# Partly Right on the Crisis (Book Review)

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Fault Lines: How Hidden Fractures Still Threaten the World Economy by Raghuram G. Rajan; 260 pages; Princeton University Press, 2010

Jimmy Stewart Is Dead: Ending the World's Ongoing Financial Plague with Limited Purpose Banking by Laurence J. Kotlikoff; 241 pages; John Wiley and Sons, 2010

In Fault Lines, University of Chicago finance professor Raghuram Rajan gives his take on what led to the U.S. and global financial crisis of the last three years and what should be done about it. His analysis and proposals are uneven. When he sticks to what he knows best — international financial markets — he is usually clear and often insightful. When he ventures beyond his expertise — in discussing such topics as income inequality, education, and health care — he fails to go back to basics and thus repeats many of the myths that have been propagated by "progressives."

**Income inequality and housing finance**

Rajan's basic message is difficult to put succinctly. There are so many strands in his argument, so many hedges, and so much vagueness that this reader came away, even after a careful reading of every word and every footnote, without a clear understanding of his thesis.

But let me try anyway. His argument is that because income inequality in the United States has increased in the last few decades, politicians, aware of this but unwilling or unable politically to engage in massive distribution from rich to poor, have instead looked for a quick fix. Their quick fix is to subsidize home ownership for people who have not qualified for traditional mortgages. That was a major factor leading to the mess we are in. Another factor behind the mess is the incentives that cause financial firms to bet against the small probability of a large loss. Rajan's solution is to pare down the amount of government subsidization of home ownership and substitute more government spending on schools and unemployment insurance for those who will often be temporary losers in a dynamic economy. Much of Rajan's analysis is spot-on. In a 12-page section titled "A Short History of Housing Credit," for instance, he walks us through the dreary alphabet of government agencies that, starting during the Franklin Roosevelt era, subsidized house mortgages. Before this intervention, he notes, mortgages were typically for five years, at variable rates, and for no more than half the value of a house. That gave house buyers a strong incentive to be careful before purchasing. But beginning with the Home Owner's Loan Corporation and the Federal Housing Administration in the 1930s, and then on to the Federal National Mortgage Association in all its guises (first as a government agency and later as a government-sponsored enterprise), the federal government shifted the risk from the borrower and lender to the hapless taxpayer. The Clinton administration added to the mess in the 1990s by beefing up enforcement of the Community Reinvestment Act of 1977. A 1995 Clinton administration document stated:

For many potential homebuyers, the lack of cash available to accumulate the required down payment and closing costs is the major impediment to purchasing a home.... Financing strategies, fueled by the creativity and resources of the public and private sectors, should address both of these financial barriers to homeownership [emphasis Rajan's].

He comments:

Simply put, the Clinton administration was arguing that the financial sector should find creative ways of getting people who could not afford homes into them, and the government would help or push wherever it could.

In 2004, notes Rajan, George W. Bush increased the low-income mandate on Fannie Mae and Freddie Mac to 56 percent of their assets. Rajan quotes the findings of Edward Pinto, a former chief credit officer of Fannie Mae, that, on average, Fannie, Freddie, and the FHA accounted for 54 percent of the housemortgage market and, in 2007, a whopping 70 percent. Rajan comments, "It is very difficult to reach any other conclusion than that this was a market driven largely by government, or government-influenced money." Indeed.

**Risk**

Also, I think Rajan is correct in his fundamental analysis of what caused the 2007–2008 financial crisis: the mispricing of risk. In a chapter titled "Betting the

Bank," he gives an excellent analysis of the incentives of financial managers to bet on "tail risks" — that is, risks that occur very rarely. If nothing goes wrong, the firm and manager make high profits and bonuses, respectively. But in that small-probability case where things go wrong, the firm takes a huge hit. He points out that the prospect of a government bailout makes the long-tail bet even more attractive. Interestingly, he does not mention Columbia University finance professor Charles Calomiris's point that decades-old laws make it illegal for hedge funds to own banks or for any other entity to own more than a small percent of a bank's shares. If such concentrated ownership were allowed, and if financial firms could count on not being bailed out, then owners would monitor management more effectively and be more likely to enforce restrictions against excessive risk-taking.

Rajan's arguably most important chapter is "Reforming Finance." In it, he advocates a number of major reforms and criticizes other proposed reforms. The analysis is too wide-ranging to summarize. But one of the most important proposals involving housing finance is to "back off from government intervention, to the extent possible." This would involve breaking up Fannie and Freddie into a number of smaller private entities, none of which would have an explicit government guarantee, and shrinking the FHA and Ginnie Mae. He also proposes having the Fed avoid cutting interest rates to near zero, as he claims it did during the last decade. (An aside: In "Greenspan's Monetary Policy in Retrospect," (Cato Briefing Papers, November 3, 2008), Jeffrey Hummel and I show that the data do not support this standard view of Alan Greenspan's monetary policy. Virtually all of the economists and journalists who have repeated this claim judge the tightness or looseness of monetary policy by interest rates rather than by the growth of various measures of the money supply. By that standard, monetary policy during the early part of the Great Depression, when the money supply fell by 30 percent, was loose.)

One of the book's greatest strengths is Rajan's masterful exposition of the Chinese government's currency policy. He explains a relatively complicated issue step-by-crucial-step. China's central bank, the People's Bank of China, buys

dollars from Chinese exporters to keep the Chinese currency, the renminbi, from appreciating. But with the number of renminbi increasing, the result would normally be inflation and the PBOC does not want that either. So, it "sterilizes" the excess renminbis by selling debt. To avoid paying too high an interest rate on this debt and taking a large loss, the PBOC sets interest rates artificially low. It does so by limiting the interest rate banks are allowed to pay on their deposits so that the government-issued debt is competitive. Then, when the Chinese government wants to limit credit, it uses the blunt tool of credit controls, which cause banks to discriminate against private firms that lack strong connections. That makes it hard for private Chinese firms to plan long-term.

**Criticism of Rajan**

So, why am I not in love with this book? Start with Rajan's discussion of income inequality, a crucial part of his case for different government intervention. Although he is correct that U.S. income inequality is high, Rajan also argues that U.S. income mobility is low and that the economic well-being of lower-income people is not improving. He writes, for instance: "[C]ross-country studies suggest that people in the United States are not much more mobile across income classes than in European countries." But this nonetheless means that lower-income Americans are more mobile, if only a little, than their European counterparts. More important, the income distribution in European countries is typically much more compressed than in the United States. Therefore, the ranges of income for each quintile in Europe are smaller, which means that if a person were to experience the same absolute increase in income in Europe and in the United States, that person would have a much higher probability in Europe of moving to the next compressed quintile. But income mobility in the United States is slightly higher even though a move up to the next quintile takes a larger increase in absolute income. This is eloquent testimony to the still-large degree of income mobility in the United States.

Only two paragraphs after acknowledging that income mobility in the United States is higher than in Europe, Rajan treats as fact the idea that "Americans no longer have the chance to be upwardly mobile." To be sure, he puts an "if" in front of this claim, but the paragraphs that follow suggest that Rajan accepts the idea that upward mobility is almost dead. The words "economic freedom," he asserts, "offer a nightmare of great and continuing insecurity, and growing envy as the have-nots increasingly become the have-nevers."

Moreover, he makes an assertion at odds with much of the reality of economic progress. He writes, “[T]he immobile are hurt when others move up.” How? “When others in town become richer,” he writes, “the cost of everything goes up, and the real income — the income in terms of its purchasing power — of the economically immobile falls.” Certainly, one can find examples like that. If, for example, the government in a town restricts building, the resulting fixed supply, combined with increasing demand from richer people, will drive up the cost of housing for everyone. But economic progress is often the story of new products entering the market as luxuries and later falling in price so that a generation — or even a few years — later, even the lowest-income people can purchase them. Think about VCRs, for example. The first ones were priced above $2,000 in mid-1970s dollars. Twenty-five years later, they often sold for under $100. Now they are obsolete. Or think about the falling prices — along with the increasing quality — of cell phones, microwaves, electric washers and dryers, electric dishwashers, and airline travel.

To buttress his income inequality concerns, Rajan throws in the emotion of envy. Even if the apparently immobile are buying more and better items, they compare themselves negatively with those who have even more and better items. “[M]y Chevrolet becomes much less pleasurable when my neighbor upgrades from a Honda to a Maserati,” he writes. I think that is Rajan’s problem. If the apparently immobile are getting nicer and nicer cars — yes, even Chevrolets are getting better — then it is up to them to control their own green-eyed monster. It is hardly an indictment of the system if wealthier people can afford Maseratis.

Finally, he admits that one reason for high income inequality in the United States is the large number of immigrants who “swell the ranks of those who appear down and out in America.” So, earning low incomes in the United States is progress for those immigrants compared to their previous situations in their home countries. Although Rajan recognizes this fact, his discussion that follows completely ignores it.

Also, although Rajan states as a principle for policy that we should “make decision makers internalize the full consequences of their decisions,” some of his own proposals violate this principle. One major violator is his idea for tax credits for workers who, after having worked a number of years, decide to take time off “to study or retool.” This is a subsidy to people where there is no large externality. Rajan makes this proposal because he worries that people do not have a savings buffer to handle the exigencies of the job market. But he never even mentions the possibility of a private voluntary solution: save more. Also, rather than eliminating the huge subsidy to mediocrity that current government schools represent, Rajan writes like a central planner who wants, by fiat, to change this wage and tweak that program within the government school system.

Something that undercuts Rajan’s message and proposals is his on-again, off-again treatment of the incentives and motives of government officials. He writes, for instance:

When a U.S. Treasury employee goes directly from running the biggest bailout fund in history to work for a company that runs the biggest bond fund in the world, and when another Treasury employee goes from organizing financial-sector rescues directly to running one of the banks that is most in need of rescue, the public’s trust is strained. No matter how honorable the intentions of the individuals in question (and I have no doubt that they are honorable) or how careful the new employer in avoiding conflicts of interest, the deals, to put it mildly, stink.

Really? He has no doubt that they are honorable? Based on what evidence or reasoning? He does not say.

Rajan states that the adverse-selection problem in health insurance is that health insurance plans attract too many of the high-cost sick people and too few of the low-cost healthy people whose premiums are necessary to subsidize the expenses of the sick. But this statement of the adverse-selection problem makes it sound as if it would be desirable to charge high rates to the low-risk people. In fact, the adverse-selection problem, if it even exists, exists because of the high cost to the insurance company of distinguishing between low and high risks. The solution to adverse selection is to distinguish between high and low risks and price accordingly so that low-risk people do not subsidize high-risk people. That is why it is a bad idea to ban insurance companies from pricing based on pre-existing conditions.

Also, Rajan sometimes uses fuzzy language where precise language is needed. For example, in correctly criticizing the proliferation of government requirements for people to engage in various occupations, he characterizes these requirements as "workplace demands." But they are often simply government demands. Many people would like to hire a flower arranger, for example, whether or not the government has certified her, but the government will not allow it in Louisiana. Indeed, lawyers at the Institute for Justice, a public-interest law firm, make a living suing against just such outrageous requirements.

Finally, Rajan sometimes leaves out important details that would have been easy to fill in. He writes, for example, that "[t]oo many mortgages came from the same suspect, aggressive broker from the same subdivision in California." But he does not tell us who the broker was. Inquiring minds want to know.

**Kotlikoff**

Laurence Kotlikoff 's book Jimmy Stewart Is Dead gives an excellent, dramatic play-by-play on many of the policies that led to the financial crisis of 2007–2008 — or should I say, 2007–201? — and on many of the participants. You will not read this book and come away feeling secure about our financial future. And the reason is that various government policies — deposit insurance for bank deposits, bailing out banks and other financial firms, bailing out Fannie Mae and Freddie Mac — have created a situation in which we are all in this together whether we like it or not. (Those are my words, not his.) In other words, even if you want to avoid having your financial future tied in with that of Fannie Mae, AIG, Citibank, or the U.S. government, even if you prudently plan your financial life and diversify your risk, the U.S. government can bite you. One way is to tax much of your future income to pay for bailouts.

Boston University's Kotlikoff, a well-published economist who has written articles for many of the top scholarly journals, writes with a humorous anger that is, frankly, refreshing. Here is Kotlikoff on Stan O'Neal, former chief executive officer of Merrill Lynch, who had Merrill buy $41 billion in subprime mortgages:

Merrill, whose symbol is a horned bull and whose motto is "Merrill Lynch is bullish on America," survived lots of bear markets, including the Great Depression, but it didn't survive Stan.

In telling why AIG hired Joseph Cassano, former chief financial officer of AIG's Financial Products unit, who "more or less single-handedly destroyed the entire company" by selling credit defaults swaps, Kotlikoff writes:

[H]e had majored in political science, which everyone knows provides superb training in actuarial science, stochastic calculus, time-series econometrics, risk modeling, and the many other, highly specialized mathematical and quantitative skills needed for a career in insurance and banking.

Refreshingly also, Kotlikoff does not hesitate to criticize even his own past co-authors. One such co-author is Lawrence Summers, of whom Kotlikoff writes:

Summers received $5 million for working just one day a week for D.E. Shaw, one of Wall Street's largest hedge funds. Again, connections, rather than financial acumen, seem to have been at play in setting pay.... Funny enough, the Geithner-Summers plan for ridding banks of their toxic assets, the Public-Private Investment Fund ... includes a starring role for large hedge funds.

If D.E. Shaw was paying Summers to advise on financial matters, they were likely wasting their money. When it comes to making financial deals, Summers' skills aren't exactly impeccable. Harvard lost well over $1 billion of its endowments thanks to interest rate swaps Summers had the university purchase while he was running the show.

Kotlikoff also retells the story of Bernie Madoff, who ran a Ponzi scheme that lost billions of dollars for his investors. The Securities and Exchange Commission had received six different complaints about Madoff over the years, and one of them was a detailed letter in 1999 that actually accused Madoff of running a Ponzi scheme. Madoff himself later pointed out how easily the SEC could have investigated this charge: check his asset holdings with the third parties that supposedly hold the assets and conduct the trades. The SEC never did.

**Financial regulations**

So what is Kotlikoff 's solution? Announce the dissolution of Fannie Mae and Freddie Mac? End the policy of bailouts? End deposit insurance? No. Kotlikoff would dramatically change the financial industries by having government require what he calls Limited Purpose Banking. Under this form of banking, the government would require all banks, which he defines broadly as "all financial and insurance companies with limited liability," to operate as pass-through mutual fund companies. Those companies, in other words, would simply operate as middle-men. They would not be allowed to invest on their own account. To make sure they do not break the rules, Kotlikoff would replace the existing 115 financial regulatory agencies (that number includes state agencies) with one giant regulator: the Federal Financial Authority (FFA).

Kotlikoff would give the FFA a huge role in regulating the activities of financial firms. He gives an example of someone who wants a mortgage so that he can buy a house. When the potential borrower applies for the loan, the bank sends the paperwork on to the FFA, which would use private rating agencies to assess the loan's risk. Then the FFA would reveal this information online (hiding the borrower's identity) and open it up for bids on the mortgage.

Do you see the problem here? The same government that failed to catch Bernie Madoff and that takes months to get back to people about their applications for Social Security Disability Income is suddenly competent and able to get information about a specific person quickly to a bank. I think this makes Kotlikoff's proposal a non-starter, and I have not even discussed the fact that various financial firms will try to find ways around his proposed draconian restrictions on corporate risk-taking.

The sad fact is that for all his criticism of government, Kotlikoff still clings to a strong belief in good government intentions and government efficacy. For example, he points to the Food and Drug Administration as an example of a government agency that works well. He states that the FDA has gotten in trouble in recent years "by letting the drug companies play far too large a role in the drug approval process," but, he claims, "our drug approval system works because it's not too strict." Those who read my recent review of two books on the FDA ("Regulation Overdose," Summer 2010) will be surprised to learn that the FDA works and is "not too strict." Kotlikoff actually claims that the FDA allows drug companies to sell drugs that have not been tested. That has not been true since 1938. Who else thinks that the system does not work? Probably some of the tens of thousands of people who cannot buy drugs because the huge testing burdens put on drug companies often make the drug not worth pursuing.

Why not get rid of Fannie, Freddie, and the FHA? Kotlikoff explains, “Were it not for new mortgages issued by Uncle Sam through Fannie, Freddie, and FHA, we’d have almost no housing market, period.” This is a stunning case of failing to recognize what 19th century economic journalist Frederic Bastiat called the “unseen.” The fact that the U.S. government, with the agencies Kotlikoff names, has pushed out private lending by subsidizing risk does not mean that if those agencies closed down, lenders would not exist. It is just that they would have tighter standards and mortgage interest rates would be somewhat higher. If Kotlikoff were to look at Canada’s Medicare — Canada’s single-payer plan — through the same lens, he would write, “Were it not for payments by the Canadian government to doctors and hospitals, there would be almost no market for medical care, period.” The reality, of course, is that if health insurance in Canada were not socialized, Canadians would buy health care as they did in the 1960s, before it was heavily socialized. When there are willing buyers and sellers, and neither side is subsidized, there will be a market as long as buyers are willing to pay more than the price that suppliers insist on. This applies whether the good is health care or mortgage loans.

**Conclusion**

So, read Rajan and Kotlikoff if you want to learn more about the laws (Rajan) and the players (Kotlikoff) behind the current financial mess. But if you want solutions, Rajan has a few in the financial area and none outside his expertise, and Kotlikoff ’s pet solution is a non-starter.