interesting that the author suggests that "one possibility is to keep the deposit guarantees for small banks which, in turn, should pay a fair insurance premium, reducing them gradually in the case of larger banks, until they are phased out "(p. 322).

The chapter titled "Improving access to opportunities in America" proposes reforms in the U.S. economy, which, as expected and given the prominence given to the respective fault lines, are related to quality improvement of human capital and strengthening the safety net both for the protection of the unemployed and for access to health care, security of pensions, labour mobility, and, marginally, to encouraging savings and fiscal policy.

In the last chapter ("The fable of the bees replayed"), the author addresses the question of current international economic relations, the role of multilateral organizations and, in particular, the positioning of China in this context, without explaining who will make a change in the *status quo* and how.

Two final considerations:

One may argue whether this crisis is more or less similar to previous ones or if it is completely different. Reading this book also helps to reflect on this. At least apparently, when one casually leafs through a book on financial history, the general features of all crises are alike. Does the germ of the crisis in the financial industry have a congenital and chronic nature?

Consider, for instance, this description referring to an event that took place in the eighteenth century: "Warsaw organized a major bills of exchange business, which was based on, and aimed to guarantee, the usury of bankers. In order to get money they could lend to the great squandering lords at an interest rate of 8% and above, they sought and found outside the country bills of credit that were not based on any trade in goods, and that the foreign drawer accepted indulgently until the remittances obtained by means of speculation failed. With the bankruptcy of Tepper and other highly reputable bankers in Warsaw, they paid dearly for this business”[6].

One may equally argue whether “the financial sector actually contributes to economic growth and well-being or whether it is only a secondary element, largely irrelevant, that only makes its presence felt when it periodically implodes" (p. 282).

It would be highly desirable not to have any doubts about these two issues.

How to cite this Critical Review

Paiva, Amadeu (2011). Critical Review of Rajan, Raghuram G. (2011). *Linhas de Fractura – As fracturas escondidas que ameaçam a economia mundial*. Lisbon: Babel: 429 pp. ISBN 978-972-22-3024-7 (Translated by Carla Pedro), *JANUS.NET e-journal of International Relations*, Vol. 2, N.º 1, Spring 2011. Consulted [online] on date of last visit, observare.ual.pt/janus.net/en_vol2_n1_rec3.

6 Büsch, J. G. (1808). *Theoretisch-praktisehe Darstellung der Handlung...*, 3rd ed., volume II, Hamburg: 232s pp., quoted in Marx, Karl. *The Capital*, Book 3, vol. 5, Ed. Civilização Brasileira / Centro do Livro Brasileiro.