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Q&A-Better U.S. stimulus targetting needed as pandemic continues; Fed to hold rates, but won't go negative: Raghuram Rajan



The new U.S. virus relief bill should be more targetted than the previous round of spending in order to keep ammunition if a second wave-prompted shutdown should require further aid, **former Reserve Bank of India Governor Raghuram Rajan** told the Reuters Global Markets Forum on Wednesday, August 5.

"We should provide the relief that is needed, but not act as if we have infinite fiscal space," said Rajan, who is professor of finance at the University of Chicago Booth School of Business.

Rajan, formerly chief economist and director of research at the IMF, said the U.S. Federal Reserve is in no hurry to raise rates, but they won't go negative either.

"There is some mixed evidence from across the world, and so, I think the Fed at this point is willing to wait and watch rather than go into negative territory."

Following are edited excerpts from the conversation:

Q: What do you think is the right size for the next U.S. stimulus package - closer to the \$3 trillion the Democrats are pushing for, or the \$1 trillion that the Republicans want? Do you see that translating successfully into consumer spending?

A: It's anybody's guess what the appropriate amount of relief is. We should provide the relief that is needed, but not act as if we have infinite fiscal space. That's important to remember because there will be more spending that is needed down the line, if the economy is sluggish and doesn't recover, then we will have to move to some forms of additional stimulus spending, and that will add up. Also, if there's a second wave, prompting fresh shutdowns, there will be need for more spending at that time for relief for the unemployed and people who are rendered unemployed at that time. Just because one can spend at this point, doesn't mean one has a blank cheque. Clearly, what is important is to ensure that households have enough to live on going forward, while activity is low.

The unemployment insurance benefits top-up should probably not be at \$600 per week, but should taper down over time. But certainly, benefits should continue so long as unemployment levels are high in a particular area. Relief to households is important and relief probably to small and medium business that have been deeply affected. Here, one has to be a little discriminating between businesses that have a future, and businesses that unlikely to be able to reopen.

The number [of the relief bill] should probably be some place between the Republican and Democrat number - that seems appropriate.

Q: More specifically, do you think that the stimulus should be more focussed on direct payments (like the \$600 UI top-up) which has actually driven consumer spending, or should the focus now on businesses?

A: It should be more targetted than the previous round of spending in the sense that any monetary transfers should be aimed at the very poor, and those who have families with children and so on, rather than be an indiscriminate cheque sent to everyone. As this pandemic is prolonged, targetting should become better.

On the firms' side, there is a lot of information coming out on many businesses closing, like local restaurants or flower shops, and it would be a mistake to prop these up indefinitely if the pandemic is going to last a long time. Instead Relief is better targetted at medium-sized businesses that have difficulty accessing finance and that employ a fair number of people.

Q: How do you see the return of inflation in the world after all these monetary stimulus packages?

A: In a number of industrialised countries, central bankers would be very happy if they see inflation emerge over the medium term. They've been trying, but haven't succeeded. The adage "be careful what you wish for" could apply here. Given the tremendous amount of stimulus they're attempting, they would probably want to see inflation come in much later, after they've done their bit and revived the economy. If inflation comes earlier, then they have to switch from their rescue missions to fighting inflation, and that could be problematic.

There is an ideal time, may be two or three years down the line, when economies hopefully are recovered, and inflation helps reduce the real value of the debt that has built up. At that point many central banks will find it appropriate to shrink the size of their balance sheets.

Q: What other tools do you see the Fed using from its ammunition from here? Do you see Fed taking rates into negative territory? What could trigger such a move, if at all? Also, how long do you expect the low-rate environment to last?

A: If inflation is quiet, the low rate environment lasts indefinitely. I don't see the Fed in any hurry to raise interest rates. In fact, Chairman (Jerome) Powell has said we're not thinking about thinking about raising interest rates. They're certainly happy to let interest rates remain where they are. I think it will take a lot to move them into negative territory, primarily because I don't think a number of Fed policymakers are overly enthusiastic about negative interest rates. They don't know that they have as much effect going into negative territory as cutting when you're in positive territory. There is some mixed evidence from across the world, and so, I think the Fed at this point is willing to wait and watch rather than go into negative territory.

My sense is it will continue with the existing instruments. There may be some attempt at forward guidance. One possible area of action is yield curve targetting -- YCT -- and that is the place where some innovation may take place. At this point, they're likely to wait to see what the effects of their actions has been so far. Also, the Fed will make clear its revised mandate in the next few months. Where they've been boldest is credit, and they would rather wait and watch, and see fiscal policy kicking in rather than do more themselves.

Q: With gold above \$2,000, are gold buyers seeking a hedge against ultra-loose central bank policy?

A: Gold is an interesting instrument. Clearly, if you were convinced it would hold its value, it would be better than buying negative yielding government bonds. The only problem is that the value of gold can fluctuate, and so the question is are you buying at a price which is likely to remain stable or go up, or are you buying at a place where it is already overvalued. That's a tricky question as there is very little to link gold to fundamental value. Gold is what people will pay for it. And since at this point it is trading at fairly elevated levels relative to recent past, it is clearly not a one-way bet, and whether it will continue to be a sought-after instrument, given that it can also plunge in value. If you had asked me at the beginning of the year, I would've been much more positive about gold.

Q: Given the dollar's recent weakness and the consequences of the U.S. government's coronavirus response, do you think there is a risk to the dollar's status as a global reserve currency in the medium- to longer-term?

A: Clearly the U.S. economy's role in the global economy plays an important part in the dollar. But it's not just that. It's the liquidity in U.S. markets, the faith in the rule of law in the United States, the confidence that foreign investors have that they can get their money back and not be subject to sanctions. These are all important aspects of why the dollar is a reserve currency. And while there have been some hits to some of these beliefs in recent years, I don't think it has been so significant as to completely take away the rationale for the U.S. still remaining the dominant reserve currency. At the margin, it may diminish a little bit. But it has a natural position that is hard to undermine, for now.

The euro was seen as a potential alternative, and certainly over time the holdings of other central banks went up in euros, but has now come down. That's an example of a challenger that didn't quite rise to the challenge. Of course, with the new euro bonds that are going to be issued by the European Union, may increase the interest in the euro as a reserve currency. But again, it's not going to take over overnight. Similarly, the renminbi is gradually attracting more interest, and perhaps the central bank digital currency that is being issued by China may be a potential source of change, but it is going to take a long time.

Q: Is it a good idea to keep the taps flowing behind bad money? Should the U.S. now allow more companies, such as airlines and hotels to fail, in an effort to create healthier corporations?

A: As the pandemic lasts, as I said, we have to target better. In many of these cases, the company is not going to go out of business if you allow it to go into bankruptcy. It will primarily restructure its debts and that may be a good thing to enable it to perform its services better in the longer run, rather than support it with taxpayer money. The longer the pandemic lasts, the more we should see airlines, hotel chains, etc. go through a bankruptcy process or an out of court restructuring. There is no real need for the taxpayer to be on the hook for all these things.

Q: One of the remarkable features of the past few months has been the run-up in stocks while the economy has lagged. What is your analysis of the disconnect, and where does it lead us?

A: Whenever we come to prices it's hard to be categorical. Low interest rates are supporting higher prices of all assets. The easy credit is also supporting corporations tide over because it allows them to borrow and finance even some of the significant losses that are happening as a result of the pandemic. Also, by putting the weaker companies out of business, some of the stronger companies which are typically quoted on the stock market may actually have higher profitability in the future. And certainly, stock valuations in different

countries are being driven by market leaders who are seeing to benefit from the economic change that the pandemic will bring. So, for example, in the U.S., some of the tech leaders account for a significant portion of the market run-up. So, all these are ways you can argue fundamentals are supporting stock prices.

There are non-fundamental forces also. The low yields on bonds is causing a number of pension funds and insurance companies to search for yield. The Fed backing to markets has convinced them that markets will just go up, never sharply down. And of course, there are lots of new retail investors, whether in India or the U.S., who are chasing stocks as a hobby. And they are creating potentially some mild mispricing. There are non-rational reasons also, and I would argue that it's not clear which effect is more important at this point, which suggests that investors should be reasonably diversified.

Q: Finally, turning to India -- The RBI MPC meet is tomorrow. How do you think the RBI and the government have responded to the COVID-19 crisis so far? What other policy tools could the RBI use? And do you think a rating downgrade of India is possible in the next 12 months?

A: The RBI and government have certainly been cooperating, but it seems like it is elsewhere, the ball is in the government's court to do more.

The RBI has to focus on whether credit is going through to the stressed areas of the economy, and here again the key decision it has to make is, is credit going to viable firms, or is it propping up unviable firms. And I think that's where it has to focus its attentions, because resources, as you well know, are limited in India today.

What India should focus on at this point is protecting its economic capabilities, so that when it has dealt with the virus it can go resume activity in a reasonable way. That should be the focus. And if it does that, there is no reason why the rating agencies will not see that as an appropriate policy. Overly focussing on what the rating agencies think might take your eyes off what you need to do. It is also important to convince both domestic and international investors that after the crisis associated with the pandemic is over, we will return to fiscal responsibility over the medium term, and the government should do more to convince them of that.

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