INDIAN INSTITUTE OF MANAGEMENT
CALCUTTA

PGPEX BUSINESS REVIEW

March 2015 | Second Edition

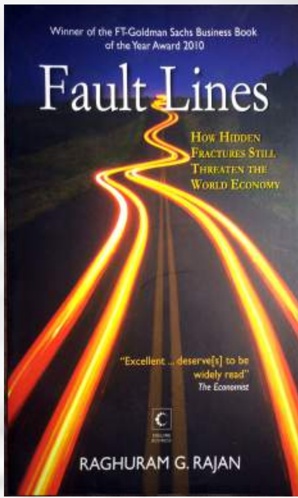
Fault Lines: A book review by Professor Menahem Prywes
Pg 03

The Growth-Inflation Dilemma: Who is the Real Culprit
Pg 06

Loans for Developing India, Gains for Japan ?
Pg 09

(Don't) Horn OK Please !!!
Pg 11

Fault Lines: A Book Review by Professor Menahem Prywes



Raghuram Rajan taught for many years at the University of Chicago's School of Business. He served as Chief Economist of the IMF, and is now Governor of the Reserve Bank of India. His book is one of what must be hundreds written on the global financial crisis of 2007-2009 but deserves to be read for delving beneath the superficial explanations for the crisis: such as greed, fraud, and bankers' excessive salaries - although these played a role. He identifies three underlying fault lines:

1. Rising income inequality in the US;
2. Developing country dependence on exports to the US: and the
3. Clash between industrial and developing country financial systems.

Rising Income Inequality in the US: Over the past several decades, the real incomes of the top 10 percent of Americans rose steadily relative to the median income—which was nearly flat. Moreover, the real income of Americans with university degrees rose relative to those with secondary degrees. This is partly because technological change increased the importance of education in the labor market. American politicians from both parties are acutely sensitive to the resulting political pressures and to the consequences for their reelection.

"...real income of Americans with university degrees rose relative to those with secondary degrees. This is partly because technological change increased the importance of education in the labor market"

However, it's difficult and time-consuming to correct the causes of inequality. The first step would be to fix the American education system. The quality of American primary and secondary education is often poor and many colleges and universities have to teach material that should have been learned at the secondary level. Limited English language skills constrain the opportunities and incomes of some migrant workers. Despite the partial failure of the system, teachers' unions often resist reforms.And the evidence suggests that the reform agenda of holding schools accountable through standardised testing, private competition with public schools, and linking teacher salary to pay may not be working.

Unaffordable health care is probably a further source of inequality. The US Congress adopted President Obama's Affordable Care Act, but health insurance reform is still politically poisonous. Further, mental health issues and especially depression, anxiety, and addictions, although rarely discussed by economists, are probably a source of unemployment and of low incomes.

Rajan differs from the conservative tradition—for which Chicago is famous—in urging the US to deepen its social protection system. He reasons that a social safety net relieves political pressures on a government, giving it time to achieve fundamental reforms, and that it relaxes pressure on a central bank to run an irresponsibly expansionary monetary policy.

His insight into the financial crisis that, in the absence of quick solutions and of an adequate safety net, politicians pressured the Federal Reserve to increase middle class consumption and home ownership by expanding the money supply and driving down interest rates. To reinforce this policy, they pressured banking and housing regulators, and government-related mortgage agencies to relax regulations on mortgage lending. The result was an expansion of mortgage lending, a deterioration of the credit-worthiness of mortgage loans, and a bubble in housing prices. Since the US is connected to the developing countries through trade and financial markets, this left everyone exposed to deflation of the bubble.

Export Dependence: This is especially serious for the newly industrialised countries that depend on exports to absorb new entrants to the labor market, to continue their growth, and to form a middle-class. To achieve this, the newly industrialised countries promoted export industries. These were kept efficient by economies of scale and international competition. But the newly industrialised countries' continued growth depends on industrial country, and especially in US, policies that promote household consumption, low savings rates, and housing, as well as on booming asset markets and in several countries (US, Greece, Italy), high government consumption. The problem is, "too many exports chasing poor policies."

A retreat in US consumption, or adoption of less consumption-promoting US policies, could then reduce the newly industrialised countries' exports and employment. Poor, developing countries are vulnerable to a crisis, such as that of 2007-2009, which would reduce their receipt of workers' remittances (for example to Mexico, Philippines, Sri Lanka, Moldova, and Tajikistan). Moreover, businesses in most developing countries would receive less credit as foreign financiers withdrew funds to gain liquidity and to reduce their risk.

> **"...to reduce their vulnerability, the newly industrialised countries should promote domestic consumption rather than exports. But these countries historically protected their inward oriented industries and these became uncompetitive..."**

The argument is that, to reduce their vulnerability, the newly industrialised countries should promote domestic consumption rather than exports. But these countries historically protected their inward oriented industries and these became uncompetitive. So, relatively low efficiency led to higher prices for goods and services supplied to domestic consumers. This increases the cost of stimulating domestic demand.

Clash between Industrial and Developing Country Financial Systems: Rajan observes that developing country financial systems depend on guarantees and assessments obtained through relationships and informal exchange of information. In

contrast, the industrial country and especially Anglo-American system is based on arms-length relationships,professional risk analysis, and transparency. This is of course a gross generalisation, considering the many industrial country corruption scandals discovered during the recent financial crisis.

So industrial country financiers find strategies to reduce their risk. They lend short-term so they can flee quickly. They often lend in foreign exchange to avoid inflation and depreciation risks. A further strategy is to lend through commercial banks, to gain the government's implicit guarantee. Sometimes they buy equities. While these strategies protect industrial country institutions, they reduce illiquid long-term investments and expose developing countries to rapid capital flight.

Could it happen again? Have these fault lines been resolved in the years that followed the crisis of 2007-09?

There have been several improvements. In the US, bank capital requirements are tighter, corporate statements are more transparent, and the regulation of mortgage lending is somewhat stricter, but the rules are now being loosened.The IMF is less likely to impose contractionary policies during a crisis and more likely to accept developing countries' use of capital controls to impede capital flight.

Moreover the industrial countries created or expanded stabilisation funds, but the focus is still on industrial and not on developing countries! The US government created a $475 billion rescue package (TARP) during the crisis. And the Fed bought $1.1 trillion in mortgage-backed securities, reducing the risk borne by the private sector. The European Central Bank intervened in the Greek Euro-crisis and the Europeans created the $615 billion European Stabilisation Mechanism. Member countries increased the IMF's capital by $345billion, but there was relatively little increase to funding of the World Bank or other development agencies.

Yet in many ways nothing has changed. Industrial country monetary policy is still accommodative and their real interest rates are now close to zero. With unattractive yields on bank deposits and on bonds, funds flow into the housing and equity markets, reflating the bubbles. In the US, the household savings rate is low and the government deficit is high.

Developing countries still depend on continued high US consumption and expansionary US policies to sustain and increase their exports and to absorb their unemployed. These same developing countries still finance US consumption, exposing themselves to dollar exchange rate and interest rate risk. Cautious foreigners still lend short-term to developing countries, through banks, and in foreign exchange, so that capital can flee easily.

With all these risks still in place, a global financial crisis can happen again! But the timing and circumstances are not easy to predict.

***Professor Manahem Prywes** is a former World Bank Economist, with over 25 years experience working in post-conflict countries leading teams in delivering effective social programs. He teaches the "Globalisation and Developing Countries" course in his capacity as a visiting faculty at IIM Calcutta.*