Economy

Monetary Policy

INDIA

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UPDATE

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RBI hikes rate and turns dovish. The RBI hiked repo rate by 25 bps to 8.5% and virtually signaled a pause. Consequently, reverse repo rate and MSF rate automatically adjust up to 7.5% and 9.5%, respectively. If inflation behaves as per expected trajectory and falls to 8% or lower by December and there is no crisis in the global financial markets, we would expect RBI to stay on a pause mode for an extended period, probably till June 2012. The other important announcement in this polity is the complete deregulation of the savings bank deposit interest rate with immediate effect.

Much more dovish tone than expected

The RBI's outlook for the economy in the policy communiqué sounded more concerned on growth rather than on inflation. The RBI stated that over the past few months global growth has weakened significantly, emanating from the Euro area sovereign debt issues. And, a major downside risk to domestic growth emanates from the global side with impact likely through the trade, finance and confidence channels. Further, yesterday's pre-monetary policy curtain-raiser indicated that the fall in the new investments since the second half of FY2011 has been significant and can impact the pipeline investment in the coming years. As per RBI's assessment, consumer demand is still robust, but some impact is likely ahead as a result of higher interest rates and changing business conditions. In fact, RBI has now cut its growth forecast for FY2012E to 7.6% from 8% earlier and indicated in the press conference that a sub-8% growth could be seen as below trend. We continue to hold our GDP estimate for FY2012E GDP growth at 7.3%.

RBI's anti-inflationary bias still remains

The RBI is categorical about the fact that its anti-inflationary bias continues, even as growth is slowing. Even when headline WPI inflation (above 9%) and inflationary expectations continue to stay on the higher side, RBI is pinning its hopes on the fact that these "*levels are expected to persist for two more months*". In fact, our inflation trajectory also points to a similar direction and formed our basis for indicating that RBI should pause soon. But RBI is quick to caution that any change in the policy stance immediately could be risky. This is because the weakening bias for growth globally has failed to translate into any significant fall in global commodity prices. Further, the current depreciation bias of the domestic currency has also weakened any positive impact on domestic inflation from falling global commodity prices. However, a likely momentum for inflation on the lower side provides scope for the RBI to now turn its attention to growth risks, something that remained sidelined with the inflation trajectory pointing north.

RBI now signals an extended pause

RBI has signaled that "*notwithstanding current rates of inflation persisting till November (December release), the likelihood of a rate action in the December mid-quarter review is relatively low. Beyond that, if the inflation trajectory conforms to projections, further rate hikes may not be warranted*". Given our expectation of inflation and growth in 2HFY12E and FY2013E in normal conditions, we think that the growth-inflation trade-off could lead to RBI remaining on a pause mode for an extended period of around 9-12 months.

10-year benchmark paper (7.80%GS2021) yielded around 8.82% at close yesterday. It fell to close to 8.67% post-policy as the RBI clearly indicated that this could be the last of the rate increases in this cycle. However, the yield on the benchmark 10-year paper reverted to 8.75%. For the remaining part of the year, even as inflation is likely to stabilize and head lower, it might be difficult for the 10-year benchmark yield to decline significantly due to the large supply pressures. We now expect the 10-year benchmark yield to be in a range of 8.60-8.85%.

QUICK NUMBERS

- RBI revises its GDP growth for FY2012E to 7.6% from 8% earlier
- Inflation expectations kept unchanged at 7%
- RBI signals an extended pause; unlikely to have very significant impact on bond yields

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