Bloomberg

India Raises Interest Rates More Than Estimates, Spurring Slide in Stocks

By Kartik Goyal - Jul 26, 2011

India's central bank raised its benchmark interest rate more than forecast to quell the fastest inflation among major economies, spurring a slide in stocks and gain in the rupee.

The Reserve Bank of India increased the repurchase rate to 8 percent from 7.5 percent, it said in a statement in Mumbai today. None of the 22 economists surveyed by Bloomberg News predicted today's decision. Twenty estimated a quarter-point rise, while the remainder expected no change.

Governor Duvvuri Subbarao acted as the central bank elevated its inflation forecast for the year through March by 1 percentage point, to 7 percent. With rising rural wages and a lack of corporate investment growth straining capacity, India's price pressures mean it lacks the leeway in setting monetary policy afforded to counterparts in South Korea, Malaysia and Indonesia, which kept borrowing costs unchanged this month.

"Today's statement makes it clear that the RBI intends to take more monetary measures to get a handle over headline inflation," said Ramya Suryanarayanan, an economist at DBS Group Holdings Ltd. in Singapore, who boosted her forecast for the repurchase rate to 8.5 percent for the end of December from 8 percent before today. "Inflation isn't going to ease anytime soon to allow the central bank to take its eyes off a huge problem."

Worst in Asia

The benchmark Bombay Stock Exchange Sensitive Index slid 1.9 percent, the day's worst performance in Asia and the biggest drop in five weeks, at the 3:30 p.m. close in Mumbai. The rupee advanced 0.5 percent to 44.18 per dollar and the yield on the 7.8 percent government bonds due April 2021 climbed 15 basis points to 8.44 percent, an eight-week high.

“Today’s policy action will reinforce the point that in the absence of complementary policy responses on both demand and supply sides, stronger monetary policy actions are required,” Subbarao said at a press conference in Mumbai today. “A change in stance will be motivated by signs of a sustainable downturn in inflation.”

India’s benchmark wholesale-price inflation, which quickened to 9.44 percent in June, may remain near 10 percent until November, according to HSBC Holdings Plc and Yes Bank Ltd. By comparison, consumer prices rose 6.7 percent in Brazil, 9.4 percent in Russia, 6.4 percent in China and 5 percent in South Africa.

‘Strong Signal’

The Reserve Bank’s action is a “strong signal” to check prices, Finance Minister Pranab Mukherjee said in a statement in New Delhi today.

Policy makers have now increased rates 11 times since the start of last year, and today’s was the second half-point move in three meetings.

By contrast, the U.S. Federal Reserve has kept its target rate in a range of zero to 0.25 percent since December 2008 and the Bank of England this month left its benchmark unchanged at 0.5 percent. The European Central Bank on July 7 raised borrowing costs for the second time in 2011.

Today’s decision could be the last for Subbarao, 61, whose term concludes before the next scheduled rate announcement on Sept. 16. A former top bureaucrat in the Ministry of Finance, Subbarao took office in September 2008. Prime Minister Manmohan Singh’s government hasn’t publicly indicated whether it intends to reappoint him.

Fuel Costs

Subbarao made today’s announcement after the government last month boosted diesel prices for the first time in a year to cut subsidies and reduce losses at state-owned refiners including Indian Oil Corp., efforts that have contributed to higher living costs. The RBI yesterday also cited a high share of production capacity in use, risk of a “wage-price spiral” and “stickiness” in food prices contributing to inflation pressures.

While growth has shown signs of moderation, “there is no evidence of a sharp or broad-based slowdown as yet,” according to the statement. Even so, industrial production grew 5.6 percent in May, the least in nine months. Gross domestic product in the South Asian nation will rise 8.2 percent this year and 7.8 percent in 2012 compared with more than 9 percent each year in China, according to the International Monetary Fund.

Car Sales

Sales growth at carmakers including Maruti Suzuki India Ltd. slowed to two-year low in June, the Society of Indian Automobile Manufacturers said July 11. Commercial loans given by banks such as ICICI Bank Ltd. rose 19.61 percent as of June 24, the least since September 2010, according to the central bank.

“If the domestic signs of a consumption slowdown gain further traction, the RBI might prefer to pause from here on,” Shubhada Rao, chief economist at Mumbai-based Yes Bank Ltd., said before the report. “The euro zone debt crisis and growth in the U.S. will be looked at closely by the RBI.”

Subbarao blamed the government for contributing to inflation, which erodes the purchasing power of a population where more than three-quarters of the people live on less than $2 a day. A “large fiscal deficit” is stoking price pressures, the central bank said.

‘Fiscal Consolidation’

“Fiscal consolidation is, therefore, critical to managing inflation,” the statement showed. “In the absence of appropriate actions for addressing supply bottlenecks, especially in food and infrastructure, questions about the ability of the economy to sustain the current growth rate without significant inflationary pressures come to the fore.”

The central bank maintained its economic growth forecast of 8 percent for the current fiscal year, even after citing dangers from Europe’s debt crisis to the outlook for exports.

With global growth prospects moderating, the Bank of Korea and Bank Indonesia kept rates unchanged this month. Malaysia’s central bank unexpectedly refrained from raising rates, choosing instead to order lenders to set aside more cash. By contrast, Thailand raised borrowing costs and China boosted rates for the third time this year.

“Going forward, the monetary policy stance will depend on the evolving inflation trajectory, which in turn, will be determined by trends in domestic growth and global commodity prices,” India’s central bank said in today’s statement.

To contact the reporter on this story: Kartik Goyal in Mumbai at
kgoyal@bloomberg.net