

The Impact of Central Banker Rajan's Exit

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Phillip Capital Management's CIO Jeffrey Lee shares his views

Raghuram Rajan, the Reserve Bank of India's (RBI) governor, announced this week that he would not seek a second three-year term as RBI governor when his term expires in September this year. Rajan has been widely credited for turning India from one of Emerging Markets' "Fragile-Five" economies into a safe haven for investors. Under his reign, the central bank gained credibility in controlling inflation through reforms which include using CPI instead of WPI as an inflation target, maintaining relatively high real policy rates to curb inflation and proposing to set interest rates through a Monetary Policy Committee.

Rajan's legacy is durable and will live beyond his tenure. While Rajan's achievements have been considerable, many of India's improvements can be attributed to macro-economic factors that are beyond his control. These macro trends will persist regardless of who the next RBI governor is, giving us confidence that India is still the place to be for investors in the next few years. India's strong



Raghuram Rajan
Source: Wikipedia

account deficit, and a high carry.

(i) Accelerating economic growth. India's GDP year on year growth rate has accelerated from below 5% in 2013 to its current 7.9%, due to continued strength in private consumption, growing 8.3% on a year on year basis. Agricultural output is also showing signs of a recovery after a drought took a toll on the sector in the past two years.

(ii) Improved current and capital accounts. India's current account deficit (Figure 1) has shrunk from above 3% of GDP to 1% of GDP, due to a lower import bill as oil prices fell. FDI inflows (Figure 2) have also accelerated to above US\$4b a month thanks to the government's "Make-in-India" campaign.

(iii) A high carry. Among Asian currencies, the rupee offers bond investors one of the highest spread to USD government debt at close to 6%. Bond inflows are likely to resume once short term volatility from Rajan's exit subsides.

In the short run, there will be volatility in the Indian rupee. However, one must remember that Rajan's



Figure 1 : India's Real GDP Year on Year % Change.
Source: Bloomberg, PCM

fundamentals can be summarised in three factors- accelerating economic growth, an improved current

efforts have left a far stronger central bank with the ability to intervene in the markets to protect the rupee. When FDI and capital inflows accelerated in the past

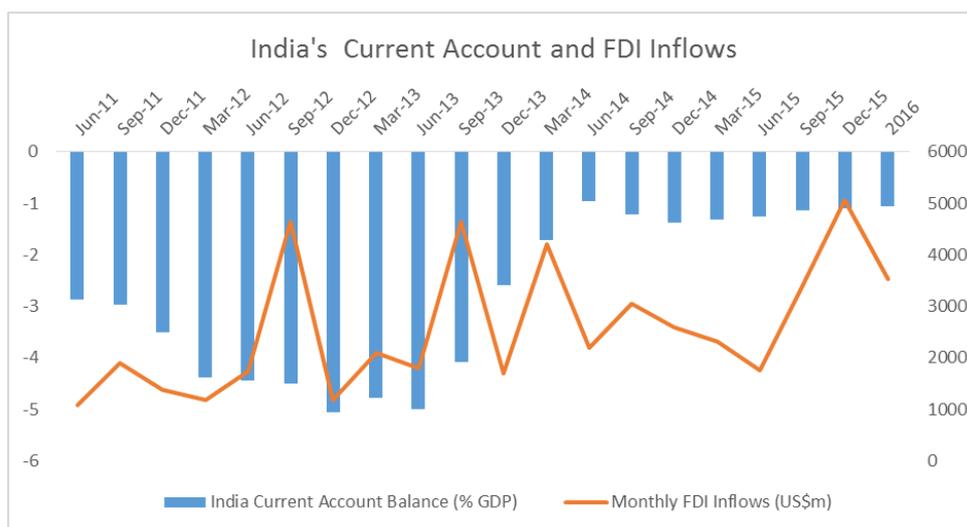


Figure 2 : India's Current Account and FDI Inflows. Source: Bloomberg, PCM

few years, the RBI "leant against the wind", actively selling rupee in the market and accumulating FX reserves. Today, India has forex reserves of \$360b or almost 10 months of imports, giving it the ability to buy rupee in the market to support the local currency if the need arises.

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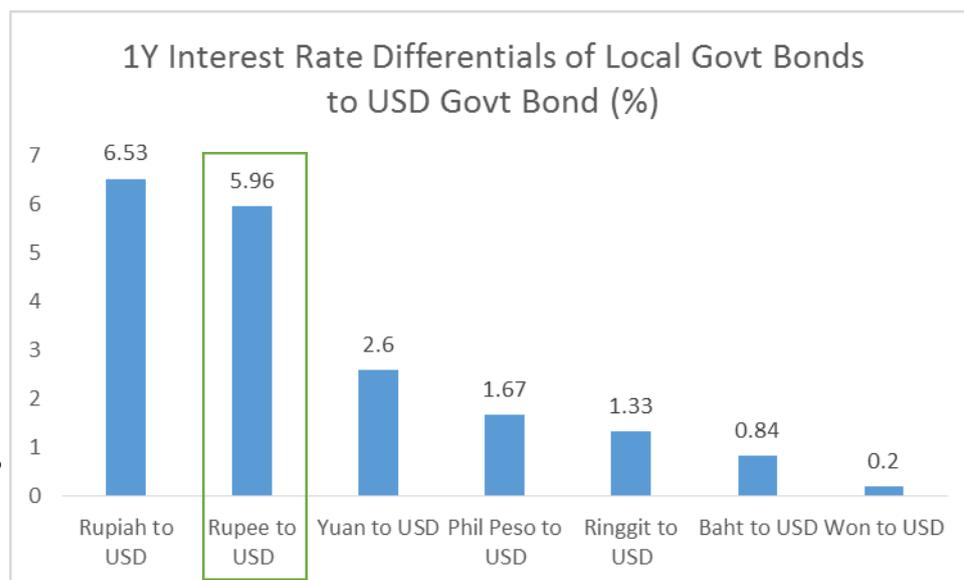


Figure 3 : 1Y Interest Rate Differentials of Local Govt Bonds to USD Govt Bond % Source: Bloomberg, PCM

The rupee/USD has weakened to the 67.5 level post Rajan's announcement- we think it is unlikely to weaken further from here. At this level, the market is ignoring the strong potential replacements for the role, which include current RBI Deputy Governor Urjit Patel, chief economic adviser Arvind Subramanian, as well as former PSU bank heads. If the new governor is more dovish than Rajan, inflation may pick up in the short run, but lower rates will boost economic growth and revive activity in the corporate sector. Rajan has established an effective framework upon which his suc-

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the markets and raise confidence in the successor's strategy. In the longer run, the narrative will shift back to India's strong fundamentals, in particular its narrowing balance of payments and accelerating FDI inflows. The recent announcement to radically overhaul of its foreign ownership rules, including allowing full ownership for airlines and defence industries, is likely to provide a further boost for FDI and give support for Indian markets in the medium term.

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