How Inequality Fueled the Crisis

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To commemorate its founding 25 years ago, PS will be republishing over the coming months a selection of commentaries written since 1994. In the following commentary, Raghuram G. Rajan explained how US public policies both created the 2008 financial crisis and fell short of responding to it.

CHICAGO – Before the recent financial crisis, politicians on both sides of the aisle in the United States egged on Fannie Mae and Freddie Mac, the giant government-backed mortgage agencies, to support low-income lending in their constituencies. There was a deeper concern behind this newly discovered passion for housing for the poor: growing income inequality.

Since the 1970's, wages for workers at the 90th percentile of the wage distribution in the US –such as office managers – have grown much faster than wages for the median worker (at the 50th percentile), such as factory workers and office assistants. A number of factors are responsible for the growth in the 90/50 differential.

Perhaps the most important is that technological progress in the US requires the labor force to have ever greater skills. A high school diploma was sufficient for office workers 40 years ago, whereas an undergraduate degree is barely sufficient today. But the education system has been unable to provide enough of the labor force with the necessary education. The reasons range from indifferent nutrition, socialization, and early-childhood learning to dysfunctional primary and secondary schools that leave too many Americans unprepared for college.

The everyday consequence for the middle class is a stagnant paycheck and growing job insecurity. Politicians feel their constituents' pain, but it is hard to improve the quality of education, for improvement requires real and effective policy change in an area where too many vested interests favor the status quo.1

Moreover, any change will require years to take effect, and therefore will not address the electorate's current anxiety. Thus, politicians have looked for other, quicker ways to mollify their constituents. We have long understood that it is not income that matters, but consumption. A smart or cynical politician would see that if somehow middle-class households' consumption kept up, if they could afford a new car every few years and the occasional exotic holiday, perhaps they would pay less attention to their stagnant paychecks.

Therefore, the political response to rising inequality – whether carefully planned or the path of least resistance – was to expand lending to households, especially low-income households. The benefits – growing consumption and more jobs – were immediate, whereas paying the inevitable bill could be postponed into the future. Cynical as it might seem, easy credit has been used throughout history as a palliative by governments that are unable to address the deeper anxieties of the middle class directly.

Politicians, however, prefer to couch the objective in more uplifting and persuasive terms than that of crassly increasing consumption. In the US, the expansion of home ownership – a key element of the American dream – to low- and middle-income households was the defensible linchpin for the broader aims of expanding credit and consumption.

Why did the US not follow the more direct path of redistribution, of taxing or borrowing and spending on the anxious middle class? Greece, for example, got into trouble doing precisely this, employing many thousands in the government and overpaying them, even while it ran up public debt to astronomical levels.

In the US, though, there have been strong political forces arrayed against direct redistribution in recent years. Directed housing credit was a policy with broader support, because each side thought that it would benefit.

The left favored flows to their natural constituency, while the right welcomed new property owners who could, perhaps, be convinced to switch party allegiance. More low-income housing credit has been one of the few issues on which President Bill Clinton's administration, with its affordable-housing mandate, and that of President George W. Bush, with its push for an "ownership" society, agreed.

In the end, though, the misguided attempt to push home ownership through credit has left the US with houses that no one can afford and households drowning in debt. Ironically, since 2004, the homeownership rate has been in decline.

The problem, as often is the case with government policies, was not intent. It rarely is. But when lots of easy money pushed by a deep-pocketed government comes into contact with the profit motive of a sophisticated, competitive, and amoral financial sector, matters get taken far beyond the government's intent.

This is not, of course, the first time in history that credit expansion has been used to assuage the concerns of a group that is being left behind, nor will it be the last. In fact, one does not even need to look outside the US for examples. The deregulation and rapid expansion of banking in the US in the early years of the twentieth century was in many ways a response to the Populist movement, backed by small and medium-sized farmers who found themselves falling behind the growing numbers of industrial workers, and demanded easier credit. Excessive rural credit was one of the important causes of bank failures during the Great Depression.

The broader implication is that we need to look beyond greedy bankers and spineless regulators (and there were plenty of both) for the root causes of this crisis. And the problems are not solved with a financial regulatory bill entrusting more powers to those regulators. America needs to tackle inequality at its root, by giving more Americans the ability to compete in the global marketplace. This is much harder than doling out credit, but more effective in the long run.