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Macro Note

India: Economy Advances Deeper Into The Business Cycle As RBI Follows U.S. Tightening Path

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- The Reserve Bank of India (RBI), as widely expected, hiked the repo rate by 25bps to 6.50% and reverse repo rate by an equal amount to 6.25% on 1 August 2018, bringing rates to a 2-year high.
- With the 25bps hike on 1 Aug 2018, the RBI has advanced further into the normalization cycle, joining a panel of economies that had hiked rates by the same magnitude (50bps) as the United States over the last 6 months.
- While Governor Patel sounded a little hawkish in the media when it comes to prospects of future rate hikes, the RBI had said that it was sticking to a neutral stance, reporting that risks to inflation are now balanced.
- As we believe that further rate hikes may provide further downside pressures on the just-picking-up economic growth and of no help to support the INR, we do not expect any more rate hikes until end of this year.
- As we expect U.S. Federal Reserve to raise interest rates by another two more times this year, the USD/INR is likely to face further upward pressure to above the psychological 69 level. We forecast that the pair will trade to 70.0 by end-2018 and towards 70.8 by 2Q 2019.

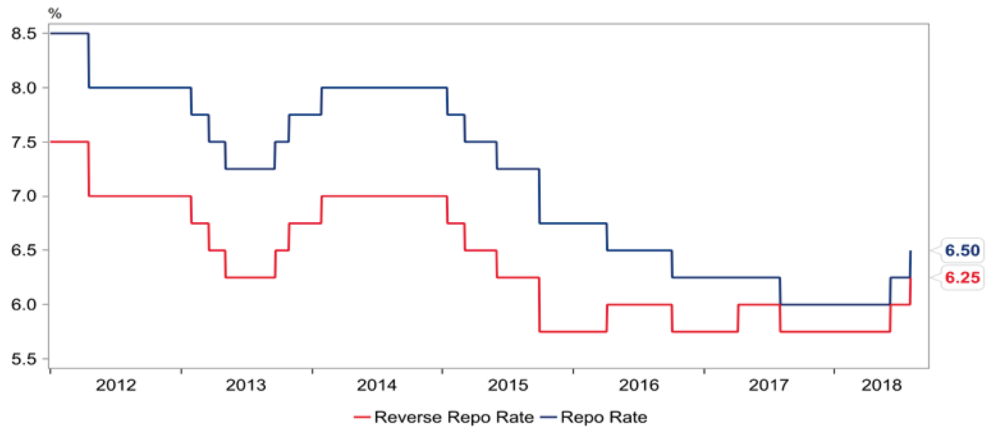
The Reserve Bank of India (RBI), as widely expected, hiked the repo rate[1] by 25bps to 6.50% and reverse repo rate[2] by an equal amount to 6.25% on 1 August 2018, bringing rates to a 2-year high. The last rate hike was on 6 June 2018 (**Exhibit 1**) (which was the first rate hike in four years). Five out of six MPC members had voted for the increase in policy rates.

We had, on the contrary, expected the RBI to keep rates unchanged for the rest of this year. Although inflation had been trending higher, we were of the view that it was not at risk of hitting the upper bound of RBI's target rate (6%) anytime this year. This is especially so since we believe that current global oil prices have reached its asymptotic peak already, due to the abilities of US shale oil producers to bring more supply to international markets.

1 The rate which the RBI lends short-term money to banks.
2 The rate which the RBI borrows from commercial banks.

Exhibit 1: RBI Hiked Key Policy Rates By 25bps On 1 August 2018

Source: Macrobond, UOB Global Economics & Markets Research



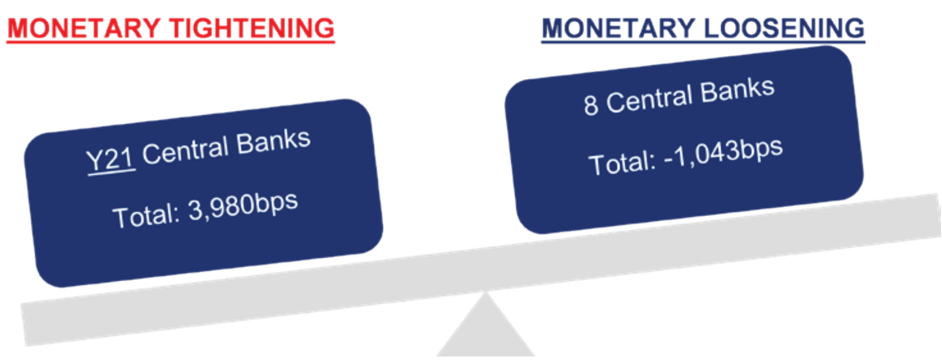
India's Economy Advances Deeper Into The Business Cycle

With the 25bps hike on 1 Aug 2018, the RBI has advanced further into the normalisation cycle, joining a panel of economies[3] that had hiked rates by the same magnitude (50bps) as the Unites States over the last 6 months, where central bankers are increasingly flagging out risks from higher oil prices, emerging markets capital outflows from a higher USD and US rates, tighter labour market conditions, to more positive output gaps.

Our global central banks monitor across 52 central banks' actions since July 2017 shows a total of 21 central banks (RBI included) hiking interest rates to a combined amount of 3,980bps; 23 central banks keeping interest rates unchanged; while 8 central banks cutting rates to a combined amount of 1,043bps. The collective actions of central banks reaffirm that we are now in a global tightening cycle (**Exhibit 2**).

Exhibit 2: More Central Banks Hopping Onto The Global Tightening Train

Source: Bloomberg, UOB Global Economics & Markets Research



3 Those that hiked a cumulative of 50bps over the past 6 months were Czech Republic, Bahrain, Hong Kong, Mexico, U.A.E., U.S., the Philippines, Saudi Arabia, and India.

Among the central banks that had taken their monetary policies on the same path as the U.S. (ie: hiking rates by 50bps), the effect on their currencies had been mixed. The RBI has hiked rates at the same pace as the US so far in 2018, and yet, the INR has been the worst performing major currency in Asia this year. (**Exhibit 3**).

Exhibit 3: INR Suffered Most From Currency Depreciation Year-To-Date

Country / Region	Policy Rate	FX YTD%
India	6.50%	-6.7%
Philippines	3.50%	-5.8%
Czech Rep.	1.00%	-3.1%
Hong Kong	2.25%	-0.4%
Bahrain	4.00%	-0.1%
U.A.E.	2.25%	0.0%
Saudi Arabia	2.50%	0.0%
U.S.	2.00%	1.5%
Mexico	7.75%	5.6%

Source: Bloomberg, UOB Global Economics & Markets Research

Contradicting Reasons For RBI Rate Hike

RBI's Governor Urjit Patel hinted at possibly more tightening to maintain economic stability amid growing risks from global trade and currency tensions. However, we think that there were contradictions and inconsistencies between the reasons and actions.

First, on Growth, Governor Patel was quoted in the media saying "*We have had a few months of turbulence behind us. This is likely to continue and for how long, I don't know. The trade skirmishes evolved into tariff wars and now we are possibly at the beginning of currency wars*."

We find this reasoning behind the rate hike (and potential future rate hikes) as strange and contradictory. If the RBI is fearful of growing risks from global trade tensions affecting their external demand, then further tightening of monetary policies will just make it worse by constraining or even reducing domestic demand via the household consumption and corporate investment transmission mechanism.

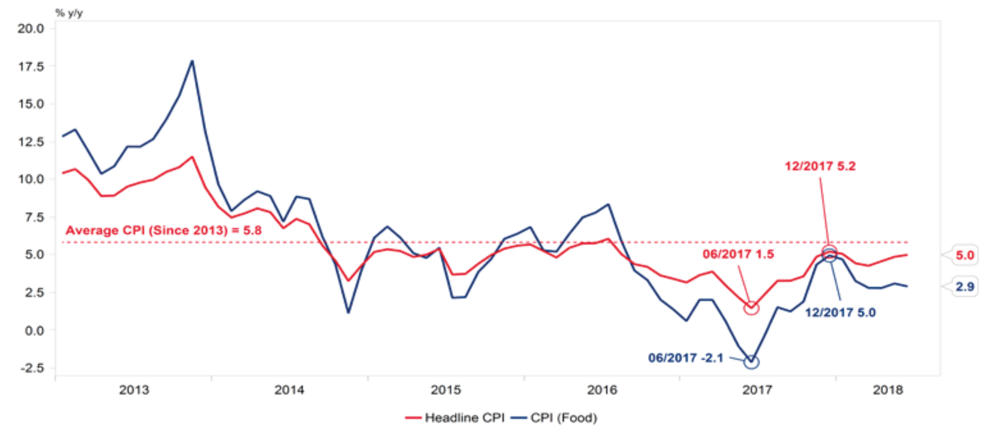
The RBI had maintained its GDP growth projection for FY 2019 at 7.4%, while we maintain our GDP growth forecast of 7.2%, from 6.7% in FY 2018. In fact, we believe that the latest rate hike could add more pressure on corporates, bad loans situation within public banks, and overall economic growth prospects.

Second, on Inflation, the RBI had lowered (surprise surprise!) its inflation projection for FY 1H 2019 to 4.6% from 4.8%, while nudging up its projection for FY 2H 2019 by 0.1%pt to 4.8%, and onward to 5.0% in FY 1Q 2020. So while the latest inflation inching to a 5-month high of 5% in June had prompted the latest RBI move, the lower inflation expectations did not seem to gel with the action, prompting market to suspect if the RBI is looking at the windscreen or the rear-view mirror.

Looking back, **Exhibit 4** shows that India's headline inflation had been hovering above the RBI's medium term target of 4% for 8 months already, indicating upside pressures on prices. However, rather than trending higher, food inflation had been on the decline since peaking in December 2017.

Exhibit 4: India's Inflation Rate Has Hovered Above RBI's Medium Term Target of 4% For 6 Months

Source: Macrobond, UOB Global Economics & Markets Research



Although headline inflation had been trending higher, we do not believe that it is at risk of heading higher towards the upper bound of the RBI's target range (6%) anytime this year. This is especially so since we believe that current global oil prices have reached its asymptotic peak already, due to the abilities of US shale oil producers to bring more supply to international markets.

Going Forward: Done For 2018

We had previously expected the RBI to maintain an unchanged stance all the way until 3Q 2019 where we expect a 25bps hike. The cumulative 50bps hike, a first in four years shows that the central bank is pricing in a steeper-than-expected trajectory in global oil prices, potential capital outflow (reflected by the depreciating INR) as developed economies continue to tighten, as well as upside surprises in domestic inflationary conditions.

While Governor Patel sounded a little hawkish in the media when it comes to future rate hikes, the RBI in its statement had said that it was sticking to a neutral stance, reporting that risks to inflation are now balanced.

As we believe that further rate hikes may provide further downside pressures on the just-picking-up economic growth and of no help to support the INR, we do not expect any more rate hikes for this year.

As we expect U.S. Federal Reserve to raise interest rates by another two more times this year, the USD/INR is likely to face further upward pressure to above the psychological 69 level. We forecast that the pair will trade to 70.0 by end-2018 and towards 70.8 by 2Q 2019.

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