Flash

India

RBI hikes rates again, but signals end of cycle

Containing inflation remained the top priority for the Reserve Bank of India (RBI) as the central bank raised interest rates by another 25 bps at its policy meeting today. The move, which was in line with the broader consensus, pushes the benchmark repo rate up to 8.5%, the thirteenth rate hike since the tightening cycle began at the start of 2010. However, the RBI explicitly noted that the likelihood of another rate action in the December mid-quarter review is relatively low. Key considerations driving RBI's policy stance were the need to control inflation, stimulate investment activity and manage liquidity to ensure effective monetary transmission. The Central bank maintained its baseline inflation projection for March 2012 at 7.0% y/y while lowering its baseline projection for real GDP growth to 7.6% from 8.0% y/y, in line with our expectations. We expect policy rates to have peaked in India as (1) major downside risks to domestic growth exist due to a weakening global macro environment (2) domestic growth has already shown discernible signs of a slowdown, particularly on the investment front and (3) momentum indicators point to moderating in domestic inflation going forward.

- The RBI maintained that inflation remains high, much above the central bank's comfort level of 4.0% to 4.5%. The RBI expects moderating inflation to provide room for addressing evolving downside risks to growth over the near term: The Central Bank stated that notwithstanding current rates of inflation persisting until November, the likelihood of a rate action in the December mid-quarter review is relatively low. Beyond that, if inflation eases (as we are currently forecasting), further rate hikes may not be warranted.

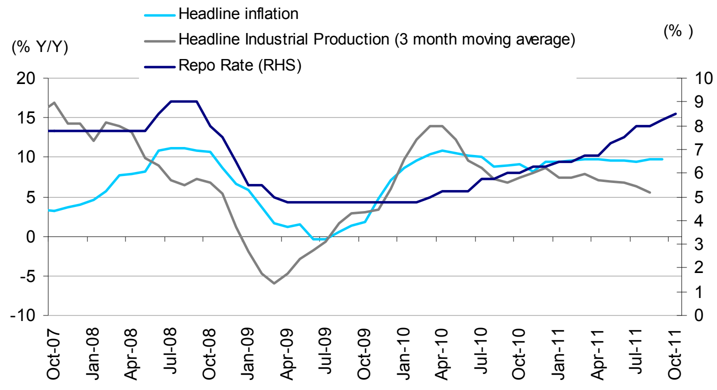
- The RBI acknowledged that risks from a global contagion were significantly high though trade and financial channels, while investment demand has also weakened. However, with growth expected to slow down but not collapse, the RBI believes that as inflation begins to decline, the current policy stance is well within the overall objective of maintaining a low and stable inflation environment.

- The RBI noted that India's policy mix was sub-optimal with fiscal policy still largely accommodative while monetary policy remains considerably tight. Policymakers warned that the recent expansion in the government borrowing program may potentially crowd out more productive private sector investment while adding to demand pressures in the economy.

- Going forward, India's rate of inflation depends upon several factors including the extent of demand moderation, behaviour of global crude prices, supply-side response to food price pressures, domestic currency movement, and the pass-through of global energy prices to administered energy prices in India.

- In other news, the RBI announced the deregulation of savings bank interest rates amongst other key measures to develop India's banking sector: Alongside the policy communiqué, Indian policymakers deliberated on several key announcements aimed at further developing India's banking sector. Chief amongst them was the deregulation of savings bank deposit interest rates, thereby giving commercial banks the freedom to determine their savings bank deposit interest rates subject to certain conditions. Following the RBI's announcement, large banking stocks fell as investors feared the savings bank rate deregulation may significantly raise the cost of funds and have a negative impact on margins. Meanwhile, to enhance banking penetration, the central bank allowed commercial banks to open branches in tier-2 cities without prior approval. It also noted that draft guidelines for the implementation of Basel-III will be issued by December end.

Chart 1
RBI hikes rates for the thirteenth time to contain high inflation, even as downside growth risks continue to increase



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