

The task before the incoming Governor

Raghuram Rajan comes in as Governor at a critical time for India's external sector. Even domestically, growth and job creation is falling, even as the consumer price inflation remains high. His policy freedom may also be constrained by the outgoing Governor's remarks about the case for a drop in reserve ratios.

Four years back, I attended a lecture on "*Financial regulation in light of the (2008 mortgage market) crisis*" by Dr. Rajan. I was keen to listen to him as he and Nouriel Roubini were the only two economists of repute to predict the crisis well before it occurred. Dr. Rajan listed the "meta" causes of the crisis as follows:

- ⇒ Insufficient global demand;
- ⇒ Emerging market focus on export led growth; and
- ⇒ Excessive willingness of US to stimulate.

As will be seen, speculation in mortgage securities is not part of the list. Later, I read his book *Fault Lines*. After his appointment as Governor, I have reviewed my notes on it.

There is little doubt of course that, howsoever objective an economist may try to be, his ideology is shaped by his own experiences and environment: for example, Hayek strongly believed that Keynesian monetary stimulus can only lead to "roaring inflation". The fact is that, despite the unprecedented monetary stimulus of the last five years, there is no sign of inflation in the US. In his *Road to Serfdom*, Hayek was equally critical of any intervention by the government in the foreign exchange market. On both the issues, his own experience surely influenced his views: the hyperinflation in Germany and Austria in the 1920s which wiped out his family wealth; and the fact that the hated Nazis brought in exchange controls.

To come back to Dr. Rajan's book, at one place he argues that "*Organizations like the IMF recruit students trained in industrial countries, especially the United States. Most of the macroeconomic principles that are taught derive from the experiences of industrial countries, where organized markets typically function fairly well. So it is natural for the staff to favor certain kinds of intervention in the functioning of markets, such as*

monetary policy, while being critical of other kinds of intervention, such as those in the foreign exchange market". Dr Rajan himself has spent most of his working life in the US, that too in Chicago, that "fresh water" haven of market fundamentalism. He was also the youngest ever chief economist of the IMF. No wonder he subscribes to the virtues of free capital flows. One example he gives in his earlier book, *Saving Capitalism from Capitalists*, is how this combination benefited Spain. In retrospect, capital inflows helped finance an unsustainable boom in the Spanish real estate market, ultimately leading to a banking crisis, which could still escalate into a sovereign debt crisis. The same goes for Ireland and, of course, Iceland. (Many home owners in central European countries took mortgage loans in JPY/CHF since domestic interest rates were much higher: the home owners and their lenders are in major trouble now.) Free movement of capital is hardly an unmixed blessing – indeed, economists like Dr. Jagdish Bhagwati have been extremely critical of the same logic being applicable to trade in goods and services and financial flows. Many believe that the crisis in south east Asian countries originated in the IMF's advocacy of a liberal capital account.

As far as trade in goods and services, Dr. Rajan is critical of export led growth followed by countries ranging from post-war Germany and Japan to China during the last 30 years. He argues that *"The global economy is fragile because low domestic demand from traditional exporters puts pressure on other countries to step up spending.... Governments (and banks) intervened extensively in these economies to create strong firms and competitive exporters, typically at the expense of household consumption in their own country"*. He also believes that, for such countries, *"the future does not look much brighter"*. Of the three major economies whose examples Dr. Rajan has quoted, practically every country in the European Union would like to have Germany's macro fundamentals; yes, Japan has gone nowhere for two decades, but we should not forget the absurd equity and real estate prices in that country, thanks to "finance capital" taking huge speculative bets on asset prices, the extremely volatile exchange rate, two major natural disasters and an aging population; and, it is perhaps too early to believe that China would necessarily fail in achieving a major rebalancing of its macro economy.

Whatever the criticism of Dr. Rajan for export led growth, the fact is that in the last 70 years it is difficult to think of any economy that has grown fast on imports, of both goods and services, and capital. In fact, at another place in the book he argues that “*We found a positive correlation for developing countries: the more a country finances its investment through its own domestic savings, the faster it grows. Conversely, the more foreign financing it uses, the more slowly it grows.*” What would he say about India, which has used \$ 250 bn of foreign financing to meet its savings investment gap, in the last 4 years alone, thanks to the floating exchange rate and the consequent galloping trade and current account deficits? Will he allow “*evidence, not theory, guide (his) policy*”? (Project Syndicate Mint, August 9).

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