Apocalypse for India
Economy in the Absence of Raghuram Rajan

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It was sad to see RBI Governor Raghuram Rajan depart after only 3 years without his term getting extended by a Government that was under intense pressure from various quarters including the international academia. Reams of newsprints and umpteen TV hours have been devoted to his indispensability to the Indian economy. But for once the Jeremiahs who had prophesied the collapse of the entire Indian financial system on his exit have been proved wrong. The stock markets did not crash, foreign investors did not rush in panic to withdraw all their money, rating agencies did not lower India's sovereign rating forthwith and Rupee did not nosedive to fall to its lowest. As yet, there is no sign that the faith of the rest of the world on the ability of the Indians to manage their economy without Raghuram Rajan has been shaken badly to trigger a large scale capital outflow.

Instead, the World Bank's India Director has asserted their faith on India's strong macroeconomic policies and continuance of banking reforms, while the global rating major Fitch has reassured that his exit will not impact India's ratings, since policies are more important than personalities as far as ratings are concerned. At least for now, there has been no loss of credibility for the Indian economy and no undermining of investor confidence.

Markets work on sentiments, and a part of it – the financial sector especially - may have been buoyed by the prospect of lower rates, post Raghuram Rajan. It could have been impacted by upbeat signals from Tokyo and Singapore exchanges when it opened after the announcements and went into positive territory within 15 minutes of opening. It might have arrested a possible slide due to aggressive buying by domestic FIIs led by LIC, with SBI controlling the forex market. Or it may have been a combination of all these factors that saw the Sensex rise by 241 points on a day it was expected to crash, the day the investor wealth increased by a whooping Rs 90000 crore. Rupee fell only marginally by 24 paise, from Rs 67.32 to Rs 67.68 against the dollar. The benchmark yield on the 10 year security in the bond market closed at 7.49% against the previous close of 7.50%. The market tranquility encouraged the Government to announce a spate of reforms in FDIs, including easing of norms for investments in defence, aviation and single brand retail and pharmaceutical sectors.

If the Government has stage-managed the scenario to arrest the widely anticipated volatility in the stock market or a steep fall in the value of the Rupee, it certainly cannot be blamed for rising to the occasion. It only proved that a robust surveillance and risk management mechanism is very much in place, of which RBI itself, still being led by Rajan, is an essential component. Rajan himself has emphasized that RBI will survive any governor and being bigger than any Governor. An institution is indeed bigger than an individual and it cannot by any other way. To make institutions subservient to an individual is a sure way to write an obituary for the institution.

This is of course not to underestimate the achievements of Rajan, who undisputably has been one of our finest and most trusted Central Bank Governors. He had taken charge in 2013, when India was beset with extreme volatility of the rupee and was branded as one of the fragile five emerging market economies in the world, the others being Turkey, Brazil, South Africa, and Indonesia, reeling under the impact of the so-called 'taper tantrum', or the reduction of the US Federal Reserve's quantitative easing programmes then unfolding on the global economy. Under Rajan's leadership, India pulled itself out of the fragile five camp, bolstered its foreign exchange reserves to a record level, stabilized the rupee and curtailed inflation from double digit to under 6 percent. All this provided sound assurance to the international investors and rating agencies for policy stability and continuance of reforms. Piggy-backing on the reforms and other positive signals, and buoyed by an end to the hitherto

prevailing policy paralysis at the Centre subsequent to a change in the Government, growth accelerated.

But with due respect to Rajan, it must be asserted, even at the risk of being politically incorrect in this highly charged times, that all this cannot be credited to a single individual. Rajan's success in containing inflation may not have been so spectacular without the government's support to rein in the fiscal deficit and in maintaining tight fiscal discipline, aided not in small measure by the fall in oil and commodity prices. The economy is - and has always been - managed by a team of competent people at the Finance Ministry as well as the RBI rather than by any single individual at the helm of affairs at either place – Ministry managing the fiscal policy and RBI steering the monetary policy. It is another matter that sometimes these roles inevitably get mixed up, forcing one to traverse another's territory, and giving rise to differences, but such differences do not usually spill over into the public domain to magnify into larger controversies.

Central banks in most developed economies – Peoples Bank of China, Bank of Japan or US Fed - work in close liaison with their Governments. No Government could have ignored the slow pace of interest rate reduction – Rajan reduced the interest rate by 1.5 percent over 18 months - and the consequent slow growth in bank lending that was causing distress to the small and medium scale sectors, as higher rates benefits the ore capitalized foreign investors rather than the domestic investors. As it was trying to revive the economy after years of slowdown, Government was faced with inadequate capital flow from the industry. RBI and the Government together could have chalked out an optimal route to to make both the fiscal and the monetary policies deliver optimally. Instead all we saw were a series of conflicts, on transferring powers of regulation of the bond market partially to SEBI, on bringing RBI at par with other financial sector regulators as recommended by the Financial Sector Legislative Reforms Commission, or on creating an independent public debt management office. Each of these measures would have curbed the powers of RBI a little, and the Government succumbed in each case- but the measures were not necessarily detrimental, either to the autonomy of the RBI or to the economy at large.

It must be said to Rajan's credit that the many of the Indradhanush reforms initiated in public sector banking flowed from his report "A Hundred Small Steps" he wrote for the Planning Commission in 2008; these included strengthening of the Bank's boards, push for financial inclusion and inflation targeting by the Central Bank. But Rajan's most singular achievement has been to attack the unholy nexus that exists between bankers, industrialists and politicians, the crony capitalism inside our financial system- which forces banks to give loans not always on sound financial considerations, loans that subsequently turn bad and become NPAs not due to economic downturns, and are concealed in their balance sheets as recoverables. Banks are then bailed out by the taxpayers' money. Rajan most aggressively took on these banks and under the Asset Quality Review, forced them to clean up their balance sheets that resulted in their declaring massive losses, which impacted not only the public sector banks but private sector majors as well. A part of the slow credit off-take by commercial banks (8-9 percent compared to 27 percent in 2009) could have been attributed to this.

The cleanup could possibly have been paced over a longer duration to moderate its impact on the economy and ultimately on employment which was the first priority for the Government, notwithstanding the long term benefits of clean bank balance sheets. But we must not stop at what he has started and must continue the 'deep surgery' he has left unfinished to cleanse bank balance sheets completely, while coming up with practical ways to recapitalise the banks without resorting to taxpayers' money. The Government also must constitute the Monetary Policy Committee announced in Finance Bill 2016 that will set up the policy framework including the RBI benchmark interest rate and inflation targets.

Meanwhile his Chicago University colleagues who think that in failing to retain Rajan, India has missed a huge opportunity and exposed itself to a huge risk of international credibility loss, may reconsider their position. India is not a banana republic in which institutions are dysfunctional; neither are its policies dictated by the whims and fancies of one or a few individuals. Nor is there any shortage of people with wisdom, competence, character, commitment and integrity in a country with more than a billion people. After all, it is the Indian system that has produced not one but many Raghuram Rajans.