The decision to raise the repo rate by 25 bps is surprising for two reasons. The first is that it is being done in expectation of inflation increasing in the coming months, though the targeted rate at 4.8-4.9% is still below the 6% upper band. This was not the stance taken earlier, even as inflation increased and expectations were in the upward direction. The second is that the decision was unanimous, which has rarely been the case in past policies where not more than 2 members spoke of rate hikes or assumed a hawkish tone.

The higher inflation expectations look real given that oil prices remain volatile and while the OPEC decision would bring some stability, it would be at a higher level. The MSP effect is still not known but an obvious issue for general price inflation. Therefore, while the inflation rate has been below 5% now since November 2017 the RBI has decided to be forward looking.

However, what is puzzling is the neutral stance taken. Normally a neutral stance indicates likely future action which in this case means no change in high likelihood. Can this mean that the repo rate hike e RBI expects things to stabilize in the next couple of months? If this is so then there would be no more rate hikes.

But, if the neutral stance is treated as being only temporary to assuage the markets, then it could mean that based on data on inflation, a decision would be taken. This looks more likely to be the way one should interpret the action as the general expectation was that there would be no rate cut but a hawkish stance going with it. That seemed logical given that the next inflation data point would come after a week and the OPEC decision would be taken after another 2-3 weeks or so.

Will this affect the market? Not really as the market had been expecting a tough stance which led to the 10-years yield remaining sticky in the 7.8% range. It will definitely not come down basedon the neutral stance taken. The rupee has held firm above 67 to the dollar and such a rate hike can send a signal for foreign investors that the returns in India could be going up. Hence, FPI flows could look positively now considering that they have been negative so far this year.

Interestingly some banks have already raised their MCLRs in anticipation of either a rate hike or a change in stance which was to be away from being accommodative. Banks will also probably increase their deposit rates selectively to increase the flow of funds, which had slowed down last year and got diverted to mutual funds given the interest rate differential.

The unchanged stance on GDP growth forecast of 7.4% indicates that notwithstanding the euphoria over the 7.7% growth in Q4-FY18, the RBI expects overall growth to be better in FY19 but would still be lower than that in FY16. It would still take some time before the 8% mark can be exceeded.

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