

RBI POLICY REVIEW

Demonstratively hawkish

The Reserve Bank of India (RBI) in a hawkish policy stance, lifted the repo rate by 25bps (as expected) and reverse repo by 50bps (more than expected), thereby narrowing the LAF corridor to 125bps from 150bps earlier. The CRR was left unchanged as expected. The central bank raised the FY11 GDP growth forecast to 8.5% from 8.0% (with an upward bias projected in April) and the inflation projections to 6% (in March) from 5.5% earlier. Further, RBI took a welcome initiative of institutionalising the mid-cycle policy review, which can reduce inter-policy speculations considerably.

Having developed comfort on the economic recovery, RBI has shifted its focus 'decisively' to containing inflation and inflation expectations, while ensuring balanced liquidity conditions to assist better transmission of monetary policy.

While we acknowledge the need of normalisation of policy rates, we are relatively less hawkish compared with RBI. We believe: (1) headline inflation will moderate significantly in the next six-eight months; (2) economic recovery is still to become fully broad-based; and (3) global growth environment has turned quite uncertain of late. Against this backdrop, aggressive monetary tightening could hurt sentiments and nascent investment recovery. We expect 25-50bps hike in policy rates by October, followed by relatively softer policy stance through rest of FY11.

- **Repo rate hiked by 25bps and reverse repo by 50bps**

RBI delivered a hawkish monetary policy response today in its First Quarter Review of Monetary Policy, raising repo rate by 25bps and reverse repo by 50bps, while keeping the CRR unchanged. Hike in repo rate by 25bps and unchanged CRR was anticipated, while the 50bps increase in reverse repo is a notch hawkish than what we had expected. Importantly, the move comes after RBI raising both the policy rates by 25bps just three weeks ago in a mid-cycle move. With this, the repo rate stands at 5.75%, reverse repo at 4.50% and CRR at 6%; the informal LAF corridor has been narrowed to 125bps from 150bps earlier, thereby restricting the volatility in call rates to some extent.

RBI possibly wanted to send across a signal stronger than the market expectation. The equity and bond market reactions, however, were rather muted. RBI highlights high inflation, particularly non-food manufacturing inflation and associated demand side pressures, as the trigger behind the aggressive move.

- **Policy stance shifts 'decisively' to contain inflation...**

As recovery set in H2FY10, RBI embarked on gradual exit from an overtly accommodative monetary stance, while ensuring that the nascent recovery is not derailed. Thereafter, as recovery gathered momentum and so did inflation, RBI's stance was one of balancing the objectives of managing the recovery while keeping an eye on the price situation. However, as recovery gathered pace in H1CY10, deterioration in inflation outlook started dominating the minds of policymakers such that in the current move, inflation and inflation expectations seem to have attained the top priority. RBI now states "with growth taking firm hold, the balance of policy stance has to shift decisively to containing inflation and anchoring inflation expectations".

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