

22 March 2010

Economy – Policy Rates

A baby step or a giant leap?

The RBI's unscheduled policy rate hikes on 19 Mar '10 defined the moment when India moved to monetary tightening. The hike's size, though, indicates future tightening would be nuanced rather than abrupt. As we expect inflation to soften beyond Apr '10 and growth to falter after 1QFY11 (less favourable base effect), sustaining growth could once again be the key policy objective.

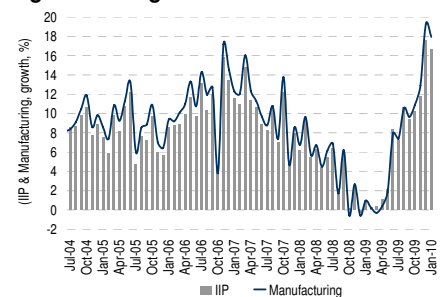
- **The RBI hardens stance.** In an inter-policy move, on 19 Mar '10, the RBI raised both the key policy rates – the repo (the rate at which banks borrow from the RBI) and the reverse-repo (the rate at which banks park their excess liquidity with the RBI) – by 25 basis points (bps) each. Although the RBI had earlier taken other measures to exit from its unusually accommodative monetary policy stance, this is the first policy rate hike since mid-2008 when the RBI started its aggressive monetary easing in response to the global financial crisis. Now the repo rate is at 5% and reverse-repo at 3.5%.
- **The RBI sees demand pressure.** The rebound in economic activity (reflected in strong GDP growth, industrial production and exports) and hardening inflation (high food prices and rise in fuel and manufactured product inflation) are the reasons mentioned by the RBI for the inter-policy rate hikes.
- **Unanticipated events and inter-policy rate hikes.** In a conference call with market participants after the Jan '10 monetary policy, the RBI had pointed out that any inter-policy rate hike would be contingent on unexpected events. The only major unexpected event since the late Jan '10 policy meeting has been the strong acceleration of inflation. That too has been driven largely by the hike in the administered petroleum product prices and partial roll-back of indirect taxes announced in the Central Budget in late-Feb'10.
- **Timing of the rate hike.** Market liquidity has been drying up recently owing to rising demand for funds ahead of the end of the financial year FY10. The rate hike at this juncture is likely to increase short-term rates. In the recent past, some banks have raised deposit rates and firmed up certain lending rates. The rate hike signal from the RBI is likely to boost the move towards higher rates.
- **Signal from the RBI policy.** The RBI's rate hike is a signal that India is firmly on the path of monetary tightening, which, of course, is no surprise. The question is: How much tightening will happen and at what pace? We have pointed out for some time that the RBI would hike repo/reverse-repo rates by 50bps by the Apr '10 policy. We continue to expect another 25 bps rate hike during the Apr '10 policy. Thereafter, we expect up to 50 bps more rate hike during the next 12 months.

Inflation: 9.89%
G-Sec yield (10-Y): 7.88%
WPI Index: 250.1

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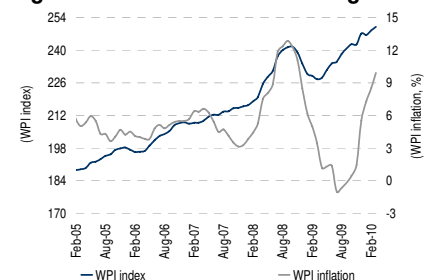
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Fig. 1 – Strong rebound in IIP



Source: Government of India, Anand Rathi Research

Fig. 2 – Inflation nears double-digit



Source: Government of India, Anand Rathi Research

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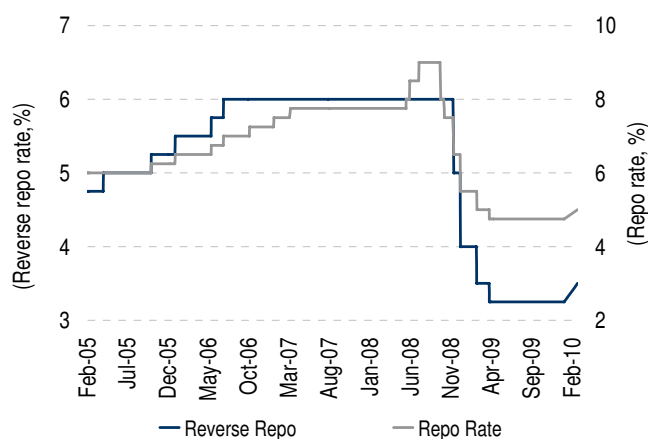
RBI and the curve. During FY10, the RBI's forecasts about both inflation and growth have been persistently conservative. Importantly, in Jan '10 the RBI forecast WPI (wholesale price index) inflation at 8.5% by Mar '10. The actual number was 9.9% in Feb '10 and we expect it to be at 10.6% by Mar '10 and over 11% by Apr '10. The RBI now expects double digit WPI inflation in Mar '10. Double digit inflation is frowned on in India and often has serious political implications. Moreover, any apprehension by market participants that the RBI is 'behind the curve' in anticipating the trajectory of inflation and initiating appropriate action could destabilize inflationary expectations. The RBI's latest move seems to be aimed at dispelling such apprehensions.

Baby step. Despite discussing the build-up of strong demand pressure, the RBI has raised the policy rates by only 25bps. This seems to be a symbolic and guarded move rather than the no-holds-barred tightening approach, which the RBI followed the last time WPI inflation was moving towards double-digits. This guarded action confirms our assessment that despite the smart rebound, growth in India is still not well entrenched and a large part of the rebound is colored by a low-base and other factors like large government spending, tax cuts and a sharp fall in real imports. Moreover, while inflation is likely to get worse by Apr '10, we expect it to soften thereafter. Until economic growth starts becoming broad-based and unless the demand-side feedback to inflation starts assuming threatening proportions, we expect the RBI to move in small steps towards tightening.

Impact of the tightening. The 25bps hike in the rates, in itself, is unlikely to lead to major changes in interest rates, either in the debt or credit markets, although it could be a harbinger to a stronger realignment in interest rates. To the extent the measure is viewed as the start of an aggressive tightening cycle, this can lead to a rapidly rising interest rate scenario in different financial markets. Such events pose the real danger of compressing growth to lower levels. While this is not our base case scenario, the consensus view of further strengthening of growth and continuation of inflation at elevated levels suggest that strong round of monetary tightening cannot be ruled out.

Sectoral impact of the tightening. The immediate impact of the recent rate hike would be marginal on banks and interest sensitive sectors. A strong pace of tightening – more than 75bps hike in the policy rates – in the next 12 months, however, would be negative for both banks and interest sensitive sectors.

Fig. 3 – First hike in repo rate since mid-2008



Source: RBI, Anand Rathi Research

Appendix 1

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