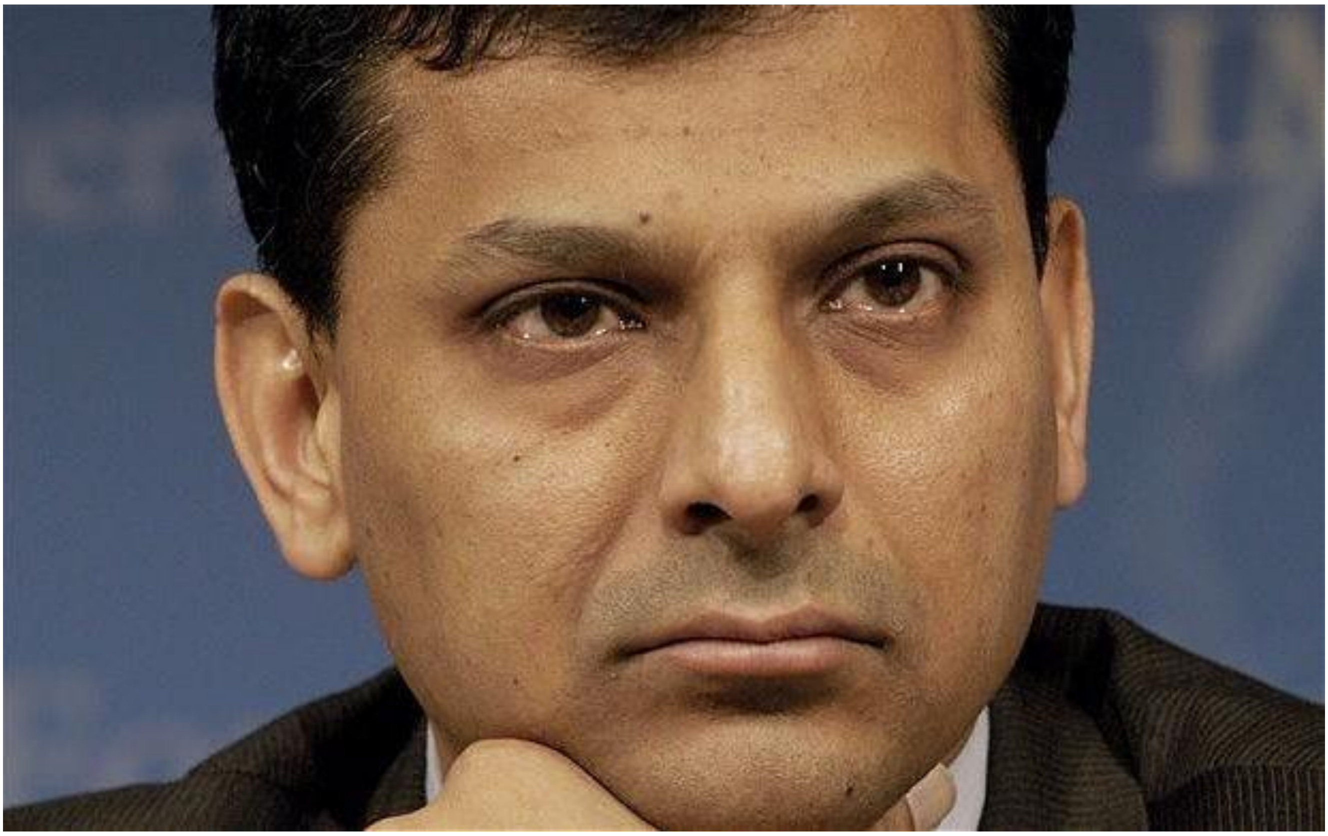
The Telegraph

AEP: India's rockstar central banker defeated as Modi revolution stalls



India's financial prophet Raghuram Rajan has lost a power struggle over monetary policy, an ill omen for the country

- Ambrose Evans-Pritchard

20 JUNE 2016 • 7:28PM

India’s bid to become the ‘economic super-tiger’ of Asia is in serious doubt after an assault on the independence of the central bank and failure to deliver on promised reforms.

The country has been the darling of the emerging market universe since the Hindu nationalist Narendra Modi swept into power in May 2014 promising a blitz of Thatcherite reform and a bonfire of the diktats, but key changes have been blocked in the legislature. The government has turned increasingly populist.

Matters have come to a head with the de facto ouster of Raghuram Rajan, the superstar governor of the Reserve Bank of India (RBI), rebuked for keeping monetary policy too tight. It is part of a pattern of attacks on central banks by politicians across the world, and the latest sign that the glory days of the monetary overlords are waning.

Mr Rajan has been battling criticism for months but threw in the towel over the weekend, sending tremors through the Indian financial markets and provoking a flurry of warnings from global investors. “He has decided not to wait until he is refused a second term,” said Lord Desai from the London School of Economics.

“This is ‘Rexit' – India’s equivalent of ‘Brexit. It looks very bad for India and will not go down well in financial markets. He was defeated by the crony capitalists up against him,” he said.

The government has dampened the impact with by relaxing barriers to foreign investment in the country, but it may have underestimated the totemic status of Mr Rajan outside India. He is seen by funds as the guarantor of good practice and market integrity.

Mr Rajan is a former chief economist for the International Monetary Fund, famed for warning that the US subprime debt bubble was out of control long before the Lehman crisis blew up in 2008.

While Mr Rajan said he wished to return to his academic home and the “realm of ideas” at the University of Chicago, it is an open secret in India that he can no longer work with Mr Modi’s Bharatiya Janata party (BJP). He will step down in early September after just three years.

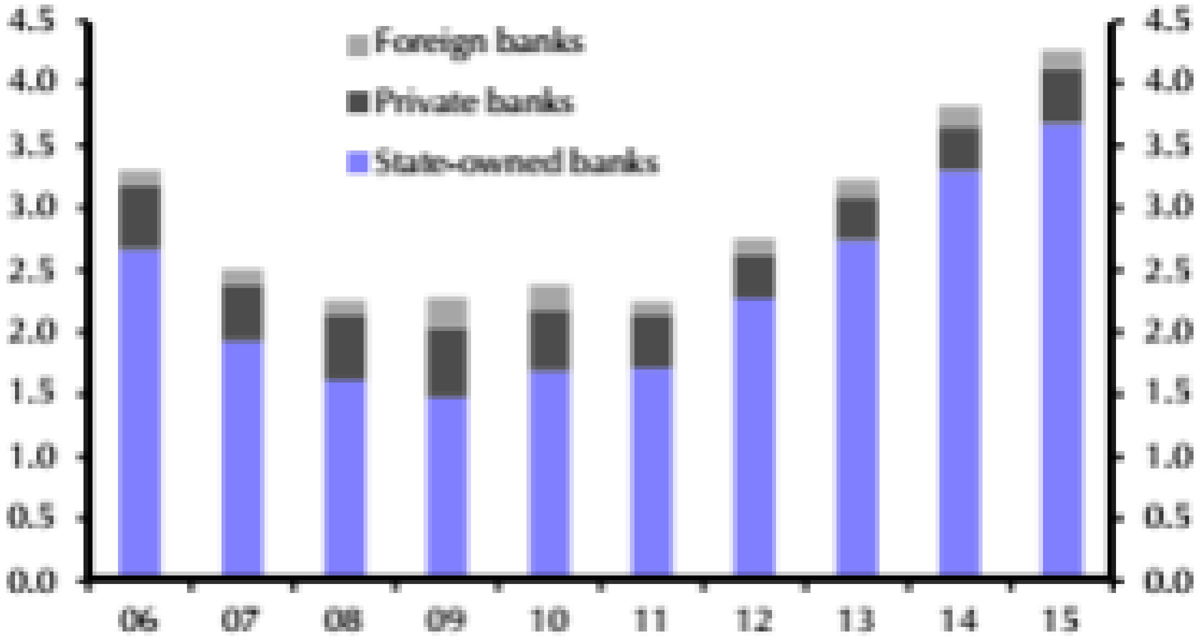
Mr Rajan’s ‘tough love’ policies are widely credited for averting a currency crisis and an inflationary blow-off during the emerging market ructions three years ago, when the country was shunned as one of the ‘fragile five’ most at risk as the US Federal Reserve began to wind down monetary stimulus. He became the pin-up central banker of the emerging world, a symbol of a new age.

His orthodox policies beefed up India’s financial defences but led to constant clashes with the BJP party. The government’s Keynesian economic guru Subramanian Swamy accused him of a “willful and deliberate attempt to wreck the Indian economy” through deflationary overkill.

Bad loans and restructured loans have reached 14.5pc of the balance sheets of the banks, but this has been festering for a long time and the causes pre-dates Mr Rajan. The RBI says the banks need a $30bn recapitalization by 2018.

Ed Smith from Rathbones said Mr Rajan has taken exactly the right line. “The quickest way to restore the health of the banks is to crystallize the bad loans, and get everything out in the open. Unfortunately it is sill to be finished,” he said.

CHART 1: NON-PERFORMING LOANS (% OF TOTAL LOANS)



Sources – CEIC, Capital Economics

India's bad debts are very high, rising to 14.5pc of loans if all forms are included

The government's reform agenda is coming off the rails, despite the rhetoric. While it has overhauled the archaic bankruptcy laws, a 'big bang' effort to cut through the nightmare of different tax rates has come to little. Plans to end bottlenecks in transport and infrastructure have been paralyzed by land procurement problems.

"All the reforms seem to have stalled. Indian equities are trading at a premium to emerging market peers and we're running out of reasons to see why this is justified," said Mr Smith.

India outpaced China last year with stellar growth of 7.5pc but analysts have lost trust in the GDP data, suspecting that the growth rate may have been massaged upwards.

In any case, the boom belies a host of deep structural problems, and is unsustainable without a radical overhaul of the economy. "Modi is not a Thatcherite. He is a conservative who wants to make the old system work better," said Lord Desai.

Mr Modi does not control the upper house of parliament, so gridlock is built into the system. The 29 states are pulling in different directions. "India has the same governance pathologies as the eurozone," said one IMF veteran.

Bhanu Baweja from UBS said the risk is that India will opt for "short-term growth", succumbing to the 'Philips Curve' temptation – a belief that a little more inflation is a price worth paying to create growth and jobs. This has rarely paid off in the developing world. "The currency is rapidly becoming less competitive. India's export volumes have languished," he said.

Mr Rajan has long argued that the country cannot achieve economic take-off without a structural shift to boost the savings rate and to make the money available for investment through the banks, instead of being stashed in gold. This requires ending the curse of inflation once and for all.

The central bank has cut inflation from 10pc to 5pc under Mr Rajan – helped by falling oil prices - but this has not yet lasted long enough to change consumer psychology, let alone ancestral culture.

Shilan Shah from Capital Economics said the test for India will be whether or not Mr Rajan's successor comes from Mr Modi's political circle. "The appointment of somebody from the finance ministry would raise concerns over the RBI's independence and monetary policy credibility," he said.

Mr Rajan has been an acerbic critic of zero rates and quantitative easing by the western central banks. He blames them for flooding the international system with excess liquidity that emerging markets could not easily control. This fueled dangerous boom-bust asset cycles.

While QE might have 'worked' for the US, UK, and Europe – the jury is out even for them – Mr Rajan argues that the policy is a "Pareto sub-optimal" for the world as a whole, and ultimately increases the danger of a deflation-trap in the future.

The Fed and the leading central banks of the West have never really answered his critique.