INDIA: RBI GOVERNOR RESIGNS

CENTRAL BANKER'S SURPRISE EXIT ADDS TO MARKET UNCERTAINTIES

Authors

DONG CHEN
dchen@pictet.com

JULIEN HOLTZ
jholtz@pictet.com

SUMMARY

- Urjit R. Patel, the governor of India's central bank (RBI), unexpectedly resigned on Monday. His successor, Shaktikanta Das, a former economic affairs secretary, was promptly appointed the following day.
- Patel's resignation came amid a period of acute tension between the RBI and the Indian government over a range of issues, from banking regulation and the use of excess reserves to central bank governance.
- In the short term, the impact of Patel's departure on the Indian economy and RBI policies may be fairly limited, but RBI's monetary policy may turn more dovish from its current "calibrated tightening" stance.
- Initial market jitters quickly faded. The upcoming general elections and corporate earnings should prove the main drivers of equity performance in the months to come. Current valuations leave little room for disappointment.
- In the longer term, central bank independence remains critical to strong and stable growth prospects. The state of relations between the RBI and the government should be closely scrutinised in this regard.

Unexpected resignation

Urjit R. Patel, the governor of India's central bank, the Reserve Bank of India (RBI), announced his immediate resignation on 10 December. Patel had been appointed to the role in September 2016 for a three-year term, having served as the RBI's deputy governor since 2013. His departure, which was largely unexpected, came four days ahead of a crucial RBI board meeting meant to discuss internal governance issues.

Shortly after Patel's resignation, Prime Minister Narenda Modi appointed Shaktikanta Das to replace him. When serving as the secretary of economic affairs from 2015 to 2017, Das oversaw the controversial "demonetisation" programme, which invalidated high-denomination banknotes as legal tender overnight in 2016.

Rising tensions with the government

Although he cited "personal reasons", Patel's resignation comes amid a period of acute tension between the RBI and the Indian government. There are various differences, but they essentially revolve around the RBI's independence. These tensions were apparent in a comment last month from the RBI's deputy governor that "governments that do not respect central bank independence will sooner or later incur the wrath of financial markets".

Given intrinsically different objectives, frictions between a country's central bank and its government are not unique to India. An example is Donald Trump's recent criticism of

INDIA: RBI GOVERNOR RESIGNS

CENTRAL BANKER'S SURPRISE EXIT ADDS TO MARKET UNCERTAINTIES

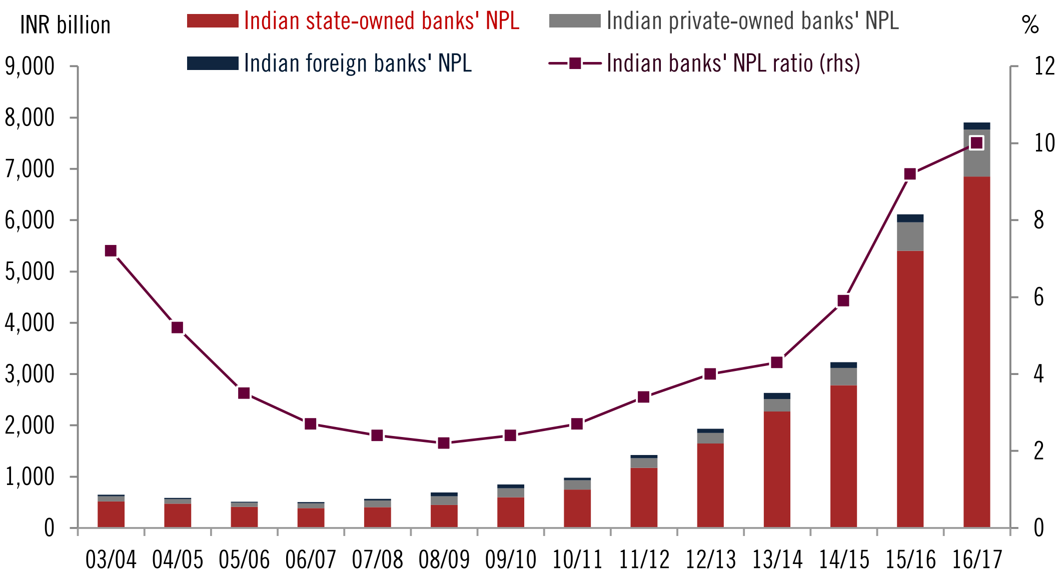
the Fed for hiking rates in the US. Governments care about boosting growth to please their voters while central banks care about taming inflation and controlling financial risks. The inevitability of such tensions is the reason for central banks' independence in the first place.

In India's case, the disagreement focuses on three areas: tough regulations to control financial risks in India's banking sector, the use of RBI reserves to bridge India's budget deficit and potential changes in RBI governance.

Bank regulations. During his tenure as RBI governor, Patel continued the central bank's push to clean up a banking sector saddled with huge non-performing loans (NPLs). The RBI now applies more stringent regulations on Indian banks, especially those owned by the government, when it comes to recognising bad loans. Troubled banks also face restrictions in terms of lending, opening new branches and dividend distributions when they breach certain regulatory requirements on minimum capital, returns on assets and NPLs (the Prompt Corrective Action (PCA) plan).

While these measures should benefit India's banking sector in the long term, they have caused short-term pain. Banks subject to PCA procedures have seen their ability to extend loans greatly reduced. The more stringent NPL recognition rules have also contributed to the surge in bad loans reported by Indian banks in recent years (*Chart 1*).

CHART 1: NON-PERFORMING LOANS IN INDIA'S BANKING SECTOR



Source: PWM - AA&MR, RBI, the World Bank

These measures have not been welcomed by the Modi government. Various government officials have criticised the RBI for being too tough on banks and hurting the economy. The government wants some of the restrictions to be loosened so that banks can start lending and boost growth, especially ahead of the general election early next year.

RBI dividend transfer. The Indian government has long looked enviously at the RBI's reserves, which it believes are way too high. Some officials argue that, at 27% of its assets, the RBI's reserves are significantly higher than the 13-14% levels seen at other major

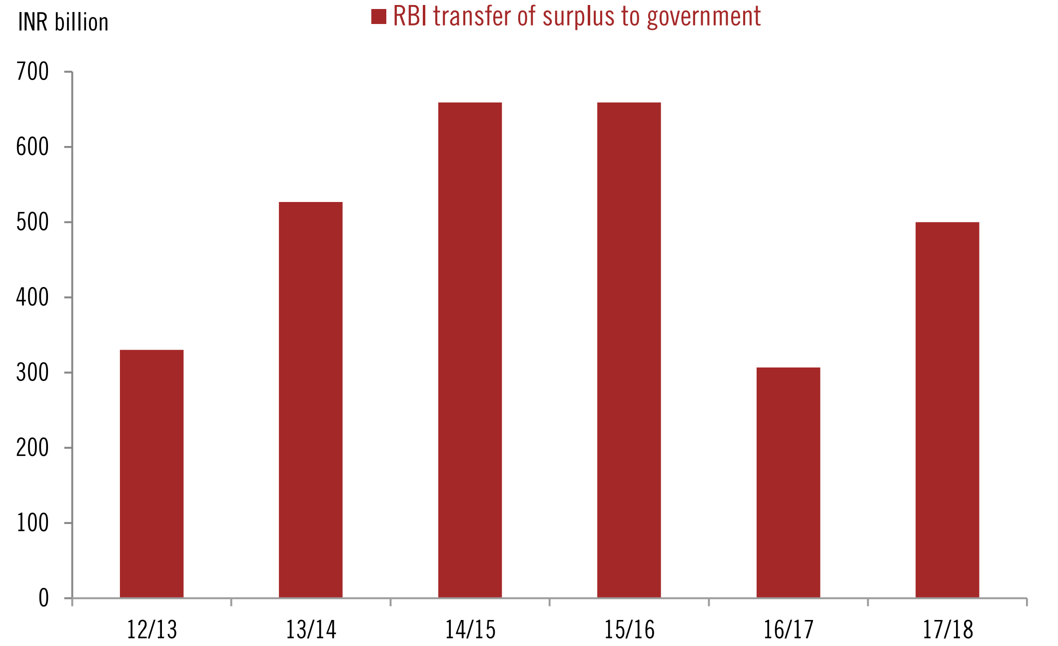
INDIA: RBI GOVERNOR RESIGNS

CENTRAL BANKER'S SURPRISE EXIT ADDS TO MARKET UNCERTAINTIES

central banks, and that the "excess" reserves could be put to productive use if they were returned to the government. However, the RBI opposes this idea. It insists that adequate reserves are necessary to face potential losses from central bank operations. More importantly, the reserves could stop the RBI having to ask the Indian government for capital injections in times of need, thus ensuring the central bank's independence.

The government has been looking to the RBI to help fund its fiscal deficit. In fiscal year (FY) 2017-18, the RBI transferred INR500 billion of its surplus to the government, 60% more than in the previous fiscal year, but lower than its peak in 2015-16 (*Chart 2*).

CHART 2: RBI TRANSFER OF SURPLUS TO GOVERNMENT



Source: PWM - AA&MR, RBI

RBI governance. Given its numerous disagreement with the RBI, the Modi government has tried to exert greater influence on the central bank. Two recent moves in particular are worth noting.

First, in August the government appointed Swaminathan Gurumurthy as RBI board member. As a close advisor to Modi and a long-time critic of the RBI, Gurumurthy's appointment is generally viewed as compromising the ability of the RBI to make independent decisions.

Second, in October the Modi government reportedly invoked a never-used law (Section 7 of the RBI Act), which empowers the government to "issue direction" to the RBI regarding policy. According to media reports, the government sent several letters to Patel in October on issues ranging from liquidity for non-banking financial companies (NBFCs), capital requirements for weak banks and lending to micro, small and medium enterprises (MSMEs).

INDIA: RBI GOVERNOR RESIGNS

CENTRAL BANKER'S SURPRISE EXIT ADDS TO MARKET UNCERTAINTIES

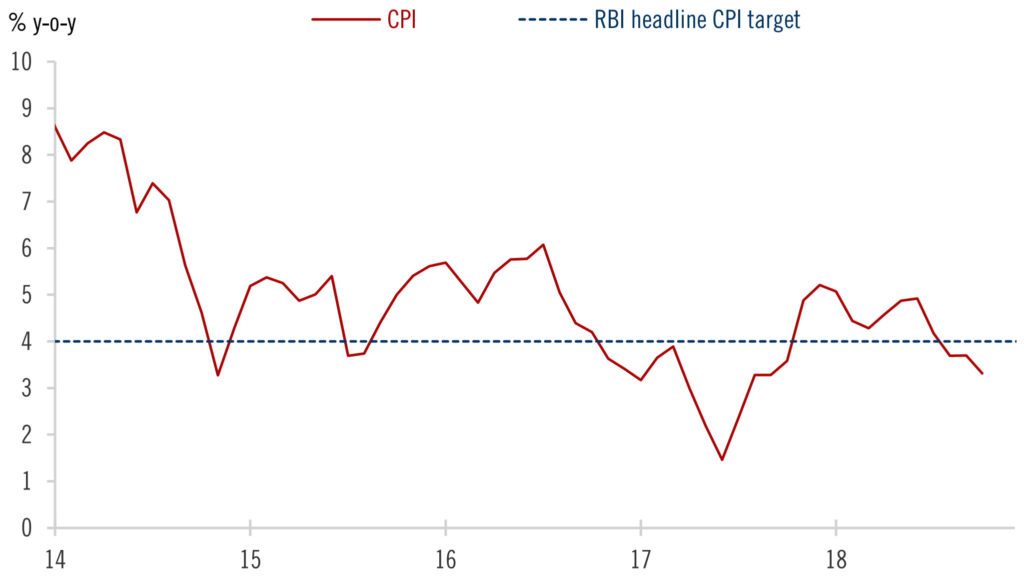
Implications

Patel's resignation sends a bad signal about RBI's independence, and thus could be negative for the economy in the long term, although such an impact is hard to measure.

In the short term, while Patel's abrupt departure adds to market uncertainties, its impact on the Indian economy and RBI policy may be fairly limited. We expect the RBI's monetary policy to turn more dovish from its current "calibrated tightening" stance, but we think this will be more driven by the shifting fundamentals in the Indian and global economy rather than the change of RBI governor per se (although the latter could facilitate such an adjustment).

First, inflation is no longer a pressing concern. Since mid-2018, headline inflation in India has been trending downward, mainly due to sluggish food inflation. In October, headline inflation in Indian was only 3.3%, well below the RBI's 4.0% target (*Chart 3*). For full fiscal year 2018/19 (ending 31 March 2019), we expect headline inflation to settle at 3.8%. The recent slump in global crude oil prices could put some further downward pressure on inflation.

CHART 3: CHANGES IN INDIAN HEADLINE CPI



Source: PWM - AA&MR, India Central Statistics Office

Second, the latest reading of Indian GDP in Q3 was disappointing. Industrial activity and consumption were both soft, with the economy dragged down by a rise in the trade deficit. The downside surprise in Q3 has led us to downgrade our expectations for GDP growth for FY2018/19 to 7.2% from 7.6% previously. Although leading indicators are pointing to a rebound in growth momentum in Q4, the benign inflation environment and potential stabilisation of the current account (due to lower crude oil prices) have made the RBI's tightening policy stance harder to justify.

INDIA: RBI GOVERNOR RESIGNS

CENTRAL BANKER'S SURPRISE EXIT ADDS TO MARKET UNCERTAINTIES

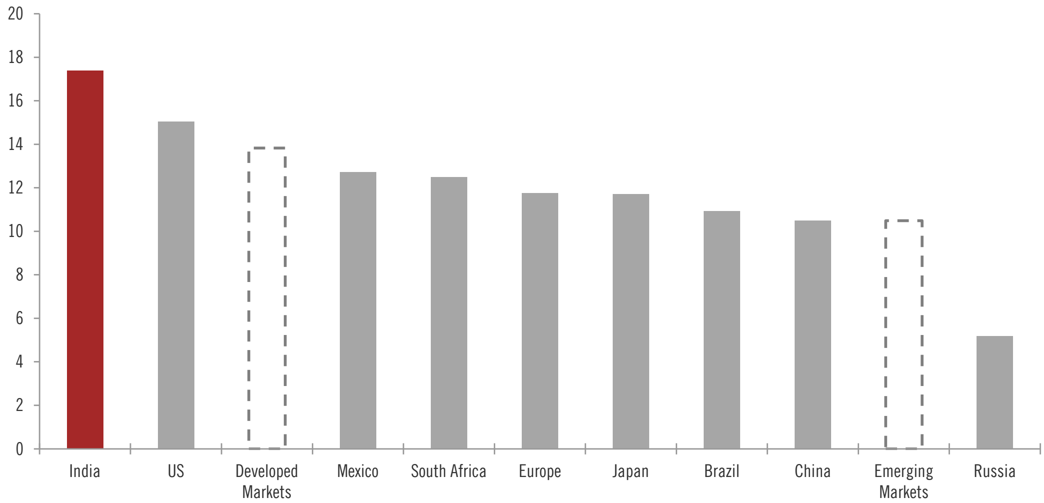
Market perspective

The Indian rupee dropped by ~1.5% against the US dollar immediately following Patel's resignation on 10 December, 10-year government bond yields rose by 12bps to 7.70%, and the Nifty 50 – one of the main equity indices – opened down by about 1%. Yet markets quickly recovered as attention turned to the policy implications of an upcoming change at the helm of the RBI. By the end of the day, sovereign yields were actually down from the previous day's close, while equity markets were up and the rupee pared back some of its losses.

Such movements are similar to what happened when the previous governor, Raghuram Rajan, announced in June 2016 that he would not seek a second term. Following that announcement, equities and the rupee initially dropped while sovereign yields jumped. But apart from the rupee, Indian assets had recovered within a day.

Patel's departure may even prove moderately positive for equities in the short term, as it could herald a more accommodative RBI stance on regulatory and monetary policy issues. The shares of state-owned banks and several non-bank financing firms – two sectors that had been under particularly strong scrutiny by the RBI – have rallied on hopes of looser restrictions and stronger support for credit growth. Other sectors such as construction may also benefit from a change in the RBI's tone.

CHART 4: 12-MONTH FORWARD P/E RATIOS FOR SELECT EQUITY MARKETS



Source: PWM - AA&MR, Factset

In the medium term, however, we expect Indian equities to be mainly driven by two factors—namely the 2019 general elections and actual growth in corporate earnings.

– A victory by the ruling BJP party would provide political stability and facilitate the continuation of gradual structural reforms. Recent local elections in three key states (Chhattisgarh, Madhya Pradesh and Rajasthan) indicate that the popularity of BJP has declined. On a national level, however, a BJP-led government is still likely in next year's general election (although it may need to seek to form a coalition). Securing a stable government might prove even more critical for markets than what party ends up governing (BJP or the rival Congress party).

– Equity valuations in India are notoriously higher than in most markets, thanks largely to a superior and resilient GDP growth story (*Chart 4*). This, coupled with structural reforms, is fuelling high earnings growth expectations for 2019 (above 20%). Should growth disappoint, Indian equities may well face a stronger derating than they did during this year's emerging market rout (-8% vs. -16% for emerging markets).

We therefore expect further turbulence in the run-up to the general elections scheduled for April/May 2019, especially if there are mixed signals on earnings in the meantime.

In the longer run, it will be critical for Indian financial markets that the RBI's independence be preserved, despite recent events. Otherwise, international investors may baulk at the double risk of below-potential growth and foreign-exchange losses that wipe out any market gains. In this regard, the relationship between the government and the central bank, as well as the operational governance of the latter, should be monitored closely.

From a positioning perspective, we still like the long-term growth story in India relative to other emerging markets, which led us to start building exposure in November.

DISCLAIMERS

Distributors: Banque Pictet & Cie SA, Route des Acacias 60, 1211 Geneva 73, Switzerland and Pictet & Cie (Europe) SA, 15A, avenue J. F. Kennedy, L-1855 Luxembourg/B.P. 687 L-2016 Luxembourg.

Banque Pictet & Cie SA is established in Switzerland, exclusively licensed under Swiss Law and therefore subject to the supervision of the Swiss Financial Market Supervisory Authority (FINMA).

Pictet & Cie (Europe) SA is established in Luxembourg, authorized and regulated by the Luxembourg Financial Authority, Commission de Surveillance du Secteur Financier.

This marketing communication is not intended for persons who are citizens of, domiciled or resident in, or entities registered in a country or a jurisdiction in which its distribution, publication, provision or use would violate current laws and regulations.

The information, data and analysis furnished in this document are disclosed for information purposes only. They do not amount to any type of recommendation, either general or tailored to the personal circumstances of any person. Unless specifically stated otherwise, all price information is indicative only. No entity of the Pictet Group may be held liable for them, nor do they constitute an offer or an invitation to buy, sell or subscribe to securities or other financial instruments. The information contained herein is the result neither of financial analysis within the meaning of the Swiss Bankers Association's Directives on the Independence of Financial Research, nor of investment research for the purposes of the relevant EU MiFID provisions. All information and opinions expressed in this document were obtained from sources believed to be reliable and in good faith, but no representation or warranty, express or implied, is made as to its accuracy or completeness.

Except for any obligations that any entity of the Pictet Group might have towards the addressee, the addressee should consider the suitability of the transaction to individual objectives and independently assess, with a professional advisor, the specific financial risks as well as legal, regulatory, credit, tax and accounting consequences.

Furthermore, the information, opinions and estimates in this document reflect an evaluation as of the date of initial publication and may be changed without notice. The Pictet Group is not under any obligation to update or keep current the information contained herein. In case this document refers to the value and income of one or more securities or financial instruments, it is based on rates from the customary sources of financial information that may fluctuate. The market value of financial instruments may vary on the basis of economic, financial or political changes, currency fluctuations, the remaining term, market conditions, the volatility and solvency of the issuer or the benchmark issuer. Some investments may not be readily realizable since the market in the securities can be illiquid. Moreover, exchange rates may have a positive or negative effect on the value, the price or the income of the securities or the related investments mentioned in this document. When investing in emerging countries, please note that the political and economic situation in those countries is significantly less stable than in industrialized countries. They are much more exposed to the risks of rapid political change and economic setbacks.

Past performance must not be considered an indicator or guarantee of future performance, and the addressees of this document are fully responsible for any investments they make. No express or implied warranty is given as to future performance. Moreover, forecasts are not a reliable indicator of future performance. The content of this document can only be read and/or used by its addressee. The Pictet Group is not liable for the use, transmission or exploitation of the content of this document. Therefore, any form of reproduction, copying, disclosure, modification and/or publication of the content is under the sole liability of the addressee of this document, and no liability whatsoever will be incurred by the Pictet Group. The addressee of this document agrees to comply with the applicable laws and regulations in the jurisdictions where they use the information reproduced in this document.

This document is issued by Banque Pictet & Cie SA. This publication and its content may be cited provided that the source is indicated. All rights reserved. Copyright 2017.

Distributors: Bank Pictet & Cie (Asia) Ltd ("BPCAL") in Singapore, 10 Marina Blvd #22-01 Tower 2, Marina Bay Financial Centre, Singapore 018983 and Pictet & Cie (Europe) S.A., Hong Kong branch ("Pictet HK branch") in Hong Kong. The registered address of Pictet HK branch is 9/F, Chater House, 8 Connaught Road Central, Hong Kong.

The information, tools and material presented in this document are provided for information purposes only and are not to be used or considered as an offer, an invitation to offer or solicitation to buy, sell or subscribe for any securities, commodities, derivatives, (in respect of Singapore only) futures, or other financial instruments (collectively referred to as "Investments") or to enter into any legal relations, nor as advice or recommendation with respect to any Investments. This document is intended for general circulation and it is not directed at any particular person. This document does not have regard to the specific investment objectives, financial situation and/or the particular needs of any recipient of this document. Investors should seek independent financial advice regarding the appropriateness of investing in any Investments or adopting any strategies discussed in this document, taking into account the specific investment objectives, financial situation or particular needs of the investor, before making a commitment to invest.

BPCAL/Pictet HK branch has not taken any steps to ensure that the Investments referred to in this document are suitable for any particular investor, and accepts no fiduciary duties to any investor in this regard. Furthermore, BPCAL/Pictet HK branch makes no representations and gives no advice concerning the appropriate accounting treatment or possible tax consequences of any Investment. Any investor interested in buying or making any Investment should conduct its own investigation and analysis of the Investment and consult with its own professional adviser(s) as to any Investment including the risks involved with transactions on such Investment.

This document is not to be relied upon in substitution for the exercise of independent judgment. The value and income of any Investment mentioned in this document may fall as well rise. The market value may be affected by, amongst other things, changes in economic, financial, political factors, time to maturity, market conditions and volatility, and the credit quality of any issuer or reference issuer. Furthermore, foreign currency rates of exchange may have a positive or adverse effect on the value, price or income of any Investment mentioned in this document. Accordingly, investors must be willing and able to, and effectively assume all risks and may receive back less than originally invested.

Past performance should not be taken as an indication or guarantee of future performance and no representation or warranty, expressed or implied, is made by BPCAL/Pictet HK branch regarding future performance.

This document does not constitute the investment policy of BPCAL/Pictet HK branch, or an investment recommendation, and merely contains the different assumptions, views and analytical methods of the analysts who prepared them. Furthermore, the information, opinions and estimates expressed herein reflect a judgment at its original date of publication and are subject to change without notice and without any obligation on BPCAL/Pictet HK branch to update any of them. BPCAL/Pictet HK branch may have issued or distributed other reports or documents that are inconsistent with, and reach different conclusions from, the information presented in this document.

While the information and opinions presented herein are believed to be from sources believed to be reliable, BPCAL/Pictet HK branch is not able to, and do not make any representation or warranty as to its accuracy or completeness. Accordingly, BPCAL/Pictet HK branch accepts no liability for loss arising from the use of or reliance on this document presented for information purposes only. BPCAL/Pictet HK branch reserves the right to act upon or use any of the information in this document at any time, including before its publication herein.

BPCAL/Pictet HK branch and its affiliates (or employees thereof) may or may not have long or short positions in, and buy or sell, or otherwise have interest in, any of the Investments mentioned herein, and may or may not have relationships with the issuers of or entities connected with Investments mentioned in this document. BPCAL/Pictet HK branch and their affiliates (or employees thereof) may act inconsistently with the information and/or opinions presented in this document.

The information used to prepare this document and/or any part of such information, may have been provided or circulated to employees and/or one or more clients of BPCAL/Pictet HK branch before this document was received by you and such information may have been acted upon by such recipients or by BPCAL/Pictet HK branch.

This document is provided solely for the information of the intended recipient only and should not be reproduced, published, circulated or disclosed in whole or in part to any other person without the prior written consent of BPCAL/Pictet HK branch.

Singapore

This document is not directed to, or intended for distribution, publication to or use by, persons who are not accredited investors, expert investors or institutional investors as defined in section 4A of the Securities and Futures Act (Cap. 289 of Singapore) ("SFA") or any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or would subject BPCAL and any of its affiliates or related corporations to any prospectus or registration requirements.

BPCAL has obtained an exemption from the Monetary Authority of Singapore ("MAS") under section 100(2) of the Financial Advisers Act ("FAA") for the provision of financial advisory services to High Net Worth Individuals (as defined in the MAS Guidelines on Exemption for Specialised Units Serving High Net Worth Individuals FAA-G07) (the "Exemption") and is exempted from the requirements of sections 25, 27, 28 and 36 of the FAA, the MAS Notice on Recommendations on Investment Products (FAA-N16), MAS Notice on Appointment and Use of Introducers by Financial Advisers (FAA-N02), MAS Notice on Information to Clients and Product Information Disclosure (FAA-N03) and MAS Notice on Minimum Entry and Examination Requirements for Representatives of Licensed Financial Advisers and Exempt Financial Advisers (FAA-N13).

Please contact BPCAL in Singapore in respect of any matters arising from, or in connection with this document.

Hong Kong

This document is not directed to, or intended for distribution, publication to or use by, persons who are not "professional investors" within the meaning of the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong) and any rules made thereunder (the "SFO") or any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or would subject Pictet HK branch and any of its affiliates or related corporations to any prospectus or registration requirements.

Pictet & Cie (Europe) S.A. is incorporated in Luxembourg with limited liability. It is an authorized institution within the meaning of the Banking Ordinance and a registered institution (CE No.: AQ515) under the SFO carrying on Type 1 (dealing in securities), Type 4 (advising on securities) and Type 9 (asset management) regulated activities.

Warning: The contents of this document have not been reviewed by any regulatory authority in Hong Kong. You are advised to exercise caution in relation to the offer. If you are in any doubt about any of the contents of this document, you should obtain independent professional advice. Please contact Pictet HK branch in Hong Kong in respect of any matters arising from, or in connection with this document.

Distributor: Pictet Bank & Trust Limited, where registered office is located at Building 1, Bayside Executive Park, West Bay Street & Blake Road, Nassau, New Providence, The Bahamas.

The document is not directed to, or intended for distribution or publication to or use by persons who are not Accredited Investors (as defined in the Securities Industry Regulations, 2012) and subject to the conditions set forth in the Securities Industry Regulations, 2012 or to any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or would subject Pictet Bank & Trust Limited to any prospectus or registration requirements. Pictet Bank & Trust Limited is incorporated in The Bahamas with limited liability. It is a bank and trust company that is licensed in accordance with the Banks and Trust Companies' Regulation Act and is regulated by the Central Bank of The Bahamas. Additionally, Pictet Bank & Trust Limited is registered with the Securities Commission of The Bahamas as a Broker Dealer II and is approved to (i) Deal in Securities 1.(a) & (c); (ii) Arrange Deals in securities; (iii) Manage Securities ; (iv) Advise on Securities.

Warning: The content of this document has not been reviewed by any regulatory authority in The Bahamas. You are, therefore, advised to exercise caution when processing the information contained herein. If you are in any doubt about any of the content of this document, you should obtain independent professional advice.