

## Reviewing Krugman

Paul Krugman and Robin Wells caricature my recent book *Fault Lines*<sup>i</sup> in an [article](#) in the New York Review of Books.<sup>ii</sup> The article, and their criticism, however, do have a lot to say about Krugman's policy views (for simplicity, I will say "Krugman" and "he" instead of "Krugman and Wells" and "they") which I have disagreed with in the past. Rather than focus on the innuendo about my motives and beliefs in the review, let me focus on differences of substance. I will return to why I believe Krugman writes the way he does only at the end.

First, Krugman starts with a diatribe on why so many economists are "asking how we got into this mess rather than telling us how to get out of it." Krugman apparently believes that his standard response of more stimulus applies regardless of the reasons why we are in the economic downturn. Yet it is precisely because I think the policy response to the last crisis contributed to getting us into this one that it is worthwhile examining how we got into this mess, and to resist the unreflective policies that Krugman advocates.

My book emphasizes a number of related fault lines that led to our current predicament. Krugman discusses and dismisses two – the political push for easy housing credit in the United States and overly lax monetary policy in the years 2002-2005 – while favoring a third, the global trade imbalances (which he does not acknowledge are a central theme in my book). I will argue shortly, however, that focusing exclusively on the imbalances as Krugman does, while ignoring why the United States became a deficit country, gives us a grossly incomplete understanding of what happened. Finally, Krugman ignores an important factor I emphasize – the incentives of bankers and their willingness to seek out and take the tail risks that brought the system down.

Let me start with the political push to expand housing credit. I argue that in an attempt to offset the consequences of rising income inequality, politicians on both sides of the aisle pushed easy housing credit through government units like the Federal Housing Administration, and by imposing increasingly rigorous mandates on government sponsored enterprises such as Fannie Mae and Freddie Mac. Interestingly, Krugman neither disputes my characterization of the incentives of politicians, nor the detailed documentation of government initiatives and mandates in this regard. What he disputes vehemently is whether government policy contributed to the housing bubble, and in particular, whether Fannie and Freddie were partly responsible.

In absolving Fannie and Freddie, Krugman has been consistent over time, though his explanations as to why Fannie and Freddie are not partially to blame have morphed as his errors have been pointed out. First, he argued that Fannie and Freddie could not participate in sub-prime financing. Then he argued that their share of financing was falling in the years mortgage loan quality deteriorated the most. Now he claims that if they indeed did it (and they did not), it was because of the profit motive and not to fulfill a social objective. Let me offer details.

In a July 14, 2008 [op-ed](#) in the New York Times, Krugman explained why Fannie and Freddie were blameless thus<sup>iii</sup>:

"Partly that's because regulators, responding to accounting scandals at the companies, placed temporary restraints on both Fannie and Freddie that curtailed their lending just as housing prices were really taking off. Also, they didn't do any subprime lending, because they can't: the definition of a subprime loan is precisely a loan that doesn't meet

the requirement, imposed by law, that Fannie and Freddie buy only mortgages issued to borrowers who made substantial down payments and carefully documented their income. So whatever bad incentives the implicit federal guarantee creates have been offset by the fact that Fannie and Freddie were and are tightly regulated with regard to the risks they can take. *You could say that the Fannie-Freddie experience shows that regulation works.* [emphasis mine] “

Critics were quick to point out that Krugman had his facts wrong.<sup>iv</sup> As Charles Calomiris, a professor at Columbia University and Peter Wallison at the American Enterprise Institute (and member of the financial crisis inquiry commission) [explained](#), “Here Krugman demonstrates confusion about the law (which did not prohibit subprime lending by the GSEs), misunderstands the regulatory regime under which they operated (which did not have the capacity to control their risk-taking), and mismeasures their actual subprime exposures (which he wrongly states were zero).”

So Krugman shifted his emphasis. In his blog critique of a Financial Times op-ed I wrote in June 2010, Krugman no longer argued that Fannie and Freddie could not buy sub-prime mortgages.<sup>v</sup> Instead, he emphasized the slightly falling share of Fannie and Freddie’s residential mortgage securitizations in the years 2004 to 2006 as the reason they were not responsible. Here again he presents a misleading picture. Not only did Fannie and Freddie purchase whole sub-prime loans that were not securitized (and are thus not counted in its share of securitizations), they also bought substantial amounts of private-label mortgage backed securities issued by others.<sup>vi</sup> When these are taken into account, Fannie and Freddie’s share of the sub-prime market financing did increase even in those years.

Of course, one could question this form of analysis. Asset prices and bubbles have momentum. Even if Fannie and Freddie had simply ignited the process, and not fueled it in the go-go years of 2004-2006, they would bear some responsibility. Krugman never considers this possibility.

In the current review piece, Krugman first quotes the book by Nouriel Roubini and Stephen Mihm<sup>vii</sup>: “The huge growth in the subprime market was primarily underwritten not by Fannie Mae and Freddie Mac but by private mortgage lenders like Countrywide. Moreover, the Community Reinvestment Act long predates the housing bubble.... Overblown claims that Fannie Mae and Freddie Mac single-handedly caused the subprime crisis are just plain wrong.”

Clearly, Fannie and Freddie did not originate sub-prime mortgages directly – they are not equipped to do so. But they fuelled the boom by buying or guaranteeing them. Indeed, Countrywide was one of their largest originators of sub-prime mortgages, according to work by Ed Pinto, a former chief credit officer of Fannie Mae<sup>viii</sup>, and participated from very early on in Fannie Mae’s drive into affordable housing.

For instance, consider this press release from 1992<sup>ix</sup>:

Countrywide Funding Corporation and the Federal National Mortgage Association (Fannie Mae) announced today that they have signed a record commitment to finance \$8 billion in home mortgages. Fannie Mae said the agreement is the single largest commitment in its history...The \$8 billion agreement includes a previously announced \$1.25 billion of a variety of Fannie Mae's affordable home mortgages, including reduced down payment loans...

"We are delighted to participate in this historic event, and we are particularly proud that a substantial portion of the \$8 billion commitment will directly benefit lower income Americans," said Countrywide President Angelo Mozilo... "We look forward to the rapid fulfillment of this commitment so that Countrywide can sign another record-breaking agreement with Fannie Mae," Mozilo said.

"Countrywide's commitment will provide home financing for tens of thousands of home buyers, ranging from lower income Americans buying their first home to middle-income homeowners refinancing their mortgage at today's lower rates," said John H. Fulford, senior vice president in charge of Fannie Mae's Western Regional Office located here.

Of course, as Fannie and Freddie bought the garbage loans that lenders like Countrywide originated, they helped fuel the decline in lending standards. Also, while the Community Reinvestment Act was enacted in 1979, it was the more vigorous enforcement of the provisions of the Act in the early 1990s that gave the government a lever to push its low-income lending objectives, a fact the Department of Housing and Urban Development (HUD) was once proud of (see the HUD press releases below).

Perhaps more interesting is that after citing Roubini and Mihm, Krugman repeats his earlier claim; "As others have pointed out, Fannie and Freddie actually accounted for a sharply reduced share of the home lending market as a whole during the peak years of the bubble." Now he attributes the inaccurate claim that Fannie and Freddie accounted for a sharply reduced share of the home lending market to nameless "others". But that is just the prelude to changing his story once again; "To the extent that they did purchase dubious home loans, they were in pursuit of profit, not social objectives—in effect, they were trying to catch up with private lenders." In other words, if they did do it (and he denies they did), it was because of the profit motive.

Clearly, everything Fannie and Freddie did was because of the profit motive – after all, they were private corporations. But I don't know how we can tell without more careful examination how much of the lending they did was to meet government affordable housing mandates or to curry favor with Congress in order to preserve their profitable prime mortgage franchise, and how much was to increase the bottom line immediately. Perhaps Krugman can tell us how he determined their intent?

Interestingly, before the housing market collapsed, HUD proudly accepted its role in pushing low-income lending through the various levers that Krugman now denies were used. For instance, in 2000 when it announced that it was increasing Fannie and Freddie's affordable housing goals, it [concluded](#)<sup>x</sup>

"Lower-income and minority families have made major gains in access to the mortgage market in the 1990s. A variety of reasons have accounted for these gains, including improved housing affordability, enhanced enforcement of the Community Reinvestment Act, more flexible mortgage underwriting, and stepped-up enforcement of the Fair Housing Act. But most industry observers believe that one factor behind these gains has been the improved performance of Fannie Mae and Freddie Mac under HUD's affordable lending goals. HUD's recent increases in the goals for 2001-03 will encourage the GSEs to further step up their support for affordable lending."

And in 2004, when it announced yet higher goals it [said](#)<sup>xi</sup>

"Over the past ten years, there has been a 'revolution in affordable lending' that has extended homeownership opportunities to historically underserved households. Fannie Mae and Freddie Mac have been a substantial part of this 'revolution in affordable lending'. During the mid-to-late 1990s, they added flexibility to their underwriting guidelines, introduced new low-downpayment products, and worked to expand the use of automated underwriting in evaluating the creditworthiness of loan applicants. HMDA data suggest that the industry and GSE initiatives are increasing the flow of credit to underserved borrowers. Between 1993 and 2003, conventional loans to low income and minority families increased at much faster rates than loans to upper-income and nonminority families."

If the government itself took credit for its then successes in expanding home ownership then, why is Krugman not willing to accept its contribution to the subsequent bust as too many lower middle-class

families ended up in homes they could not afford? I agree there is room for legitimate differences of opinion on the quality of data, and the extent of government responsibility, but to argue that the government had no role in directing credit, or in the subsequent bust, is simply ideological myopia.

Let me move on to Krugman's second criticism of my diagnosis of the crisis. He argues that the Fed's very accommodative monetary policy over the period 2003 to 2005 was also not responsible for the crisis. Here Krugman is characteristically dismissive of alternative views. In his review, he says that there were good reasons for the Fed to keep rates low given the high unemployment rate. Although this may be a justification for the Fed's policy (as I argue in my book, it was precisely because the Fed was focused on a stubbornly high unemployment rate that it took its eye off the irrational exuberance building in housing markets and the financial sector), it in no way validates the claim that the policy did not contribute to the manic lending or housing bubble.

A second argument that Krugman makes is that Europe too had bubbles and the European Central Bank was less aggressive than the Federal Reserve, so monetary policy could not be responsible. It is true that the European Central Bank was less aggressive, but only slightly so; It brought its key refinancing rate down to only 2 percent while the Fed brought the Fed Funds rate down to 1 percent. Clearly, both rates were low by historical standards. More important, what Krugman does not point out is that different Euro area economies had differing inflation rates, so the real monetary policy rate was substantially different across the Euro area despite a common nominal policy rate. Countries that had strongly negative real policy rates – Ireland and Spain are primary exhibits – had a housing boom and bust, while countries like Germany with low inflation, and therefore higher real policy rates, did not. Indeed, a working paper by two ECB economists, Angela Maddaloni and José-Luis Peydró, indicates that the ultra-low rates by both the ECB and the Fed at this time had a strong causal effect in relaxing banks' commercial, mortgage, and retail lending standards over this period.<sup>xiii</sup>

I admit that there is much less consensus on whether the Fed helped create the housing bubble and the banking crisis than on whether Fannie and Freddie were involved. Ben Bernanke, a monetary economist of the highest caliber, denies it, while John Taylor, an equally respected monetary economist insists on it. Some Fed studies accept responsibility while others deny it. Krugman, of course, has an interest in defending the Fed and criticizing alternative viewpoints. He himself advocated the policies the Fed followed, and in fact, was critical of the Fed raising rates even when it belatedly did so in 2004.<sup>xiii</sup> Then, as he does now, Krugman emphasized the dangers from a Japanese-style deflation, as well as the slow progress in bringing back jobs.<sup>xiv</sup> Then, as he does now, he advocated more stimulus. Then, as he does now, Krugman ignored the longer term adverse consequences of the policies he advocated.

Finally, if he denies a role for government housing policies or for monetary policy, or even warped banker incentives, then what does Krugman attribute the crisis to? His answer is over-saving foreigners. Put simply, trade surplus countries like Germany and China had to reinvest their financial surpluses in the United States, pushing down long term interest rates in the process, and igniting a housing bubble that eventually burst and led to the financial panic. But this is only a partial explanation, as I argue in my book. The United States did not have to run a large trade deficit and absorb the capital inflows – the claim that it had to sounds very much like that of the over-indulgent and over-indebted rake who blames his creditors for being willing to finance him. The United States' policies encouraged over-consumption and over-borrowing, and unless we understand where these policies came from, we have no hope of

addressing the causes of this crisis. Unfortunately, these are the policies that Krugman wants to push again. This is precisely why we have to understand the history of how we got here, and why Krugman wants nothing to do with that enterprise.

There is also a matter of detail suggesting why we cannot only blame the foreigners. The housing bubble, as Monika Piazzesi and Martin Schneider of Stanford University have argued, was focused in the lower income segments of the market, unlike in the typical U.S. housing boom. Why did foreign money gravitate to the low income segment of the housing market? Why did past episodes when the U.S. ran large current account deficits not result in similar housing booms and busts? Could the explanation lie in U.S. policies?

My book suggests that many – bankers, regulators, governments, households, and economists among others – share the blame for the crisis. Because there are so many, the blame game is not useful. Let us try and understand what happened in order to avoid repeating it. I detail the hard choices we face in the book. While it is important to alleviate the miserable conditions of the long-term unemployed today, we also need to offer them incentives and a pathway to building the skills that are required by the jobs that are being created. Simplistic mantras like “more stimulus” are the surest way to detract us from policies that generate sustainable growth.

Finally, a note on method. Perhaps Krugman believes that by labeling other economists as politically extreme, he can undercut their credibility. In criticizing my argument that politicians pushed easy housing credit in the years leading up to the crisis, he writes, “Although Rajan is careful not to name names and attributes the blame to generic “politicians,” it is clear that Democrats are largely to blame in his worldview.” Yet if he read the book carefully, he would have seen that I do name names, arguing both President Clinton with his “Affordable Housing Mandate” (see *Fault Lines*, page 35) as well as President Bush with his attempt to foster an “Ownership Society” (see *Fault Lines*, page 37) pushed very hard to expand housing credit to the less-well-off. Indeed, I do not fault the intent of that policy, only the unintended consequences of its execution. My criticism is bipartisan throughout the book, including on the fiscal policies followed by successive administrations. Errors of this kind by an economist of Krugman’s stature are disappointing.

*Raghuram Rajan is a professor of finance at the University of Chicago’s Booth School and author of Fault Lines: How Hidden Fractures Still Threaten the World Economy.*

---

<sup>i i</sup> The book is *Fault Lines: How Hidden Fractures Still Threaten the World Economy*, Princeton University Press, 2010

<sup>ii</sup> <http://www.nybooks.com/articles/archives/2010/sep/30/slump-goes-why/>

<sup>iv</sup> “The Last Trillion-Dollar Commitment: The Destruction of Fannie Mae and Freddie Mac”, by Peter J. Wallison and Charles W. Calomiris, <http://www.aei.org/outlook/28704>.

<sup>v</sup> <http://krugman.blogs.nytimes.com/2010/06/03/things-everyone-in-chicago-knows/>

<sup>vi</sup> See, for example, “Government Housing Policies in the Lead-up to the Financial Crisis: A Forensic Study”, 2010, Edward Pinto, p130-132.

<sup>vii</sup> *Crisis Economics: A Crash Course in the Future of Finance*, Nouriel Roubini and Stephen Mihm, Penguin Press, 2010.

<sup>viii</sup> “Government Housing Policies in the Lead-up to the Financial Crisis: A Forensic Study”, 2010, Edward Pinto.

<sup>ix</sup> <http://www.thefreelibrary.com/COUNTRYWIDE%2c+FANNIE+MAE+ANNOUNCE+RECORD+%248+BILLION+COMMITMENT+TO...-a012314102>

<sup>x</sup> <http://www.huduser.org/Publications/PDF/gse.pdf>

<sup>xi</sup> P 63645, <http://fdsys.gpo.gov/fdsys/pkg/FR-2004-11-02/pdf/04-24101.pdf>. I am indebted to Edward Pinto’s work for this and the previous reference.

<sup>xii</sup> “Bank Risk-Taking, Securitization, Supervision and Low Interest Rates: Evidence from the Euro Area and the U.S. Lending Standards”, Angela Maddaloni and José-Luis Peydró, 2010, ECB working paper.

<sup>xiii</sup> <http://www.nytimes.com/2004/08/10/opinion/spin-the-payrolls.html?ref=paulkrugman>

<sup>xiv</sup> <http://www.nytimes.com/2003/05/24/opinion/fear-of-a-quagmire.html?ref=paulkrugman>, <http://www.nytimes.com/2004/08/10/opinion/spin-the-payrolls.html?ref=paulkrugman>