

Is RBI really 'behind' the curve?

A comparison with its Asian counterparts doesn't suggest so

- In contrast to the general perception, we believe the Reserve Bank of India (RBI) has been unduly aggressive in its monetary policy normalization. As India's economic fundamentals are very different from that of the US and other major nations that have hiked interest rates sharply, a gradual approach would have been more suited.
- Although there is some agreement with this reasoning, many market participants defend the RBI's actions in the context of financial markets. Without such sharp rate hikes, the argument goes, the spread between India and the US bond yields would have narrowed further, leading to faster outflows from India, creating further depreciation in the Indian rupee (INR).
- A comparison of India with other major Asian emerging market economies (EMEs) confirms that RBI is the most aggressive and many of its counterparts are yet to begin their rate hiking cycle (although economic fundamentals are similar in many EMEs). Notwithstanding the divergent rate actions, the movements in bond yields and local currencies are not significantly different in these EMEs in 1H CY22.
- This analysis, thus, makes us wonder if the ongoing aggressive rate hikes in India have actually helped the economy or stabilized the financial markets more. If not, it is possible that while domestic financial markets will follow the movements in global markets, quick rate hikes may hurt the already feeble growth in the near future.
- In any case, we argue that RBI is not behind the curve. Instead, a comparison with other Asian EMEs suggests that it may be running ahead of the curve. We continue to believe that the terminal repo rate should be ~5.5% in this rate hike episode (from 4.9% at present). We also recommend that RBI raise the repo rate by 25bp in its next monetary policy.

Dr. Mridul Saggar, the retired Executive Director of the RBI and who was a part of the Monetary Policy Committee (MPC) up to Apr'22, stated in a recent [interview](#): *"In hindsight, it can be argued that maybe we should have started normalising the corridor in December 2021, changed the stance in February and started hiking in April"*. Dr. Saggar is not alone. There is almost unanimity among participants that the RBI was late in normalizing its monetary policy. This delay is believed to explain the aggressive rate hikes implemented by the RBI in the past three months.

The question, asked in the title of the article, thus, may come as a surprise to many readers. However, a comparison of major EMEs confirms a remarkable similarity in their financial market movements during the past six months, notwithstanding the very divergent monetary policy actions by their respective central banks. Moreover, the economic fundamentals of some of these EMEs are similar to that of India (IN), raising questions over the divergence in monetary policies. Is this the case of IN leading or others lagging? Both will have serious consequences.

RBI: The fast and the furious

A comparison of 10 EMEs (that together account for 70% of all EMEs) reveals that the cumulative hikes of 130bp in the effective policy rate (i.e. the standing deposit facility rate and the repo rate hike of 90bp) by the RBI in the past three months are among the highest and the fastest (*refer Exhibit 1*). Some major Asian EMEs such as Indonesia (ID), and Thailand (TH) have either not yet begun raising rates, while few such as Malaysia (MY) and the Philippines (PH) lifted it by 25-50bp. China (CN), on the other hand, reduced its policy rate by 10bp in Jan'22. South Korea (SKr)/South Africa (SAf) implemented their first rate hike in Aug'21/Nov'21, but the cumulative

Rate hikes in IN during the past three months is the highest and the fastest among Asian EMEs

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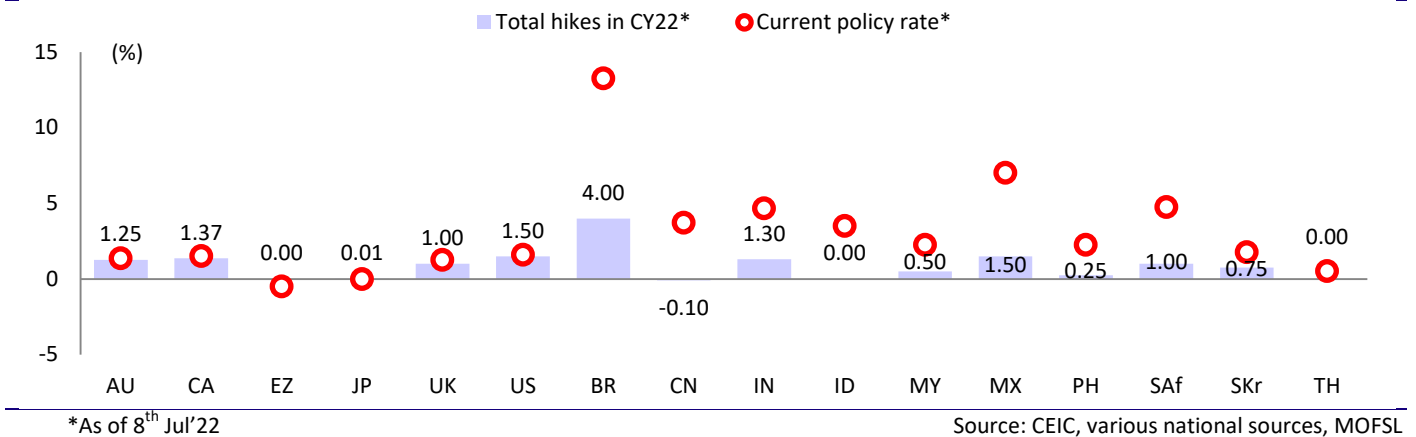
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rate hikes till now have been 125bp each – lower than that in IN. Not only have major Latin American EMEs – Brazil (BR)/Mexico (MX) – been more aggressive (hiked by 400bp/200bp in 1HCY22), they have also started their rate hikes much earlier in Mar'21/Jun'21.

Exhibit 1: IN has seen rapid rate hikes compared to other Asian EMEs in CY22*



A divergence in economic fundamentals can help explain the deviation in monetary policy actions, which can help explain the movements in financial markets. Nevertheless, this is not the case

There are two possible reasons for the RBI actions. Either the domestic economic fundamentals (in the shape of a very strong GDP growth recovery and/or very high inflation) or the fear of a serious dislocation in financial markets (in the shape of currency depreciation or a sharp surge in bond yields) or a combination of both can defend such strong monetary tightening. Since RBI's actions are in contrast to most Asian EMEs, the central bank actions in other Asian EMEs must also be seen in light of their economic fundamentals and the movement in the financial markets. A divergence in economic fundamentals can help explain the deviation in monetary policy actions, which, in turn, can further explain financial market movements. Nevertheless, this is not the case.

Economic fundamentals are similar in many EMEs: Weak growth and high inflation

After contracting 6.6% YoY in FY21, IN's real GDP grew 8.7% in FY22, thus becoming the fastest growing nation in the world. In contrast, CN's real GDP grew 5% in FY22, following a growth of 8%/2.9% in FY21/FY20. While IN's annual growth in the past two/three years was just 0.8%/1.7%, it was as high as 6.5%/5.3% for CN. It will, thus, be misleading to look at just FY22 growth, without taking into account the slowdown in FY21.

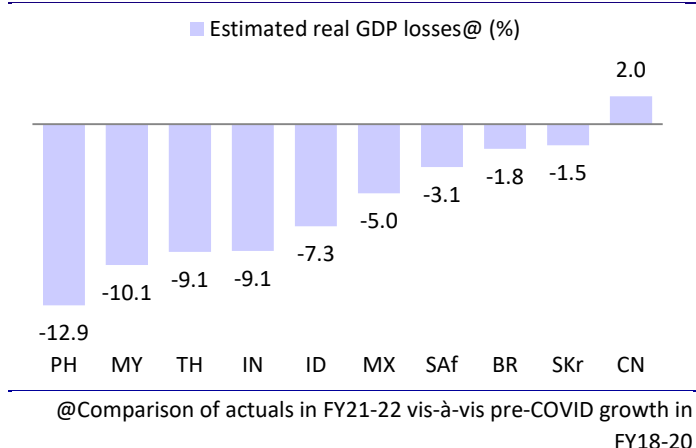
In order to estimate the potential output loss, we compare the actual real GDP growth in the last two years (FY21-22) vis-à-vis the preceding three fiscals (FY18-20). IN grew only 0.8% per annum in the last two years, compared to its pre-COVID average growth of 5.7%. In contrast, CN's real growth in the last two years was 6.5%, higher than the average growth of 5.5% in the pre-COVID period. While IN's real GDP in FY22 was 9.1% lower than what it could have been if not for the COVID-19 pandemic, it was 2% higher for CN.

The estimated potential losses in IN were among the highest (at 9.1%), with similar losses in TH, higher losses in PH and MY, and lower losses in other EMEs

Performing a similar exercise for all 10 EMEs in our sample, we find that the estimated potential losses in IN were among the highest (at 9.1%), with similar losses in TH, higher losses in PH and MY, and lower losses in other EMEs (*Exhibit 2*).

Along with potential real GDP losses, we also find out the extent of an inflation surge in our sample economies. A comparison of the average headline inflation (preferably, the target inflation measure in respective economies) in CY22 vis-à-vis the target reveals that IN's headline CPI inflation is 1.7x the desired level – averaged 6.8% in Jan-May'22 as compared to the medium-term target of 4%. A similar exercise was performed for other EMEs in our sample, and the results are shown in *Exhibit 3*. As CN and MY do not follow an inflation targeting regime, the average inflation in CY18-19 is taken as the benchmark for desired/target inflation. While inflation in CN in CY22 is lower than pre-COVID levels, higher inflation in IN is not an exception. Although MY and TH are witnessing very high inflation (2.6-2.9x of the desired/target level), the surge in inflation is moderate in SAF and PH (1.3-1.5x). Inflation in ID in CY22 averaged 3%, same as its target.

Exhibit 2: Potential real GDP losses are among the highest in IN...



Compared to other major EMEs, IN's potential real GDP losses are among the highest, but the surge in inflation is not among the worst

As compared to other major EMEs, IN's potential real GDP losses are among the highest, but the surge in inflation is not among the worst. So, are the aggressive rate hikes justified in this context?

The above analysis, however, could be countered. The policymaking process is forward looking, and thus, the past and present are important, but secondary. The projections hold key to understand policy decisions. In order to take comparable data, we use IMF projections (last published in Apr'22) for all these economies. Although economic realities and projections would have certainly changed since then, the uncertainty or the staleness would be uniform across all nations.

We use the IMF's CY22 and CY23 projections for real GDP and inflation for all these EMEs and compare them with their pre-COVID trends. The higher the real GDP growth and inflation projections are, the greater the need for aggressive monetary tightening. *Exhibit 4* plots the difference between the post-COVID and pre-COVID trends in all these nations.

Exhibit 3: ...but the surge in inflation is certainly not among the worst

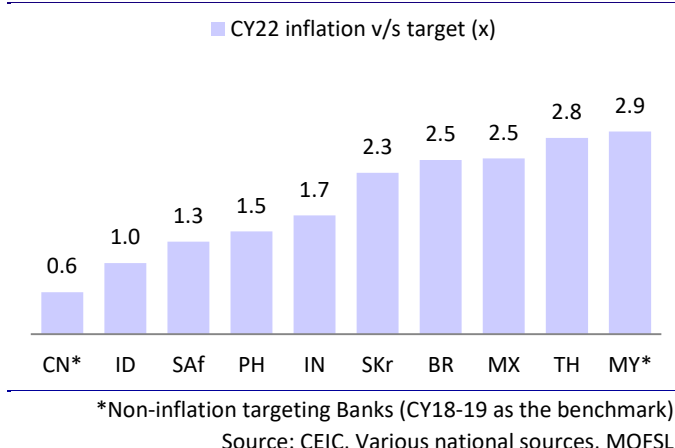
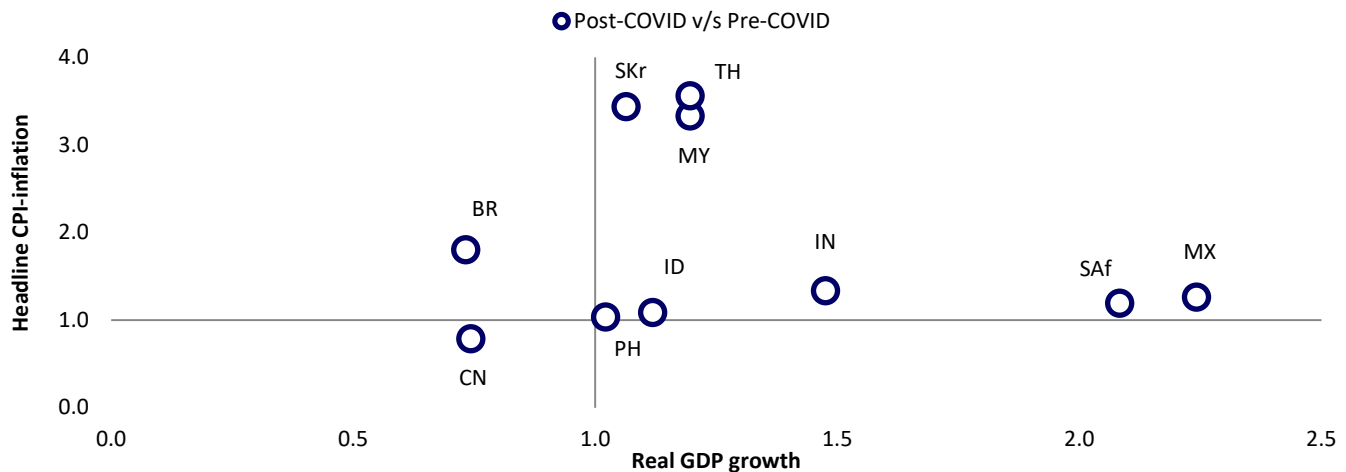


Exhibit 4: A comparison of economic projections among EMEs

Comparison of CY22-23 projections vis-à-vis CY18-19 data

Source: IMF, MOFSL

Going by the projections, IN is an ideal candidate for moderate tightening

Going by these projections, it can be inferred that SKr, TH, and MY should be practicing very aggressive monetary tightening; CN, PH, ID, Saf, and MX need not be thinking about it at all; and IN lies somewhere in between – an ideal candidate for moderate tightening. The projections suggest that Brazilian policymakers have the most difficult task as the country is witnessing stagflation – higher inflation with lower real GDP growth. The actual monetary policy in many of these EMEs, however, is in contrast to what this analysis suggests, since other factors, such as financial market movements, are also important.

Do domestic monetary policies really drive local financial markets?

Economic fundamentals are important when it comes to formulating monetary policy. However, they are not the only factors considered. IN, like other EMEs, has to pay close attention to the policies of major global central banks, especially the US Federal Reserve. Being the world's largest economy, the US Fed's policies can have a significant impact on global financial markets, including that of EMEs. As the Fed starts hiking rates, an uptrend in US bond yields follows. This has direct implication for monetary policy in EMEs as the narrowing spread between the US and IN's (for instance) 10-year bond yield may lead to capital outflows from the latter. As the argument goes, IN must also hike rates to stem those foreign capital outflows and currency depreciation risks. This line of reasoning should hold for all EMEs and more so for others than IN.

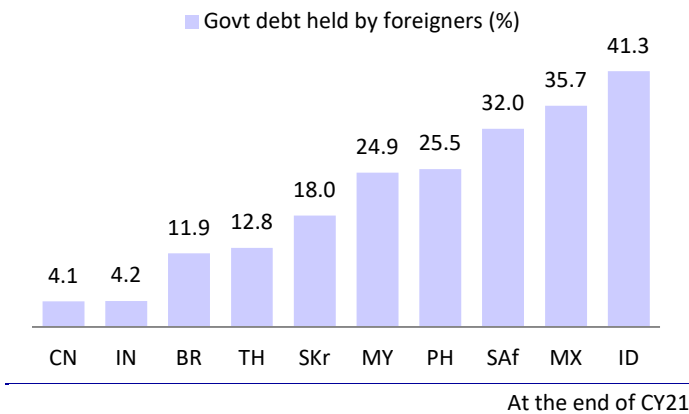
IN (along with CN) has one of the lowest shares of foreign ownership of domestic government debt. However, IN has capital controls as well

When comparing bond yields of two economies, the capital account convertibility and the share of foreign holdings in total outstanding debt must be considered. IN (along with CN) has one of the lowest shares of foreign ownership of domestic government debt. However, IN has capital controls as well. As at the end of CY21, ~4% of outstanding government debt in IN/CN was owned by foreigners as compared to ~25% in MY and PH and 30-40% in ID, MX, and Saf (*refer Exhibit 5*).

Despite the differences in monetary tightening and the foreign ownership of government debt, the rise in the benchmark 10-year bond yield was similar in many EMEs (*refer Exhibit 6*). IN's 10-year yield has risen by 93bp (one basis point is one-hundredth of a percentage point) since the end of CY21, slightly higher than the rise

in ID and TH. However, the duo have a much higher foreign participation than IN and have not yet hiked policy interest rates. The rise was lower in MY and CN, but more than 140bp in other EMEs.

Exhibit 5: Foreign ownership of outstanding government debt is the least in IN...



IN's 10-year bond yield has risen by 93bp in CY22, slightly higher than the rise in ID and TH

Many EME currencies have weakened 5-6% against the US in CY22, including a 6.3% depreciation in the INR

It is amazing to note the broadly similar hikes in the 10-year bond yields, despite very different monetary policies and the dependence on foreigners. If the spread between the US and an EM bond yield is an important determinant of bond purchases, and thus bond yields, then the surge in the Indonesian, Malaysian and Thai yields should have been much higher than that of IN, which is not the case. Similarly, many EMEs have seen a 6-11% fall in their benchmark equity indices in CY22, with the Nifty falling ~8% YTD (*refer Exhibit 7*).

With falling equities and bonds (which translates into higher yields), the fear of a weaker currency is also commonplace. The Indian Rupee (INR) has weakened to a record low and has crossed 79 against the USD. It implies a depreciation of 6.4% against the USD in CY22 (*refer Exhibit 8*). Interestingly, many EME currencies – Indonesian Rupiah (IDR), Chinese Yuan (CNY), South African Rand (ZAR) and Malaysian Ringgit (MYR) – have weakened 5-6% against the USD in CY22, with slower appreciation in Latin American currencies and more weakness (8-10%) in the Thai Baht (THB), Korean Won (KRW), and the Philippine Peso (PHP).

Exhibit 7: Most EMEs have seen a 6-11% fall in their benchmark equity indices in CY22#...

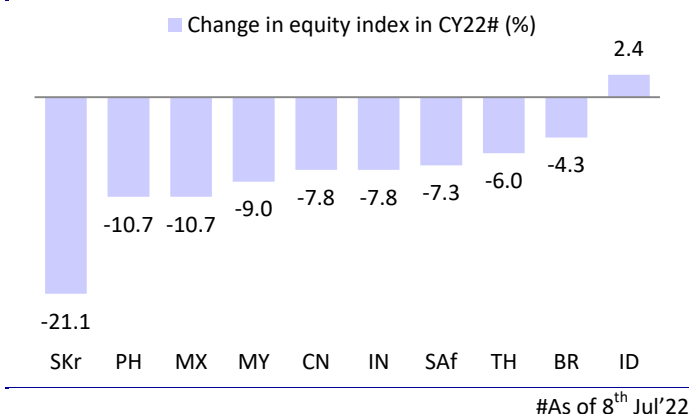
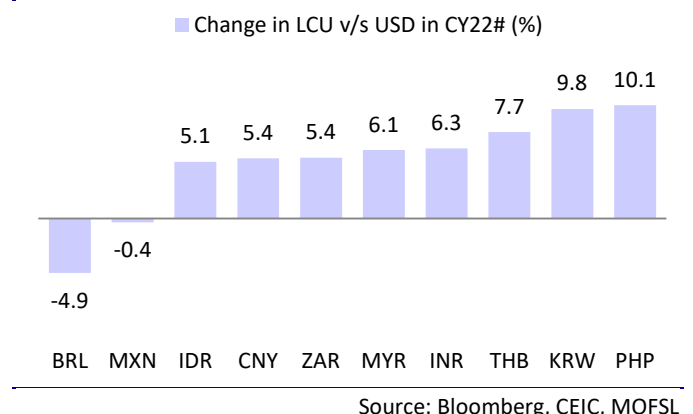


Exhibit 8: ...and EME currencies have weakened by 5-6% against the USD



Notwithstanding, the diverging monetary policy actions, the financial market response has been very similar in EMEs

Despite similar economic fundamentals, there is a remarkable divergence between the monetary policy responses of India vis-à-vis other Asian EMEs. Even if we entirely shrug off these differences, the response of financial markets have been very similar – bond yields have risen by 60-140bp in most Asian EMEs (except CN with no increase and a much higher jump in PH), equity indices has fallen 6-11% in most EMEs, and their respective currencies have weakened by 5-6% against the USD in CY22.

Conclusions: RBI is not 'behind' the curve

RBI has hiked the repo rate by 90bp in the past two months and the effective policy rate, i.e. SDF, by 130bp since Apr'22. A comparison of the world's major EMEs suggests that rate hikes in IN are the highest and the fastest as well. This is interesting because IN's economic fundamentals are similar to that of other Asian EMEs such as ID, MY, PH, and TH, which have practiced a much slower monetary policy normalization so far. A comparison of financial markets reveals very similar movements across EMEs, irrespective of their monetary policy actions.

Our fear is that quick rate hikes in IN may hurt the already feeble growth in the near future

This analysis makes us wonder if the ongoing aggressive rate hikes in IN have actually helped the economy or stabilized the financial markets more. If not, it is possible that while domestic financial markets will follow the movements in global markets, quick rate hikes may hurt the already feeble growth in the near future.

A comparison with other Asian EMEs suggests that it may be running ahead of the curve

In any case, we argue that RBI is not behind the curve. Instead, a comparison with other Asian EMEs suggests that it may be running ahead of the curve. We continue to believe that the terminal repo rate should be ~5.5% in this rate hike episode (from 4.9% at present). We also recommend that RBI raise the repo rate by 25bp in its next monetary policy.

Exhibit 9: A comparison of major Asian EMEs suggests that RBI is not 'behind' the curve

	Inflation# (x)	Potential loss in GDP@ (%)	Cumulative change in CY22 in				Foreign holding of G-Sec debt (%)
			Policy interest rate (pp)	10-year yield (pp)	Equity index (%)	Currency v/s USD (%)	
Brazil (BR)	2.5	-1.8	4.00	2.5	-4.3	-4.9	11.9
China (CN)	0.6	2.0	-0.10	0.1	-7.8	5.4	4.1
India (IN)	1.7	-9.1	1.30	0.9	-7.8	6.3	4.2
Indonesia (ID)	1.0	-7.3	0.00	0.8	2.4	5.1	41.3
Malaysia (MY)	2.9	-10.1	0.50	0.6	-9.0	6.1	24.9
Mexico (MX)	2.5	-5.0	1.50	1.4	-10.7	-0.4	35.7
Philippines (PH)	1.5	-12.9	0.25	1.8	-10.7	10.1	25.5
South Africa (SAf)	1.3	-3.1	1.00	1.5	-7.3	5.4	32.0
South Korea (SKr)	2.3	-1.5	0.75	1.1	-21.1	9.8	18.0
Thailand (TH)	2.8	-9.1	0.00	0.7	-6.0	7.7	12.8

All data as of 8th Jul'22

@refer Exhibit 2 above for more details

#CY22 inflation v/s target (refer Exhibit 3 above for more details)

Source: CEIC, Bloomberg, IMF, various national sources, IMF, MOFSL

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