

A Cautionary Note from the World's Most Influential Economist

By Dan Richards

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Raghuram Rajan is an expert in the finance of economic growth. In 2005, his paper “Has financial development made the world riskier?” warned of the problems that subsequently led to the global financial crisis. The Economist recently named him the economist with the most-important ideas for the post-crisis world, and his 2010 book “Fault Lines” was named Business Book of the Year by the Financial Times and Goldman Sachs.

Rajan was Economic Counselor and Director of Research at the International Monetary Fund – its chief economist – from October 2003 to December 2006, the youngest person ever to hold the position. He is a professor of finance at the Booth School of Business at the University of Chicago.

A video of this interview is available [here](#).

Dan Richards interviewed Rajan at the annual CFA conference in Scotland on May 11.

In your talk this morning, you concluded on a note of qualified optimism. You forecast “sunny with thunderstorms” in the short term, provided that we get things right going forward, and you voiced midterm optimism, but that was with a big proviso. What do you see that public policymakers have to get right to get broader economic growth globally?

In the very short term, dealing with the problems of sovereign debt in Europe must be front and center. You don't want to rattle the financial markets all over again, and you need to find a sensible way to contain this problem. There was a strategy of muddling through that seems to be reaching its limits, and how to get ahead of the problem is something that we need to think about.

Similarly in the United States there is certainly a short-term worry about the fiscal deficit. My sense is that the United States has a little more room than Europe has, and the main issue is to be aware of the problem and to put in place structures or processes that will lead to some kind of resolution in the next couple of years. The US has a little more room in part because Europe has bigger problems. In that sense, the US is fortunate.



The greater issue is how to create the kinds of capabilities to prevent the workforce from falling behind. This is true in Europe as well as in the United States. In Spain, for example, substantial portions of the population don't have a reasonable education. That makes them capable of working in construction or restaurants. Of course when those sectors contract there is a lot of unemployment, and they can't be employed in higher-quality work.

Similarly in the United States one alarming statistic is that 35% of males between 26 and 54 who have less than a high school degree are unemployed. That suggests that this economy requires more skills, and somehow the system is not providing that.

One educational policy you discussed today was investing in education for the future that would affect students today. You pointed to the success of the Obama administration's initiatives. But that begs the question of what do you do with the 25- to 50-year olds who currently lack proper education. What public policy solutions do you recommend?

That is the central question in the short run. Unfortunately, one answer seems to be jail; too many unemployed people end up in jail simply because they have no other option. They have no real source of work and no alternatives at that point that are more attractive. Tackling that issue has to be front and center.

As much as we argue that trying to build skills for mature workers is something that has had very limited success, we can't give up. We need to find ways of getting the person who left high school back into a program where they acquire skills that will improve their employability.

Some of it is just improving their presence, their ability, their discipline to go for jobs, to stay in jobs, and so on. Another issue is the skills for the jobs themselves. Building skills is not necessarily a job that government alone has to do alone, but government has to make the push to bring together the different parties – the private sector, state and local governments, as well as the individuals – to make this happen.

There are a lot of ideas. For example, you could subsidize certain kinds of entry-level jobs, so that people actually spend some time at work, and the company might hold its nose while employing them, but they become employable. That is a benefit for society as a whole.

How do you structure these programs in a way that they can actually work? This is where there will be a lot of trial and a lot of error, but we need to do it.

It sounds like you are suggesting Mao Zedong's "a thousand flowers bloom" approach – experimentation in a variety of different ways.



Which is what the US has been doing in education, and what we need to do in employability and skill building, because there is no one single answer that pops out right now. But we need to find answers quickly and roll them out in a bigger way.

Development economists like Esther Duflo of MIT have been seeing results by rigorously testing ideas in the field. That's the kind of approach where an evaluation of what works might be useful, because it may seem that some programs are working when they are not, when others may be more successful.

So you are calling for experimentation, different things, with rigorous measurement of outcomes versus costs.

We need much broader experimentation than we are doing right now. This is one of those things that may require outlays, but this could be money well spent to ward off a whole variety of different issues that could plague the system.

In your talk this morning, you also outlined the fault lines that you identified as the real causes of the financial crisis, which were not greedy bankers. You talked about inequality in the US and the lack of a safety net. But you also talked about the model for growth post-World War II, which was led by exports, as not being sustainable going forward. Could you talk a little bit about that last point?

First, of course, I am not absolving greedy bankers. They were a part of the problem, but I won't say they were the only problem.

The export-led growth model has been a very successful model. It is one in which you subsidize producers, sometimes with cheap interest rates and cheap capital and sometimes by a favorable exchange rate – but you build up firms that can go out and compete in the global markets. This combination of government support together with competition works very well in creating a strong export sector.

The problem is that it also has a dark side, which is that the domestic-facing sector benefits from the same cartelization, but not from the competition. So many of those countries have erected barriers around their domestic sector. As a result, you've got a very inefficient domestic sector, because there is limited competition. That restrains the growth of those countries beyond a certain point. To my mind, that is one of the big worries about those countries; the initial support is great, and maybe that is all you need, but once they become developed countries they become a drain on the global economy, because they require other countries to create demand.

Creating demand, especially demand beyond what you produce, is something that is a source of fragility, because it requires that at least some sectors spend more than they produce, live beyond their income, or require credit.



Credit often takes a life of its own. We saw that with the US household sector, which started splurging and – even in the most sophisticated financial system in the world – went beyond its capacity.

I worry about requiring countries or regions to overspend as a condition of their pattern of growth. That is why this pattern of growth imposes costs on other parts of the world. It's a cost that other parts of the world can bear if the point is to lift you from poverty. But once you reach reasonable levels of income, you should think about changing that pattern.

That raises the question of what should be the public policy in emerging markets going forward. Certainly there is a very bullish outlook that there will be a transition in markets like China and India to a domestic-fueled economy. You have identified some questions as to whether that is going to happen as easily as others would suggest.

The first thing is any pattern of growth builds up vested interests in those who like it. For example, exporters in China, such as state-owned firms, are benefiting from this pattern of growth. They get cheap credit. They like that. It allows them higher profits.

A subsidized currency allows emerging markets to export cheap resources such as fuel. So the interests in the build-up, as a result, don't want to go back to a more competitive structure or a fairer structure where they pay full price. So the longer you stay in this pattern, the harder it is to move away.

This is one version of what some people call the middle-income trap. You are locked into a pattern of growth that worked well when you were coming out, but which works less well later on.

That is something that China has to contend with. Premier Wen Jiabao said, "The leadership wants to move. What we need now is to take the people along." In China, that means taking the big powerful interests outside the leadership along with them.

Other emerging markets also need to think about how they may make that change. India is already in a pattern where it is more balanced. In fact, it is running a current account deficit. The Indian exports are also strengthening. It's a good sign, because it's showing that Indian manufacturing is coming into its own, but India also has to be careful.

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