JPMorgan

Economics

India: Making sense of RBI's hands-off approach

India

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- Congress President Sonia Gandhi's reported admission that higher inflation was an important cause for the party's defeat in recent state legislative elections appears to have put the ministry of finance (MoF) and the Reserve Bank of India (RBI) on the front-foot to undertake aggressive measures to check inflation. The Congress party is the leader of the ruling coalition government headed by Prime Minister Manmohan Singh.

- Almost all the state legislative elections scheduled for the first-half of the year are over. However, polling in the key state of Uttar Pradesh (UP) is still under way, but it is highly unlikely that any of the inflation-fighting measures now will help the Congress party to improve its standing in the state. Note that there is widespread consensus of a poor showing by Gandhi's party in UP.

- The RBI announced unexpected hikes in the repo rate and the cash reserve ratio (CRR) on March 30, perhaps owing to the increased political pressure. More recently, the fx market has been surprised by the extent of the move in USD/INR from 44 to touch below 42 now. While the initial leg of the move was largely owing to local liquidity tightness that prompted banks to sell USD to generate INR funds, the recent appreciation suggests a hands-off approach by the RBI.

- Capital inflows have been strong and improving global risk appetite contributed to strengthening INR, but the key is more likely a shift towards reduced intervention by the RBI. Almost no intervention by the RBI will lower the probability of having to hike the CRR to sterilize the fx intervention, and a stronger INR will also lower imported inflation. The RBI has been juggling the "impossible trinity" for some time, and has come under fire for having boosted domestic liquidity owing to its fx intervention.

- Absence from the fx market might also be owing to the RBI being close to its ceiling of INR800 billion for the market stabilization scheme (MSS), under which it issues bills and bonds to sterilize its fx intervention. A review of that ceiling will be triggered when the RBI crosses INR700 billion, most likely this week.

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There is political pressure to fix inflation, and now the RBI appears to be using INR appreciation to check inflation and/or limit expansion in domestic liquidity. Note that historically the RBI has not been a big believer in using the exchange rate to check inflation.

However, letting the INR strengthen has its costs, especially as it continues to appreciate the real exchange rate. On our calculation, the INR's REER has appreciated substantially, by 10.4% since the middle of last year, and consequently exports have been crippled: export growth decelerated to a mere 7%oya in the three months to February.

Where do we go from here? Here are some markers that might be useful:

1. **REER and exports:** For all practical purposes, the RBI is ignoring the continuing appreciation of the REER. However, it is not a policy that can continue for long: exporters are complaining about the sharp appreciation, and those protests will only grow stronger.

2. **Intervention risk:** Record-high REER valuation increases the risk of intervention by the RBI.

3. **Inflation and loan growth:** On the JPMorgan forecast, headline WPI inflation is likely to come off. Indeed, latest data already show a decent retreat, and, on our expectations, fall within the RBI's forecast range of 5-5.5%oya by May. Improving inflation and exporter protests will likely prompt the RBI to reconsider its hands-off approach. Monetary measures to check domestic demand are also beginning to pay dividend: loan approvals are beginning to moderate.

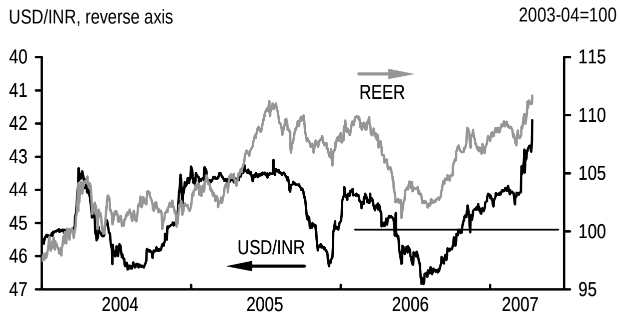
4. **Ability to intervene:** An increase in the MSS ceiling will make the markets wary of intervention by the RBI. The RBI will continue to prefer a combination of CRR/MSS to manage liquidity.

5. **April 24 policy:** Either in the run-up to the RBI policy on April 24 or in that policy, the RBI will either cut the ceiling on external commercial borrowings (ECBs) and/or make the domestic use of money raised overseas via ECBs more restrictive. Indeed, increasing the ECB ceiling last year to US$22 billion added pressure on INR appreciation pressure and also boosted domestic liquidity. The RBI is likely to lower the ceiling to ease capital inflows.

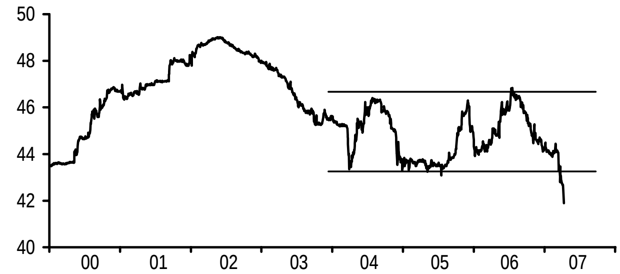
The single-minded political focus to lower inflation means that the policy makers are likely to be slow in reacting to other emerging pressure points, especially since their actions have probably been signed off by politicians. The RBI's credibility is being rightly questioned, especially owing to the absence of any guidance/opinion on recent moves. We maintain our view of a weaker INR over the course of this year, but acknowledge the risk to our current year-end forecast of 44.50.

The INR could easily strengthen further in the very near-term if the RBI is absent from the fx market, but such an approach only risks a greater adjustment later. The bottom is that the RBI appears to be solving one problem by creating another one, though the political costs associated with each are different.

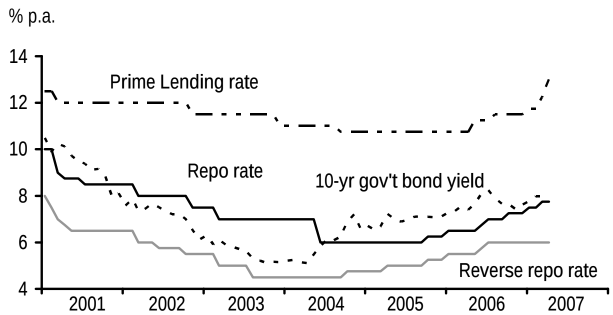
USD/INR and RBI's 6-country REER



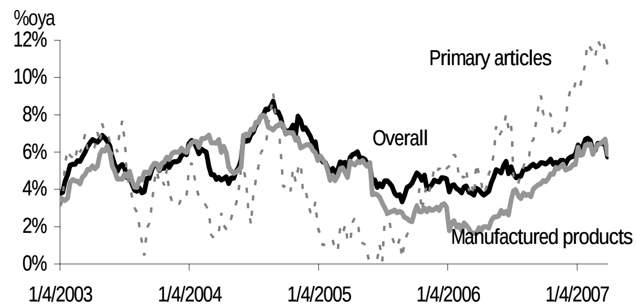
USD/INR



Key interest rates



WPI



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