

# Dr. Raghuram Rajan Exits: What's Next for India

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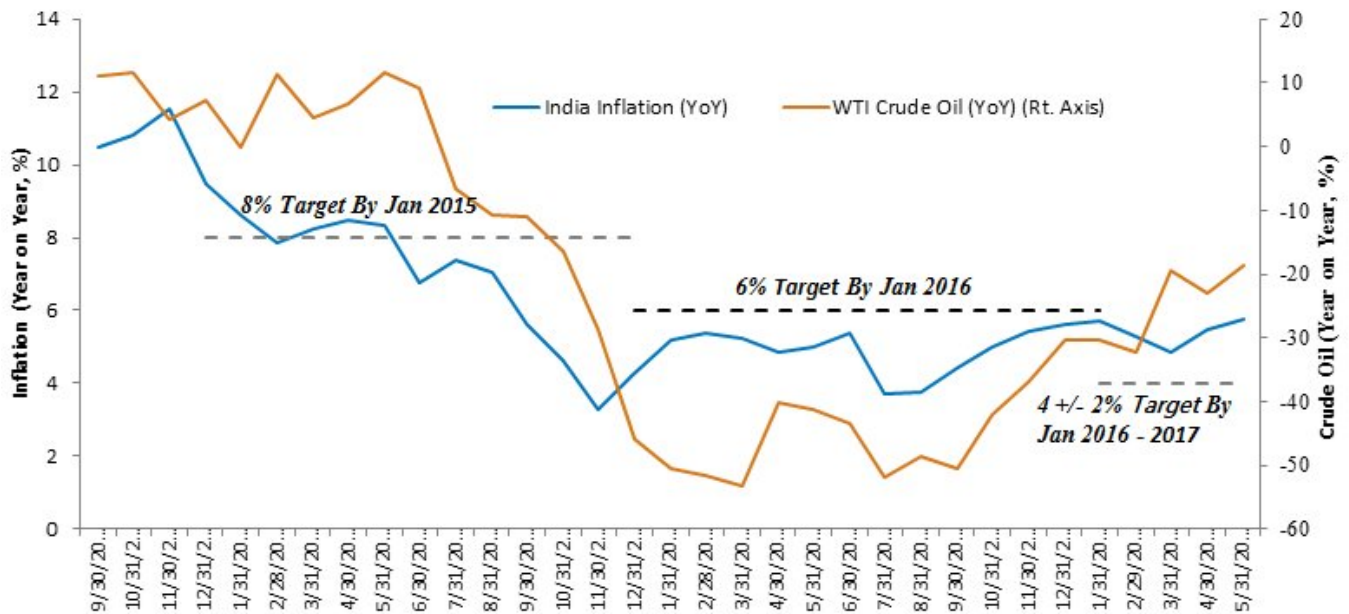
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June brought a number of surprises for investors: Brexit threw markets off and brought uncertainty surrounding a messy divorce process between the UK and the European Union (EU). However, I want to talk about another surprise that happened a week earlier, which I will call “Rexit.” In a surprise move, the Reserve Bank of India’s (RBI) governor, Dr. Raghuram Rajan, communicated his desire to return to academia after his term ends September 4, 2016. Below, I will cover some highlights of his term and the potential road ahead for India.

**Dr. Rajan Starts as Governor During "Taper Tantrum" Infection in Emerging Markets (EM)** Let’s rewind the clocks to September 2013, when Dr. Rajan joined the RBI as its governor. The entire emerging market (EM) currency basket was reeling under pressure of the Federal Reserve’s (Fed) taper tantrum and the fear of what a rise in interest rates from the U.S. would do to EM. A combination of global and local factors led the rupee to depreciate more than 25% in just the first eight months of 2013<sup>1</sup> —a massive decline. Dr. Rajan’s first task was to halt this decline using the RBI’s declining foreign exchange (FX) reserves (also down 7.1% for 2013 as of the end of August 2013). With limited means, Dr. Rajan was able to stabilize the rupee, and by year’s end it had not only recovered by more than 10% from its lows, but the FX reserves also went up by 7.1%.<sup>2</sup>

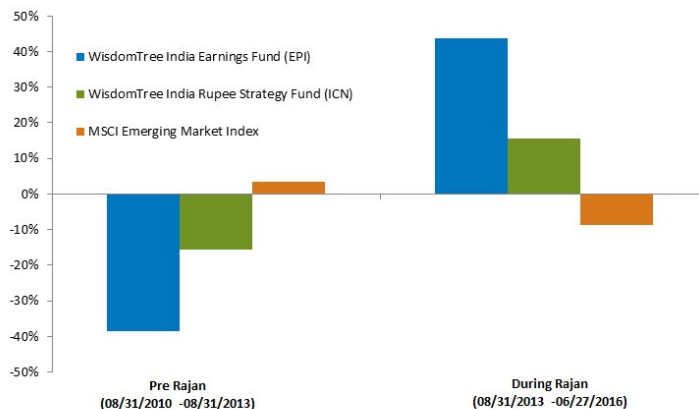
**Stabilized Economy Now Set for Long-Term Recovery Process** Once there was stability, Dr. Rajan set out his long-term vision. He argued that higher historical inflation in India was raising unemployment (this is contrary to what many economists illustrate using the classic “Phillips curve”). If India were to finance its 8%–10% economic growth trajectory, its saving rate would need to rise significantly. This could occur only if the country’s large non-financial savings, primarily gold and cash-based real estate market, would morph into financial savings held at banks. Thus Dr. Rajan became a rare breed among global central bankers: while his peers were competing to keep rates lower and flood the system with liquidity, Dr. Rajan set out to bring inflation and its expectations down. When Dr. Rajan joined the RBI, inflation in India was running above 10% and increasing. The RBI hiked interest rates on three occasions between September 2013 and January 2014, and inflation fell from 11.5% to 9.5%, shortly after Dr. Rajan announced a target rate of 8% by January 2015. As the chart below shows, this target was achieved by July 2014, six months ahead of schedule.<sup>3</sup>



Source: Bloomberg, as of 6/30/2016.

India being the fourth largest importer of crude oil, it's important to highlight here that reduction in inflation was not all because of declining global oil prices. India's inflation already fell below 8% (from its peak of 11.5%) by July 2014, before the decline of oil prices. Oil prices were consistently going up by roughly 10% annually (right-hand axis). In January 2015, inflation was 400 basis points (bps) below the RBI's target of 8%—**a massive turnaround in 1.5 years, where inflation dropped from over 11% to below 5%**. Assured by a speedy recovery of the economy, the astute governor kick-started the next round of his treatment by cutting rates, leading to 125 bps in consecutive cuts in 2015, with a new inflation target of 4% +/- 2%.<sup>4</sup>

**Comparing Markets before and after Treatment by the Doctor** India also saw a significant improvement in its macro fundamentals. Current account and foreign reserves both built up significantly—a key reason for reduced volatility of the rupee and the gain in equities. While external circumstances were also beneficial to India, Dr. Rajan helped in compounding results and achieving what was previously unheard of. While credit risk in EM has been rising, India managed to navigate in the opposite direction. Lower FX volatility helped make the rupee one of the best carry-to-volatility trades in EM. If there was one chart that could capture Dr. Rajan's tenure, I believe it would be a performance comparison of the [WisdomTree India Earnings \(EPI\)](#) and [Indian Rupee Strategy \(ICN\)](#) Funds to EM (represented by the MSCI Emerging Markets Index) generally in periods before and during Dr. Rajan's tenure. For standardized performance, visit the [EPI](#) and [ICN](#) pages.



Sources: WisdomTree, Bloomberg, as of 6/30/2016.

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***The three-year period preceding Dr. Rajan's tenure marked an era of significant underperformance by both EPI and ICN, while results of his three-year tenure were completely opposite. What's Next; the Road Ahead for Investors*** Dr. Rajan's exit as governor of the RBI may dampen sentiments; however, his work of setting the right conditions for growth should have a lasting effect. Having dealt with many of the negatives associated with previous cycles (especially inflation), India is close to the trough of its expansion cycle. I believe lower inflation would allow for lower nominal rates and, along with that, a lower cost of capital over time. In fact, it is quite possible that Dr. Rajan decided to return to academic life only after he was satisfied with the longevity of current structures and the groundwork he had laid at the RBI. I don't expect any meaningful change in monetary policy going forward, as the government is equally interested in attracting capital flows, in my view. Continuing on its liberalization agenda, there has been a recent push for opening the defense, pharmaceutical and aviation sectors. We expect Dr. Rajan's replacement will be a capable economist who maintains the RBI's goal of lowering inflation, clearing out stress from banking books and boosting domestic savings. The long-term macro trends, combined with the groundwork laid by Dr. Rajan that turned around the monetary and inflation outlook, are likely going to structurally make India an attractive investment destination for strategic investors, in my view. ***Unless otherwise stated, data source is Bloomberg, as of 6/30/2016.*** 1Source: Bloomberg, as of 6/30/16. 2Source: Bloomberg, as of 6/30/16. 3Sources: Reserve Bank of India, Bloomberg, as of 6/30/16. 4Sources: Reserve Bank of India, Bloomberg, as of 6/30/16.

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