

# In policy debut, RBI chief Rajan prescribes bitter pill

Raising the repo rate by 25 basis points to 7.50 percent as India stumbles through its worst economic crisis since 1991 puts pressure on New Delhi to relieve supply-side bottlenecks in the economy, such as poor infrastructure, that keep inflation high even when demand is soft.

That is a big ask for a weak coalition government, which also faces a general election by May.

Rajan is expected by many in the market to shift the RBI's main inflation gauge to consumer prices from wholesale prices, putting India in line with most big economies but pushing up near-term rate expectations. Consumer price inflation was 9.5 percent for August, meaning the cost of living is rising faster than interest rates. The wholesale price index rose 6.1 percent.

"If he goes ahead and hikes further, which I think he might, then it might affect growth. But ultimately, if you have to bring down inflation, there is no other option," said A. Prasanna, economist at ICICI Securities Primary Dealership Ltd in Mumbai.

A prominent former IMF chief economist who famously predicted the global financial crisis, Rajan took office earlier this month amid much media fanfare and high expectations that he could engineer a turnaround for the sluggish economy and rescue a currency that had fallen as much as 20 percent this year.

A flurry of measures by Rajan's predecessor and fresh moves on his first day in office have helped lift the rupee off its record low.

Rajan rolled back part of the sharp increase in the marginal standing facility (MSF), an overnight rate, reassuring some in financial markets that the rupee measures are temporary. But in raising the repo rate, traditionally the policy interest rate, Rajan showed the central bank's priority had shifted from defending the rupee to fighting inflation.

"It should bring down inflation expectations and help correct India's macroeconomic imbalances. However, this means severe growth pain in the coming year," Nomura analysts wrote.

Nomura now expects the RBI to raise the repo rate by another 50 bps in the fiscal year ending in March to take it to 8.00 percent, followed by a lengthy pause.

It had previously expected no further rate move this fiscal year followed by 75 bps of cuts in the next fiscal year. It also said there are downward risks to its GDP forecast of 4.2 percent, which would be the lowest in a decade, and 5.1 percent for this fiscal year and next, respectively.

Edelweiss Securities, which had expected 50 bps of rate cuts by the end of March, now expects rates to stay unchanged.

### 'INTERESTING EXPERIMENT'

While the U.S. Federal Reserve's decision on Wednesday not to begin unwinding its monetary stimulus fuelled expectations that the RBI would begin cutting the MSF back to its earlier level, not a single analyst in a Reuters poll had predicted that Rajan would increase the repo rate.

Lifting rates may compel Indian households to shift more of their savings towards banks and away from real estate and gold, addressing a trend that has pushed down deposit growth.

"I think it's an interesting experiment," said Rahul Bajoria, an economist at Barclays Capital in Singapore.

"I am not saying whether I know it will work or not, but I think it sort of shows the RBI's hand in the sense that they really want to focus more on the inflation side of things than on growth at this point," he said.

Also, one of the biggest drivers of inflation in India, the rising cost of food, is generally not sensitive to rates, meaning the net effect of Rajan's policy tightening may be on managing inflation expectations as much as inflation itself.

If Rajan raises rates further, he might not do so dramatically. On Friday, he noted that a weak economy can provide a "cushion in terms of disinflationary processes at work but also will give us an incentive to then perhaps look to putting greater emphasis on reviving the growth of the economy."

India grew at 4.4 percent in the June quarter, its worst pace in four years.

### NOT LOOKING FOR 'LIKES'

Indian markets took the policy badly, with bonds and stocks plunging and dragging the rupee down with them only a day after a Fed-fuelled rally. Still, in recent weeks the rupee has recovered some of its losses and the sense of crisis surrounding the currency has eased for now.

Traders said the 10-year government bond yield - which jumped 39 basis points on Friday - could rise close to 20 basis points this week, partly as the market factors in higher policy rates.

Some Indian companies worried the higher rates could prove damaging. Many companies are struggling after the central bank's rupee measures supported the currency but dried up credit.

"Industry is truly concerned about the policy rate hikes and their adverse impact on the investment sentiment," Srei Infrastructure Finance Ltd (SREI.NS) said in a statement.

Finance Minister P. Chidambaram, who has in the past pushed for pro-growth monetary policy, did not make any public comment on Friday, although several ministry insiders said they were understanding of the challenge Rajan faces.

At his first-day press conference earlier this month, Rajan, 50, impressed RBI-watchers with a multi-pronged action plan to bolster the rupee and strengthen financial markets but also warned that he would have to make unpopular decisions, that his job was not to accumulate "likes" on Facebook.

"This is possibly the part where the new RBI governor pre-empted that the course of action by the central bank was not to accumulate "likes", said Radhika Rao, economist at DBS in Singapore.

(Reuters)