The Reserve Bank of India's (RBI) Governor, Urjit Patel resigned from his position earlier this week for "personal reasons". He is the first central bank governor to resign after more than 43 years and has just been replaced by Shaktikanta Das, a figure more aligned to Prime Minister Narendra Modi and likely to accommodate the latter's policy objectives.

Das is set to govern over India's top financial institution until 2021. As a member of the Economic Affairs Ministry, he had a hand in devising the most central and unpopular policies of the Modi government, namely the General Sales Tax which imposes an average 18% tax rate on most goods and demonetisation which invalidated 86% of the currency notes. These policies mostly hurt small and medium enterprises and caused the loss of more than 2 million jobs in the unregulated sector in urban zones. These developments have been thorns in the side of the Modi government, as the latter generally -but not solely- attracts votes from small businessmen and rural regions of India. This led the government to put the blame of its policy failures on the RBI, which led to a momentous showdown between the government and the central bank, meant to be autonomous.

Over the last two years, India's financial and economic sector saw the resignation of many key figures, who despite leaving for personal reasons, might have good grounds to have left as a reprimand against the government's creeping foothold on the central bank. In 2016, the famed RBI Governor Raghuram Rajan was not given a second term by the government, something unprecedented in the last two decades. Arvind Panagariya, the former Vice Chairman of the government think tank Niti Aayog left his chair in 2017 and Arvind Subramanian, a former Chief Economic Advisor for the government left office in June of this year. With the surprise resignation of Governor Patel, there seems to be an uneasy relation between the government and central bank of India, something which could impact market confidence in this emerging market.

The Governor seems to have decided to leave his chair after a meeting with the government which soured back in November. The RBI itself seems to be fractured between board members aligning with Patel and his anti-inflationary measures and those siding with Prime Minister Modi, who would like to see an easing of the central bank's tightening policies. While the deputy Governor Viral Achary, who is in charge of monetary policy has been vocal against the government's desire to be more active in managing the central bank's policies and risks leaving his post before the end of his term in January 2020, the bank's board also includes Swaminathan Gurumurthy who is highly critical of the central bank's policies to date, especially in relation to its harsh treatment of over-leveraged state-run banks.

Indeed, one of the two most contentious points between the central bank and the government is India's high non-performing loan (NPL) ratio, which is now around 11.6% of all loans and risks rising to 12.2% by March 2019, the highest level in the world after Italy. NPLs are basically bad loans, handed by over-optimistic bankers who were reluctant to apply due diligence measures and therefore fail to be repaid by their debtors. According to the former Governor, Raghuram Rajan, this is a problem that exists since the mid-2000s but is especially acute today due to the high-profile of many debtors, who are also accused of fraud. India's banking sector has seen a series of high-level fraud scandals, most notably at the second biggest state-run lender, Punjab National Bank, which amounted to nearly $2 billion and involved high-profile figures like Nirav Modi, a businessman specialising in jewellery and allegedly seeking political asylum in Britain.

The extent of the NPL crisis, amounting to as much as $200 billion according to some sources, has led the RBI to adopt new bankruptcy laws -which the country lacked- and helped it enter the top 100 countries for Ease of Doing Business, according to the World Bank. The Insolvency Code included a circular stipulating that debtors were considered as non-performing if they failed to repay their loans 90 days after the repayment deadline. Up to three annual quarters, the assets of the debtors would then be liquidated if the debt surpasses 100,000 Rupees. This has allegedly led to a significant change of behaviour amongst debtors and over-leveraged banks which have cleared dues worth $12 billion in the months following the adoption of the law in May 2016. The measure was also followed by new rules to hold accountable individuals in case of default, especially in the case where cross-border assets must be pursued. In spite of their effectiveness, these measures have enraged the government as they have had a harsh impact on 11 state-run banks, on whom many debtors and crucial voters depend.

For the government, the central bank has applied unilateral moves that are hurting average Indians and slowing its economic development. The RBI's monetary tightening has also drawn the ire of the government. The Repo rate, on which the central bank bases its loans to commercial banks in need of funds, is at 6.5%. This is judged to be too high and the government would like to see interest rates decrease so as to put liquidity toward small and medium enterprises ahead of the 2019 General Elections. Having much stakes in the vote of this constituency, the government of Modi, who is from the Bharatiya Janata Party (BJP), has called for the constitution of oversight committees over the various RBI functions like foreign exchange management and financial stability. Another reason why the current government would like to see an expansion of the monetary policy is to further lower the budget deficit which stands at 3.2% GDP. The government stresses the fact the central bank holds at least $50 billion of excess reserves and could well use these funds to ease fiscal pressures.

All in all, the current showdown between the central bank and the government is more political than anything. With General Elections coming in less than six months, the BJP is trying to adopt policies that will make it gain votes and make people forgive its earlier economic policy failures, such as demonetisation. Until mid-October, high oil prices were the most potent inflationary factor in the country in correlation to a weakening Rupee. Although such prices are much lower now and the US has given India sanctions waivers to import 300,000 bpd from Iran, the fact remains that economic inefficiencies minimise the impact of such gains. Indeed, the Rupee has not seen a significant upward trend and most importantly Indian oil refiners are set to take a hit from lower oil prices. Another great challenge for the incumbent party is the agrarian crisis, with hundred of thousands farmers in distress as a result of drought, hailstorms and high debt. The agricultural sector, drawing public investments worth only 0.4% GDP, is thus in a dire position and the government has sought to waiver farmers' loan, which is only a measure scratching the surface of the problem.

Whilst the 2017 state elections were encouraging for the BJP with wins in Gujarat, Himacha Pradesh and Uttar Pradesh, the elections of this year fare much worse for the party's performance next year. In 5 states serving as a barometer for next year's election, the BJP lost or got a small margin win. The worst is that these states constitute the Hindu and rural heartland of India, which have generally supported the BJP during the 2014 general elections. In Rajasthan, the Indian National Congress (BJP) won slightly over the BJP while the opposite is true for Madhya Pradesh. But in Telangana and Mizoram, the BJP was not even in the top three parties leading the polls. The reelection of Modi is therefore uncertain and market volatility concerning India is likely to rise until mid-2019.

There are indeed several causes for concern for market watchers interested in the sub-continent. The credit rating agency Fitch has warned that Urjit Patel's resignation was a bad sign for the macroeconomic and financial stability of India. Moody's has also recently shown signs of concern a year after upgrading India's sovereign rating to Baa2 from Baa3. This concern is mainly due to the NPL crisis and GDP growth stalling at 7.1% in Q2 of 2018-2019 FY, from 8.2% the previous year. The resignation of the RBI's governor also shows worrying signs of a possible institutional degradation in India, with the autonomy of independent bodies being threatened by the government. It is likely that the latter will seek to push expansionary policies forward in this electoral period, thus creating risks on the public debt side, which now covers 68% GDP, a rather manageable percentage especially considering India’s low foreign denominated debt, but still a risk notwithstanding.

There is therefore much uncertainty over the country’s future fiscal and monetary policy. In the most recent quarter, nearly $3 billion of capital have fled the country, thus showcasing investors’ apprehension. On the 14th of December, RBI board members are set to meet with their newly appointed Governor. It remains to be seen whether the latter’s pro-government approach is going to improve the situation by easing tensions between the two bodies or rather accelerate the crisis by putting aside the central bank’s autonomy. This could be worrying for emerging markets, especially if one draws parallels with Turkey, a country in which the President has lately gained the power to directly appoint central bank governors and whose Finance Minister is his son-in-law, thus compromising the autonomy of financial policies in his country. Although India is definitely not in the same predicament, it could very well be that Prime Minister Modi will use this current opportunity to extract capital from the RBI and loosen lending curbs on weak banks, so as to win back votes for the General Elections.

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