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Thematic Report

RBI's Surprise Rate Cuts: Beating The Rush?

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INR, not inflation, to drive RBI rate cuts in 2015

Two consecutive out-of-policy-cycle rate cuts by an RBI governor hitherto reluctant to cut rates have surprised all. The resounding welcome received by these cuts from all (industry, government, markets) indicates the necessity for lower rates, especially with moderating inflation and an uncertain recovery from economic slowdown. Although inflation, the raison d'être for high interest rates, is certainly moderating, it may not be the sole reason for the RBI governor's unusual urgency in cutting rates. Having successfully combated the excessive depreciation in INR at the start of his term, Dr Raghuram Rajan may have acted keeping in mind the possible rate hike by the US Federal Reserve, expected in the latter half of 2015.

With the possibility of being forced to raise rates to slow down the potential outflows from Indian capital markets due to US rate hike, he may need room to maneuver rates higher. This seems to be the best time to create that room now, when several factors are in favor of rate cuts: slowing inflation, maintained fiscal discipline, and an economy in the need of lower rates. However, maintaining the competitiveness of the INR versus the currencies of export peers may be the governor's topmost priority. Several central banks across the world have also surprised markets in the past two months by cutting rates.

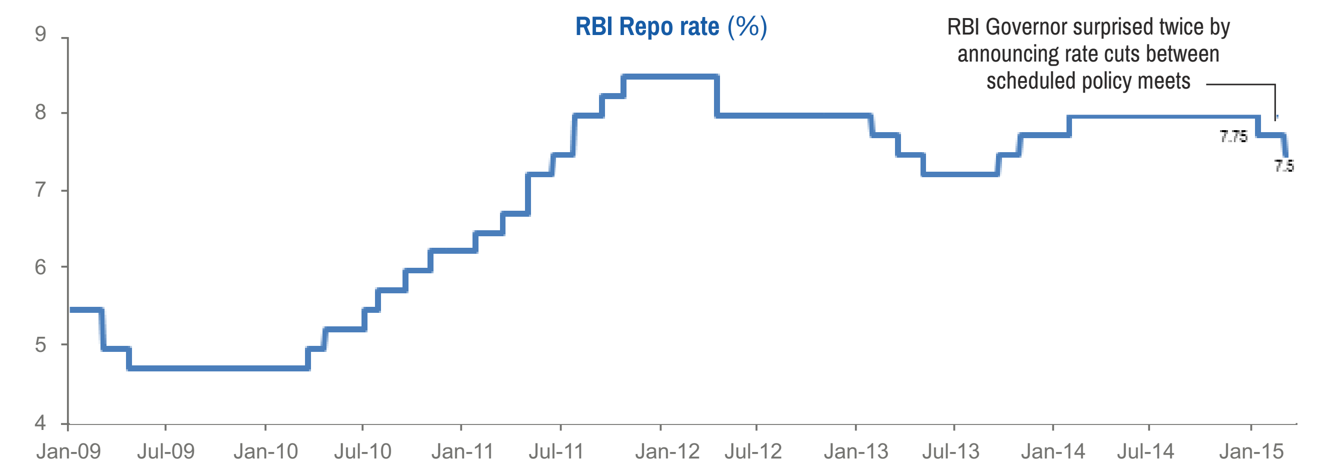
With the confluence of these factors and possible emergence of volatility by events in the future, such as an earlier-than-anticipated rate hike by the US Fed, RBI's repo rate cuts create room for future action. Hence, for the rest of 2015, there may be more cuts in store, at 'out-of-policy-cycle' times and if the conditions are right, even higher than 25 basis points (bp) at a time.

You found the two rate cuts in 2015 surprising? You are in for more!

The significance of the two rate cuts in 2015 (January 15, March 4) cannot be overstated. The rate cut on January 15 was not only the first one since May 2013 but also Dr. Raghuram Rajan's first out-of-policy-cycle announcement. It is interesting to note that the rate cut was announced on January 15, just one day after the release of WPI, which was close to zero. The timing of the second rate cut, coming close on the heels of the Union Budget 2015–16, was another surprise.

Although the budget prolonged the period of reaching 3% fiscal deficit target to three years instead of two, the RBI governor still announced the second rate cut, giving a long rope to the government ('…the government intends to compensate for the delay in fiscal consolidation with a commitment to an improvement in the quality of adjustment'). After maintaining repo rates at 7.25–8.5% for nearly three-and-a-half years (during which India's GDP growth rate nearly halved to 5%), rate cuts were long overdue to support economic growth, especially as inflation has taken a breather.

However, the urgency to cut rates in an unscheduled manner was perplexing, especially when policy meets were due in a few weeks? The answer to this question may provide better clarity on the possible rate cuts in the future. Overall, it appears that rapidly evolving currency and macroeconomic developments may be influencing the RBI's monetary policy actions rather than domestic developments.



Source: RBI, Aranca Research

Global disinflation = lower inflation in India

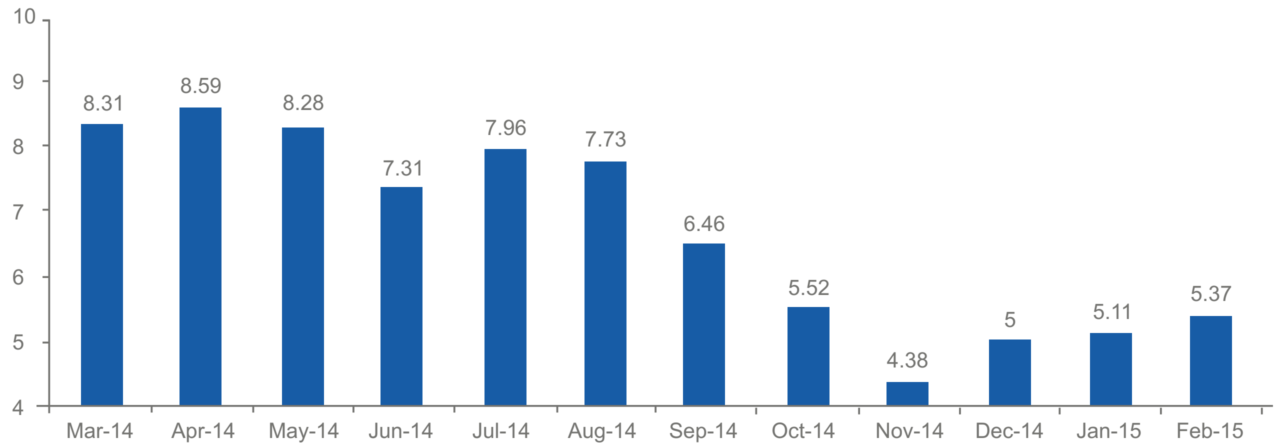
Although the RBI had kept interest rates high for a long period to curb runaway inflation, price rise has cooled off only recently, that too led by exogenous factors. A sharp fall in oil prices on account of oversupply has really befitted India as it imports nearly 80% of its crude requirements. Furthermore, weaker commodity prices (copper, iron, coal) due to a slowing Chinese economy have added to the inflation downtrend. Weaker currencies (except the USD) too have helped in bringing down the 'imported' component of inflation. Broadly, a disinflationary wave in developed economies, especially those in Europe, has created a favorable tailwind for emerging markets such as India, which struggled to curb inflation for several years.

The RBI sought to tackle inflation driven by 'supply constraint' by dampening demand.

Until as recently as the last month of 2014, the foremost argument for a rate cut was cooling inflation. Even before the welcome relief by declining crude prices, India's inflation had shown signs of a decline, on both WPI and CPI fronts. However, the RBI governor Raghuram Rajan had resisted calls from both government officials and the analyst community to cut rates. His public stance, 'We want to solve inflation problem once and for all', cemented his image as an 'inflation hawk'. This was needed as India experienced one of the highest inflation rates among its peers. The RBI sought to tackle this issue of inflation driven by 'supply constraint' by dampening demand in the form of a high interest rate regime or a tight monetary policy. It is also logically consistent to believe that with the abatement in inflation, interest rate policy would also change.

The surprise is the urgency with which the rates have been cut despite gradual rise in inflation post rapid deceleration. Even while cutting rates, the RBI governor's statements highlight the upward risk to inflation in the form of delayed fiscal tightening adding to inflationary pressures. This is a clear indication that inflation is not off the governor's mind, especially since the RBI has now explicitly adopted an inflation target of4% CPI by January 2018.

CPI Inflation (%) slowly inching up again



Source: MOSPI, Aranca Research

Rapid rate cuts to boost growth? Not at all!

India's worst annual GDP growth rate has fallen to5% in 2013, way below its peak of ~9% in 2011, but still significantly above that of several of its peers. Considering the high interest rate regime maintained by the RBI for nearly three-and-a-half years, in addition to a near policy paralysis during the previous government's regime, a slowdown in growth was expected. However, with the change in government and a reformist agenda, supply-side constraints are expected to ease, going forward. As such, the outlook for growth was positive, and the RBI had room to gradually reduce rates to support growth, which would also keep inflation concerns in check.

Although the RBI cut repo rates in relatively rapid succession (by its earlier standards), the rate cuts have not been passed on to consumers by banks.

The real rate cuts are yet to come.

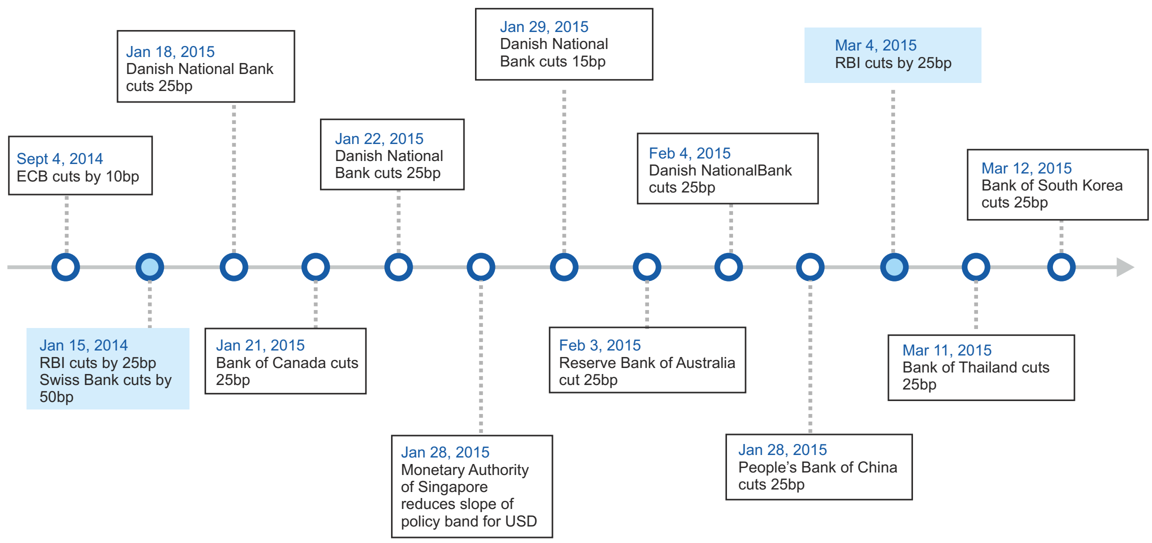
Out of 32 banks, 30 have not cut rates, citing margin pressure and weak deposit growth rate. It is unlikely that the RBI was not aware of this possible breakdown in transmission mechanism. Equally unlikely is that a rate cut would immediately boost growth in an economy that is gradually reviving. Hence, from a perspective of short-term economic benefits, the rate cuts appear to be more symbolic in nature, signaling sympathy to the new government's expressed commitment to 'quality' fiscal discipline. Therefore, the real rate cuts required to pass on through the transmission mechanism are yet to come.

Rate cuts: RBI not the lone ranger

The RBI was not the only central bank that surprised markets in the months of January and February. Bank of Canada's rate cut on January 21 was an even bigger surprise to all with unexpected rationale of deflation concerns cited by the central bank. On February 4, Denmark's central bank cut rates for the fourth time in just three weeks, taking the main deposit rate to -0.75% from -0.5% earlier, and spent $15bn trying to maintain its currency peg of kroner versus euro (according to the estimates by Svenska Handelsbanken, a Scandinavian lender).

Singapore's central bank cut rates as well, seeking slower appreciation of the SGD versus the USD. Australia's central bank cut rates citing currency concerns, surprising everyone. New Zealand's central bank recently abandoned its tightening bias. China's central bank also cut reserve requirements by 50 bp, effectively loosening its monetary policy, without an explicit stimulus to prop up a slowing economy. The Swiss National Bank sent major shockwaves through the currency market by both abandoning the peg to the euro and cutting rates by 50bp to -0.75%. Most recently, the central banks of South Korea and Thailand cut rates on consecutive days, citing weaker-than-expected economic recovery.

Rate cuts announced by banks across the world



Country	Bank/Monetary Authority	Date	Quantum of Rate Cut	Rationale
South Korea	Bank of South Korea	12 March	25 bp	To boost momentum in economic recovery
Thailand	Bank of Thailand	11 March	25 bp	To combat a weaker-than-expected economic recovery
China	People's Bank of China	28 February	25 bp	To spur economic activity
India	Reserve Bank of India	15 January 4 March	25 bp 25 bp	Easing inflation, providing room for rate cut
Canada	Bank of Canada	21 January	25 bp	To offset the negative economic impact of lower oil prices on Canada
Australia	Reserve Bank of Australia	3 February	25 bp	Concern that Australia's resource-rich economy was facing another year of below-average growth
Singapore	Monetary Authority of Singapore (MAS)	28 January	NA (MAS uses currency as main policy tool)	To seek slower appreciation of SGD vs. USD by lowering the slope of policy band for USD
Europe	European Central Bank	4 September 2014	10 bp	To spur economic growth and stave off the threat of deflation
Denmark	Danish National Bank	4 February 29 January 22 January 19 January	25 bp 15 bp 15 bp 15 bp	To maintain currency peg to EUR
Switzerland	Swiss National Bank	15 January	50 bp	To weaken currency after peg to EUR abandoned

Higher monetary policy divergence anticipated

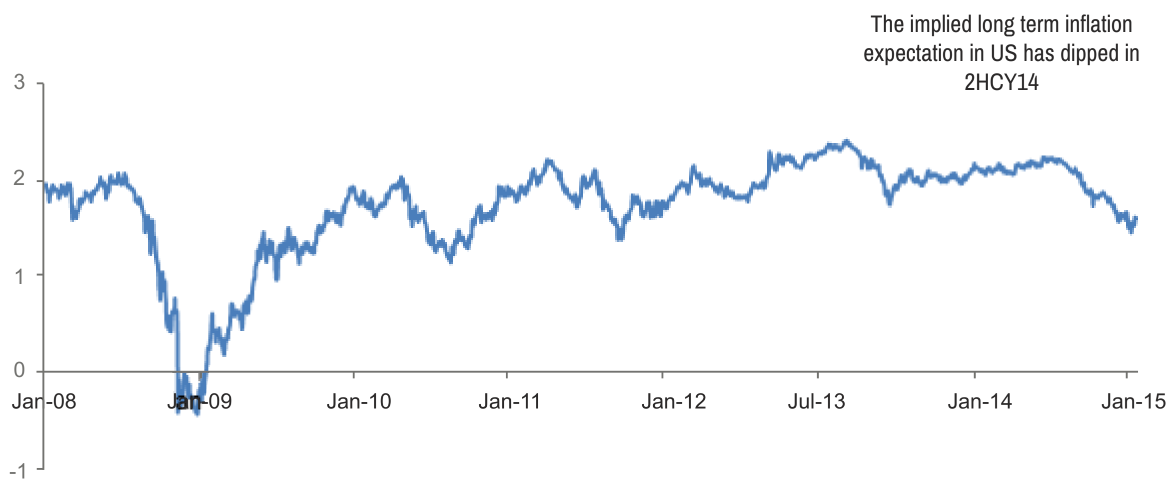
The quick succession of rate cuts by central banks across several nations, both developed and developing, may not be unrelated. The world's strongest economy, the US, is gaining strength day by day, if we consider employment data as an indicator. It may be a matter of time before the US Fed returns to normal monetary policy and raises rates from the extraordinary near-zero levels since 2008. This would mark a divergence in policies of the top two major central banks: the US Fed and the European Central Bank (ECB).

The ECB, although with much deliberation and delay, has finally embarked upon a quantitative easing (QE) program, nearly coinciding with the US Fed's policy change to normalcy from extremely accommodative. The last time there was hint of return to normalcy (June 2013 testimony by the then Fed Governor Ben Bernanke), global markets went into a tailspin. Considering this, central banks need to be shoring up to limit outflows from their markets, rather than reducing rates. Yet, we see the opposite happening.

Major central bank governors' worry – Deflation or Currency? Or Both?

Inflation figures for both the US and Europe have been consistently below the targets of central banks for nearly two years now, with no signs of them going up anytime soon. Europe's headline inflation turned negative in the past two months, triggering large-scale ECB stimulus from March. Inflation in the US is soft despite massive QE, as on-ground demand for goods and services is weak due to marginal wage growth. This has led to lower consumption, thereby dragging industrial demand. Industrial inputs, from oil to copper, have seen major price falls due to lower demand. Therefore, the risk of deflation is steadily rising. Overall inflation expectations continue to decline, as implied by the movement in bond yields, e.g., US long-term inflation expectations have fallen, as measured by the difference in 10-year sovereign yields and US TIPS yield versus actual current consumer inflation.

US implied inflation (10-yr sovereign minus 10-yr inflation protected treasuries or TIPS)



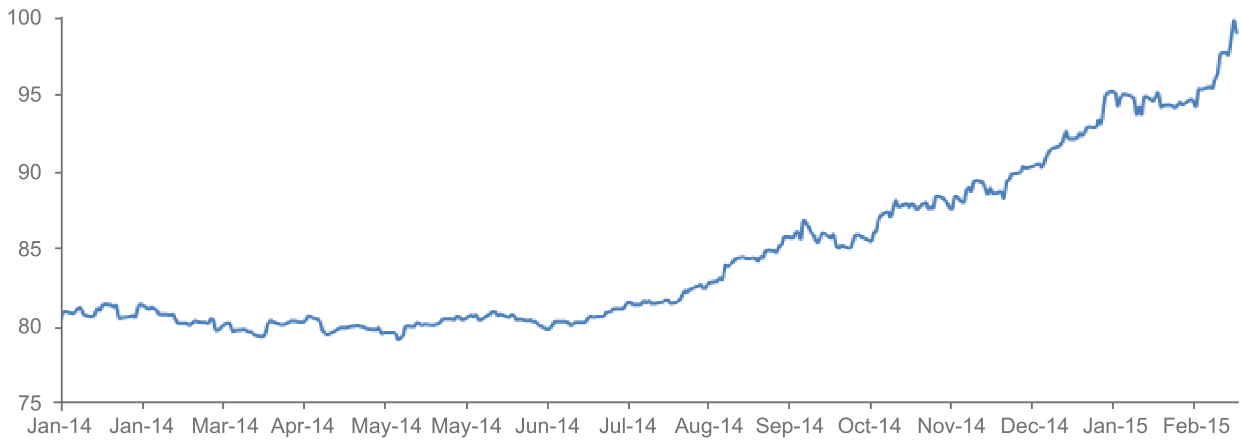
Source: Aranca Research, Thomson Reuters

Currency appreciation: A major worry causing central banks to seek depreciation

Major economies are acutely aware that their main source of competitiveness in global trade is their currency. In Japan's Abenomics, the depreciation of the yen is a major pillar of the strategy to lift Japan out of its multi-decade stagnancy. Other export-driven Asian economies competing with Japan also need to maintain their currency's competitiveness by depreciating it. The ECB has now joined the race with its massive QE program.

On the other hand, the USD has been gaining in strength day by day, especially in anticipation of the upcoming rate hike by the US Fed. Although no specific timeline has yet been provided by the US Fed, expectations of the first rate hike in six years are increasing due to consistently stronger-than-expected jobs creation numbers. Although the expectations may be somewhat tempered due to the lack of wage growth or inflation, it may be only a question of 'when' rather than 'if' the US Fed would undertake its first rate hike in 2015.

USD index movement showcases recent strength of USD versus other currencies



Source: Aranca Research, Thomson Reuters

RBI worried over currency appreciation?

The INR has relatively held its ground against the USD over the past few months despite the USD itself appreciating against most currencies. Consequently, the INR has attained a premium with currencies of competing nations (China, Thailand, Russia, Japan, and other Asian countries). The INR's sharp appreciation is detrimental to its exports competitiveness. Although the RBI has not stated any specific INR target, it does aim for currency stability and influences the INR rate by market intervention through state-owned banks.

Such intervention involves using up its precious foreign currency reserves, which is not desirable at the moment as large repayments are due soon. The RBI needs ~$30bn to fund deposit repayments to banks (refinance window) for the funds attracted by schemes announced one-and-a-half years ago to stop the free fall of the INR versus the USD. Furthermore, India's private sector needs to repay debt totaling ~$60bn.

Relative strength of INR against other currencies, especially in past three months (in % terms)

Source: Aranca Research, Thomson Reuters

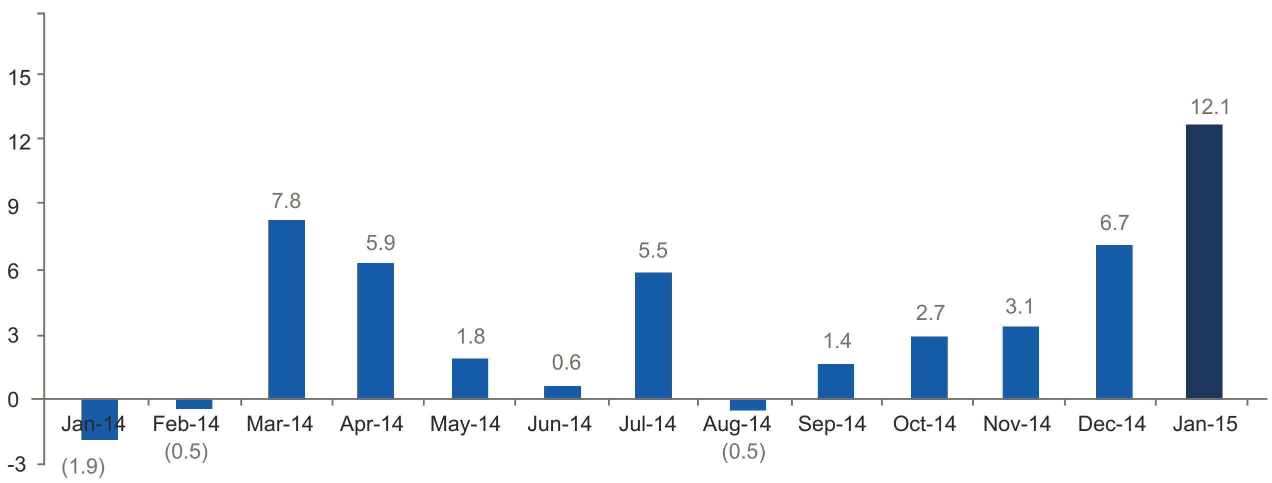
Pressure to stabilize USD flows: RBI's net dollar purchases touch seven-year high in January 2015

In January 2015, the RBI bought a net USD12.14bn in the spot market. Not only was this amount a multi-year high, it was also sharply higher than the previous month's purchases of USD6.74bn. Corresponding to the USD inflows in January 2015, the Indian currency had strengthened to below INR 62 in face of uncertainties in global economies such as those in Europe, beating the trend of weaker emerging-market currencies. This possibly led to the RBI mopping up dollars by record purchases in the spot market.

One of the most effective policy actions is rate cuts; easing up pressure on the RBI.

Historically, the RBI has not targeted a specific currency rate; it rather aims for currency stability. Therefore, it follows that the RBI would look to make such an exceptionally high intervention only occasionally. Given the sensitivity of currency markets to global developments, the RBI would preferably look to stabilize the currency through policy actions rather than market interventions. One of the most effective policy actions is, of course, rate cuts; this would reduce the inflow of dollars into India, easing up pressure on the RBI to intervene.

RBI's net dollar purchases (USD Billion)



Source: Aranca Research, Thomson Reuters

INR carry trade: the joker in the pack?

Even after the twin rate cuts, the interest rate differential between advanced economies and India is very large. For example, the differential between 10-year sovereign yields in the US and India is approximately 6%. Although the difference in sovereign ratings levels would keep India's debt out of bounds for many investors, the country's rating is expected to be upgraded, led by stronger growth prospects, adherence to fiscal discipline, reforms pipeline, and overall positive improvements expected over the next few years.

India's sovereign rating is expected to be upgraded.

Indian bonds too have rallied on better prospects (80 bp improvement over the past six months), with inflows worth USD26bn in the debt markets in 2014. This was partly driven by the ~500bp yields (unhedged) possible in carry trade due to the differential in sovereign yields. Equity markets have already attracted USD42bn inflows in 2014. Although a rate hike by the US Fed would narrow the gap, the RBI is not likely to wait until then to lower the rate differential, given the uncertainty surrounding the market response to a US Fed rate hike.

Difference in yields of US and Indian sovereign 10-year bonds(%)

Source: Aranca Research, Thomson Reuters

A limited window of opportunity to cut rates?

An interest rate hike by the US Fed is an event being debated strongly across markets. Any data point (jobs data, wage growth) or comment (by various Fed governors) triggers a movement across markets. Given the sharp reaction of currency markets to the previous indication of monetary policy change (in 2013), central banks around the world would want to gear up to maintain stability in their currencies. A part of the preparation would be to have enough room to maneuver interest rates and hike them if markets react too strongly to any increase in the US Fed rates. Especially in the case of India, with the rates already being high compared to peers, any rate hike would further hurt an already slow moving economy.

Even if India follows an independent monetary policy, the RBI would need to respond appropriately to the events as they unfold, and may need to hike rates temporarily to contain outflows. However, to do so without hurting the economy would first require the rates to be at lower levels.

Ideally, the RBI would lower rates gradually.

Ideally, the RBI would look to lower rates gradually. However, with the US jobs data surprising all with its strength, the US Fed may hike interest rates earlier than expected. Thus, the time for the RBI to lower rates may come sooner than expected.

Perfect time for further rate cut

With inflation not exactly a priority anymore and a domestic economy paying a high cost of debt, any rate drop would be welcome in India from most quarters. Until the currency remains stable, further rate cuts would keep a lid on INR appreciation versus the USD and even cause some depreciation, as witnessed over the past few weeks, thereby leveling the playing field in export competitiveness.

These may neither be the last of rate cuts nor the last out-of-policy-cycle cuts.

Furthermore, with several central banks across the world lowering rates, it would not be out of context for the RBI to also respond and maintain the INR's competitiveness vis-à-vis the basket of other currencies.

With all the requisite reasons to cut rates, it is no surprise that the RBI governor adopted an unconventional, although not unprecedented, option of twin out-of-policy-cycle rate cuts, signaling the urgency of cuts.

We believe these may neither be the last of rate cuts nor the last out-of-policy-cycle cuts. We may even see a rate cut of higher than 25 bp at a time, if inflation falls sharply. Overall, considering the abating inflation and imminence of the RBI lowering rates from high levels, more rate cuts may be expected and at a faster pace, possibly following each inflation report.

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