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# Yale Program on Financial Stability

## Lessons Learned

Raghuram Rajan

By Matthew A. Lieber

*Raghuram Rajan, a University of Chicago professor of economics and finance, served as director of research at the International Monetary Fund (IMF) from 2003 to 2006. In 2005, Rajan warned very publicly of the risks of a financial crisis. Following his tenure at the IMF, Rajan served as chief economic adviser to India's Finance Ministry and governor of the Reserve Bank of India. An expert on financial institutions and their effects on economic growth and development across countries, Rajan was recognized as a fellow of the American Academy of Arts and Sciences in 2009. He is co-author of *Saving Capitalism from the Capitalists* (2003) and author of *The Third Pillar* (2019), about community organization. This *Lessons Learned* is based on an interview with Rajan conducted on December 16, 2020; the full transcript may be accessed [here](#).*

**Central bankers and regulators must probe deeply into distortions in the financial system lest they cause a crisis.**

Asked why he was able to anticipate the 2007–09 financial crisis that other central bankers failed to see coming, Rajan replied that it was all there in plain sight: “What you had to have was a skepticism about the system.” He traced his skeptical stance to his early experience “traversing systems”—between East and West, developing and developed countries, open and closed economies.

“The difference between me and some of the people in that room at Jackson Hole<sup>1</sup> was not that I saw anything different,” Rajan said. Speculative excess was in plain sight, but “they somehow had the confidence that the problem we saw would be taken care of,” that the industry would police itself.

Rajan saw danger in the incentives in the system that favored risk-taking, specifically so-called tail risks that involved low probabilities. He theorized that the majority of industry participants just followed the prevailing practices at the time, and a herd mentality took over because everyone was earning huge bonuses. He shared some anecdotes depicting the prevailing mindsets at work at the time, both among industry personnel and among the regulators. The private-sector actors were saying to the central bankers, “You guys have to stop us”; they were generally unwilling to move away from lucrative and risky behaviors while their competitors continued to engage in the same. Meanwhile, the central bankers believed that the private sector would control itself.

Rajan attributed this to a systemic ethos that had taken hold in the aftermath of the dot-com bubble and bust. He related that, prior to that crisis, then–Fed Chairman Alan Greenspan had

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<sup>1</sup> Rajan delivered a controversial paper at the 2005 Federal Reserve conference in Jackson Hole, Wyoming: Rajan, Raghuram. 2005. “Has Financial Development Made the World Riskier?” 2005 Jackson Hole Economic Policy Symposium. <https://www.kansascityfed.org/Jackson%20Hole/documents/3326/PDF-Rajan2005.pdf>

talked about the “irrational exuberance” in the equity markets and had received “tremendous pushback” from Congress and others who said, “Who are you to be talking about stock markets?” The general belief at the time was that the Fed should not intervene when things are building up because it can intervene powerfully when things collapse. And so, when the dot-com bubble burst, the Fed came in and cut interest rates, and it was a relatively mild recession. Rajan questioned whether this posture is the most effective one for a central bank to take and urged that the Fed should scrutinize more carefully when fragility is developing in the financial system, especially if it’s in the debt markets.

**The Fed’s interventions of 2008 and 2020, while extraordinary and effective, may have adversely shaped market expectations and helped perpetuate a boom-bust cycle.**

When asked about a “rogue wave” theory that a unique constellation of events triggered the 2007–09 Global Financial Crisis (GFC), Rajan instead described 2008 and 2020 as instances of a larger pattern of excessive risk-taking followed by massive interventions by the Fed. Rajan pointed out that the Fed did not stop leverage from building up during the GFC, nor in the period leading up to March 2020, activity that had material impact on the financial fall-out. He pointed out:

A fair amount of leverage had been building up over the last 10 years, and easy monetary conditions were in part responsible for that leverage building up in the private sector. And this time, the leverage was not as much in the household sector as in the corporate sector. And so, suddenly in March 2020, you have panic spreading in markets, and the Fed comes in with all guns blazing and says, “Don’t worry, the US Fed is here to rescue you.”

Rajan acknowledged the need to intervene in 2008 and acknowledged US financial leaders for carrying out the interventions in an adroit manner. But he expressed concern about the return to the same playbook just 12 years later: “And so, you can feel happy that it was all available and the system was built out again. Or you can say, well, this is the second time it’s happening in maybe 12 years.” What message, he asked, do such massive interventions send? “Is it telling the markets we will always be around, and every time we’ll do what we did the previous time, plus a little more to deal with any new circumstances? In which case, aren’t you in danger of creating dependence?”

Mindful of the system and incentives for risk, Rajan considered the effects of the demonstration of government capabilities on market participants’ expectations. Referring to the US Treasury’s Troubled Assets Relief Program (TARP) and the various emergency liquidity facilities the Fed created, Rajan explained that the extraordinary set of things that were done in 2007–09, and a second time in 2020—more rapidly and massively—will be expected when the next difficult bout sets upon us:

Pandora’s box has been opened, and there’s no way to push the evil spirits back into the box. Because the real magic was nobody knew how to open the box or knew precisely how the box would be once opened. And once we learned how to open the box, that unlocking stays with us. We can’t unlearn it.

But, questioned Rajan, “Are there some unanticipated or unintended consequences of their actions, which they claim they can’t really do anything about, but perhaps we should pay more attention to?” He urged that we should ask: Is the Fed “doing too much and ignoring the financial stability consequences?”

**The real problem underlying financial crises is a development problem; we are using the wrong tools and thereby fueling an unsustainable cycle.**

The recurring use of large-scale monetary interventions gets us into trouble, Rajan said, because, at their core, the boom-bust cycles that threaten financial stability rest upon a structural problem in the real economy. He defines that issue as a development problem of inequality. Monetary policy is the wrong tool to correct such deeper structural troubles in the economy, and so is credit policy or fiscal policy alone.

According to Rajan, the problem is that large parts of the population lack sufficient income. Chronic demand weakness is directly related to the increasing inequality in very developed countries in which some “parts of the economy are third world and falling behind.” Monetary, credit, and fiscal policy accomplish little structural change and may only spur credit excess, incentivizing unhealthy risk-taking, “where we go from boom to bust.” Rajan explained,

I would argue that the inequality, the inadequate demand, the measures to try and boost it all create this unsustainable cycle where we go from boom to bust, to boom, to bust. And we need to get out of it. And it seems to me the way to do that is to see how we can really help the people in communities that are falling behind.

To build a more sustained, stable macroeconomy—with true financial stability—the answer doesn’t lie with either monetary policy or the financial sector, said Rajan. We should focus on fixing the deeper structural problems of the real economy.

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