

496th Convocation

Address: "Crisis and Change"

By Raghuram G. Rajan

December 12, 2008

This is a wonderful day for you, as you prepare to test the knowledge you have accumulated against the realities of the world outside. You deserve the confidence that many of you feel because if you can survive the rigors of a Chicago education, you can survive anything in the real world.

Unfortunately, the last hurdle in that education is to survive my speech. Worse still, I have a monopoly over your time conferred upon me by the university, where I can say what I want and you have no choice but to listen. Chicago Nobel Laureate, Ronald Coase, would say that if we could create a spot market where you get together a collection to bribe me to cut my speech short, and I leave with the money, the world would be a better place for both of us. This would also accord well with the traditions of our fine state of Illinois that have been highlighted in recent days.

However, there are transactions costs in setting up that market, including the possibility that I might still inflict the speech on you even after you pay me, simply because I am attached to my duty as speaker, or because I love the sound of my own voice. We need an outside enforcer for the contract – perhaps President Zimmer might consent to step in? Before the murmurings about crass economists willing to sell their souls for money get too loud, let me tell you the serious point in all this. Markets and competition don't appear by magic, they have to be nurtured through appropriate regulation and enforcement. And because self-regulation by interested parties is ineffective in a variety of situations, it is appropriate for an outsider to undertake the regulation and enforcement. Ideally markets and competition need a Goldilocks level of regulation – neither too little, nor too much.

For example, if you wanted to fly and there was no supervisory authority in the airline industry enforcing safety standards and conducting safety inspections, you would be very reluctant to fly fledgling airlines. You would prefer the established ones that had the track record and the reputation. So a complete lack of safety regulation in the airline industry would favor established firms, making entry impossible, and killing competition. But if the regulation said that you had to have a proven five year track record of profitable flying before you would be allowed to take passengers, new entry would again be killed off, for how can new airlines have a proven record? It is the delicate middle ground, where enough regulations are in place so that people feel confident in flying the entrants, but not so much that the entrants can never qualify, where competition flourishes.

The problem is that the regulatory process is often captured by incumbents, who have

little interest in seeing competition flourish. As Adam Smith wrote:

...to narrow the competition is always the interest of the dealers...The proposal of any new law or regulation of commerce which comes from this order, ought always to be listened to with great precaution... It comes from an order of men, whose interest is never exactly the same with that of the public, who generally have an interest to deceive and even oppress the public, and who accordingly have, upon many occasions, both deceived and oppressed it.

Karl Marx, the prophet of the Left, and George Stigler, a Chicago Nobel laureate economist usually beloved by the Right agreed on this diagnosis but their solutions differed. Karl Marx said the government had become “the executive committee of the bourgeoisie”, so get rid of the bourgeoisie, and George Stigler said the government was in the pocket of big business, so minimize government.

Through the years, the Left and the Right have fought over whether the government or the private sector should own business. It seems to me that this focus on ownership is a little misplaced. The relevant focus should instead be on whether the structure of industry and regulation creates competition and the right incentives for innovation and growth, and not just on who owns business. And in recent decades, increasing international trade and capital flows have ensured that countries and their large corporations have the incentive to get domestic regulation just right, or lose out to competitors from other countries.

Unfortunately, this process has gone spectacularly off-track, as evidenced by the economic crisis that is paralyzing the world. What the financial sector was trying to do with sub- prime mortgage lending was not intrinsically bad – it was channeling savings from Shenzhen, China into investment in housing in Phoenix, Arizona, a very worthwhile example of the benefits of an integrated world. But with a world awash in desired savings, market discipline on both financial intermediaries and their regulators broke down. While it ought to be the duty of regulators to lean against prevailing winds of optimism (or pessimism), regulation was driven by the misplaced view that markets will take care of themselves, a view that time and time again makes the extreme Right play into the hands of the extreme Left.

With crisis, of course, come demands for change. We have those who say there is nothing fundamentally wrong with markets and competition, and what is needed is to improve the quality of regulation. This is the side representing Opportunity. And on the other side, we have those who say markets are fundamentally broken, we need government intervention and subsidies, trade protection, and managed competition. This is the side of Safety. And which side do you think incumbent big business is typically on? No surprises here -- while it is on the side of Opportunity in good times, when good times turn sour, it shifts to Safety. After all, it has the entrenched positions that will be protected.

What about the Demos, what do the people think – after all, it is their representatives who will decide the direction of change? Clearly, the Demos is composed of very different groups. Some like you, trained in the best schools in the world, confident of your abilities and young enough to be flexible, will prefer opportunity. But the fifty-year-old worker

for General Motors, who has little ability to retool, and who has spent a lifetime acquiring benefits that are now threatened by domestic and foreign competition, will prefer safety. And so might the youth who have grown up only a few miles from here, but are worlds away from you in terms of attitudes and capabilities. Their indifferent education and the absence of universal healthcare exacerbate their fear that if competition dislodges the precarious foothold they have, the abyss is deep indeed.

These differences are not just in the United States. The global economy spells opportunity for the IT worker in Gacchi Bowli in Hyderabad. Their education is their passport to the wages set by a global market, enabling them to finesse the increasing hurdles placed in the way of international migration. But for the farmer, only a few miles away from them, that same global economy means more insecure property rights as industrialists bribe government officials to expropriate her land, diminished crop revenues as she has to compete with subsidized farmers from industrial countries, and higher prices for consumption goods such as private education and healthcare fees, driven up by richer IT workers. One person's opportunity comes at the expense of another person's safety.

And in a time of deep crisis like the current one, the aggrieved amongst the people -- those looking for safety -- far outnumber those looking to maintain opportunity. And, of course, elected representatives look to satisfy the electorate as well as their moneyed supporters. Is it any surprise therefore that they will find ways of bailing out the big, the powerful, the incompetent, and the unlucky, as well as limiting competition, to the detriment of future innovation and growth? More problematic, as borders close to trade and capital flows, there will no longer be cross-border discipline on regulation. This is the change we should fear, for if it does happen, it will reduce world growth dramatically. There is a better way, though. It is to give more individuals in every society the chance to take advantage of the myriad opportunities well-functioning markets create. This requires giving them access to the education, the healthcare, and the finance they need, the kind that most of you have had, and will have. It also requires creating a safety net, not so wide that it destroys all incentive for effort, but not so narrow that the fear of falling kills all risk-taking. By offering more individuals the ability to take advantage of opportunity, as well as some safety, by protecting the individual and not the company, our economy, and economies around the world, may be better disposed to emphasize the markets and trade that have increased our collective well-being in the last few decades.

Such change is not easy. One of the most powerful motives for expanding opportunity and setting up safety nets for all is the feeling "There but for the grace of God go I". Unfortunately, when society is divided by immigration, ethnicity, religion, language, and especially economic capacity, the tendency is for privileged groups to see threats, rather than themselves, in others. They build fortresses around their positions rather than extending ladders to the underprivileged. Thus as inequality increases, it becomes more difficult to change. This will be one of the most important challenges that awaits your generation, a challenge that I am confident you will meet.

With your education, you will be able to take advantage of the best opportunities this world offers – Trust me, though the world currently looks bleak to some of you, you will all land on your feet! By all means set yourself ambitious goals. But remember that the goal itself – greater wealth, rapid promotion, or increasing renown -- is of limited utility, it is the process that matters most. If you do not like going to work every day, the fact that you are driven to it in a Bentley is not going to make it any more pleasant. If in doing your work, you can help others take advantage of the opportunities you have had, and if you can enhance their sense of safety only a little, you will increase the stability of this society that so many of us take for granted. Adam Smith famously said that it is through the self-interest of the baker, that we have bread on the table. It is equally true that it is from the broader access of society to opportunity and safety that we obtain our continued ability to pursue self-interest. :

Let me conclude. You have been very patient in listening to me, despite your lack of choice. I wish you good luck in your future endeavors and hope they are crowned with success. Thank you all.

: Adam Smith 1776 ed. Edwin Canaan 1976. *The Wealth of Nations* Chicago: University of Chicago Press, Book 1, Chapter XI, p. 278.