Mizuho Chart Speak: RBI

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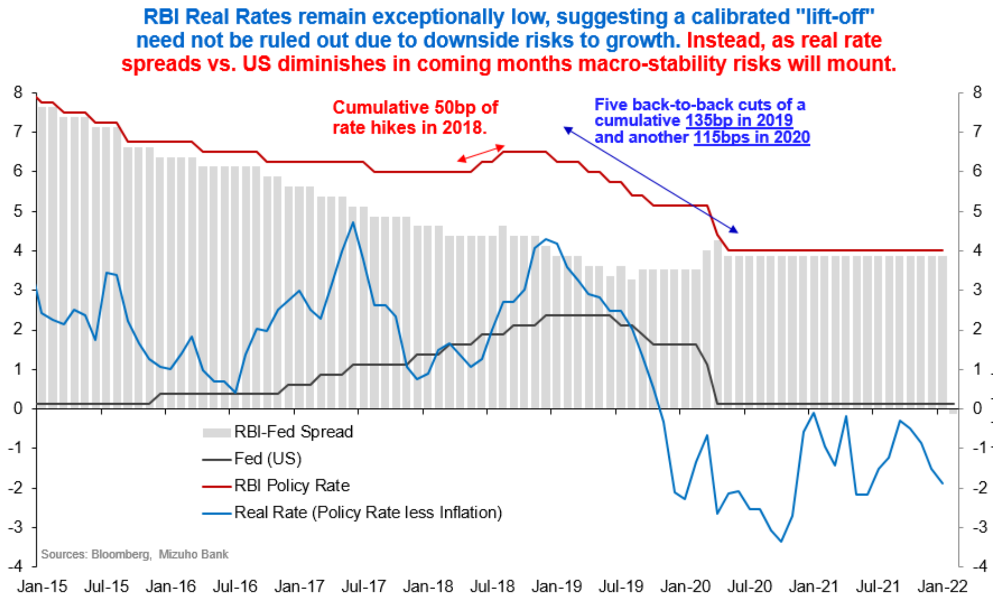
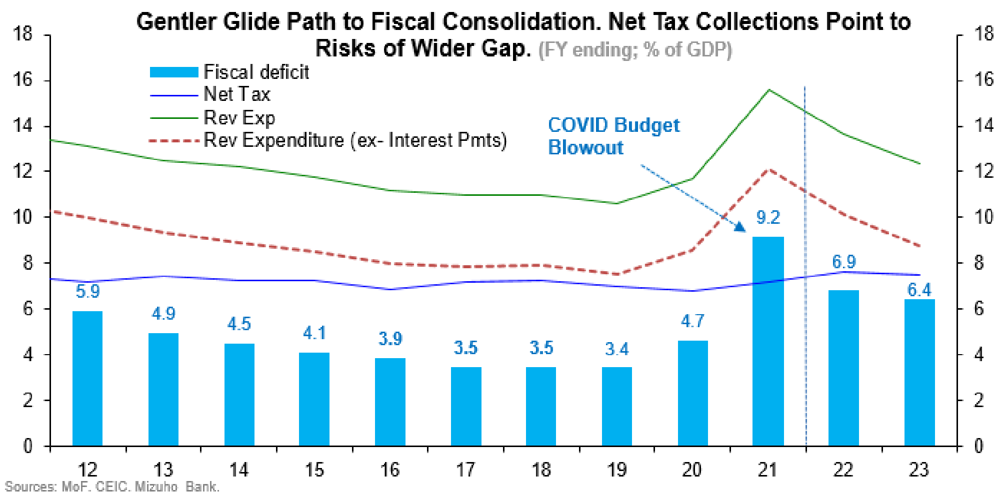
The RBI's Risky, Leveraged Bet





"The curious incident of the dog in the night-time" – **Sherlock Holmes**

- The **RBI's dovish insistence**, citing **lingering downside risks to growth** (amid COVID "variant" risks) alongside **expectations of peaking inflation** (in Q1 2022) **is a high-stakes, leveraged policy bet**; *with a narrow window for course correction*.

- Especially given that the RBI notably abstained from even a token narrowing of the repo window (with a calibrated shift higher in the reverse repo rate towards the policy repo rate)

- To be sure, the RBI is **not wrong in its assessment of an incomplete and uneven recovery that has probably been interrupted**, albeit slightly dampened rather than seriously derailed, by Omicron.

- ***But*** trouble is, the **RBI appears too sanguine, if not recklessly overconfident about inflation risks**. **Especially given elevated and escalating oil prices** amid worrying geo-political risks.

- Point being, **inflation** expected to be **close to the 6% upper limit of the RBI's 4%+/-2%-pts target band in Q1 2022**, **may not only fail to subside as quickly** towards 4% by Q4 2022/Q1 2023, **but could instead accelerate** in coming months due to a conspiracy of hard-to-predict energy market volatility, commodity cost-push and global supply-chain kinks.

- What's more**,** the RBI **endangers macro-/rupee-stability as policy inaction** amid inconveniently high inflation, *particularly at a time when the Fed* is *turning increasingly hawkish*, threatens to **squander**, **price-stability credentials**; which is notoriously more costly to restore than exploit.

- Admittedly, while real (India-US) rate spreads are buffered for the time being by record high US inflation. But this *exceptional inflation differential inversion* (with US inflation higher than India's) *and resultant policy buffer are on borrowed time*. Hence, the **RBI has merely delayed the inevitable** (policy calibration). And in the process **upped the risks of being thrown further behind the curve**.

- Crucially, this **policy feet dragging risks** being rendered as an unwitting **high-stakes game of brinksmanship given a far looser, and more highly leveraged fiscal position**.

- Specifically, **a far more gradual glide-path to fiscal consolidation**, and the resultant jump in public debt alongside its attendant debt financing obligations, **amplifies macro- and rupee stability risks** (particularly as it resonates via credit and exchange rate channels).

- All said, the **RBI's intentional inaction**, *subordinating inflation risks to growth recovery*, **comes at the cost of much sharper macro-stability trade-offs**. Crucially, **significantly higher public debt servicing burden imposed by a pro-growth budget** (stretching out fiscal consolidation plans) amplifies these macro-/rupee-stability risks.

- Particularly if the **myopic desire to anchor debt financing costs** (by holding down policy rates) **backfires rudely in the event of capital outflows** amid surging global inflation rates; which more than wipes out policy anchor effects on yields as risk premium jump brutally.

- While worst case outcomes may be avoided, the path to **regaining a grip on macro-stability risks may entail the RBI changing course fairly abruptly** (as early as April) to put through a quick succession of rate hikes. Risk is, the *slower the initiation of "lift off", the greater the amplitude of hikes the RBI will be forced to undertake to compensate.*

- On balance, the **RBI slipping behind the curve further at this meeting** has **tipped out rate outlook from 75bps to 100bps of cumulative hikes for 2022**. The "*curious incident*" of the RBI doing nothing (akin to the dogs not barking in the Sherlock Holmes mystery) in response to inflation risks, is in fact the "smoking gun" that warns of a knife's edge between heightened pipeline macro- and rupee-stability risks and the RBI having to scramble to compensate with more tightening later.