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EXECUTIVE BRIEFINGS
POLITICS AND ECONOMY: RAGHURAM RAJAN

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June 2016

A fine innings

India's economy is precariously perched. Its current account deficit has crossed 5% of GDP. Fiscal imprudence over successive years has led to high deficits, which in turn have created sticky retail inflation in the 10-12% range. Foreign exchange reserves are down to USD 280 billion and both industrial output and investment have shrunk. Adding to the misery has been a rude shock dealt by the United States Federal Reserve through an announcement that it proposes to taper its bond buying programme. The ensuing taper tantrum is leading investors to dump emerging market assets fearing the end of cheap money. Consequently, the Rupee has come under a bear hammering shedding around a quarter of its value. Liquidity is tight and analysts are worried about external solvency and a balance of payments crisis. Adding to all of this is a threat, most serious, of a sovereign downgrade by rating agencies.

All this happened in the autumn of 2013 when an academic from the University of Chicago was brought in to assume charge as Governor of India's Reserve Bank. In a few months from now, Raghuram Rajan will complete his three-year term in office. The disquiet within the markets is whether he will get a second term. As this note will argue, he richly deserves it.

It is within the bounds of tradition that central bank Governors in India are given extensions and usually serve for two terms. Very few have not done so. Be that as it may, Dr Rajan deserves to continue on grounds of individual merit. His approach was refreshing and honest and his understanding of India's economy – having previously served as the treasury's Chief Economic Advisor – gave him a unique perspective of its challenges and strengths.

His first worry was the currency crisis, in the wake of the taper tantrum, to which he responded with an innovative scheme to attract foreign capital. Commercial banks could offer lucratively-priced dollar deposits to non resident Indians (NRIs) whilst being insulated from currency movements through a Reserve Bank-financed currency swap. Sceptics then argued that commercial banks would cream away the profits whilst the RBI would carry the financial burden. Despite the merits of their argument the fact remained that the greater risk to India, its economy and trade, was a balance of payments crisis, which outweighed cost considerations. In a matter of weeks, banks collected USD 34 billion in deposits with an average maturity of 1-2 years. This figure exceeded even the most generous expectations. The panic subsided as the markets began to settle. Subsequently, the Reserve Bank arranged adequate dollar supplies through forward contracts and the redemption of these deposits at maturity happened without so much as a whimper.

Under Dr Rajan's term, the Reserve Bank undertook several initiatives to create a more robust platform for monetary policy formulation. Perhaps the most important amongst them was the adoption of the consumer price index (CPI) as the primary benchmark for inflation targeting. This was intended to ensure a more responsive and transparent monetary policy reducing distractions that previously stemmed from the simultaneous targeting of multiple, unclear and at times conflicting, objectives. Second, it was during his term that additional bank licenses were granted – an astounding 23 in number – to a combination of universal banks, 'payments' banks and small finance banks. This move is bound to usher fresh competition in what is generally perceived as a complacent and sterile industry. Thirdly,

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Dr Rajan's initiatives to address the bad loans problem have forced commercial banks to acknowledge that they are in a mess. Unreasonably, for too long, this matter had been kept under cover in the hope that things will eventually sort themselves out. With policy support from the Government of India, in the form of a new bankruptcy code, there is a good chance that the operations of banks going forward will be better managed.

Most credibly, Dr Rajan has maintained the Reserve Bank's independence. Despite political pressures and those from industry lobbies, he has stuck to his guns on interest rates because he believed the environment was not conducive for substantial cuts. Central bank governors need to understand their domestic economies just as much as the vagaries of international financial and currency markets. The actions of the United States Federal Reserve, and to a lesser extent the European Central Bank and the Bank of Japan, have as much of an impact on India's monetary policy, currency flows and liquidity as those of the Reserve Bank itself. It, therefore, seems logical that decisions on interest rates and liquidity considerations need to be made in the context of external developments. Clearly, Dr Rajan understands this.

As his term comes to a conclusion in September 2016, India's economy is in better shape. In part due to Dr Rajan's efforts, inflation has moderated, the currency markets are more stable and liquidity is adequate. Most importantly, the threat of a crisis is happily in the past. At the time of writing this note, it was not clear whether Dr Rajan has been offered, or has accepted, a second term. If he stays, it would be good for the Reserve Bank, the financial markets and for India. If on the other hand, he returns to academics at the University of Chicago, he will carry with him the best wishes of a grateful nation.

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