SAMPLE -1

Book Title:
Fault Lines: How Hidden Fractures Still Threaten the World Economy
Author:
Raghuram G Rajan
Our Headline:
What caused the global financial meltdown
Writer:
XXXX

Briefer:
Fault Lines are breaks in the earth's surface where tectonic plates collide. Enormous stresses build around these fault lines. The book talks about economic fault lines across the globe, explains what went wrong in 2008, and outlines a few suggestions to avert a potential future crisis.

Target Audience:
CXO, CFO, Economists, Policymakers, and Academics

Author:
Raghuram G Rajan is the former rock-star governor of the Reserve Bank of India

The Summary
In this 2010 book, Raghuram G Rajan points out that almost all disasters have had some political root. Most of the incidents mentioned in this book relate to the financial crisis in the USA during 2008, which the author had famously predicted. Here's a listing of the causes global financial crisis and the lessons that we can learn:

1. Rising inequality and push for housing credit
Over the years, economic inequality in the USA has increased. In 1976, the top 1% of the households accounted for 9% of total income; by 2007, they accounted for 24%. The inequality was caused by a few reasons, including stagnant high school graduation rates, higher college fees, and lower income from property, stocks, and bonds. Politicians realized that making easy credit available would provide immediate and widely distributed benefits, especially to the bottom end of society. This generous distribution was the genesis of Fannie Mae and Freddie Mac. Successive governments supported them, which led to the boom in low-income lending. It was not a surge in demand, but a higher willingness to supply credit, which lead to the massive housing boom. The crisis proved to be a costly way to redistribute wealth. Those who bought houses without the needed equity were evicted after losing their savings, and have now become homeless. This sad story has lessons for similar lending across the world.

2. Export-led growth and dependency

After the Second World War, developing countries took an export-led strategy to become developed economies. Examples include Germany, Japan, South East Asian countries and currently China. In fact, history records that no country has grown as fast as Japan between 1950 and 1973, and this was possible due to an exports-led strategy. During early periods of this policy, exports were the low value-add items, but they slowly moved up the innovation ladder. Governments provided the vital ecosystem necessary, such clear norms, procedures, financing, etc. However, the problem arose when exporters become stinking rich, like Germany and Japan. With increasing trade surpluses, their currencies appreciated. To stay competitive, they had to move up the value chain of innovation continuously. And too much of focus on foreign demand resulted in reduced domestic services sector changes. With lower domestic consumption, these economies begin to depend too much on global demand for their products. China could deepen this fault line, or if they manage to develop the domestic market, can bridge this.

3. Flighty Foreign Financing

The surpluses generated by exporters had to be utilized. At the same time, emerging countries needed external financing to fund their private sector growth ambitions and to bridge deficits caused by overspending and subsidies. The foreign investors, to minimize their risk, preferred to lend at shorter durations and in their home currency. This set backdrop for the East Asian crisis. Thailand, Korea, Malaysia, and Indonesia were running massive investment to GDP ratio, which could not be funded by domestic savings. As most of the investments became technology intensive, the national governments withdrew from supporting them. Foreign investors stepped in. To avoid currency risk they funded through their domestic banks and did not take direct exposure to the companies expanding. This strategy had all ingredients for a classic bubble – excessive investment financed by short-term debt with the additional risk of foreign currency mismatch.

The bubble eventually burst. Foreign investors started pulling out their money and speculators joined in. The countries tried to defend exchange rates, but quickly depleted their foreign exchange reserves in the bargain. Eventually, many firms that had borrowed in foreign currency went bankrupt, and banks realized they had to repay foreign investors themselves. In summary, the export-focused countries understood the perils of falling to the temptation of easy and short-term money. This crisis made these countries to focus on building foreign reserves to ensure safety. And these reserves were looking for a safe home – the US - which emerged as the system willing to spend more than its producers could supply.

4. US Safety Net

The unemployment benefits in developed economies have evolved over time and in line with their culture. The US culture did not believe in elitism; it always found America to be a land of unlimited opportunities where the reward is commensurate with effort. So, unlike Europe, unemployment benefits, offered by the US was significantly lower. This absence of a safety net made people adaptable to change and quickly build skill sets required for a new role. For example, during the crisis in the automobiles sector, General Motors and Chrysler secured funding from the US government on condition they restructure their firm, close unviable plants and sell losing brands. But in France, Peugeot and Renault got government funds on the condition they do not close plants and do not fire workers. So, a weak safety net in the US and its political willingness to stimulate jobs makes the US the simulator of global consumption. Many economies hitch themselves to the US engine to simulate their own.

5. Regulators' reactions to bubbles

Another fault line is the role of the regulator per se. The Federal Reserve has the mandate to maintain maximum sustainable employment and stable prices. Post dot-com crisis, interest rates were reduced to unprecedented low levels. While the Fed attempted corporates to invest through ultra-low interest rates, the costs of financial assets and housing were skyrocketing. Also, the money that was exiting the US in the hunt for riskier pasture that would yield higher return was returning to the US now looking for seemingly safe, high-yielding mortgage-backed securities. The Fed made statements, suggesting their support if a crisis happened (called "Greenspan put"). So, strong fiscal and monetary stimulus led to an explosion in lending, and the quality of credit continuously deteriorated.

6. Betting the bank

The mortgage-backed products structured by the banks worked on probabilities. These products ignored the tail risk that is they did not take into account risk that would rarely occur. So banks hopped on to this risk to generate alpha, namely returns that outperformed the peers. In explaining how the CEOs took such tail-risks, there is a theory that Bank CEOs graduated from the Universities during the 70's, when finance was not a hot profession. Things changed in the 90s when the best and brightest students opted for finance as a career. It could be tempting to conclude that these CEOs were not talented enough to pick what their subordinates were structuring in a fiercely competitive financial sector. But it must be said that someone like JP Morgan's CEO, Jamie Dimon, played a crucial role in preventing his bank from taking a significant position in the mortgage-backed securities market. Less confident CEOs followed the herd, bet their banks, and took them to the cleaners. All stakeholders -- employees who had stock options, other shareholders who were getting stock price return, and regulators trying to stimulate the economy, were betting against this tail risk event's taking place.

7. Reforming Finance

Finance should be for the benefit of as many people as possible while minimizing the risk of instability. The industry, despite giving us credit default swaps and collateralized debt obligations, also gave us useful products like credit cards, mutual funds, etc. The sector should remain competitive, but incentive structures need modification in line with long terms benefits, rather than short-term profits. While government subsidies to financial institutions should end, the regulations should be cycle-proof. Fed's mandate should include financial stability, along with employment and inflation. The institutions should be transparent and should carry a "living will," a plan that would enable handling failures. Also, the nexus between bankers and regulators should be broken to improve the trust in the system.

8. Improving access to opportunities in America

There are several steps that we could take to correct a few fault lines in the system. These include a focus on education, building non-cognitive skills and improving the quality of teaching. The weak US safety net, the short duration of unemployment benefits and the high cost of health care, are a significant risk if recessions last longer. What we hence need are changes in the structure of Unemployment Insurance and Health Care. Current household savings rate and the social security payouts are not sustainable. Some tough steps like extending retirement age and slowing the rate of increase of benefits are required. America has always been able to reboot itself from adversity, and it can do so again.

9. Global Economic Co-operation

Without global economic cooperation, countries could descend into detrimental opportunistic nationalism. Unlike the WTO, where states enter into a binding legal contract, the IMF does not have any legal teeth. China's effort to keep its currency undervalued distorts not only its own but also the global economy. There is a need for China to transit from a producer-oriented capital-intensive economy to a private sector oriented economy, far less dependent on foreign demand. With USD 2 trillion foreign exchange reserves in its kitty, China has much at stake in global economic cooperation. Multilateral agencies should play a more significant role in defining global economic citizenship and appeal directly to thinking people across the world, instead of holding international meetings and conferences.

10. What lies ahead for India

If we can create jobs in sectors where productivity is high, then the households can generate higher income by moving into those high productivity ones. But there are serious impediments: land acquisition, insider dealing in infrastructure projects, large unproductive public sector, etc. The vibrant private sector must get regulatory support to flourish. The steady deterioration in India's universities needs a reversal. Thousands of students who leave India are a lost opportunity. The creation of an underclass

that does not have access to nutrition, healthcare, governance, is a recipe for political and social conflict.

Sadly, many of this seems to be coming true.