RAGHURAM Rajan, now the head of India’s central bank, was the IMF’s youngest, and first nonwestern, chief economist.

But when Rajan, then 40, turned up at the IMF’s Washington headquarters in 2003, many of his peers thought he had entered the wrong building. The finance professor from the University of Chicago was reporting to work as the new economic counsellor and director of the Research Department. But although he was a highly regarded finance economist, he was filling a job that had always been held by a leading macroeconomist. And to the macroeconomists who populate the IMF, Rajan was an unknown entity.

But the IMF picked Rajan for a reason: it wanted to build up its financial expertise in the wake of the Asian financial crisis of the late 1990s. Anne Krueger, then the IMF’s second in command as first deputy managing director, had recently read a book Rajan coauthored with Luigi Zingales, *Saving Capitalism from the Capitalists* (2003), so she called Rajan. When asked if he would be interested in being chief economist, Rajan says he told her: “Well, Anne, I don’t know any macroeconomics.” To which Krueger joked, “Neither do I.” He decided to give it a shot and flew out for an interview.

A decade later, when Rajan reported for his first day as governor of the Reserve Bank of India (RBI), no one doubted that he had entered the right building. It was as if all his academic work since his 1991 doctoral thesis on the dangers of cozy bank-firm relationships had been leading up to this day. Plus his stint at the IMF had given him valuable experience, not only in policymaking but in engaging with advanced economies. As one former colleague puts it, Rajan can stand his ground because “he isn’t in awe” of the major industrial powers. In addition, he was one of the few economists to have warned about the risks of financial innovation well before a
devastating financial crisis hit the United States in 2007 and then disrupted the global economy.

The demands on, and expectations for, Rajan are high—domestically and globally. He is leading India’s central bank as the country tries to regain its economic momentum, and policymakers around the world look to him for guidance on reforming the global financial system. Unsurprisingly, the Chicago professor advocates free markets, but, as he wrote in the 2003 book, he also views the market as “a fragile institution, charting a narrow path between the Scylla of overweening government interference and the Charybdis of too little government support.”

That said, it is difficult to put Rajan into a particular economic camp. He likes to call himself “a pragmatist.” As he tells Fe&D: “It’s not just economics but the political layer that is imposed over it that determines outcomes—and the political layer is much less well understood than the economics. So when you combine the two, basically it’s a process of navigation. How do I make sure that sensible economics prevails?”

**Saving capitalism**

Rajan was born in Bhopal, in central India, in 1963, but spent much of his early youth in Indonesia, Sri Lanka, and Belgium (his father was with the foreign office) before returning to India at age 11. He says his fascination with finance dates to his graduate school days at the Indian Institute of Management in Ahmedabad, which followed a bachelor’s in engineering from the Indian Institute of Technology in Delhi. He recalls reading Nobel laureate Robert Merton’s theory of rational options pricing (a formula for evaluating options, which are contracts that give a buyer the right to buy or sell a financial asset at a set price in the future). He was struck, he said, not only by the theory’s “mathematical elegance” but also by “its usefulness in the real world.” In 1991, he received a doctorate in finance at the Massachusetts Institute of Technology’s Sloan School of Management and became an assistant professor at the University of Chicago’s Booth School of Business—both institutions that attracted the top options-pricing researchers.

For most of the next 12 years, Rajan would make Booth his home, teaching banking and finance while undertaking much-cited work with such colleagues as Doug Diamond and Zingales. In January 2003, Rajan won the American Finance Association’s inaugural Fischer Black Prize for the leading finance researcher under 40, for “path-breaking contributions to our knowledge of financial institutions, the workings of the modern corporation, and the causes and consequences of the development of the financial sector across countries.”

The prize announcement noted that “even while many economists were extolling the virtues of bank finance, Rajan pointed out in his influential Ph.D. thesis that there might be a downside to cozy bank-firm relationships of the kind that one saw in Japan.” It goes on to cite his work with Diamond that “knits together the microtheory of banking with macroeconomic theory,” along with shedding more light on “the role banks play in the provision of liquidity, why this function makes banks so prone to systemic crises, and why changes in monetary policy have such a significant effect on bank lending.” And it cited his work with Zingales that provided “a new method of pinpointing the effect of institutions on economic growth” and showed that “industries dependent on external

**“It’s a process of navigation. How do I make sure that sensible economics prevails?”**

**From academia to the IMF**

In August 2003, Rajan took over as IMF chief economist from Harvard’s well-known Kenneth Rogoff. Rajan admits that “it was an interesting transition.” He recalls, with a smile, that “the reaction was—after Ken Rogoff, this gigantic macroeconomist—’Who’s this guy? You know, ’Rajan who?’” He says that “one of the first things that I had to establish was that I knew some macroeconomics,” and he worked hard to keep—and attract—a good team. “When people started wanting to come in [to the Research Department], I realized that we had turned the corner.”

With the global economy relatively calm—the turmoil finally subsiding from an Argentine default at the end of 2001—Rajan was able to step up financial sector research and explore how to integrate financial sector issues into the IMF’s economic country models. This might have seemed doable given that the IMF already had models for handling fiscal and monetary issues. But creating a model for financial issues
turned out to be much tougher. As a result, while Rajan is credited with laying the groundwork, the issue is still very much a work in progress, not just for IMF researchers but for hundreds of academics.

The big difference is that a decade ago creating such a model lacked urgency, whereas now it is a high priority. As Rajan wrote in a Project Syndicate column in August 2013: “In the run-up to the 2008 financial crisis, macroeconomists tended to assume away the financial sector in their models of advanced economies. With no significant financial crisis since the Great Depression, it was convenient to take for granted that the financial plumbing worked in the background. Models, thus simplified, suggested policies that seemed to work—that is, until the plumbing backed up. And the plumbing malfunctioned because herd behavior—shaped by policies in ways that we are only now coming to understand—overwhelmed it.”

IMF Chief Economist Olivier Blanchard says that “we’ve made a lot of progress in how we look at the financial system, at isolating some kinds of risks, and getting the data that allow us to do more work in real time. But it’s not as if we have a complete understanding of the issues, and the integration of the two is progressing but it’s not there yet.” The fundamental problem, Blanchard says, is that “we’re not sure what financial stability means.” He also worries that a macro-financial model could remain elusive—that “it’s going to be a cat-and-mouse game forever”—because “maybe if we identify the risks today, maybe in two years it’s a different set of risks in a different part” of the financial system.

What makes Rajan a key figure in these financial debates is what some colleagues say is his ability to see the forest for the trees. Stijn Claessens, an assistant director of the IMF’s Research Department, says Rajan is one of “a small set of people who academically as well as professionally have the skills to be able to talk about macroeconomics and know finance in the sense of the institutional details, plus see the links and how they interface and work together.” Says Chicago's Anil Kashyap (also a Rajan coauthor): “The arguments about setting interest rates are usually pretty simple. In contrast, the evolving debate over how to deliver financial stability is much more nuanced, in part because we do not have a standard workhorse model to rely upon. Raghu has the great advantage of having a clear vision of the financial system and what does well and where it poses challenges. I think this is why he has been at the forefront of many of the financial stability debates.”

**Showdown at Jackson Hole**

Not that Rajan’s vision is always well received. In August 2005, he came in for heavy criticism following what turned out to be a prescient speech about the dangers lurking in the financial system. He was invited to speak on how the financial system had evolved under Alan Greenspan (the soon-to-retire chairman of the Federal Reserve Board) at the annual symposium of central bankers and other high-powered economists in Jackson Hole, Wyoming. He says he had expected to find that the dramatic expansion in financial markets had reduced the risks for banks, but instead, the figures that his staff assembled showed the opposite.

With Greenspan in the audience, Rajan delivered a talk based on his paper “Has Financial Development Made the World Riskier?” He warned that recent financial innovations (such as credit default swaps, which act as insurance against bond defaults) could create “a greater (albeit still small) probability of a catastrophic meltdown.” This message did not go down well in some quarters. Former U.S. Treasury Secretary Lawrence Summers called Rajan’s premise “slightly Luddite” and “largely misguided.” Federal Reserve Board Vice Chairman Donald Kohn suggested that Rajan was nostalgic for the old days of bank-dominated systems—which Rajan strongly denied.

Rajan has written that he left Wyoming with some unease—not because of the criticism, but because “the critics seemed to be ignoring what was going on before their eyes” (see box). Several years later, his warning came true: the U.S. market for subprime mortgage securities began to implode in 2007, leading to the global financial crisis.

Of course, Rajan’s time at the IMF was about far more than Jackson Hole. He says it was a tremendous on-the-job learning experience during which he sharpened his macroeconomic skills. He also immersed himself in the art of global economic policymaking—for example, leading a team to try to help some major economies reduce their huge (and unprecedented) balance of payments imbalances. It was also his first stint as a manager—a hundred people worked for him in the Research Department. But that number must now seem incredibly small, as he oversees 17,000 staffers at the RBI.

Former IMF colleagues say that what is so remarkable about Rajan is his humility, integrity, and intellectual curi-
Bank Chief Economist Kaushik Basu hopes that Rajan can ensure macroeconomic stability. In the process, World
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Back to India
Rajan may have made his career in the United States, but he
never forgot India, making it a frequent topic of speeches and research. He says that he was drawn to economics because it offered a way to help India enter the “pantheon of nations.” In 2008 he got the chance to help shape India’s financial sector when he chaired a high-level government committee on financial sector reforms. The committee report, “A Hundred Small Steps,” suggested that the RBI should target a single objective—low and stable inflation—rather than juggling multiple mandates (such as inflation, the exchange rate, and capital flows).

It also proposed that India promote the availability of financial services—including credit, saving, and insurance products—to a wider number of people (especially in rural areas, where most people lack access to formal sources of credit and insurance); reduce the heavy government presence in the banking system; and step up foreign participation in its financial markets.

In September 2013, he took the helm at the RBI, after five years of advising Prime Minister Manmohan Singh from Chicago and a year as chief economic advisor in the Finance Ministry in Mumbai. At that point, India’s markets were in turmoil because of rising inflation, large fiscal and current account deficits, and a slowdown in growth. But he moved quickly to stabilize the rupee, reduce inflation sharply, and build up foreign exchange reserves—earning him the sobriquet “rock star” in the local media. He also wasted no time in laying the groundwork for adopting an inflation target and is pursuing many other reforms suggested in “A Hundred Small Steps.”

Rajain’s hope is that the RBI can help India create jobs by ensuring macroeconomic stability. In the process, World
encourage the RBI to be “a bit more experimental.” Basu, who preceded Rajan as India’s chief economic advisor, says emerging market economies need not rely so heavily on the monetary practices that worked well in the major industrial countries, although the risks of central banking efforts to

Rajan may have made his career in the United States, but he never forgot India.

Laura Wallace is a communications consultant and former editor-in-chief of F&D.