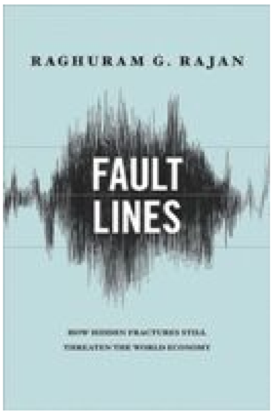
Book Review: Bankers, blogs and bailouts

***Natacha Postel-Vinay** takes a closer look at Fault Lines, a book which remains at the centre of debate and controversy.*

Fault Lines, How Hidden Fractures Still Threaten the World Economy. By Raghuram G. Rajan. Princeton University Press. May 2010.



Not only is *Fault Lines* the subject of countless reviews, but it was also named the Business Book of the Year 2010 by the Financial Times, has its own blog, and can pride itself for being the centre of a dispute between a Nobel Prize winner Paul Krugman and a former IMF chief economist – its author. Today a Chicago University professor, Raghuram Rajan is also famous for having ruined a 2005 Federal Reserve celebration by pointing to the possibility of a "full-blown financial crisis". Fortunately he may no longer feel like "an early Christian who had wandered into a convention of half-starved lions" as the bubble burst, and the book he longed to write on the global economic fractures came out. Rajan's central claim is that the actions of Western governments before and after the global financial crisis were wrong and did nothing but encourage further disaster. Thankfully, Rajan also comes up with original and important long-term remedies – arguably more so than Krugman.

Rajan's book is a bold enterprise in three ways: firstly it aims to explain the US financial crisis by looking at deep, decade-long fractures in economies and societies; secondly it suggests well-known but radical solutions that few dare put forward; and finally it supplies innovative answers to practical questions. Rajan's explanation for the crisis consists of the following: since the 1980s US wage inequalities have increased due to a growing gap between college graduates' pay and the pay of non-graduates. Jobless recoveries plus an inadequate safety net have led to rising worker anxiety. The government used a quick and easy solution: a push for credit. A low-interest rate policy and a government bailout guarantee gave it strength. Export-led growth in Asia led to a global savings glut, and dollars flowed to the US looking for high-yield investments. His striking conclusion is that the crisis resulted from "a confusion about the appropriate role of the government and the market". Indeed, Rajan believes that the government should have ensured that perceptions of inequalities didn't develop as much as they did, getting more people into college to respond to the demands of technological change, as well as providing for contingent but predetermined unemployment insurance. By contrast, Rajan also writes that it should have neither intervened in the housing market nor given the certainty of a government bailout in case of trouble. Now is a good time to implement these changes. As for global imbalances, the IMF and World Bank could use soft power to influence emerging countries' populations into asking for higher and market-driven interest rates.

Despite Krugman's claims to the contrary, Rajan gives a balanced account of the role of the government in the crisis. He does not absolve bankers; he intelligently remarks that it is for the government to step in and "make them internalize the full consequences of their actions". This remains however something of a hot topic, after the clash between David Cameron and Ed Miliband over bank bonuses and tax cuts in the House of Commons last week. Perhaps one problem with Rajan's analysis is its failure to discuss the consequences of an absence of government bailout guarantee. This radical solution is put forward as the main deterrent to tail risk-taking; however it looks like we will have to go through another full-blown crisis, this one unchecked by the government, to ensure a change in expectations! Krugman is right at least to discuss the merits of bailout packages; but it is true also that he fails to provide any long-term solutions. Perhaps Rajan thought that a discussion on the topic might weaken his argument. But at what cost?

Overall, the book will please any reader looking for an inquiry into the deepest causes of the recession and a consistent account of government's errors of omission and commission.

Natacha Postel-Vinay *is a PhD student in economic history at LSE.*