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# Interview with Raghuram Rajan

by *John Cassidy*

I met Rajan in his office at the Booth School of Business. I began by asking him about the academic work he and several colleagues at the business school did in the years leading up to 2007 on banking and liquidity. In addition to exploring theoretical issues that turned out to be important, Rajan, in the summer of 2005, issued a prescient warning about the dangers of a financial blowup involving the credit markets. It was striking, I remarked, that despite Chicago's image as a bastion of market efficiency, it was also home to much more questioning research in the financial system.

Raghuram Rajan: Forget the public utterances: the research done at this place was, essentially, right on the ball—issues of liquidity, the fact that liquidity might dry up, and who's there to provide liquidity in those situations. One of my colleagues, Doug Diamond, is, in many ways, the father of modern banking theory. He wrote the book on bank runs, literally. When he was traveling around giving his talks, people used to say, "Why are you working on history?" Unfortunately, this stuff is all too real these days.

The point is, research drives thinking, and there are all kinds of research being done here. People at the extremes get a lot of press, people who say: "Let's not do anything, let's liquidate"—the Andrew Mellon kind of view. There are people at Chicago who hold that view. There are others who understand that the banking system is a lot more important than, and different from, most corporations. Yes, you can close down some banks without a problem, but there are some banks that are so intertwined you don't have an option.

There are some people who say, Simon Johnson [an M.I.T. economist who was formerly at the International Monetary Fund] for instance, "Oh, we know how to shut down these banks. We did it at the I.M.F." The I.M.F. never did anything of this size—not by any stretch of imagination. The U.S. has closed down banks, such as Wachovia or Washington Mutual, or at least dissolved them, which are really big banks. But when you come to Citigroup or Bank of America it is a completely different kettle of fish. We have to figure out how to do it—without any question. And we could have been much tougher on the banks than we have been. Even now, we could be much tougher than we are. But to argue that it's a very simple thing to do—it's just a matter of nationalizing them or shutting them down—there are a whole lot of issues that are raised there.

All I am saying is that there are no easy answers in this thing … and one doesn't have to be corrupt or in the pay of the financial sector to say, hey, wait a minute: it's not as simple as letting them all go under or taking them all over. That's my rant about the banking sector. By and large, I think we've done all the things that needed to be done. I think the downside of what we haven't done is that we haven't made the banks face up to more pain. That would have made it politically easier to do what needed to be done.

*When you say, "make the banks face up to more pain," what do you mean? Tougher regulation? Big equity stakes for the government—along the British lines?*

Equity stakes and other things. For example, even now [the government] can require all compensation above a certain amount to be paid in equity, and equity that is real equity. The way banks do it now is they pay people in shares, but they also buy back equal amounts of shares [in the market]. So there is no increase in capital.

What we have right now is a situation where every saver in the country is, essentially, paying a huge tax to bail out the banking system. We are all getting screwed on our money market accounts—getting 0.25 per cent—and the banks are making a huge spread on nearly every asset they hold, because they are financing them at pretty close to zero rates. Another way of doing this—a way that would be nice to try—is to force the banks to load up on capital.

What is the point of all this? The point of all this is to get banks to lend. Well, they have been doing everything else except lending. Now, it may be that there aren't that many profitable lending opportunities at this point. But if there aren't, why are all the savers paying for this? Because you are not getting them to lend any more, and you are not getting more investment, which was the whole point of having interest rates so low. In fact, what you are doing is setting up a whole lot of other asset bubbles at this point.

Another way would be to put more direct pain on the banks. For example, if they were flush with capital and found they couldn't pay bonuses, so all of this [money] went into increasing the capital base, they would have an incentive to make loans to reduce the effective capital that they had. What we have at the moment is that the citizenry is paying for the banks. Get the banks to pay for themselves.

That gets away from the whole Chicago issue. But what I'm arguing is in Chicago you have the extreme, which says, "Let the chips fall they may. What's the problem with letting a few banks go under?" Whether you hold that view depends on how much you think the banks as an institution matters. Doug Diamond and I think it does matter. There is a lot of organizational and relationship capital embedded in the banks. If you let them go, it is very hard to start them up [again].

*What about the causes of the crisis?*

Within the big tent of Chicago, again, there are [also] so many different explanations for why this happened. Whether it was an agency problem in the banking system itself. Whether it was markets going haywire—Dick Thaler would be in that camp—irrational exuberance of one kind or another. Or whether it was government intervention—the story about pushing credit to the less well off segments of the population. My sense is, if you think seriously about this, all parts of it are important.

When you have a systemic crisis of this kind in a developed country … the whole point about development is that you deal with some of these problems. You don't have populist extension of credit. You don't have banks going haywire. There is reasonable supervision. That is what we have always argued—you get good institutions. And all of it broke down. Which would suggest it is not a small breakdown; it is not a small thing that went wrong. You can't pin it all on Greenspan. It is a systemic breakdown, and we need to look more broadly at why it happened.

*How long have you been in Chicago?*

I came here in 1991.

*When it was largely associated with the efficient-markets hypothesis?*

I would guess…. When I came here, Merton Miller and Gene Fama were the leaders of the finance group. Clearly, both of them were strongly persuaded of the old Chicago viewpoint. Since then, I would say that Dick Thaler and Rob Vishny have been two important figures arguing that there are some serious departures from fundamentals. The whole point about a strong form of efficiency is this: If everybody knows things are going wrong why don't they correct it? Vishny's arguments have been about why it doesn't get corrected—limits to arbitrage and stuff like that. I think that is quite persuasive. Dick Thaler's [work] has been about how people make mistakes of a certain kind. That by itself is not enough to explain major departures. If somebody makes mistakes, why doesn't somebody else see those mistakes and try to take advantage of them?

*Who brought in Thaler and Vishny? Was a deliberate decision taken to try and broaden out the Chicago approach?*

Vishny evolved. He was a dyed-in-the-wool corporate-finance guy when he came in, and then he got interested in market efficiency and things like that. He put his money where his mouth is. He ran a very successful [investment] fund. And now he's come back. Vishny evolved and therefore wasn't an import of the virus. Thaler was a direct import. I think Gene, to his credit, and Vishny played a big role in bringing Dick in.

I want to tell you a story that I don't know if anybody else has told you. Dick Thaler used to teach a course on market inefficiency. For nine weeks, he would pound the notion that markets were inept in this way and that way. The tenth week he would invite Gene Fama in. And Gene would demolish everything that Dick had taught the students over those nine weeks. It was Chicago at its best—where you have a debate but you respect each other's viewpoint even though it is diametrically opposed to yours…. It's not about people; it's about ideas. Unfortunately, in too many departments, disagreements about ideas turns into personal disagreement. That's an important difference in Chicago—that we criticize the idea, and we criticize it very fiercely internally, but not the person.

*Is there a big difference between the business school and the university economics department?*

The economics department, as you know, has these giant personalities. I would say the business school has fewer personalities…. Maybe there are fewer giants at the business school, but it may also be that the culture here is one of greater give and take.

*As an outside observer, it sometimes seems that the business school is starting to loom over the economics department. Is that fair?*

We have a lot more younger people—just because of the size. We have an economics group, a behavioral group, a finance group. I think in the numbers we are bigger. Also, business schools typically have substantial resources, and so on. All those things help. But I would say it is still a formidable economics department.

*Have there been a lot of in-house debates about the crisis? Seminars, that sort of thing?*

Oh yes, when the crisis started getting worse and worse we had a whole bunch of seminars across the school. And our lunchroom is full of debate about this, all the time—again, because we differ internally about what the causes and remedies may be. It boils down to two or three things.

One: the extent to which it was animal spirits and mistakes versus distorted incentives.

Two: the importance of the banking system. If you let them all collapse, can they regenerate immediately, or is there a difficulty in rebuilding organizations once they collapse? Some people say liquidate and from the ashes you will see the phoenixes rising. Other say no—ashes are ashes and you get nothing from that.

Three: there is also some argument about the extent of the financial center-political system nexus. Those on the left and the right basically think they are in bed with each other. Those at the center think that [policymakers] are in a difficult situation.

*So you have some sympathy for Tim Geithner, Larry Summers, and others in the Obama Administration who are being attacked for being too soft on Wall Street? After all, people tend to forget how dire things seemed at the end of 2008 and the start of 2009.*

(*Nods*) Here's the thing. A lot of people were saying the only way out was to nationalize the banks, and now they are not revisiting what they talked about then. And what about the guys who said, "Let them all fail"? They aren't going back to what they said either…. Maybe if we had let them fail we would have had a better outcome—who knows? But I think you have to give the authorities credit for at least putting a floor under the panic. And I think [Hank] Paulson deserves some of the credit. This Administration followed some of what he did.

Now, they were playing in an environment where they really were making it up as they went along, so I have a lot of sympathy for what they did. But I do think in hindsight, and even at the time, that they could have been a lot tougher. Their fear was that if they were a lot tougher they would have taken the bottom out. I think even at that time they could have been tougher.

*You mean when they were handing out debt guarantees and equity injections and so on?*

Yes. At that time, they could have asked for more [in return], but I don't think they were focussed on it. The problem now is the banks act as if there was never a problem. It's the ex post rationale: we paid you back with profits. Well, nobody was willing to lend to you then. The effective interest rate the government should have charged would have been infinity. When there is no quantity available, the price was infinity. (*Laughs*) So to argue that it wasn't a subsidized loan just because you paid it back is ridiculous. They know it, but, obviously, it's harder to make the case to the public.

*Where do we go from here?*

The real problem is that the United States has, in many ways, been encouraging too much consumption as a palliative for other things that haven't been solved. So we muddle along because the crisis wasn't deep enough [to force big changes]. We used all our bullets. We don't have any bullets left, and we are in the process of encouraging risk-taking all over again. I'm not saying we are necessarily going to have another crisis soon. But what do we have in reserve if we haven't dealt with the fundamental problems? That's my worry—that we will emerge without a serious sense that there are problems we need to fix. We will have identified bonuses as an issue, or something like that, and imposed some constraints. But we won't have dealt with the underlying deep problems.

*Back to your own research on banking: Did you encounter any opposition to it internally?*

No, we weren't raising any hackles. Our research was about liquidity and the possibility of it drying up. It wasn't about market efficiency, or anything of that sort. It was technical and a bit obscure. In a sense what we did was we added some institutional detail to the traditional theory.

*Were there are precursors at Chicago to your line of work?*

Well, there is Ronald Coase. Coase is an important figure at Chicago, and he started this whole thing about worrying about organization.

*We have talked about the efficient-markets theory. What about the other big modern theory associated with Chicago—the rational-expectations hypothesis? What's left of that one?*

The fault of the macroeconomics profession was not so much rational expectations, which is a convenient and useful device. It was to ignore the plumbing. Economists could afford to do that for a long time because the plumbing didn't back up. Now that the plumbing has backed up you find that loans aren't really made in a pristine, pure market. Things can break down. There can be quantity constraints, when nobody is willing to lend to anybody at any price.

It's not so much rational expectations, which I think was an important advance. The mistake was that we thought the economy works reasonably well, and we could ignore the institutional details. We learned that was wrong.