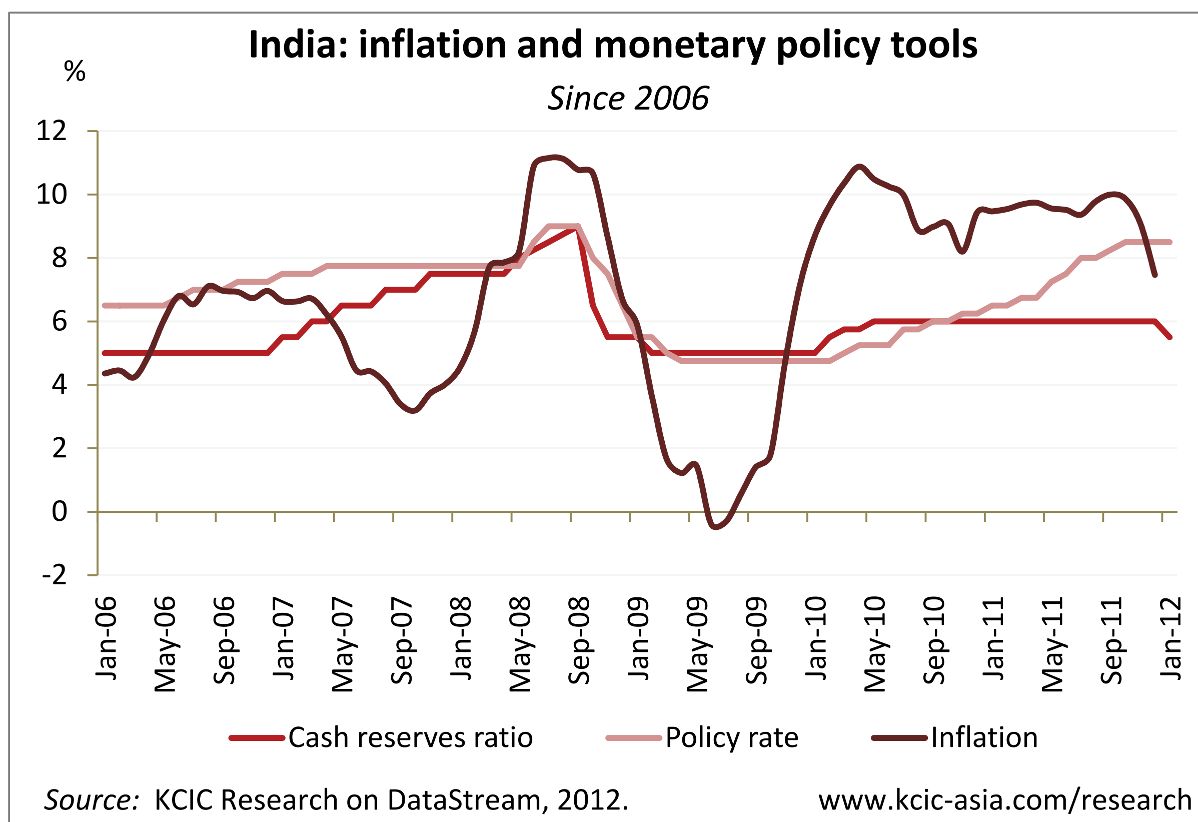
Pro-growth monetary loosening has begun in India

Gulf's sovereign wealth funds increasing their allocations



Why is this graph important?

The world's economy has been looking east for the last five years. While the most developed economies were saddled with a combination of slow growth, ageing population and high levels of debt, India and China emerged as alternative engines to pull the world's demand. In the case of India, with more than 1.2 billion people and high GDP growth rates, millions of people every year reach a "middle class" status involving increased consumption capacity. However, the country has encountered significant obstacles in its path. Inflation is probably the most relevant among them, since it has been hampering the capacity of the government to stimulate a slowing economy. After a short deflationary period in 2009, inflation went up to over 10% in April 2010 and remained around those levels until very recently. The impact on Indian consumers was exacerbated by the strong depreciation of the Indian rupee (INR), almost 20% against the USD in 2011, which made imports of commodities - mostly oil - more expensive. In that period, the Reserve Bank of India (RBI) was forced to hike interest rates 12 times for a total of 375 basis points (bps) or 3.75% until it reached its current 8.5%. High interest rates have restrained consumer credit, increased savings and prevented firms from undertaking additional investments for expansion. Finally, inflation began to cool in October, and investors have been expecting a shift towards growth-supportive policies. That shift only started taking place last Tuesday, when the RBI announced that the percentage of deposits that banks must keep with the central bank in the form of liquid cash, the "cash

reserve ratio", was reduced by 50 bps to 5.5%. A new period of pro-growth monetary loosening, which will probably last throughout 2012, has begun with this cut.

What does the indicator tell us?

When a country needs to stimulate its economy, a range of fiscal and monetary policies can be used. The tool most commonly used is the policy rate, which makes credit for the financial sector and consumers more or less expensive. Other instruments are the open market operations, with which central banks inject or remove liquidity from the system by purchasing or selling bonds, and the cash reserve ratio (CRR). Most financial sectors in the world use a "fractional reserve banking system". Banks are only required to keep a fraction of their deposits with the central bank in the form of cash with the goal of ensuring liquidity for depositors. In the case of India this ratio was set at 6% since May 2010. Under this level of CRR, 3.85 trillions of INR (approximately USD 77bn) were locked with the RBI. The 50 bps cut will release USD 6.4bn in the Indian economy, increasing liquidity available for firms and consumers which, in turn, should translate into higher levels of consumption and investment, pushing GDP up.

What are the economic and financial implications?

Most analysts have reduced their GDP forecasts for India in 2011 and 2012, and the government of India has recently joined them by cutting the expected growth for the fiscal year ending in March 2012 from 7.6 to 7% compared to the same period last year. Downside risks persist in 2012. Global demand is weakening, regulatory reforms regarding foreign investment are urgently needed, and inflation is still well above the central bank's desired level of 4 to 5%. The fiscal stance is not in very good shape. But the fundamentals of the Indian economy remain unchanged. The long period of high interest rates kept the savings rate high, and that should increase capital expenditure as rates come down. The government has elaborated a five-year plan, running from 2012 to 2017, with a strong emphasis on improving the poor infrastructures of the country. More importantly, India has a large and, unlike China, young population that is now reaching working age. Indian universities are producing highly skilled English-speaking professionals. These factors create a wide range of opportunities in infrastructure and consumer related sectors that investors, despite the negative performance of Indian markets in 2011, are starting to consider. The *Kuwait Investment Authority*, one of the largest sovereign funds in the world, has recently allocated USD 1bn to several India-specialized long-only mutual funds to invest across sectors, mostly in equities. Other Gulf's sovereign funds have already a strong presence in India. The Abu Dhabi Investment Authority owns stakes in technology, financial, chemical and automotive firms. Oman and Qatar's investment funds also own significant positions in the Indian stock market. They all share the conviction that India's long term drivers of growth are solid; betting on them will pay off.

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