PRO-ACTIVE FIRE FIGHTING FROM THE RESERVE BANK OF INDIA

What has happened?

The Reserve Bank of India (RBI) implemented a significant switch in policy overnight, shifting away from an accommodative stance of liquidity infusion into the banking sector to an implicit tightening position. The RBI stopped short of raising the repurchase rate (repo) for banks, implying that this is a temporary measure that will be reversed (perhaps in 12 months), assuming the policy change has achieved the desired effect.

Currently overnight bank borrowing requirements from the RBI, in excess of what is covered by the existing statutory liquidity ratio limits, is not only restricted to a percentage of deposits, but also the rate at which this excess requirement can be accessed has been raised by 200 basis points. In tandem the RBI has announced an additional sale of government securities which will further drain liquidity from the system. The announcement caused an immediate spike in bond yields across the curve and caused INRUSD cross rate to strengthen 1.1%. Since May the INRUSD has weakened approximately 11%.

Why has this been implemented?

This is a proactive measure designed to reduce current speculation and volatility in the INR, to create a window of opportunity for the Government to announce further reform, and indicates that external sector considerations (i.e. the Federal Reserve's proposed QE tapering programme) have taken priority over domestic growth recovery. Similar moves have taken place in Indonesia and Brazil, as emerging economies around the world take steps to protect their economies from the effects of rising bond yields in the United States, via higher domestic interest rates onshore.

It is also designed to protect the country's FX reserves which have taken a knock recently as the RBI, whilst not intervening directly to support the INR, has used up reserves to the tune of USD40bn in an attempt to reduce volatility. The country has FX reserves to cover six months of imports at current levels.

What will be the outcome?

The move has caused a negative reaction in the equity market as investors fear the higher cost of borrowing will impact growth via higher borrowing costs as well as increasing the risk of rising asset quality issues on banks' lending books. Beyond the banks, cyclical sectors, in particular infrastructure and industrials, plus those with weak balance sheet positions will be most affected.

However we believe the impact on the real economy will not be significant, providing that the measures do not remain in place for an extended period. Indeed if stability in the INRUSD rate is achieved in the next few months it will give policy makers some room to announce further reform measures. As highlighted by Ocean Dial in earlier publications, we believe the increase of foreign direct investment limits in sectors such as insurance and defence is possible. We do however also caution that we are already expecting consensus GDP growth rates for FY14 to come down over the next few months from 6.2% to between 5.5% and 6.0%

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