Insight INVESTMENT

GLOBAL MACRO RESEARCH
POLICY IN A POST PANDEMIC WORLD

A DISCUSSION WITH DR. RAGHURAM RAJAN

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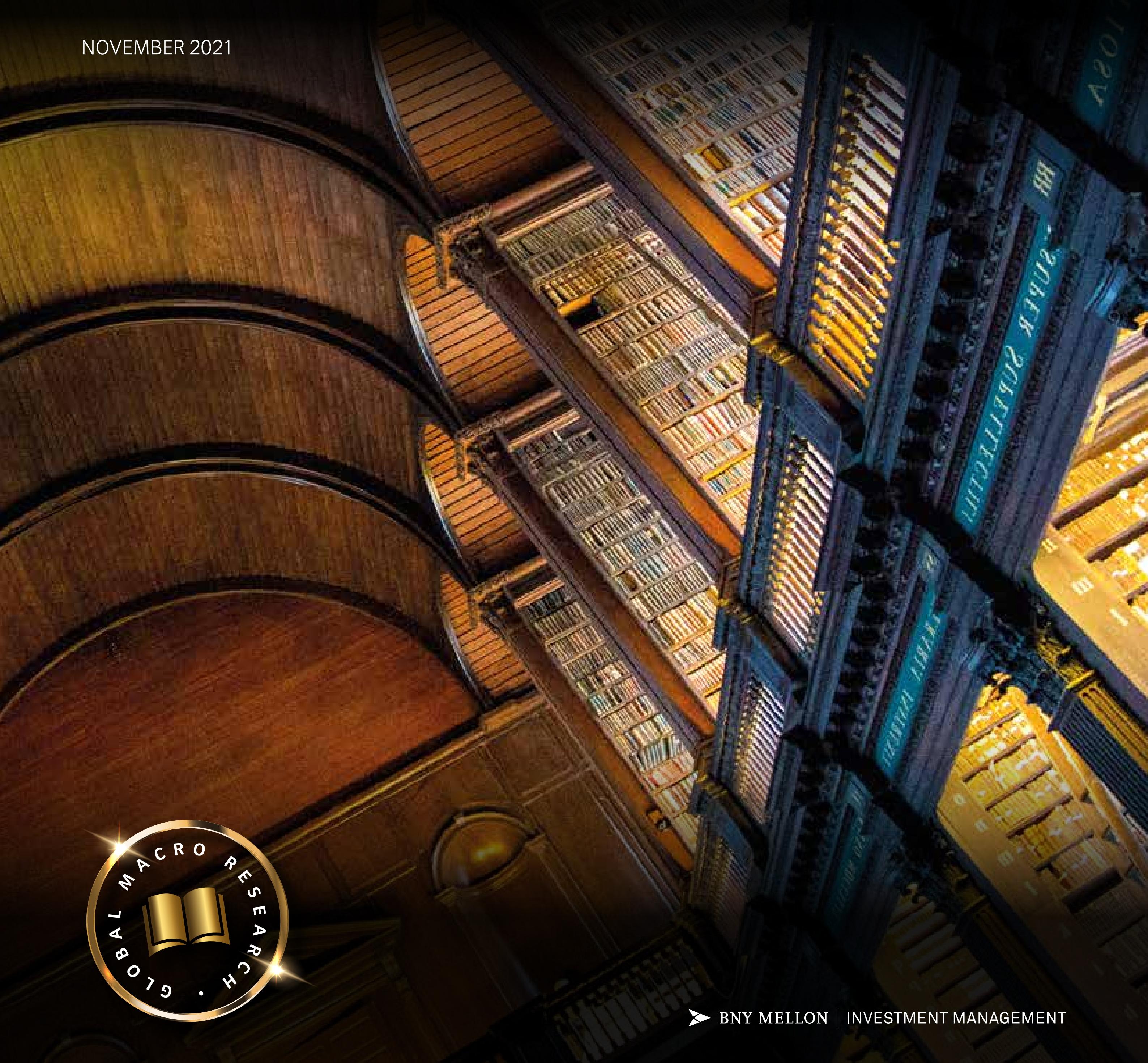

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BIOGRAPHY
DR. RAGHURAM RAJAN

Dr. Raghuram Rajan is the Katherine Dusak Miller Distinguished Service Professor of Finance at the University of Chicago's Booth School. He was the Governor of the Reserve Bank of India between 2013 and 2016, Vice-Chairman of the Board of the Bank for International Settlements (2015-16) and Chief Economist at the International Monetary Fund (2003-2006).

Dr. Rajan's research interests are in banking, corporate finance, and economic development. His book Fault Lines: How Hidden Fractures Still Threaten the World Economy was awarded the Financial Times-Goldman Sachs prize for best business book in 2010. His most recent book, The Third Pillar: How Markets and the State hold the Community Behind, was a finalist for the Financial Times-McKinsey prize for best business book in 2019.

Dr. Rajan was the President of the American Finance Association (AFA) and is a member of the American Academy of Arts and Sciences and the Group of Thirty. He received the AFA's inaugural Fischer Black Prize in 2003, Euromoney magazine's Central Banker of the Year Award in 2014, and The Banker magazine's Global Central Banker of the Year award in 2016. In that year, Time magazine chose Dr. Rajan as one of the 100 most influential people in the world.

Rajan is Chairman of CDPQ's Global Advisory Council, Senior Economic Advisor to BDT Capital, member of the Economic Advisory Panel, Federal Reserve Bank of New York and of the IMF Managing Director's External Advisory Group.

WE ASK RAGHURAM RAJAN, FORMER CHIEF ECONOMIST AND DIRECTOR OF RESEARCH AT THE INTERNATIONAL MONETARY FUND AND FORMER GOVERNOR OF THE RESERVE BANK OF INDIA, TO SHARE HIS THOUGHTS ON SOME OF THE ISSUES FACING THE WORLD AS IT SLOWLY EMERGES FROM THE PANDEMIC.

CHINA'S POLICY DILEMMA

AN OPPORTUNITY TO STRENGTHEN REFORMS

China has emerged from the pandemic as one of the stronger economies, and Chinese authorities have decided to use this as an opportunity to build on their long-term reform programme.

In China, long-term economic growth has been driven by export markets – global demand for goods upon which the country has become overly dependent. This is now causing strategic problems for China, making them vulnerable to international pressure as seen during recent trade disputes with the US. China wants domestic consumption to become a more important component of growth, but it faces a problem as low wages have held back savings and consumption. To rebalance their economy requires tremendous reform; the export sector is too reliant on low-skilled industries, and this makes it difficult to improve domestic demand.

To pay workers more, boosting consumption and domestic demand, requires the industrial base to be upskilled. China needs to move towards making chips, to go into artificial intelligence – businesses of the future. That requires more education, research and training to create a high-skilled workforce, a goal that China laid out in its China 2025 strategy, which was launched in 2015[1].

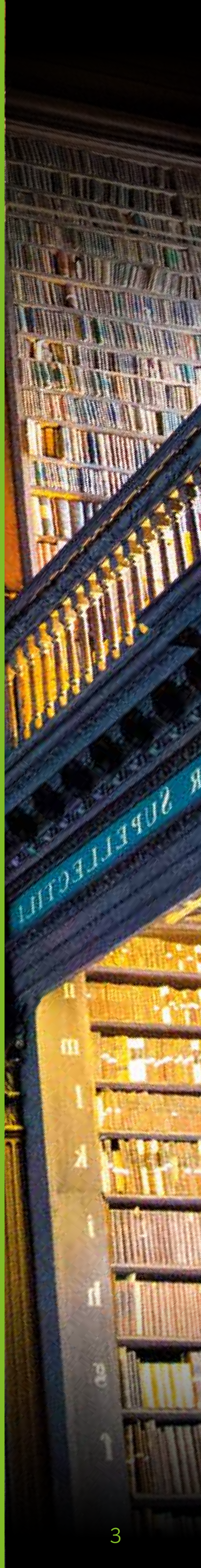
But the authorities have realised that is only part of the task. It also requires better use of capital, moving away from building blocks of flats, regardless of demand, and focusing on building specific things that people need and to a high quality. To allocate capital effectively and price risk appropriately requires reform of the financial sector.

FINANCIAL REFORMS HAVE CREATED THEIR OWN PROBLEMS

To move the country further towards its China 2025 goals, stricter rules have been introduced for developers, forcing them to better manage their assets and liabilities so as to reduce systematic risk. But the problem with these types of reform is that in the process of trying to fix the system, you can potentially break things, and hence you find a developer like Evergrande unable to finance itself.

Evergrande is very highly leveraged. When it has been building apartments, it has required the purchaser to pay up front, but it has also then borrowed in bond markets against those apartments, effectively leveraging twice. When something like Evergrande fails, it touches every part of the financial system. There are at least 10 more developers like Evergrande, and by trying to rectify the system, China has effectively made it impossible for them to get finance. So now China is faced with a dilemma. They want these developers to bear the consequences of their actions, and don't want to encourage moral hazard by quickly bailing them out. But at the same time there is a risk to financial markets and consumer confidence if the problem starts to spiral. That is the problem with modern economies: everything is connected to everything else. When you try to rectify something, it can end up becoming more problematic.

[1] In its China 2025 strategy, China aims to upgrade its manufacturing base, aiming to be 70% self-sufficient in high-tech industry by 2025, and to dominate global high-tech markets by 2049.



A CAREFULLY WORDED SHIFT TOWARDS GREATER SOCIALISM

The other measures that China is undertaking are effectively a shift back towards a more socialist economy in the hope that greater equality will boost household incomes and increase consumption. But they can't call it socialism, so they use terms like 'common prosperity', or that 'houses are for living, not speculation'. In theory these are goals that most people would agree with but, in reality, we are now seeing the authorities attack individual sectors, creating enormous anxiety for markets, businesses and households. For example, private tutors give richer families an advantage, so must be stopped. Video games are bad as they are targeted at children, so must be restricted. People are now questioning which sectors are next and which are protected, and whether everything has to now be run through the filter of Communist Party approval.

This means that there is a lot of uncertainty emanating from China right now. The Chinese authorities believe that they can control the economy and implement policies as they have in the past, but the economy is far larger now than it was. It is more sophisticated, more complex and there is far greater potential for unforeseen consequences. If the population and markets lose trust in policy, it will be very difficult to backtrack and to return things to the way they were.

> A common question is how much the US is prepared to spend to defend Taiwan, but actually there is also a question as to how much China is willing to spend to attack it.

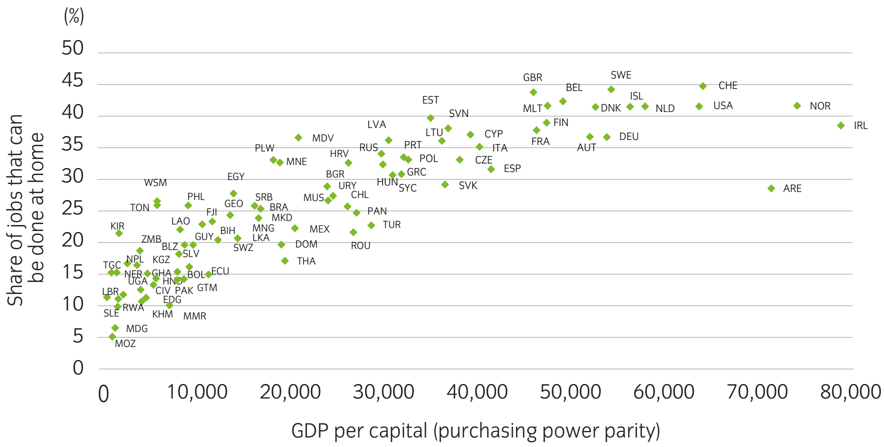
TAIWAN IS PROBABLY NOT A CONCERN IN THE SHORT-TERM

I think China initially hoped that it could convince Taiwan that it had a place within the broader structure of China, much like Hong Kong. Unfortunately, after what has happened in Hong Kong, any hopes of that have now vanished. So, a military option is probably the only way now that China could regain control of Taiwan. But that is certainly not a risk-free option – China is still dependent on the world and if the world united to impose sanctions on China then it would be extremely disruptive. A common question is how much the US is prepared to spend to defend Taiwan, but actually there is also a question as to how much China is willing to spend to attack it. Taiwan clearly understands that there is a potential military threat, so is rearming. For those reasons I don't think China will venture into Taiwan for some time yet, if at all – but where I do worry is if there were Chinese domestic problems of sufficient magnitude that military adventurism starts to look attractive to distract from that. What's happening in China today has more than just economic ramifications, it could also have political ones. So far China has navigated its domestic problems well – but that may not be the case forever.

DEVELOPING COUNTRIES HAVE TAKEN A BACKWARD STEP

More broadly, developing countries have had a terrible pandemic, both in terms of the numbers of deaths but also the economic impact. Critically, it has proved far more difficult to effectively lock their economies down as people are much less able to work from home. In the developed world, 45% to 50% of jobs can be done at home, but in poorer countries such as Bangladesh, only 10% to 12% of jobs can be done at home (see Figure 1).

Figure 1: Share of jobs that can be done at home is far lower in the developing world[2]



The other problem facing developing countries is that the governments of pandemic-struck countries had very little room to increase spending, which has left them unable to support households and only able to provide limited support to businesses. Access to vaccinations has also been limited, and many remain very vulnerable to further outbreaks of the virus should they occur.

The pandemic has also increased inequality. Those that have been able to work from home have generally been the rich or upper middle class service-sector employees. They have continued to receive income and have built savings through the pandemic. For the lower-middle classes, unemployment has seen many slip back into poverty, leaving them very angry. Large companies have generally done well, and stock markets have risen, but smaller companies have suffered.

For children, losing a year to a year-and-a-half of school is potentially disastrous. Parents are unable to make up that lost school time, so look for other options. If you are a young woman, there will be greater pressure to marry. If you are a young man, there will be greater pressure to work in the family store than to return to school. This could be a significant backward step in many developing countries, which could ultimately reduce growth over the medium term.

[2] Source: Dingel, J.I. & Neiman, B. (2020). How many jobs can be done at home? (No. q26948). National Bureau of Economic Research (https://www.nber.org/papers/w26948). UBS. Note: The chart excludes Luxembourg (x=116, 152, y=53.4%)

FISCAL DISCIPLINE COULD BE A PANDEMIC CASUALTY

One positive for developing countries has been their fiscal discipline in the years before the pandemic, a policy that has allowed them to withstand fluctuating capital flows after the pandemic hit. But the rapid increase in debt in the developed world is likely to make it very difficult for politicians in the developing world to maintain this discipline. This has been compounded by policy failure in countries such as Chile, previously the poster child for conservative, moderate policy. Chile encouraged long-term pension savings, but then used these savings as a safety net during the pandemic. The promotion of effective long-term policies is likely to become increasingly difficult and a form of fiscal radicalism is now permeating the world.

So emerging markets are the clear loser from the pandemic, both from a growth perspective, but also from a political perspective. We've already seen the pandemic impact politics in some countries, and this is likely to spread.

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DEVELOPED MARKETS HAVE FARED FAR BETTER

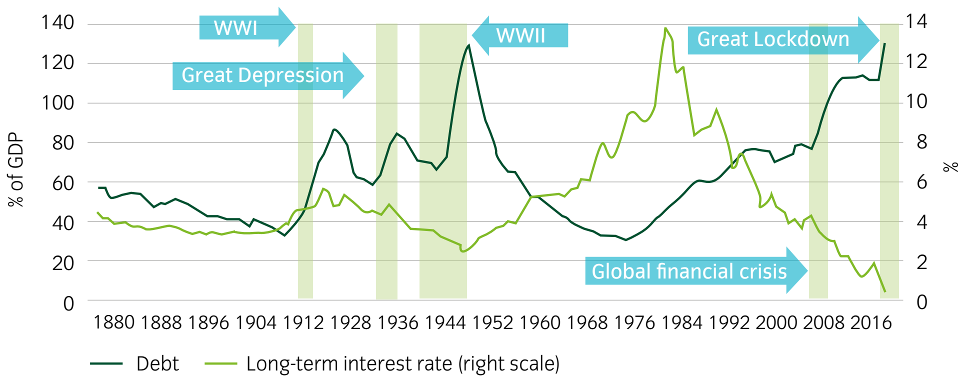
Inequalities have also deepened between developed and developing markets. In the US, middle class households have been able to use the pandemic to pay down their debts, leaving them in a stronger position to spend post pandemic. Government spending continues to provide support; for example, in the US, the Build Back Better and infrastructure bills should provide a further large fiscal stimulus.

Because services represent such a large proportion of GDP in richer economies there are also potential productivity gains that could stem from the pandemic. The mix of working from home and coming into the office in certain industries will reduce commuting times. The new communication tools we have become used to are likely to become more deeply embedded, improving efficiency over the long term. Even ideas such as ordering from an app or an iPad when you are in a restaurant are all potential productivity gains. Low productivity in developed markets has been a problem for some time, so anything that raises productivity is welcome as it should lead to stronger trend growth.

DEBT IS NOW A MAJOR CONCERN

One problem for developed markets, however, is that the fiscal responses to the pandemic have resulted in a huge build-up of debts. Pre-pandemic Italy was a clear outlier amongst developed markets with government debt in excess of 100% of GDP; that is now the norm. Debt as a percentage of GDP has now returned to levels seen after World War II (see Figure 2). Whether it is a significant concern is debatable. Some would argue not – that the very low level of interest rates means that countries can afford to sustain much higher levels of debt. That argument works, as long as interest rates remain low.

Figure 2: Debts have risen as interest rates have declined[3]



[3] Source: IMF. Historical Public Debt Database: IMF, World Economic Outlook database. JST Macro-History database; Maddison Database Project: Thomson Reuters Datastream. Global Financial Data: and IMF staff calculations.

ESCAPING THE DEBT TRAP

Typically, there are four approaches to bring debt back to levels that are more sustainable in the long term.

1 YOU CAN GROW YOURSELF OUT

I think we will see strong growth in the short term, but it's unlikely to be spectacular once the initial rebound is done, as headwinds such as aging populations are still with us. So, this is not a solution.

2 YOU CAN USE AUSTERITY

Such a solution would likely prove very difficult after governments have become addicted to spending. It's far easier to push the problem into the future, leaving our children to pay for it along with all of the other problems they will face from climate change to unfunded pension systems.

3 YOU CAN DEFAULT

But that has huge problems, and no industrial country wants to default on its debts.

4 YOU CAN INFLATE YOUR WAY OUT

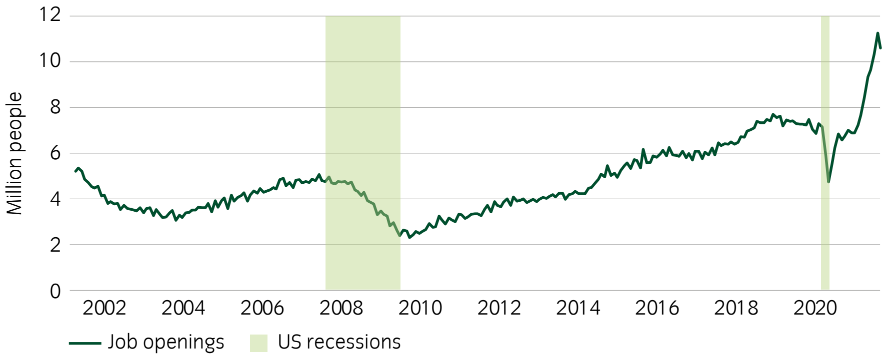
Some people appear to believe this is the only solution, but I think it's more complex once you start to properly investigate it. In order to inflate your way out of debt you need to fix your interest rates with very long maturities, effectively surprising your financiers with inflation without them being able to demand any compensation for that inflation. The UK appears well placed here, with an average maturity of 15 years. But looking more closely it also has a lot of short-term debt, and the median maturity reduces to around 11 years – still a long time. Quantitate easing also complicates things, as central banks buy long-dated debt from the market and fund it with overnight paper. In the US, this makes an already poor situation far worse. The average maturity of US debt is only around five years but taking into account the debt the Federal Reserve owns, my calculations suggest that the median maturity is only around two years. So even for those who believe we can inflate away the debts, the solution is not so easy as it may first appear.

INFLATION MAY PROVE LESS TRANSITORY THAN PEOPLE THINK

Although inflation is not necessarily a solution to the debt problem, it may prove to be more sustained than many people are suggesting. Bottlenecks were initially focused on cars via chip shortages, but they are spreading, and the global nature of supply chains is leading to knock-on effects between countries. We also now have labour shortages. We are creating new jobs more quickly than people can be found to fill those jobs.

The answer isn't as simple as people returning to labour markets after the pandemic – they are more systematic. Some of those jobs are jobs that people don't want to do anymore. People no longer want to work in low-paid frontline jobs, where they are interacting with the public and have a higher risk of getting the virus. You will have to create a lot more pain before people will feel forced to return to those positions. Secondly, many of the jobs that are being created are new, needing skillsets that are in short supply. For example, as the pandemic has accelerated the shift to digital, you need more programmers. You need an upskilling of segments of labour markets, which will require a longer-term adjustment. That won't be easy, and labour markets are likely to get tighter and remain tight for some time even after supply chains are sorted out.

Figure 3: US job openings have soared[4]



The last reason we need to worry about inflation is that policymakers themselves have changed. Post the global financial crisis, politicians produced a $1 trillion package in Obama's recovery act. Today we are already looking at a $6 trillion stimulus, with around $4.5 trillion still to come over the next 10 years. That's a huge amount of spending.

Central bankers are like the dog chasing the car: when they catch up, you can see that they aren't quite sure what to do. Central banks have introduced new inflation targets when inflation was really low and when monetary policy was the primary tool to stimulate growth. But the fiscal taps have now been fully opened. Has the environment really changed so much that such vast monetary and fiscal stimulus can be put to work together, or is this just dangerous, leaving the Fed ultimately playing catchup sometime down the line? Unfortunately, only time will provide the answer.

CENTRAL BANKS HAVE BECOME A PRISONER TO MARKETS

Another problem facing central banks is that asset prices have become highly dependent on very low levels of interest rates. This has effectively made central banks a prisoner. If they start to raise interest rates, equity markets start to fall, triggering a negative wealth effect and impacting growth. We have also seen this become a political issue. In 2018, when the Fed tried to break out of this trap, it was castigated by President Trump for tightening too early. We don't know how the new administration will act in similar circumstances. Equity markets now appear to be betting that the Fed will always come to the rescue and that interest rates will remain low into perpetuity.

In bond markets, if inflation does prove sustained, and bond markets start to think the Fed is behind the curve, then a rise in inflation expectations could see longer-maturity yields rise. As the Fed attempts to suggest that it is both hawkish and dovish to manage these two dynamics, it appears to have a split personality, with half of the Federal Open Markets Committee talking about rising rates, and the other half saying that any tightening must wait. Effectively, they are simply buying time to see how things work out. Separating tapering and interest rates is one way to do this, as it gives them eight months to watch the economy. It gives the impression that they are acting without really having any significant impact, as it's the stock of debt that the Fed holds that matters, not the flow of purchases.

[4] Source: US Federal Reserve, data as at 30 September 2021.

MODERN MONETARY THEORY (MMT) IS SIMPLY A WAY FOR POLITICIANS TO JUSTIFY MORE SPENDING

There are obviously some people who believe that policy frameworks should change even more radically, and MMT is one proposal that has been put forward. In my view, there are some serious problems with this theory.

On a basic level, MMT suggests that the only limit to fiscal spending is when it exceeds the capacity of the economy and starts to become inflationary. Spending is financed via central banks with printed money and is simply slowed or reversed once inflation starts to become problematic.

Unfortunately, though, inflation is not to be dealt with lightly. When inflation becomes a problem, it becomes embedded into people's expectations and into institutional thought, and this is unlikely to be changed by simply switching off the printing presses.

Then, even if I did believe in MMT, why would printing money have any advantage over issuing long-term debt? Right now, it is possible to issue 100-year debt at very low interest rates. So, ultimately, it appears that some politicians have seized on MMT as they are simply looking for economic theories that support their ideology. They want to spend, and MMT justifies that spending.

CENTRAL BANKS ARE LIKELY TO EXPERIMENT WITH DIGITAL CURRENCIES, BUT MORE SLOWLY THAN CHINA

Digital currencies are another major topic for central banks, and China is often seen as at the forefront of this move. In China the digital yuan is already being used as an experiment to increase control of the private sector. However, there are reasons for China's rapid implementation that aren't so pressing in other markets. Around 90% of retail payments in China are already being made digitally via Tencent's WeChat Pay and Alibaba's Alipay, leaving the authorities concerned with the concentration risk implicit in those platforms. A central bank digital currency would provide people a safe, and controllable, alternative.

Other global central banks are watching this experiment but from a more cautious position. A major problem with digital currencies is their potential to be a direct substitute for bank deposits. Today, we don't tend to hold large amounts of physical cash as it could be stolen but, if cash could be held in a very liquid digital form, inside a secure wallet, then it becomes a real alternative to a bank account. Longer term, the benefits of digital currencies to central banks are clear, as they would dramatically increase the available transaction data, allowing central banks to see transactions as they were occurring. This means we are likely to see their introduction over time, but potentially with restrictions until there is greater confidence that they won't undermine banking systems.

THE UNFAIRNESS OF CLIMATE CHANGE POLICY

The overarching problem facing the world is obviously climate change, and the UN Climate Change Conference (COP 26) is taking place in the UK in November.

Although a huge problem to solve, the silver lining of climate change is that as well as making the planet more sustainable, it could also become a source of growth. Huge amounts of investment will be needed to replace carbon-intensive industry with greener alternatives.

One problem that the world is still to come to terms with, however, is who is ultimately responsible for dealing with climate change. For example, if you look at per-capita carbon emissions, Uganda is at 0.2 tonnes per year versus 16 tonnes in the United States. So, there is an argument that developing markets weren't responsible for creating this problem, and thus shouldn't bear the cost of solving it. Yet we see policies such as the European Union's carbon levy, which will see additional trade tariffs imposed on countries that aren't implementing carbon taxes. But should Uganda really have to pay the same as the EU? Until we deal with this issue of unequal responsibility then whatever is agreed will be seen as profoundly unfair for the developing world.

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