CONVERSATIONS
A Global Forum

Raghuram Rajan

in conversation with
Ann Bernstein

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To mark 25 years since its establishment, in November 2020, CDE initiated a series of discussions with global experts and prominent individuals in South Africa on important questions on democracy, business, markets and development. The series was relaunched in 2022 as CDE Conversations. This is the 28th event in the series.

Ann Bernstein: We are delighted to have Raghuram Rajan, one of the world's leading financial economists, as our guest tonight. He is a professor at the University of Chicago's Booth School of Business. His career includes a stint as the chief economist at the IMF in Washington (2003 to 2006), where, in 2005, he famously warned of the impending global financial crisis, that indeed became a reality in 2008. Raghu served as the chief economic advisor to the Indian government and was governor of the Reserve Bank of India (2013 to 2016). He is the author of many books, and I am going to touch on a few of them during our conversation today.

I will start with comparisons between China and India. Why was China so successful – in comparison to India – in leveraging low-cost manufacturing to move hundreds of millions of people out of poverty? India's share of the global garment trade has declined by over 20 per cent since 2015, while Bangladesh and Vietnam are surging ahead in this area. Why is export-led industrialisation so hard for India to get going at scale?

Raghuram Rajan: India and China share similarities. They are the fastest-growing developing countries and both have populations of over 1.3 billion people. However, three factors differentiate each country's development trajectory.

For one, China prioritised education earlier in its development path. This focus on education long before industrialisation took off, equipped its workforce with the basic numeracy and literacy skills they needed for factory jobs. By the time China liberalised in the early 1980s, the level of education amongst its people was significantly higher than in democratic India. But more importantly, as Yasheng Huang at MIT argues, education was a significant factor that enabled the Chinese to branch out into small enterprises, enhanced by the technical knowledge they acquired in the factories. This led to an explosion of Chinese entrepreneurship, small manufacturing workshops, and village enterprises.

India did not focus on education, partly because of a lack of demand given its largely rural economy, and perhaps the caste system imposed limitations on educational aspirations. When India began to liberalise, the demand for higher-qualified workers increased, but the focus on education came much later than in China.

Secondly, China's decentralised governance framework empowered party functionaries – who wanted to rise up the ranks of the Communist Party by driving growth locally – to waive rules and overlook regulations so long as they favoured local champions. The overall Chinese regulations, as in India, were not business-friendly, but the local Chinese authorities were able to tailor them to drive local growth. In contrast, India's centralised system meant that the rules formulated in the national or state capital applied uniformly. The local dynamics so important in China did not emerge as strongly in India.

The third contributing factor was China's authoritarian regime. Suppressing market forces and trade unions resulted in wage growth lagging behind productivity growth, which in turn incentivised firms to employ more workers. The regime also kept lending rates low to provide cheap capital to firms. None of this could have happened in India, where a strident, vocal middle class as well as unions protested for their rights.

Currently, there are several factors that prevent countries from following a manufacturing-led export path similar to Vietnam and Bangladesh. For one, China still dominates low and moderate-skill manufacturing making it difficult for newcomers to compete. At the same time, high levels of protectionism are emerging worldwide restricting developing countries' access to these markets.

Finally, with the growing importance of new technologies, cheap labour, while it can still provide a competitive edge, is no longer the advantage it once was.

Ann Bernstein: Let me move to the issues you raise in your new co-authored book, **Breaking the Mold: India's Untraveled Path to Prosperity**. In it, you make an argument for India to adopt a different approach to growth from many other developing countries. And that is one led by services. Could you talk to us about this new model for growth, and why you think it is so important now?

Raghuram Rajan: I think the mistake that countries like India have made in the past – and this is meant as a broader lesson for countries in Africa and Latin America that still need to transition to middle-income status and beyond – is to say that we are going to pick certain industries to succeed and then focus on promoting those. Countries like India should not neglect manufacturing, but they also should not pour enormous subsidies into manufacturing to create export-led growth, because that path may be much more challenging today and may not yield the successes witnessed in China, Taiwan, or Korea.

Interestingly, some of the most successful industries in India's history have been ones the government did not focus on, which is what the author Gurcharan Das implies in his book about India growing at night.[1] The idea is that growth occurs when the government is not awake to interfere. In essence, picking industries is often not a good idea because governments tend to choose the wrong industries, the 'shiny' industries with high capital costs. Today most countries aspire to become chip manufacturers, which is horrendously expensive. That is not what poor developing countries should be focusing on. A much better focus is on improving the quality of human capital. Because if there is anything that will stand you in good stead in the future, it is human capital. Yes, we need physical infrastructure and financial capital, but if you lack human capital, you lack the solid foundation for competitive growth.

Another error is that we have become so fascinated by the export-led manufacturing growth model that we assume it is the only way. The world has changed, and we need to consider alternative pathways to growth. Services it is clear, especially services embedded in manufacturing, can enhance export opportunities while employing a large number of moderately skilled people.

Let me illustrate. Both India and South Africa have a pool of highly qualified people who can work remotely as consultants worldwide. During the pandemic, we learned that consulting services can be offered remotely from Chicago to Seattle. Why can it not be Cape Town to Seattle or Bangalore to Seattle? Many consulting firms have embraced a model of creating a global workforce capable of delivering back-office and front-office services.

We should also note that a lot of value-add occurs in the services embedded in manufacturing. Richard Baldwin's 'smile curve' illustrates that the most valuable stages of the production process do not lie in manufacturing: they have shifted to services. For example, manufacturing accounts for a small fraction of the iPhone value chain. The market value of Foxconn, which manufactures everything for Apple, is about $50 billion, while Apple has a market value, on a good day, of $3 trillion. Why? Because Apple controls the strategic stages that capture greater

[1] Gurcharan Das, 'India Grows at Night: A Liberal Case for a Strong State', India: Penguin (2019).

value in the chain. It owns the intellectual property and controls the design and content creation, including digital services like iTunes, transaction and commission fees from in-app purchases, and the marketing of final products sold in iStore shops worldwide. When you own the services that are embedded in the manufactured iPhone you get a lot of the value. The manufacturing itself is a small fraction of that value.

Now, you may say, this is all very well for software programmers and designers. But who is going to create jobs in services for ordinary, moderately educated people?

Well, services can provide an enormous number of job opportunities in urban sanitation, retail, and healthcare provision, for example. Healthcare in many poor countries can be provided not just by doctors. There are very few doctors relative to the population in poor countries, but there could be a first line of contact for the public, the equivalent of the Chinese barefoot doctor. In India this is usually a person who used to be a pharmacist or somebody who used to mix medicines in a store and now calls himself a doctor. If you could train these people up to recognise 20 basic diseases, they could be the first line of contact for the public. The second line would be a qualified doctor who can then diagnose further, and the third line would be the hospitals that provide treatments and procedures. There is so much scope for job-creation in public health services.

Ann Bernstein: One of the advantages of export manufacturing is the increase in the quality of local firms, which partner with exporting firms, often from other countries. Do services provide the same sort of linkages and benefits that manufacturing generated in Thailand, Malaysia, and China in terms of huge productivity improvements in firms as well as in workers?

Raghuram Rajan: In theory you get the same 'learning-by-doing' in a services firm that you do in a manufacturing firm, especially if you invite international competition. Yes, manufacturing firms can achieve much greater scale than services firms, but we are now seeing gigantic service-oriented firms like Accenture across the globe. One of the fastest growing trends in India is the establishment of Global Capability Centres set up by multinational firms to focus on research and design. Goldman Sachs' biggest office outside of New York is in Bangalore, and it offers workers significant learning opportunities in trading and risk management models. You are getting the same knowledge transfer, which is one of the biggest benefits that foreign manufacturing firms created in developing countries. The details may differ, but the principles are the same.

The question is not whether you should have manufacturing or services. It is ideal to have both if you can. The problem is that manufacturing today may offer far less of the kinds of opportunity it once offered Taiwan and South Korea. If we were in the 1980s, I would say "go for manufacturing" to India. But we are in 2024, and the pathway is much narrower at this point, especially since every country is experiencing its own dose of manufacturing fetishism, which has fuelled a protectionist response in emerging and developed countries

Ann Bernstein: Would it be fair to say you should carry on with low-skill manufacturing where possible, because you can get people into low-skill manufacturing jobs very quickly, especially if they come from rural areas or if they have not had an opportunity for a decent education. But at the same time fix your education system as fast as you can, so that you can get people into what tend to be higher skill services jobs? Or is that wrong?

Raghuram Rajan: The second part is absolutely right; you must fix your education system to improve the quality of your human capital. And you cannot keep delaying the investment, let alone continue to make excuses for another 20 years. While you should have started ten years ago, now is the best time, given the potential job losses due to robotics, artificial intelligence and protectionism. We do not know how every sector will be disrupted, but your only protection is human capital. Firms want to hire workers equipped with the necessary skills. Equally important are the entrepreneurs capable of starting new enterprises and innovating.

On the first part, I am concerned about countries that do very little to improve the quality of their human capital because they see low-skill manufacturing as a way to mop up uneducated work seekers. Opportunities to expand low-skill manufacturing jobs are limited, and there is so much competition from countries that may have a better quality of infrastructure or may have less concern for workers' rights. While I agree that we need jobs for the work seekers we have wherever we can get them, if this is not occurring in low-skilled manufacturing we should consider low or moderately skilled services.

Service sector jobs are, in fact, often neglected area in our cities. Finding a good plumber in an Indian city is almost impossible because we have not trained people to provide modern sanitaryware services. It is essential to recognise the job creation opportunities in services that require plumbers, electricians, machine repairs, etc. Many countries, including South Africa, aspire to become fully developed countries, characterised by high levels of per capita income and low levels of inequality. However, that requires elevating the bottom of the pyramid tremendously by investing in it today. That means addressing issues such as malnutrition, poor childcare, and bad basic education. It involves laying a solid foundation from birth to provide sustainable pathways into the global economy for your workforce in 20 years' time.

Unless you fix education today, there is little hope of reaching developed country status. This is what I keep trying to tell my Indian compatriots: stop spending so much time imagining the future and focus more on fixing India's problems today.

Ann Bernstein: You have said that, rather than pushing for a better form of globalisation in which past mistakes are addressed, too many of today's elite are willing to hedge it with enough caveats so that it becomes rank protectionism. For example, the U.S. imposes minimum wages on car workers in Mexico, and India has required a license to import computers. Talk to us about this from a developing country perspective.

Raghuram Rajan: The licensing restrictions on computer imports were incomprehensible and had several unintended consequences that hindered India's booming exports from the software services industry. Fortunately, that policy has since been reversed and consigned to the rubbish heap where it belongs.

On the issue of protectionism, we are all familiar with arguments about how open markets are a great thing, and how they helped the West to grow after the post-war malaise. Every country was urged to open its economy. I remember lectures from the IMF and the World Bank, encouraging countries like India to open their economies and deepen integration into the global economy. That was not bad advice, but it neglected the fact that the benefits of globalisation were unevenly distributed and created winners and losers.

Now, we see the same problems afflicting developed countries. Numerous research papers on the China shock have highlighted how job displacement in U.S. towns that were once manufacturing hubs went hand in hand with social problems such as family breakdown. This is blamed on China and used as an excuse for labelling globalisation 'an elite project,' i.e. it only benefits the rich.

The real problem is that the U.S. failed to protect workers facing economic displacement. Ideally, the U.S. should have adopted trade adjustment measures and retrained and upskilled these workers and their communities.

The Scandinavian countries, by contrast, were proactive in reskilling their workers. These countries recognised that going against globalisation was not feasible for them, and they adopted strategies to ride the wave and support those who may have been left behind.

It was hypocritical of free trade economists to preach the virtues of open markets to the developing world knowing full well that there would be some who lost out in the process. And no one offered any understanding despite research highlighting the adverse effects of trade on the most vulnerable in developing economies. Perhaps it was good for countries to globalise, but it was very bad for those in them that were hurt. We needed a more empathetic globalisation, which we did not get because the marginalised in developing countries had no voice.

We are now witnessing the rise of anti-globalisation movements in democratic countries as more and more well-resourced marginalised people vocalise their concerns. Both political parties in the U.S. are effectively anti-globalisation.

There appears to me to be a deficiency in the attitude of economists from industrialised countries who have suddenly rediscovered the value of protectionism or who now hedge all endorsements of free trade with enormous caveats. This is further compounded by subsidy wars as every country tries to outdo its strategic competitor.

Ann Bernstein: Let me touch on industrial policy. You mentioned earlier that the new elite project is industrial policy aimed at creating national champions. What is wrong with that in your view?

Raghuram Rajan: There is nothing wrong if the national champions become national champions through open competition, not just domestic competition but also international competition.

The 'infant industry' argument is that you have to protect certain industries to give them the room to grow bigger. That has worked in specific cases, but all too often, as India has discovered, the protectionist policies stay in place much longer than necessary. Some industries remain protected for 30 or 40 years, well into mature adulthood, in other words.

Countries like South Korea did sometimes protect local industries temporarily, but over time a pattern emerged of national champions emerging as large, dominant, politically connected firms. The end result is monopolistic practices that harm consumer welfare, restrict market access and generate a lot of inequality.

I would recommend a different approach, which is to create a competitive business environment domestically where all firms, including foreign firms, can compete. This could be reinforced by offering some aid where necessary, but bureaucrats are not good at choosing the sectors to aid. Alternatively, I would implement an inclusive approach to helping firms more broadly, for example, through a better business environment, and provide favourable credit to entities creating jobs regardless of firm size or the sector. The key here is to make it as competitive as possible and focus less on picking winners.

Ann Bernstein: India recently held a remarkable election, and you often reflect about democracy in your work. In your view, what does the election tell us about democracy and its possible advantages over a more authoritarian form of government? Is democracy good for economic growth and development?

Raghuram Rajan: As with all economic matters, the answer depends on the context. But I would argue that democracy is beneficial for India today.

First, democracy lets the government know when it is going off track. This election highlighted the electorate's concern about the government's refusal to acknowledge the slow rate of job creation in India. The dissatisfaction was particularly evident amongst the lower middle class, which was concerned about the country's direction and its future, even though the economy was growing at seven or eight per cent. It tells you that democracy is more than a governance framework supported by elections. It is a mechanism that enables course correction by holding the government accountable.

The fact that Mr Modi no longer holds a majority in Parliament and is compelled to work with coalition partners also implies that, more broadly, other democratic institutions and actors, such as the opposition and the media, are emboldened to voice their concerns. At the same time, the judiciary can challenge government policy decisions. Even in an illiberal democracy, the possibility of losing power incentivises a responsive government. People will let you know when you get it wrong, and you cannot suppress public protests. And that is good for the government because it pushes it into altering policies. We saw that in the recent budget, where the government, for the first time, outlined a series of policies to enhance job creation.

The second is that democracy allows for bottom-up processes. People feel more empowered to protest against bad public services and poor-quality healthcare and education.

The third is the interdependence between innovation and creativity in democracies. As countries become more democratic, innovation stems from people willing to challenge scientific and political ideas. In authoritarian countries, hierarchies tend to perpetuate themselves not only in public administration but also in universities and scientific institutions where a senior doctor or professor cannot be contradicted.

Lastly, democracy helps when you are trying to sell services. Trust in institutions is vital in instances where personal data is shared. For example, privacy and data security are essential in services like telemedicine. Clients need to be confident that their private data will not be used to blackmail them or that the government will not probe companies and siphon off the data, which it then misuses for its own practices elsewhere.

So, for reasons I outlined earlier, perhaps democracy may have slowed India's early growth, but democracy certainly can benefit its future development, and this would be the wrong time to abandon it.

Ann Bernstein: I want to turn to the book you wrote in 2019, **The Third Pillar**, which is about how states and markets leave communities behind – an important issue for democracy. This is an unusual topic for a macroeconomist. What is the essential argument? What are you trying to push into the public arena and what really concerned you?

Raghuram Rajan: It was partly a response to events in developed countries, particularly the rise of Brexit and Trump. The developments in the UK and the U.S. were partly reactions to a malaise from communities struggling to compete in the global economy, particularly in the towns where industrial activity had declined.

Industrial countries have a problem of underdevelopment, not at the aggregate macroeconomic level, but at the local level. Vast areas within these developed countries – ghettoes in the big American cities, the *banlieues* in Paris, and northern towns in the UK – resemble third-world countries. However, many of these fallen-behind communities have an advantage because they live in rich countries. It is essential to reconnect local communities and local governments to the national economy while ensuring that people can strengthen their human capital to compete.

I was arguing that we need to consider approaches broader than macro-fiscal or monetary policy. Here, the discussion is about the inadequacies of development policy and an admission that we do not know how to do development well.

A key argument of the book is that the third pillar – the local community and local government – has weakened due to eroded economic activity and disconnection from the national economy. The markets and the economy form part of the first pillar, while the second pillar includes the government and agencies at the central level.

The revival of local communities – the third pillar – should be a bottom-up process rather than a top-down one dictated by the central state, i.e. "thou shalt do this or thou shalt do that". While there has been a historical reluctance to trust local communities due to concerns they may squander resources or succumb to corruption, the national government can still have light oversight to monitor resource allocation and policy outcomes, while decentralising more.

In the U.S., there is a prevailing fear that local government autonomy over education will lead to creationism being taught in schools. Bad outcomes are always possible. However, while mistakes and unintended consequences are bound to happen, localism empowers local communities, and makes them more responsible for their choices. In Uganda, for example, local communities could monitor funding allocated to local schools and push for better spending to improve education outcomes. So, I think it is time to strengthen the third pillar, not just in the West. The book argues that India could benefit from far more decentralisation. India's biggest state has a population of over 440 million people governed from the centre because the third level of government has been relatively weak for some time. Decentralisation also allows for the emergence of local leadership. I think there are greater possibilities for that.

The third pillar is about a strong local community, which is also not exclusive. That is why I call it inclusive localism. And you know, this poses considerable governance challenges, but it is the way forward when you look at successful communities across the world.

Ann Bernstein: It is such an interesting idea and relevant to South Africa, certainly. So you are in favour of the devolution of powers to local communities and local authorities. But you also say that when inclusion goes up against localism, inclusion should win out. What do you mean by that?

Raghuram Rajan: The principle to keep in mind is what one calls 'subsidiarity' in the Roman Catholic religion. It suggests power should be devolved to the lowest level where it can be effectively exercised. That empowers local communities to manage local affairs autonomously.

One example is Switzerland, where primary education is the responsibility of the local village. The canton manages secondary education, while higher education falls within the federal government's responsibility.

What you do not want is every local community erecting high walls around it and saying, nobody but us. In that case you will get divisiveness with the most affluent communities building the highest walls. Instead, communities should have small walls that foster identity and promote a sense of mutual self-help.

There are many things a community can do that a central government, or a market cannot, but at the same time, you do not want to erect high walls that isolate communities from the benefits of being part of a larger economy.

The walls should be porous but visible. Being visible gives a sense of identity. Being porous allows the free movement of goods and services. You do not want to say that only stuff made here can be sold here, because that leads to high costs and stagnation.

But if you say, "Hey, we are going to come together, we are going to have a football team, and we are going to compete against the next community", knowing where the wall of the community is allows you to know who is in the football team and gives you stronger sense of identity.

This is not the easiest thing to get right in practice, but I think we need to find the right balance. You cannot have communities without any boundaries because that leads to the facelessness of the citizen of everywhere who then becomes a citizen of nowhere. At the same time, you cannot have exclusive communities because that leads to the breakdown of society.

Ann Bernstein: I want to end with another very famous book you wrote, with a wonderful title, **Saving Capitalism from the Capitalists**. What is your essential argument? The book was published about 20 years ago; do you still hold to that argument today?

Raghuram Rajan: Well, we touched on this point earlier when we talked about national champions. Luigi Zingales and I co-authored this book in the early 2000s. We were concerned that, as countries favoured national champions, they tended to create rules and regulations that favoured the few and hurt the majority. We were against a business-friendly government that picked winners and losers as well as friends and relatives to succeed. That is the death knell of any democratic society. Instead, we argued in favour of governments that promote free enterprise and competition by creating an enabling business environment.

Interestingly, the father of communism, Karl Marx, and George Stigler – a proponent of the free market view of the University of Chicago – came to a similar conclusion: government and business are in bed with each other. But their solutions were different. In his critique of capitalism, Karl Marx advocated eliminating business, while George Stigler called for removing government.

In contrast to those views, government and business must co-exist, but we need to ensure they are not in bed with each other. This is where saving capitalism from the capitalists comes into play.

We advocate for a free market system, but we are not against safety nets. Our book recognises the importance of safety nets and government interventions that help younger people acquire the skills they need. But beyond that, the government's focus should be on creating a competitive environment, not favouring *a* or *b*. This is where we thought globalisation was beneficial because it enabled international competition that countered the tendency of local champions to monopolise the local economy. In many respects, open markets will yield positive gains and promote general prosperity.

Ann Bernstein: Thank you very much for covering such a wide field with me and giving everybody a flavour of the depth of your thinking. It was a fantastic conversation.

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