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RBI policy: don't halloo till you are out of the woods. The RBI maintained its cautious approach and effectively moderated market expectations of imminent rate cuts. The RBI continued to aim at the 6% CPI inflation mark and will calibrate its policy stance based on the trajectory till January 2016. We maintain our call for repo rate remaining unchanged till end-CY2014. Further rate action will be predicated on the retail inflation transition to 6% in January 2016 from around 8% in January 2015.

Rate cuts are not a given—focus on 6% retail inflation mark

Since the June monetary policy, markets had started to expect rate cuts as early as December. However, we maintain that rate cuts are unlikely by end-CY2014. In fact, the RBI's reaction function will hinge on retail inflation transitioning to 6% by January 2016, which would require a structural shift in inflation dynamics. The key risks for the RBI to lower policy rates would be: (1) meaningful and sustained reduction in food prices, (2) qualitative and quantitative correction of fiscal imbalances, (3) supply-side correction to accommodate higher aggregate demand without inflationary pressures and (4) global events like geopolitical risks, commodity prices and other global central banks' action.

Overall risks to inflation are 'more balanced than in June'

The RBI noted that the path to 8% by January 2015 was now more balanced than in the June policy, with a part being ascribed to the downward inflation trajectory due to steady deceleration in core CPI inflation. However, it noted some upside risks to inflation in the medium term (or the glide to 6% by January 2016), including the buoyancy in consumer and business sentiments that can also lead to aggregate demand picking up. The RBI needs to remain guarded against risks of a narrowing output gap, which can affect the growth-inflation dynamics. We believe that the RBI will probably be more comfortable to ease policy stance only after it anticipates that any monetary accommodation will not move inflation away from the glide path of 6% by January 2016.

SLR cut in line with requirement of liquidity coverage ratio (LCR) under Basel III

With the underlying fiscal consolidation in place and to signal an overall move towards reduced preemption of funds by the government sector, the SLR requirement was reduced to 22% of NDTL. Keeping in line with the Urjit Patel committee report recommendation that SLR should be reduced to a level compatible with LCR requirements of Basel III framework, the RBI will likely continue with reduction in SLR in the medium term. Immediately, the reduction in the SLR requirement might not be a market mover as (1) credit growth remains sluggish, (2) the banking system holds excess SLR of 4-5% of NDTL and (3) capex is unlikely to significantly increase soon. Additionally, requirement under the Held to Maturity (HTM) category was lowered by 50 bps to 24% of NDTL.

Limited chances of softer bond yields

The monetary policy communiqué removed much ambiguity regarding the RBI's stance. The June policy had sounded dovish for some sections of the market, which has been effectively balanced out by today's policy. The policy noted that, "*balance of risks around the medium-term inflation path, and especially the target of 6 per cent by January 2016, are still to the upside, warranting a heightened state of policy preparedness to contain these risks if they materialize*". This implies that any chance of an immediate drop in the policy rates should be pushed aside. Going forward, the direction for the bond yield would be determined by evolving (1) fiscal conditions and (2) evolution of inflation trajectory. Accounting for the new benchmark 10-year paper, 10-year G-Sec yield is likely to stay in the 8.5-8.7% range for the rest of FY2015.

QUICK NUMBERS

- SLR cut by 50 bps to 22%
- SLR securities under HTM lowered by 50 bps to 24% of NDTL
- Expect RBI on a pause till end-CY2014

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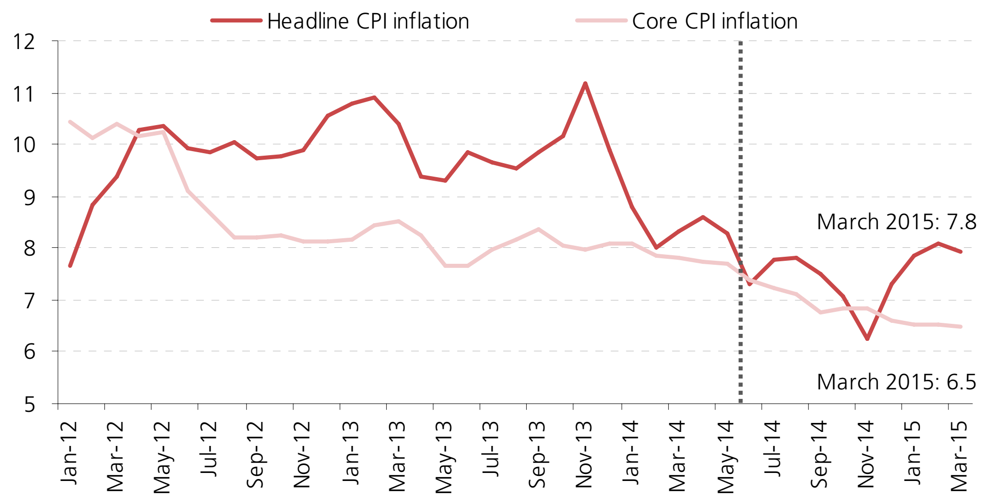
Exhibit 1: Vegetables prices have increased more than normal in July
Change in select vegetables average prices over last month (%)

	Weightage	mom changes (%)						
	CPI	January	February	March	April	May	June	July
Brinjal	0.41	(10.9)	5.3	7.3	(8.7)	13.8	5.6	23.9
Cabbage	0.33	(27.9)	(6.4)	(0.9)	10.0	20.0	26.0	32.2
Cauliflower	0.37	(20.8)	(8.4)	4.2	11.3	38.2	33.7	18.9
Onion	0.57	(30.2)	(18.4)	2.3	2.2	11.1	24.5	31.6
Potato	0.55	(16.5)	(12.9)	11.9	18.1	2.1	10.0	8.2
Tomato	0.56	(44.2)	(17.2)	6.8	11.5	1.3	12.9	142.7

Source: National Horticulture Board, Kotak Economic Research

Exhibit 2: Retail inflation of 8% achievable by January 2015
Trend in headline and core CPI inflation (%)



Source: CEIC, Kotak Economic Research estimates

"I, Suvodeep Rakshit, hereby certify that all of the views expressed in this report accurately reflect my personal views. I also certify that no part of my compensation was, is or will be, directly or indirectly, related to the views expressed in this report."

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