Q&A-Inflation transitory, but to stay elevated; No taper tantrum; Govts should mandate sustainable investments, not central banks: Raghuram Rajan,

Inflation in the United States will be transitory, but prices may remain elevated for a longer time period than expected, **Raghuram Rajan, former governor of the Reserve Bank of India**, told the Reuters Global Markets Forum on Wednesday, August 25, 2021, citing strong wages, unavailability of workforce and additional fiscal stimulus.

"Firms are feeling confident enough to pass through price increase … they don't do that until they think that these higher prices are to stay," he said.

Rajan, who is professor of finance at the University of Chicago Booth School of Business, did not expect markets to react in a 2013-style taper tantrum as the U.S. Federal Reserve unveils its plan to withdraw stimulus, which he said was unlikely to happen at Jackson Hole on Friday.

"Ideally, the Fed would like to observe as long as possible, (and)...make sure that the economy is well on track towards growth, he said. "Of course, the problem is the Delta variant, plus whatever variants are lurking in the background."

Rajan, who earlier served as chief economist for the International Monetary Fund, also said the onus of promoting sustainable investments should lie with governments and not central banks, and that central banks should instead turn their focus to financial stability of green investments and other threats such as cryptos and cyber security.

Following are edited excerpts from the conversation:

Q: What is your take on the ongoing debate regarding inflation – transitory or persistent?

A: What we have is certainly a period of confusion, but a period of confusion in which prices are elevated. Firms are feeling confident enough to pass through price increase. Typically, they don't do that until they think that these higher prices are to stay. So that means higher inflation. Wages are also pretty strong, and firms are complaining about not finding workers even though they're willing to pay more. Put all these together, it means the transitory process is going to last for some time, even if it is transitory. And of course, if all the additional stimulus we're talking about -- what the Congress in the U.S. is planning, for example, the $3.5 trillion on top of $1 trillion, they say, 'this is all fully paid for.' It's not fully paid for, there's a fair amount of deficit financing implied in it. Even though this is over 10 years, it does essentially put a floor under growth. So, when you put all these uncertainties together, it might be that we are in for a period of elevated prices. And these elevated prices could get embedded in inflationary expectations. In that sense, I'm in the camp which says, we have to be more concerned and not blindly swap this away and say this is transitory.

Q: With average inflation targeting (AIT) in place, how high would the Fed be comfortable in letting in inflation run?

A: The Fed has built in a very long runway to start the process of changing monetary policy … There's only so fast that you can taper without roiling markets. It has to start the process of tapering well before it starts raising interest rates, it has given itself enough room for that. Ideally, the Fed would like to observe as long as possible, make sure these labor market gains -- the large job addition is for real, make sure that the economy is well on track towards growth. Of course, the problem is the Delta variant, plus whatever variants are lurking in the background, as well as the greater uncertainty about the duration of the protection given by vaccines, tend to make it much harder for the Fed to forecast economic activity going forward … What this means is the Fed will have to act in an environment of uncertainty before it can be sure. I would be surprised if Chairman Powell announced an end to tapering in the Jackson Hole speech, but they will make more noises suggesting that the data are starting to look as if a fair amount of progress has been made -- not the substantial progress that they want, but a fair amount has been made.

Q: Do you think there will be a bit of back and forth in this?

A: Central banks will never say never – they're never going to say that they will not back off from a path they have chosen. But they tend to see much of their actions as being well determined, and they will change only if things change substantially. Will they say taper, or no taper based on changes in the environment, that would be extremely disruptive, they understand. That doesn't mean that once they embark on a tapering route, if the bottom falls out of the market, or if there is an extremely virulent new variant, they will not halt what they're doing. I think they will try and be deliberative about this, and when they start it will be with the idea that they will not back off unless extreme circumstances. They basically will have to put in place a policy which is robust to moderate perturbations on either side, uncertainty coming out this way or that way -- they will want to indicate some sense of firmness and confidence, rather than sway with the wind as the data come in. They might build in some data contingencies, but typically once they start tapering maybe they might say depending on the environment, we might increase the pace or reduce the pace -- those kinds of contingencies could be built in. But they are unlikely to stop completely unless the data change tremendously.

Q: How much should the Fed be worried about markets, assuming they might react negatively whenever taper happens?

A: Events rarely repeat in the same way. What may well happen is that as inflation picks up, the Fed finds it has less room, and it indicates a process of raising rates, and the market will readjust at that point. It doesn't mean the bottom falls out. Quite possibly not. The Fed will try and say we've got things under control, we're not talking about raising interest rates to 10%, it is raising it to a more normal level, and it may not be in a straight line, we'll figure it out as we go, and so on.

But certainly, some market reaction is possible. Now, whether it implies capital flows out in a tremendous way from emerging markets -- some of them are in a different position than they used to be in the earlier date pertaining to tantrum; some have built up significant levels of reserves, some have closed balance on the current account deficit. The notion of capital upping and leaving from those countries is probably more remote than it was in the last episode.

On the other hand, there are other countries that are politically fragile, that have had a substantial amount of scarring of their economies. As the Fed raises interest rates or as the Fed tightens monetary policy, it may well be that investors think we should take some money off the table here, because these are very risky investments. Now, I would suspect that some investments in developed countries will also suffer. Tech has benefited tremendously from the fact that we're pricing long-run returns at a very low discount rate. And that may change if there is a view that the Fed is going to raise interest rates reasonably over the medium-term.

Q: Is the current monetary-economic system sustainable, given the extent of debt built up in developed markets?

A: The real question is, does the spending generate revenues in the long run to pay for the debt. This is the standard thinking that any corporation has. To the extent it doesn't, it does create more problems. Now, thus far, the problems have been relatively small, because interest rates have been really, really low. In fact, the debt service requirement -- how much money you spend paying for your interest and your debt repayments -- has been really, really quite low, and in fact, has come down even as debt levels have gone up. We've been in the best of all worlds in the industrial world, because debt has gone up, but a debt service hasn't. So, a lot of people have said, we can borrow more.

The key in all this is the level of interest rates; if the level of interest rates go up, then your debt service goes up. The pace at which it goes up depends on the maturity of the debt. And increasingly, people are seeing that the maturity of the debt is not as long as you thought it was, because central banks have bought up so much, and central banks effectively shorten the maturity of government debt when they buy through a QE (qualitative easing) process. With central banks holding so much, the effective maturity of government debt can be a few years. Which means that once interest rates start moving up, as they renew some of their debt, their fiscal will get tighter and tighter. So, what looks very easy to service right now can become quite a burden soon. Bottom line, we have to maintain the quality of spending, and we have to worry about debt service, which can start ramping up as interest rates pick up. It's important that governments look to both sides at this point.

Q: Do you see more credit defaults and rating downgrades ahead? Any countries you're particularly worried about?

A: As rates go up, as it becomes harder to refinance the debt that is rolling over, some countries will undoubtedly get into trouble. Given the amount of scarring that has happened in a number of emerging markets … (and) as things normalise, as interest rates normalise, as capital starts going back to industrial countries, there will be stress. Undoubtedly, there's a fair amount of countries that will do relatively poorly in this environment. So, yes, credit downgrades, defaults could well happen, they typically happen in an environment of rising interest rates … that environment will be not so far in the future. I think we should be more prepared.

Typically, countries that don't have their political act together, that haven't set about a process of fiscal consolidation of structural reform, are the countries that investors get worried about. Unfortunately, because of the havoc caused by the pandemic, there are many more countries with likely political turmoil going forward … Typically, countries that have a difficult fiscal situation where monetary policy has to be tightened because inflation is picking up, and where the politics are getting more fragile are countries that they're watching carefully. That combination of fiscal problems, monetary impotence, coupled with political fragility is where problems arise. A lot of Latin America has these issues. We've seen a country even as stable as Chile, start to have a lot of concern, not so much on the fiscal and monetary side, but certainly on the political side.

Q: How should central banks in developed and emerging markets manage the entire shift on climate change -- should they set up a mandate, like the BOJ, to boost lending to green projects, or go the ECB way to buy green bonds?

A: I am a little wary about expanding central bank mandates to directly focus on encouraging green. I think central bank mandates already pretty wide, including financial stability, monetary stability. At this point if you also say you have to go green, unless there is a specific policy rule that the fiscal authorities can give the central bank, it seems that this is something that is best left to the fiscal authorities. If you want to encourage green investment, why don't you incentivise it by offering tax subsidies or make green bonds more attractive by offering interest rate subsidies -- fiscal authorities can do that. To my mind, asking the central bank to say you should buy only green bonds, not brown bonds, etc., is asking the central bank to impose its own views on something which is primarily a fiscal matter. The fiscal can, of course, give the central bank its marching instructions by saying we the elected representatives of the people think you should buy only bonds in these industries, but not in those. So, they take away the judgment from the central bank. In that case, that's the central bank's mandate, it's been given, it should do it. But that's the part of the fiscal rollout, rather than something the central bank has to decide. The more the central bank gets into green, which is not legislated, the more it gets into the realm of politics, and it's already fairly political, I think it's a bad idea to get further. That doesn't mean that the central bank shouldn't pay attention to greens for financial stability reasons. But then it should also be worried about crypto threats to financial stability, cyber security … and cyber hygiene … is a big issue.

Q: What is the future of crypto currencies, and how do you see it fitting in the broader financial system?

A: I think that they have a potential future. Right now, in this heady environment with asset prices really picking up, many cryptos are also being valued -- not so much as a means of payments -- but as assets in their own right. There is a valuation, but what is the fundamental backing of that valuation – it's not clear. It is, as some people term it, the new gold; except gold can be worn as jewelry, you can't wear a crypto as jewelry. I think there will be use cases that will emerge -- stablecoins, properly regulated, have a future. I think some cryptos, even though they have fluctuating values, might find a way to become an effective means of payment. Cross border payments are one area which is wide open, because of the huge transaction costs of making cross border payments.

But crypto focused primarily on evading authorities, or primarily on the somewhat silly, in my view, notion that this is much more stable a store of value than fiat currencies -- yes, there's been a lot of monetary easing, but that doesn't mean fiat currencies are going to implode and there's going to be hyperinflation. One could argue that there's much less supporting the value of these cryptos than what is supporting the value of fiat currencies.

So, there is sort of a paranoid view of the value of cryptos. This your last resort when the world implodes. I don't think so. I think the value of cryptos has to be seen more in terms of are they going to be useful in the system going forward. Yes, some of them have value because they have value, and maybe that will persist. I'm not going to say that bitcoin is going to implode tomorrow. But I will say that I would be much more confident about the value of these cryptos once they find proper use cases, and the technology is evolving to make that happen. So, we should watch it, we should not get it too big without appropriate regulation. Unfortunately, some of that might be too late, for example, with the stablecoins. But we should react quickly at this point.

Q: In India, as supply-side shocks prevail and monsoon remains in deficit; do you think this could act as a catalyst in swinging inflation higher, even as the central bank is grappling with the growth path without worrying about prices?

A: I don't want to speak directly about monetary policy in India, I think it's not fair for me to do that. But I think what India is grappling with is similar to what's happening in other countries, which is a very uncertain environment, where you have a certain amount of pent-up demand -- the richer households have managed to save, even while the poorer households have had to borrow to sustain themselves during this pandemic. And so, it is possible that at least for a certain set of goods, as we rebound from the second wave, which is underway, you can find a fair amount of demand and if we're not prepared to meet the demand, there would certainly be some bottlenecks, some supply-side constraints, which would allow firms to raise prices.

So, you could get an environment of rising prices, even though overall aggregate demand is relatively weak, because this demand is being expressed in some sectors, not in all sectors. Over the medium-term, demand will fall back because of the stressed households and the scarring as a result of pandemic. But in the short run, you could have more inflation. So, we in India may be in a similar position to a number of emerging markets. What you see around the emerging world is a number of central banks are being proactive and raising interest rates. Now, obviously, the RBI (Reserve Bank of India) is watching the data and it will make the decision when it when it has to make it.

Q: Can the U.S. dollar face headwinds as a reserve currency in the near future as widely speculated?

A: A lot of the chatter has been generated by two factors.

One, of course, is the resilience of the Chinese economy during the pandemic, and the sense that, almost inevitably, it will become the biggest economy in the world over the next decade or so. And second, the fact that China's rolling out a e-CNY, essentially a digital yuan. There is a thought that perhaps that may be the initial step in effectively displacing the U.S. dollar. I think the experiment with the e-CNY is certainly worth watching. The U.S. Fed's views on the digital dollar now are becoming more pressing, and there are some people who are urging the U.S. to move faster on it.

But when you talk about reserve currency, it is not just about whether you have an easy currency to transact, but also all the other kinds of investments that you can make when you are in that currency, as well as the rule of law, the ease of getting in and getting out, transparency, depth of markets, etc. If you take the sum total of all that, it is still the case that the United States is the deepest and most accessible for financial markets. And so, yeah, we will talk about the challenges to the dollar, but it is going to take a fair amount of time before any alternative sort of emerges, which can displace the dollar.

One of the possibilities in the emergence of an alternative will be that this (alternative) offers competition for a lot of people who want an alternative to the dollar. The U.S. dollar has more staying power than most people think. People are not going to switch overnight because there are a large number of institutions, including the U.S. judicial system, which they have grown to trust and believe that that it will protect them. The U.S. undermines some of this by sometimes arbitrarily sanctioning certain people, certain countries. It would be good for the U.S. to evolve a process by which that happens, so that people have more confidence that they can rely on the vaunted U.S. judicial system and not be subject to the whims and fancies of whoever happens to be in the administration at that point.

Q: What, if anything, has been the main development in your thinking since when you wrote *'Fault Lines'* a few years ago?

A: I obviously focused on the difficulties of the financial system then. But I said that the problems in the financial system were driven by problems from outside, primarily the growth in inequality. If anything, my conviction is stronger that the growth in inequality, especially the inequality of opportunity embedded in the industrial world, but also in many emerging markets including India, is the single biggest problem of our time. It has expanded as a result of technological change. If we don't fix it, we have increasing tensions within countries. Think of the fact that in many countries the dominant community is feeling threatened, because its economic opportunities are faltering. We see that in every country, we see that in India, where pretty dominant communities like the Patels or the Jats are feeling 'we don't have an economic future,' because our mainstay, which was agriculture, the productivity has fallen, returns have fallen, while the other jobs, you need a powerful education to get there, and that is much harder nowadays. So, I think that the same forces are affecting many countries, and we need to deal with it. Otherwise, we'll see bigger problems down the line.

Q: What would be your biggest worry for the next couple of years from a central bank perspective?

A: I think from everyone's perspective, it is dealing with the pandemic. I think the danger has been that we have taken it too lightly. We still don't have a collective global response. Every country is under-investing in vaccine production. It seems like you need vaccine production on a war footing. We're finding out now that the effectiveness of even a vaccine like Pfizer is six months, at least that's the sense now. Think of how much production we need to get the whole world vaccinated. And what if there are new variants beyond Delta? Governments have been taking this too lightly and governments haven't been coming together at the global level to have a global ramp up. I think this is a very severe indictment. I would say this is problem one, everything else pales in comparison to putting the pandemic behind us and putting it behind us effectively, so that people can gain confidence and go about their day. Look at the damage done to children during this time. Even in industrial countries, the damage done to their schooling is tremendous. But take the damage done in emerging markets, you set kids not by a year and a half, they've gone back two years or three years. And three years could be a barrier which cannot traverse.