

## Economics

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## India Macro Flash

**RBI Hikes Repo by 25bps; Reverse Repo by 50bps – Expect More Down the Road but Lower than Previous Expectations**

- **Rate Hikes – Repo in Line; Reverse Repo Higher than Expectations** — Similar to the RBI's mid-quarter policy in July, in its review meeting today, the RBI hiked the repo rate by 25bps to 6% and reverse-repo rate to 5%. The asymmetric hike in rates (1) narrows the LAF corridor to 100bp (*similar to the situation prevailing in the early/mid 2000's*) and will likely reduce the volatility in overnight rates, and (2) short-end rates will likely be anchored at a higher rate. Taking into account today's hike, since the normalization of the rate cycle, the repo and reverse repo rates have been raised by 125bps and 175bps respectively. (*Pre-crisis, the repo/reverse repo rate stood at 9% and 6%*).
- **Six Key Takeaways from the RBI's Review Statement include** — (1) The recovery is well on track and rapidly converging to its trend growth; (2) Transmission mechanism is working but Inflation remains well above its trend rate of 5%-5.5%; (3) Real rates need to edge higher to aid deposits; (4) Fiscal deficit is well within targets; (5) The repo rate is likely to remain the 'effective policy rate' as liquidity conditions are likely to remain at current levels; and (6) Concerns on developed world trends on India are moderating.
- **Inflation - Remains the Dominant Concern** — With growth indicators across sectors (agri, industry and services) indicating a sustained/consolidating economic recovery, the RBI has stated that inflation remains the dominant concern in macro-management. Key issues raised on the inflation front include (i) The headline number being significantly above the trend of 5.0-5.5%, and (ii) Process of normalizing real interest rates is on, but RBI acknowledges that this is still incomplete.
- **Market Impact** — The higher than expected hike in reverse-repo rates has resulted in bond yields edging 4bps higher with the 10-year moving from 7.92% (pre-announcement) to 7.97% currently. Going forward, given current trends in liquidity and uncertainty on the auction calendar, yields could remain under pressure and likely trade in the 7.90% to 8.05% range.
- **Will the RBI Continue to Hike? – Yes, But lower than earlier expectations** — In many ways there is a change in tone to more positive as the RBI has said that tightening done so far 'has taken the monetary situation close to normal'. However, given that inflation remains significantly above trends, we expect one or possibly two more hikes in the next 6 months. This should take repo and reverse/repo rates to 6.50% and 5.50% respectively. Interest rates hikes into the latter half of 2011 will be dependent on how both the domestic and global macro pans out. (Our earlier expectations were that of the normalizing process resulting in the repo/reverse repo rate at 7% and 6% respectively by Dec 11).

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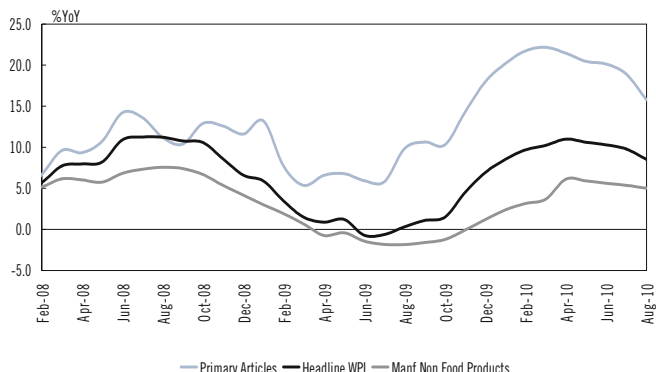
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# Key Reasons behind the Move

## Inflation the Dominant Concern

- RBI has stated that containing inflation continues to remain a '*dominant concern in macroeconomic management*'.
- While trends have seen a moderation on a sequential basis to 8.5%YoY in August (as per the new index) vs. 9.8% the previous month; average inflation during 1QFY11 remained in double-digits (+10.6%YoY).
- The RBI believes that while inflation rates have reached a plateau, they are likely to remain at '*unacceptably high levels*'. Key to watch are: (1) Food article prices, which continue to remain firm; (2) Trends in non-food manufactured products, which have moderated over recent months and indicate the impact of monetary transmission.

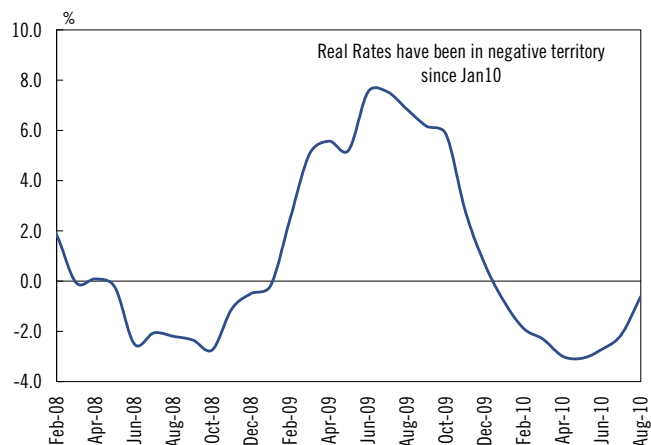
Figure 1. Trends in Inflation – WPI (% YoY)



## Need to end negative real rates

- Another key implication of high inference is its impact on real interest rates, which have been negative since Jan10.
- While there has been a decline (-0.6% currently from a trough of -3.1% in May10); negative real rates continue to remain a concern.
- This has resulted in a steady deceleration in deposit growth. Latest data indicates that incremental deposits during April-Aug were up Rs1774bn vs. Rs2466bn during the same period last year (+14.4%YoY vs. 18-20% earlier).
- The RBI has stated that policy actions have been '*motivated by the need to end the prevalence of negative real rates*'.

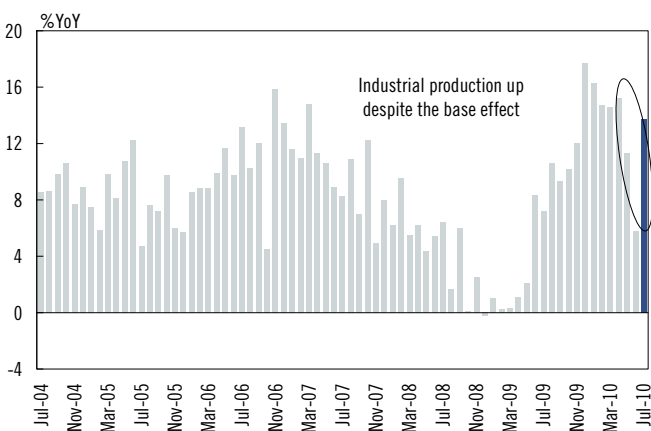
Figure 2. Trends in Real Interest Rates (%YoY)



## Growth – Trends appear healthy, but volatility a concern

- Recent data on quarterly GDP (+8.8%YoY during 1QFY11) and industrial production (+13.8%YoY in July from 5.8% the previous month) has been encouraging.
- However, the RBI believes that the '*high volatility in industrial production over the last two months does raise doubts about how effectively the index captures underlying momentum*'.
- On the global front, indicators need a close watch. However, conditions remain benign and have not worsened significantly with growth in Europe and China continuing to demonstrate resilience.

Figure 3. Trends in Industrial Production (%YoY)



Source: RBI, CSO, CIRA

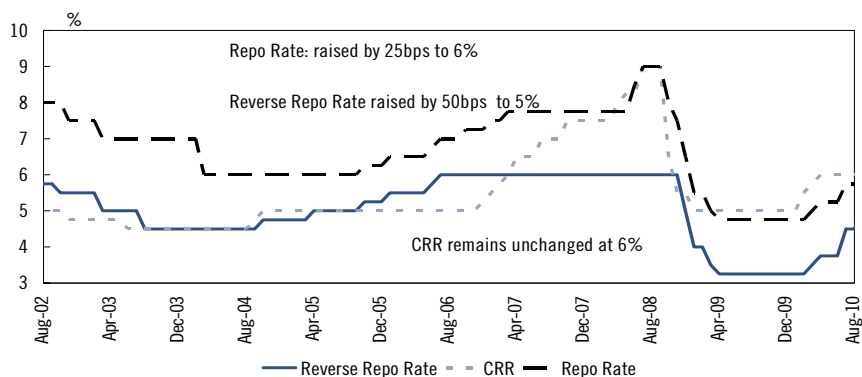
## Appendix – Inflation and Interest Rate Movements

Figure 4. Key Interest Rate Changes

Effective Since	Reverse Repo	Repo Rate	Cash Reserve Ratio	WPI Inflation	CPI Inflation
29-Apr-05	5.00 (+0.25)	6.00(+0.25)	5.00	6.0	4.6
26-Oct-05	5.25 (+0.25)	6.25(+0.25)	5.00	4.5	3.5
24-Jan-06	5.50(+0.25)	6.5.0(+0.25)	5.00	4.2	4.4
9-Jun-06	5.75(+0.25)	6.75(+0.25)	5.00	4.9	7.9
25-Jul-06	6.00(+0.25)	7.00(+0.25)	5.00	4.7	6.9
31-Oct-06	6.00	7.25(+0.25)	5.00	5.4	7.6
23-Dec-06	6.00	7.25	5.25 (+0.25)	5.8	6.7
6-Jan-07	6.00	7.25	5.50 (+0.25)	6.4	6.7
31-Jan-07	6.00	7.50	5.50	6.7	6.7
17-Feb-07	6.00	7.50	5.75 (+0.25)	6.1	7.6
3-Mar-07	6.00	7.50	6.00 (+0.25)	6.5	6.7
31-Mar-07	6.00	7.75	6.000	5.9	6.7
14-Apr-07	6.00	7.75	6.25 (+0.25)	6.3	6.7
28-Apr-07	6.00	7.75	6.50 (+0.25)	6.0	6.7
4-Aug-07	6.00	7.75	7.00 (+0.50)	4.4	7.3
10-Nov-07	6.00	7.75	7.50 (+0.50)	3.2	5.5
26-Apr-08	6.00	7.75	7.75 (+0.25)	8.0	7.8
10-May-08	6.00	7.75	8.00 (+0.25)	8.2	7.8
24-May-08	6.00	7.75	8.25(+0.25)	8.2	7.8
12-Jun-08	6.00	8.00(+0.25)	8.25	10.9	7.7
25-Jun-08	6.00	8.50(+0.50)	8.25	10.9	7.7
5-Jul-08	6.00	8.50	8.50 (+0.25)	11.2	8.3
19-Jul-08	6.00	8.50	8.75 (+0.25)	11.2	8.3
30-Jul-08	6.00	9.00(+0.25)	8.75	11.2	8.3
30-Aug-08	6.00	9.00	9.00 (+0.25)	11.2	9.0
11-Oct-08	6.00	9.00	6.50 (-2.50)	10.6	10.4
20-Oct-08	6.00	8.00 (-1.00)	6.50	10.6	10.4
25-Oct-08	6.00	8.00	6.00(-0.50)	10.6	10.4
3-Nov-08	6.00	7.50(-0.50)	6.00	8.6	10.4
8-Nov-08	6.00	7.50	5.50(-0.50)	8.6	10.4
8-Dec-08	5.00(-1.00)	6.50(-1.00)	5.50	6.6	9.7
5-Jan-09	4.00(-1.00)	5.50(-1.00)	5.50	5.9	10.4
17-Jan-09	4.00	5.50	5.00(-0.50)	5.9	10.4
4-Mar-09	3.50(-0.50)	5.00(-0.50)	5.00	1.5	8.0
21-Apr-09	3.25(-0.25)	4.75(-0.25)	5.00	0.9	8.7
29-Jan-10	3.25	4.75	5.75(+0.75)	8.5	16.2
19-Mar-10	3.5(+0.25)	5.00(+0.25)	5.75	10.2	14.9
20-Apr-10	3.75 (+0.25)	5.25 (+0.25)	6.00(+0.25)	11.0	13.3
2-Jul-10	4.00(+0.25)	5.50(+0.25)	6.00	9.8	11.3
27-Jul-10	4.50 (+0.50)	5.75(+0.25)	6.00	9.8	11.3
<b>16-Sept-10</b>	<b>5.00(+0.50)</b>	<b>6.00(+0.25)</b>	<b>6.00</b>	<b>9.8*</b>	<b>11.3**</b>

\* WPI for Aug10 and data post Jan08 is new base. \*\* CPI- IW for July. Source: RBI, Labour Bureau, Office of the Economic Advisor

Figure 5. Trend in Key Policy Rates (%)



Source: RBI, CIRA

## Appendix A-1

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