India Flash

Hopes are high on the central bank's new governor

Living up to his reputation, Dr. Raghuram Rajan (former IMF Chief Economist and Economic Advisor to the Government) hit the right notes on his first day on the job yesterday as the Reserve Bank of India's new Governor. Amidst continued currency pressures and slowing growth, Dr. Rajan made clear his intention to bolster the rupee's stability by deepening financial markets and easing external financing constraints. In that regard, he announced more steps to attract capital inflows and boost demand for the domestic currency (see below). In addition, Dr. Rajan lifted hopes that the RBI will accelerate the opening of India's financial sector. As recognized by many market observers, however, arresting India's economic woes will take more than the work of the RBI alone. In particular, the government will need to do its part to reduce the fiscal deficit in line with previously announced targets and restore investor confidence by implementing structural reforms. Specifically, actions are needed to reduce diesel fuel subsidies, alleviate food and raw material supply bottlenecks, and speed up infrastructure projects. It will also be important to implement recently passed reform bills (including the Food Security Bill, Land Acquisition bill and Pension Reforms) coherently and to keep renewed fiscal pressures in check. Given these challenges, the expected pickup in growth will take time and the outlook if fraught with downside risks.

- **Newly announced measures intended to augment capital inflows and stabilize the rupee include:** 1) Higher limits on overseas borrowing for domestic banks (100% of Tier 1 capital from 50%) and option to swap these with RBI at a discounted rate; 2) Allowing banks to swap their incremental long term (+3 years) foreign currency non-resident deposits with the RBI at a fixed rate of 3.5% per annum. We believe these measures in themselves will not alleviate current currency pressures, but should help at the margin to encourage capital inflows and lift rupee demand.

- **Measures to further liberalize and deepen India's financial markets:** In a positive to prospects for enhancing competition in the banking sector, the new Governor emphasized RBI's plans to simplify the process for granting new banking licenses and to ease restrictions on opening new branches. He also emphasized the RBI's hopes that foreign banks in India will move to a wholly owned subsidiary structure from the current branch structure. RBI is expected to issue detailed guidelines on foreign banks licenses in the near future.

Chart 1
GDP growth continued to disappoint in Q2, with downside risks increasing

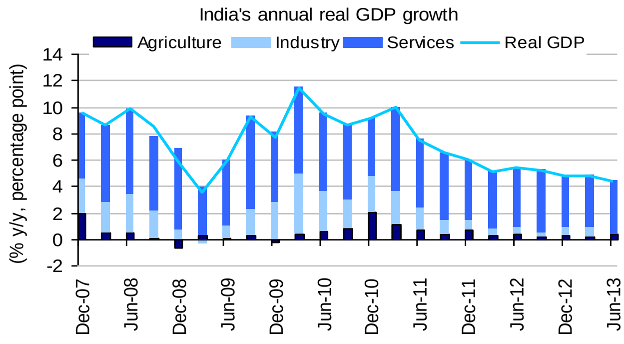
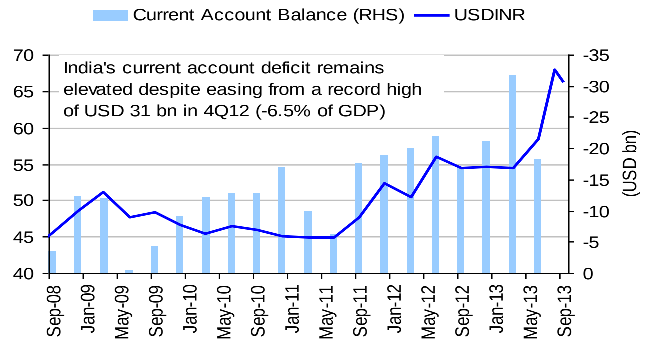


Chart 2
The rupee has clawed its way back from record lows against the USD, but remains very weak



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