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Macroeconomic impact series

India's 'Rexit'

Central bank uncertainty raises risk

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27 July 2016

Key messages

- India is a significant player in the global financial system, given its large and liquid markets. It is a concern at the present moment of global uncertainty because its macroeconomic policy leadership is in transition.
- Outgoing Reserve Bank of India (RBI) Governor Rajan had started to address key challenges, such as inflation and non-performing loans in the Indian banking system. But there is more to do.
- The Government of India should not delay in appointing a new RBI governor. It should also reaffirm its central bank's independence.

Shock absorber or shock amplifier?

When Reserve Bank of India Governor Raghuram Rajan resigned on 18 June 2016, India's 'Rexit', he emphasised that his key objectives of establishing firm foundations for domestic financial and macroeconomic stability had not yet been fully achieved. But as he leaves, the global macroeconomic situation is fragile, in the context of Brexit, a slowing China, weaker commodity and oil prices and, now, Italy's banking vulnerability.

As policy-makers try to maintain monetary and financial stability, the leadership transition at RBI could help – or make things worse.

India is a significant player in global markets, given its large and liquid financial market.[1] India is also the fastest-growing G20 economy right now, with 7.6% GDP growth, and a critical regional player vis-à-vis neighbouring low-income countries in South Asia. But Indian growth is mainly domestically driven, and it runs 'twin' structural fiscal and current account deficits. This leads to inflation risk (though low oil prices are currently offsetting this, given that India is an oil-importing economy). And, to use its government's own phrase, India also faces 'twin balance sheet challenges' for public and private sector banks with high non-performing loans (NPLs).

High NPLs discourage inflows

Governor Rajan had started to address key challenges, such as inflation (5.8% in June) and NPLs in its banking system. But, by his own account, there is more to do. India's NPLs have risen since 2013, and are reported to be as high as 18%.[2] With public sector banks holding 76% of total assets, this group is most

in need of reform.[3] Although the World Bank is optimistic on reform prospects,[4] the vulnerability of Indian non-financial corporations (relating to liquidity, profitability and leverage) is at its highest level since the early 2000s.[5] The private sector credit and investment environment is difficult.

Inflation pressures are a key macroeconomic risk. And yet the central bank might be avoiding systematic currency intervention, as the rupee has depreciated and supported exports. If that's their intention, their timing is good. India is a significant commodity and oil importer, and the low commodity price environment means slower price rises which offset 'pass-through' inflationary pressure from currency depreciation.

With the RBI's financial reforms unfinished, India is particularly vulnerable to global financial instability that could disrupt capital inflows. This could slow domestic growth and possibly worsen domestic financial risks. And that might, in turn, have not only regional growth implications but also wider global financial consequences. Foreign direct investment (FDI) inflows have been very strong for some time, yet this could change on account of domestic financial vulnerability.

Appoint a new governor soon

Given India's macroeconomic uncertainties, the circumstances surrounding Governor Rajan's departure are worrying. Six weeks on and there has been no successor named. And, just as importantly, his departure apparently resulted from political pressure (to reduce interest rates, which would contribute to increased NPL risk concerns).[6] The delay over appointing a successor suggests that political wrangling may be continuing, which is a risk in its own right. In the wake of Rajan's resignation, the government tried to reassert policy soundness by increasing FDI openness. But these steps were unconvincing.

There is a lot at stake for India and for its trading partners. India's $500 billion in currency reserves will help it stabilise its currency; the RBI acted in the wake of the Brexit vote. Its bilateral swap facilities, including for its oil importers, are also important as a buffer against shocks. Its energy import demand growth (forecast by sector experts to grow by 161% to 2035)[7] will bolster export growth for its resource-exporting trading partners. Notwithstanding all of this, India needs, crucially, to restore macroeconomic and financial institutional stability if it is to sustain its growth path and its trade and investment relationships.

The Government of India should not delay in appointing a new RBI governor, who should continue the work on its inflation framework and on cleaning up public sector bank balance sheets. Progress on both would also reaffirm central bank independence.

Endnotes

1 https://openknowledge.worldbank.org/handle/10986/20493
2 http://www.bloomberg.com/news/articles/2016-03-14/day-of-reckoning-coming-for-india-s-pigs-with-lipstick-lenders
3 http://www.worldbank.org/en/publication/global-economic-prospects
4 http://timesofindia.indiatimes.com/business/india-business/Rajans-exit-will-not-hurt-bank-reforms-World-Bank/articleshow/52842851.cms
5 https://www.imf.org/external/pubs/cat/longres.aspx?sk=42548.0
6 http://www.ft.com/cms/s/3/e679f86a-36f0-11e6-a780-b48ed7b6126f.html#axzz4FHAfgPQt
7 http://www.bp.com/en/global/corporate/energy-economics/energy-outlook-2035/country-and-regional-insights/india-insights.html

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