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Rajan's Wins at India's Central Bank Hint at Broader Ambitions

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Raghuram Rajan, governor of the Reserve Bank of India, sometimes sounds more like a chief government adviser than a central banker as he opines on everything from social inclusion to democracy.
Photographer: Tomohiro Ohsumi/Bloomberg

(Bloomberg) -- When Raghuram Rajan became governor of the Reserve Bank of India in 2013, the former International Monetary Fund chief economist vowed to shake up a central bank that had a confusing mandate and a dismal record of containing inflation.

Now, 18 months later and half way through his term, India is discovering just how deep Rajan's policy ambitions run. He's coming off a big win: On March 2, the Indian government publicly released an agreement that for the first time gives the central bank a legal mandate to target inflation.

But he's not just out to tame inflation or refocus India's central bank mandate on price stability. In speeches and interviews, Rajan sometimes sounds more like a chief government adviser than a central banker as he opines on everything from social inclusion to democracy.

"One of the greatest dangers to the growth of developing countries is the middle income trap, where crony capitalism creates oligarchies that slow down growth," Rajan said in a speech last year. "To avoid this trap, and to strengthen the independent democracy our leaders won for us 67 years ago, we have to improve public services, especially those targeted at the poor."

All of which raises an intriguing question: Might Rajan someday jump in the raucous world of Indian party

politics?

“I would not be surprised if the RBI governorship was not his last stint serving the government of India,” said Milan Vaishnav, an associate in the South Asia program at the Carnegie Endowment for International Peace in Washington. “Whether he would make for prime ministerial material is hard to say.”

Long-Held Passions

Analysts and friends say his various policy interventions merely show passion for subjects that he has long cared about, rather than political ambitions.

“I don’t think he is injecting himself into politics as much as he is injecting himself into broader discussions,” said Shang-Jin Wei, chief economist at the Asian Development Bank in Manila who worked under Rajan at the IMF.

The governor wasn’t available for an interview, according to Alpana Killawala, a spokeswoman for the RBI. She referred to his public remarks on his agenda for the central bank and relations with the government.

The RBI has produced one Indian leader in the recent past. Former Prime Minister Manmohan Singh, the Oxford and Cambridge trained economist who appointed Rajan, ran the central bank from 1982 to 1985.

Corrupt Middlemen

Rajan’s speeches over the last seven months have wandered into policy matters not usually associated with central banking.

He has proposed direct cash transfers to the poor to liberate millions from corrupt middlemen and politicians, and called for new bankruptcy law and courts to restore “the sanctity of the debt contract.”

At the same time, Rajan has advised against subsidizing exports as part of “Make in India,” Prime Minister Narendra Modi’s flagship plan to boost local manufacturing.

Rajan’s bid for greater influence does carry some risks. For one thing, he’s a holdover from Singh’s Indian National Congress-led government.

His economic policy goals -- taming inflation and winning greater independence for the central bank -- haven’t traditionally been big priorities for Modi’s Bharatiya Janata Party, whose base consists primarily of Hindu conservatives and small business owners. At least one fringe member of the party publicly called for his ouster.

‘Speaks His Mind’

“He is quite an active RBI governor and not really kowtowing to the government,” said Mohan

Guruswamy, chairman of the New Delhi-based Center for Policy Alternatives and a former finance ministry official. "He is seen, he is vocal and he speaks his mind. Usually RBI governors tended to be low key and quite often they used to be pushed around by the government."

Asked in a Feb. 4 interview with Bloomberg TV India whether the government is listening to his suggestions, Rajan laughed and said: "I hope they are," adding: "There is a dialogue that is constant, that is on a variety of issues, and I think there is a very cordial relationship."

Rajan's ability to persuade Modi's government during a year of negotiations to sign off on a formal 4 percent inflation target, plus or minus 2 percentage points, in its latest government budget was one of the biggest victories for the central bank in its 79-year history.

Economists said policy makers now have a powerful tool to tame one of Asia's fastest inflation rates, with the political legitimacy to keep interest rates higher than the government may wish if required.

Rate Cut

Tensions over interest rates, while common, had flared and come out in the open between Rajan's predecessor Duvvuri Subbarao and then Finance Minister Palaniappan Chidambaram.

"India's adoption of an inflation target is an important step forward in strengthening the operational independence of the RBI," Eswar Prasad, a former chief of the IMF's China division and now an economics professor at Cornell University, said in e-mailed remarks.

In a signal of Rajan's deft political maneuvering, days after the inflation agreement was unveiled he lowered interest rates a quarter percentage point to 7.5 percent in his second unscheduled move in as many months.

That reduction, which came sooner than economists expected, was viewed as an endorsement of the government's budget even as consumer price gains have quickened. While inflation in India has slowed sharply from a double digit pace last year, it remains the third fastest among 17 Asian economies tracked by Bloomberg, accelerating 5.37 percent in February.

Inflation Target

In a statement explaining the move, Rajan cited weak growth, softer inflation, and the quality of the government's fiscal plans as justification. He also said the rupee, Asia's second-best performer against the dollar this year, remained strong relative to peers. India's benchmark stock index, which climbed to a record soon after the rate cut, is among the world's top five biggest gainers over the past 12 months.

Traders continue to bet that more rates cuts are coming and some economists believe that the government is still pressing Rajan to lower rates. "He's under substantial pressure to cut interest rates and he has had this pressure for a while," Abhijit Banerjee, Ford Foundation International Professor of Economics at the Massachusetts Institute of Technology, said by phone.

India's move to introduce an inflation target comes decades after New Zealand's central bank first came up with the formula. The tool may not be as effective in India as other economies because the consumer price index is almost half made up of food, the supply of which depends on the weather and can be hampered by insufficient storage capacities and infrastructure. That means prices can be easily distorted.

RBI Reforms

"Inflation in India is subject much more to supply shocks than it is in other countries, which makes an inflation target difficult," said Charles Goodhart, a former member of the Bank of England's Monetary Policy Committee and a professor at the London School of Economics.

The inflation target isn't Rajan's only ambition for the central bank, though so far, the changes have been slow. He wants to diversify management, encourage staff to specialize their skill sets and appoint a chief operating officer to look after its day-to-day functioning. Faced with staff resistance he has had to put some of his plans on the backburner.

Other changes are slated to come. Modi's government, with Rajan's input, plans to introduce a monetary policy committee to steer policy in a process similar to the Federal Reserve or Bank of England.

Details on the structure and make up of the planned decision making body haven't yet been announced. Banking reforms, including efforts to corral bad loans, are also likely to remain a focus for Rajan, who already issued new banking permits for the first time in more than a decade.

Rajan Warning

Rajan's tenure as chief economist at the International Monetary Fund between 2003 and 2006 catapulted him onto the world stage. His warning in 2005 of a financial crisis was largely ignored at the time but later won him plaudits in the wake of the 2008 financial crisis.

After leaving the IMF, Rajan took up a role at the University of Chicago's business school. "He can see through to the heart of the problem and also see solutions," said Randall S. Kroszner, professor of economics at University of Chicago's Booth School of Business and a former Federal Reserve governor, said by phone.

Not all of Rajan's policy interventions have gone smoothly. In a speech in January, local press seized on his remarks that strong governments may not always move in the right direction-- Hitler's Germany was one of his examples--a veiled advice to Modi, they wrote. Neither Rajan nor the government commented on the reports.

IMF Job?

He has ruffled feathers on the world stage too. In 2014 as the Federal Reserve signaled it would end its program of quantitative easing, Rajan warned of a breakdown in global policy coordination and called for greater cooperation among central banks to avoid upheavals in emerging markets.

That view didn't resonate in Washington, where a rapidly improving U.S. economy has the Fed on course to tighten interest rates. "I thought it was a rather strange criticism for him to make but it is water under the bridge now," said George Magnus, an independent economic consultant and senior economic adviser to UBS Group AG.

Rajan's stint as governor, which expires in September 2016, can be extended by another two years if Modi wishes. That's also around the time Christine Lagarde's term as the IMF's managing director comes to an end.

Asian governments are likely to push hard for a successor to come from the region, and Rajan could be top of the list. "He is certainly one of the finest monetary economists of the current generation," Goodhart said.

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