India’s central bank said it will buy long-dated government debt after cash-supply curbs to support the rupee prompted a surge in yields. Bonds and shares of lenders jumped the most in four years.

The Reserve Bank of India will conduct open-market debt purchases of 80 billion rupees ($1.3 billion) on Aug. 23 and "thereafter calibrate them both in terms of quantum and frequency" based on market conditions, it said in a statement yesterday. The earlier liquidity-tightening steps must not "harden longer term yields sharply" and hurt lending, it said.

India’s 10-year bond yield touched 9.48 percent yesterday, the highest since 2001, as the nation struggles to curb capital outflows spurred by risks such as a record current-account deficit and speculation the U.S. Federal Reserve could taper stimulus. The RBI since mid-July raised two interest rates and capped cash injections into the banking system to aid the rupee, steps that risk hurting expansion in Asia’s No. 3 economy.

“The long-end yields reacted too much and that was, probably, not the objective,” said Prasanna Ananthasubramanian, an economist at ICICI Securities Primary Dealership Ltd. in Mumbai. “There are other objectives that the RBI has to worry about, like government borrowing costs and the impact on the economy.”

Bank Shares

Ten-year government bonds rallied the most since March 2009, with the yields plunging 60 basis points to 8.30 percent today, according to data compiled by Bloomberg. The S&P BSE Bankex index, a gauge of 13 lenders, surged 5.2 percent as of 10:10 a.m. in Mumbai, the biggest gain since May 2009.

The rupee weakened 0.2 percent to 63.335 per dollar and has tumbled about 15 percent in the past six months to a record low. The S&P BSE Sensex index climbed the most in a week.

The central bank said a review of the measures since mid-July suggests the “immediate objective of raising the short-term interest rates has substantially been achieved.”

The issue of cash management bills will be calibrated going forward, “including scaling it down as may be necessary,” the RBI said. The central bank last month increased both the marginal standing facility rate and the bank rate by 200 basis points to 10.25 percent. It has also tightened daily reserve requirements.

Overnight Rate

The interbank overnight lending rate has surged more than 300 basis points, or 3 percentage points, to 10.25 percent since the end of June. The 10-year yield has jumped 86 basis points in the same period, while that on the two-year securities soared 2.34 percentage points, according to data compiled by Bloomberg.

The RBI also allowed lenders to move a larger portion of their government bond holdings to the so-called held-to-maturity category so they won’t have to show losses when prices of the securities fall.
State Bank of India, the country's largest, led the rally in lenders' stocks in Mumbai.

"Investor sentiment got a boost from the measures," said Jisha Nair, Mumbai-based banking analyst at BoB Capital Markets Ltd. "The surge in shares may not be sustainable as they are staring at losses on government and company bond holdings for the year even after the relaxation."

State Bank of India (SBIN) advanced 4.1 percent to 1,617.30 rupees, while Yes Bank Ltd. jumped 15 percent to 278.80 rupees and IndusInd Bank Ltd. rallied 12 percent to 376.50 rupees.

**Sustainable Level**

The current-account gap widened to 4.8 percent of gross domestic product in the 12 months ended March. The RBI estimates the sustainable level is 2.5 percent of GDP.

The plunge in the rupee threatens to stoke the cost of imports such as oil, adding to price pressures.

Consumer prices rose 9.64 percent in July from a year earlier. Another gauge based on wholesale prices advanced 5.79 percent, a five-month high that exceeded the central bank's comfort zone of about 5 percent.

India's economy may expand 5.5 percent in the year through March 2014, compared with 5 percent in the previous 12-month period, the central bank estimates. That lags behind the 10-year average of about 8 percent.

The nation is suffering as Asia's role as the world's growth engine wanes and investors pull out billions of dollars.

Raghuram Rajan, the top adviser in the Finance Ministry since 2012 and a former International Monetary Fund chief economist, becomes the Reserve Bank governor in September. He succeeds Duvvuri Subbarao. The next scheduled monetary-policy review is on Sept. 18.

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