DSP CONVERSE ON RBI MPC

07-JUN-2024

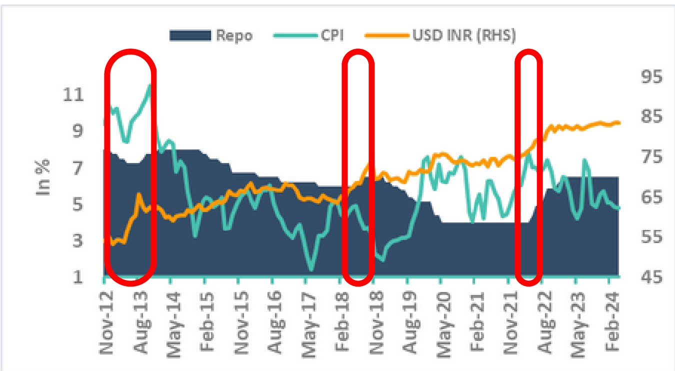
DOES RBI FOLLOW US FED OR DOMESTIC DATA: PAST AND PRESENT

MPC was non-event. But Kudos to RBI for taking the bull by the horns. Gov. Das spelt out that while they look at the US FED, but they take rate decisions based upon domestic factors. Our views:

Why did these questions crop up?

Empirical data suggests that RBI has in past raised rates for currency rather than inflation (chart 1).

- In 2012, RBI did not hike rates when inflation was above 10%. But in 2013 suddenly hiked by 300bp, even when inflation was receding - because rupee had suddenly depreciated.
- In 2018, RBI hiked rates despite CPI within target. Why? Because rupee was depreciated.
- **In 2022,** RBI did not hike rates in Apr MPC despite high CPI. Within a month, RBI hiked rates in a ad-hoc MPC. Coincidentally (?) FED hiked rates the next day. RBI had pre-empted. Even then, Rupee was fast depreciating.



But what does currency have with US FED?

Hiking rates protects currency depreciation. Thus, when rupee depreciates RBI hikes rates to protect the rupee. Tighter US policy, and loose RBI policy usually leads to rupee depreciation. Thus, when US FED started hikes in 2022, RBI had to. Thus, RBI cuts before FED creates a risk of rupee depreciation.

Which countries track US FED closely?

The countries that mimic US FED have pegged currencies i.e. their currency rarely moves. They are usually export oriented countries as peg (i) reduces volatility of their exports, (ii) keep exports competitive, and (iii) as net exporters it control inflation. Eg: most oil exporting Asian countries.

This is true for large commodity importing countries as well, A stable currency ensures (i) lower CAD volatility, (ii) lower cost of imports, and (iii) control imported inflation. Thus, at times RBI will look to manage currency.

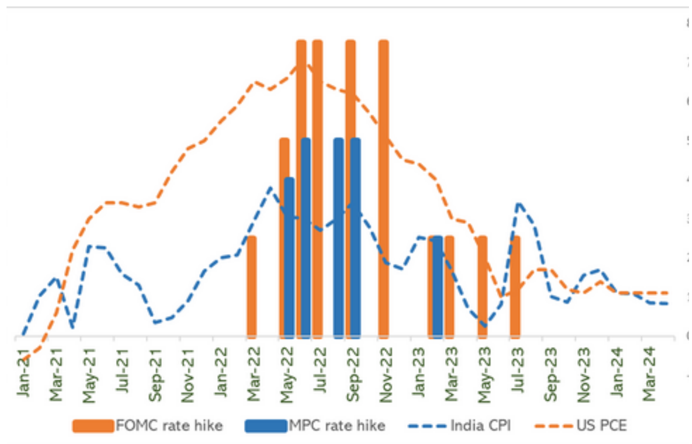
When does RBI track FED, and when inflation?

If RBI were to look only at currency, its MPC will mimic US FOMC. Like UAE monetary policy mimics FED. If RBI follows pure inflation targeting, then USD/INR would have wild swings.

In times of stress on rupee, RBI tracks US FED (instances mentioned earlier) more closely. In times of stress on inflation, RBI does inflation targeting.

As can be seen in chart 2 , after initial hike to protect currency (May 24), RBI probably tracked both (i) CPI , and (ii) US FED..

However, by FY23 end the worries on currency were over and RBI did not have to track the final hikes in US - despite spike in India CPI.



Currently, will RBI track Inflation or FED?

Today rupee and inflation both are manageable, and thus RBI is in status quo. It has luxury to not follow FED, but a rate cut during a non-dovish FED will unnecessarily attract attention to rupee. **Thus, it is unlikely that RBI will cut the rates if FED has not signaled that it is close to cutting rates.**

Is RBI wrong in looking at US FED?

On the contrary RBI is prudent and right. It cannot afford to take a lone road. Central banks across the world are more entwined than 20 years back. The central banks that took their own path eg: Turkey, Pakistan, Sri Lanka, few in LATAM etc. suffered.

Gov Das has been exceptional in guiding the RBI through uncharted territory during and post COVID. Dr. Michael Patra brought robust data driven decision making to RBI, first as ED and then DG. It is impossible to imagine that they would not be capable of running independent policy. It's just that the independent policy is not the best policy.

So why is RBI not acknowledging greater emphasis of US FED?

Stating so unnecessarily ties India's rate policy to US. RBI would need flexibility in future. It also puts unnecessary spotlight on rupee in future.