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# RATE HIKE CHORUS: THEATRICS OR REAL?

Notwithstanding the clamour for a rate hike in market, we believe ground realities call for caution and status quo and not rate action! Why?

First, even as GDP numbers are strong, private consumption continues to lose pace dropping to 6.6% in FY18 from 7.3% in previous year. In fact, the per capita PCFE has decelerated indicating negative income effect across decile groups. This calls for caution.

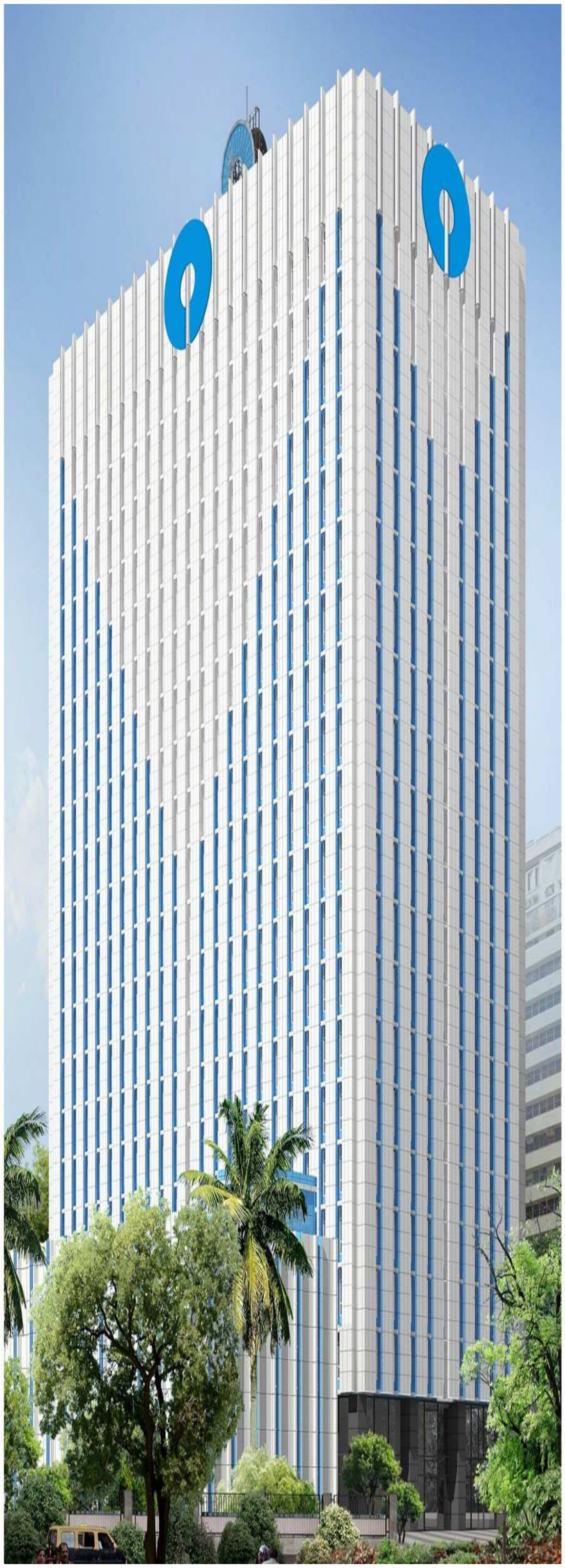
Simultaneously, we are now witnessing signs of an asynchronous global growth in the making. The latest surveys show that there is some early evidence of a slowdown in Emerging Markets Export growth. Japan's economy contraction in Q12018 marked the end to eight straight quarters of economic expansion, which was the longest sequence of growth since 1989. US wage growth is muted, while the outlook in Europe has turned negative and is expected to remain so. So global growth prospects remain a little uncertain as off now.

Second, current rise in Core inflation is quoted as the signal for rate hike in the next policy. Though the CPI inflation has increased by 221 bps since Jul'17, core inflation has increased by only 98 bps. If we further dissect the core inflation data, we find that out of 98 bps increase, only two items, viz. Housing (38 bps) and Transport (21 bps) accounts for 60% of total core increase).

So is it unfair to say that jump in core inflation is more broad based, as Housing inflation could be just a statistical artefact and Transport is because of oil, the outlook of which is shrouded in uncertainties. Interestingly, India witnessing muted wage growth of less than 3% in FY18, it is unlikely oil will have a significantly adverse impact on inflation.

We believe, In India, since, July 2017, the rise in annualized volatility in 10yr G-sec market along with tightening liquidity is giving a confused signal to both market players as well as the policy makers. This has imparted a spike in noise to signaling of RBI in recent times. Such volatility in bond market could also result in financial instability.

In the Indian context, we thus believe let the Governor speak, as too much **cacophony** in the words of noted economist **Alan Blinder** may confuse the markets about the policy signals otherwise.



## BACKGROUND

- Till the 1st Monetary Policy Review Meeting of RBI on 05 April 2018, most of the Economist/Analysts were talking about either a rate cut or a pause. While, after the 1st Monetary Policy Committee (MPC) meeting minutes published, now they are taking about a rate hike. According to the minutes, Viral Acharya, Deputy Governor of the RBI, said, "*I am, however, likely to shift decisively to vote for a beginning of withdrawal of accommodation in the next MPC meeting in June*." This statement was considered as the guidance point for rate hike.
- Interestingly, RBI Governor's statement in the post policy press meet is quite contrary to the above statement. He reiterated that any decision on rate hike would be taken with prudence and patience. In the minutes also he said, "*I would like to wait for more data and watch how various risks to inflation evolve, going forward*."
- We however, believe there are too much uncertainties on the table that calls for caution on the part of regulator, rather than action on rate front!

## DOMESTIC UNCERTAINTY

- First, a word on GDP numbers. Q4 GDP growth has accelerated significantly on the back of an increase in Government consumption, even as Private consumption continues to lose pace dropping to 6.6% in FY18 from 7.3% in previous year. In fact, the per capita PCFE has decelerated indicating negative income effect across decile groups. In particular, nominal agriculture growth expanded by only 4.5% in FY18, against a nominal GVA growth of 9.7%. The crux of the low growth in Agriculture sector was a low deflator (quarterly GVA deflator at 0.4% / GVA deflator at 2.9%) indicating significant softening of rural prices. Thus, there is indeed an urgent need to provide an income support to farmers / MSP price support, as it will create the much needed cushion in rural demand that is still only showing only incipient signs of recovery. Hence in a nut shell, there are still early signs of an impending recovery and all care should be taken to support it and not derail it.

## GLOBAL UNCERTAINTY: IS GLOBAL GROWTH NOW TURNING ASYNCHRONOUS?

- Global GDP growth is expected to touch 3% in 2018. Rise in commodity price will support commodity exporting countries but will check the growth in commodity importing countries. The world trade has also picked up but its future growth remains uncertain in an environment of rising trade war tensions between the US and China and the US and Europe.
- The latest surveys show that there is some early evidence of a slowdown in Emerging Markets Export growth. Chinese exporters are reporting slowing order growth and flat export prices. The FTCR China Export Index is below the average of 55.2 during the previous 12 months, while order growth has dropped to a 10-month low and export prices failed to increase for the first time in seven months. Export growth of Korea has softened in recent months.
- Japan's economy contraction in Q12018 marked the end to eight straight quarters of economic expansion, which was the longest sequence of growth since 1989.The US growth outlook has improved on the back of strong fiscal stimulus through cut in corporate tax rate. However, the labour market outlook is mixed. The wage growth has declined and is even lower than prior to what was in 2008 owing to structural adjustments in US retail sector. This has kept the labour force participation rate low thus lowering the U3 unemployment rate. The yield spread between 10 year and 2 year old US treasury is now at bottom of recent range, an indication of early signs of slowdown going forward.
- The outlook in Europe has turned negative and is expected to remain so. The political tension in Italy will cloud the overall outlook. It needs to seen if this will have bearing on the leadership transition in ECB and the outlook on monetary policy.
- Overall economic environment has thus turned tad pessimistic with visible fragility in the financial markets. Geopolitical tensions may also cause mood reversals and increase volatility in financial markets.
- So global growth prospects remains a little uncertain as off now.

## CPI INFLATION DATA

- Rise in Core inflation has often quoted as the signal for rate hike in the next policy. Though the CPI inflation has increased by 221 bps since Jul'17, core inflation has increased by only 98 bps. If we further dissect the core inflation data we find that out of 98 bps increase, only two items, viz. Housing (38 bps) and Transport (21 bps) accounts for 60% of total core increase). 19% has been contributed by Health and Personal Care.
- So is it then unfair to say that jump in core inflation is more broadbased, as Housing inflation could be just a statistical artefact and Transport is because of oil, the outlook of which is shrouded in uncertainties. Interestingly, India witnessing muted wage growth of less than 3% in FY18, it is unlikely oil will have a significantly adverse impact on inflation.
- This analysis indicates that only few items are contributing the rise in core inflation and hence produce too much noise to clearly witness any signal. As Viral Acharya rightly pointed out in the minutes that monetary policy needs to separate signal from noise with regard to data, we also believe that any decision on policy rates should be deliberated and proper rationale should be given.
- Further, if we see the arithmetic of core inflation, we find that the current increase in core is in part due to unfavourable base effect. If the value of the core inflation adjusted for the base effect is lower than the actual core inflation, it means we have an unfavorable base effect, i.e. base is pulling up the inflation.
- Our estimates suggest, that after adjusting for the unfavourable base, core CPI at 5.92% drops to 5.37% in April. Core CPI will peak in June 2018 (June 2017 at lowest at 3.85%) and then bottom out.

## NOISE TO SIGNAL RATIO: NEED FOR MORE EFFECTIVE COMMUNICATION?

- In last few years the predictability of monetary policy decisions has improved notably in many countries and research suggest that more and better central bank communication contributed to this improvement by "reducing noise."
- In India, since, July 2017, the annualized 10 yr G-sec yield is on higher side. The rise in annualized volatility in 10yr G-sec market along with tightening liquidity is giving a confused signal to both market players as well as the policy makers.

**Arithmetic of Weighted Contribution in CPI**

| | Apr-18 | Jul-17 | Increase (bps) |
|---|---|---|---|
| Headline CPI | 4.58 | 2.37 | 221 |
| Non-Core CPI | 1.79 | 0.56 | 123 |
| Food *of which* | 1.40 | 0.21 | 119 |
| Vegetables | 0.41 | -0.27 | 69 |
| Fruits | 0.30 | 0.09 | 21 |
| Protein (Meat, Egg & Milk) | 0.39 | 0.37 | 2 |
| Core CPI | 2.79 | 1.81 | 98 |
| Pan, Tobacco and Intoxicants | 0.21 | 0.16 | 5 |
| Clothing and Footwear | 0.35 | 0.28 | 7 |
| Housing | 0.86 | 0.48 | 38 |
| Miscellaneous | 1.34 | 0.86 | 48 |
| Household Goods and Services | 0.18 | 0.14 | 3 |
| Health | 0.32 | 0.22 | 10 |
| Transport and Communication | 0.35 | 0.14 | 21 |
| Recreation and Amusement | 0.08 | 0.05 | 3 |
| Education | 0.23 | 0.20 | 3 |
| Personal Care and effects | 0.18 | 0.09 | 9 |
| ***Memo:*** | | | |
| Core CPI Ex Housing | 1.93 | 1.33 | 60 |
| Core CPI Ex Transport | 2.44 | 1.67 | 77 |
| Core CPI Ex Housing & Transport | 1.58 | 1.20 | 39 |

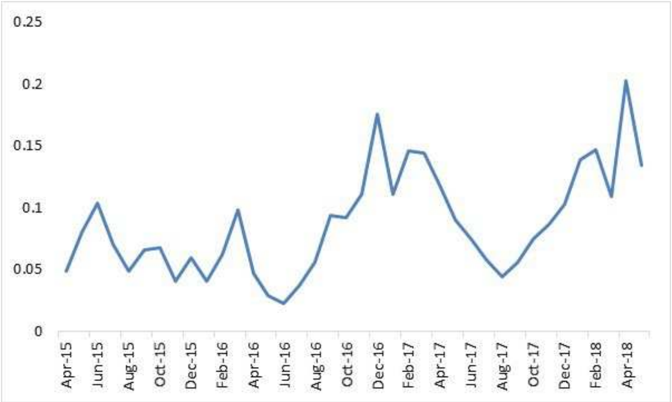
Source: SBI Research

**Arithmetic of Core Inflation (%)**

| Month | Inflation | Core Inflation Base Agnostic | Base Effect | |
|---|---|---|---|---|
| | | | Value | Comment |
| Jul-17 | 3.94 | 3.85 | 0.09 | Unfavourable |
| Aug-17 | 4.50 | 3.94 | 0.56 | Unfavourable |
| Sep-17 | 4.61 | 4.50 | 0.11 | Unfavourable |
| Oct-17 | 4.54 | 4.61 | -0.07 | Favourable |
| Nov-17 | 4.93 | 4.54 | 0.39 | Unfavourable |
| Dec-17 | 5.13 | 4.93 | 0.20 | Unfavourable |
| Jan-18 | 5.14 | 5.13 | 0.01 | Unfavourable |
| Feb-18 | 5.16 | 5.14 | 0.01 | Unfavourable |
| Mar-18 | 5.37 | 5.16 | 0.21 | Unfavourable |
| Apr-18 | 5.92 | 5.37 | 0.55 | Unfavourable |
| **Avg** | **4.92** | **4.72** | **0.21** | - |

Source: SBI Research

**Annualised Volatility in G-Sec**




Source: SBI Research

- The noise to signal ratio for the period of July'17 to May'18 comes out at 0.63 in compared 0.59 for the period of Apr'16 to June'17 shows that, there is an increase in uncertainty in the market and it further suggests that monetary policy appears to be somewhat degraded as the central bank now speaks with too many conflicting voices!

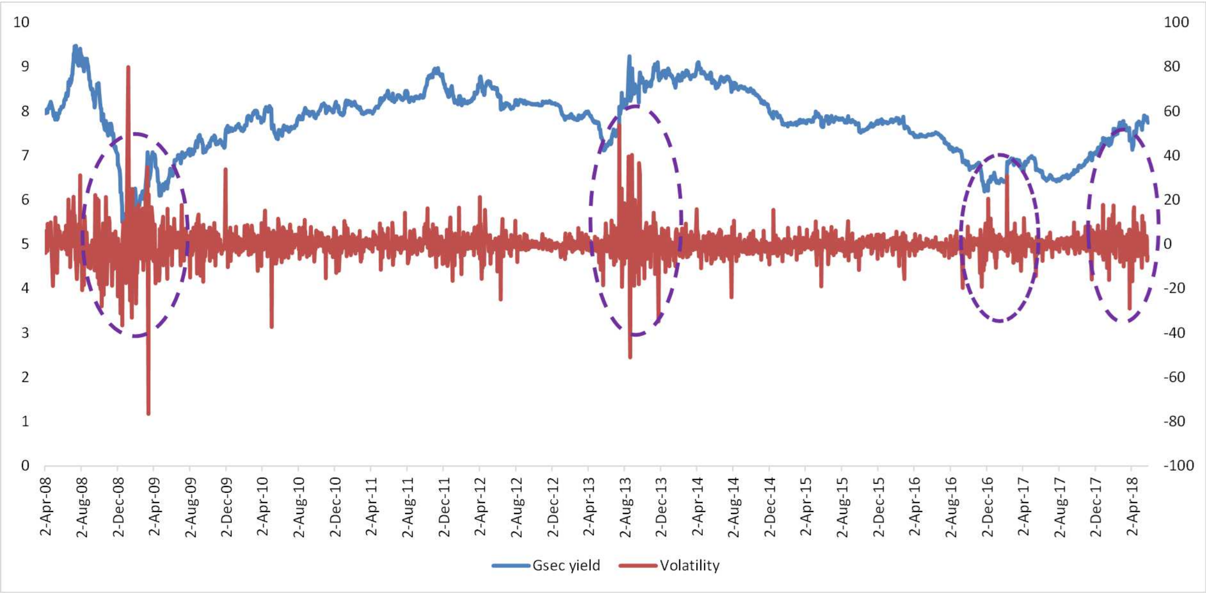
## MPC CACOPHONY

- In this context of rising noises, the "cacophony problem," as pointed out by Blinder (2004) is worth mentioning. According to his argument when monetary policy decisions are taken and subsequently explained by a committee rather than by a single individual, there is a danger that too many disparate voices might confuse rather than enlighten the public—especially if the messages appear to conflict. In his words, "*A central bank that speaks with a cacophony of voices may, in effect, have no voice at all."* On the other hand, Bernanke (2004) argues that "the willingness of FOMC members to present their individual perspectives in speeches and other public forums provides the public with useful information about the diversity of views and the balance of opinion on the Committee." Both the views hold valid. It seems to be an empirical issue. As per Blinder, "*Whether doing so is advisable or inadvisable depends, inter alia, on whether the committee has group or individual accountability*".
- **In the Indian context, we believe let the Governor speak, as too much cacophony may confuse the markets about the policy signals otherwise.**

### YIELD VOLATILITY AND MTM LOSS

- In the end, as the accompanying graph shows, volatility of 10 year G-Secs is currently at high levels, reminiscent of taper tantrum and even the 2008 crisis. Such volatility in bond market could result in financial instability, though such monitoring is not a part of an inflation targeting mandate (this is in fact, the greatest critique too of inflation targeting!). But in hindsight, the RBI by keeping the liquidity in tight leash may have already given a signal to market, and banks have also been raising the lending rates. In such a scenario, will it be thus still prudent to raise rates? Will it not be tantamount to double signalling? Let's wait for June 6 for such to unravel. But meanwhile, lets not do harakiri.

**Trend of 10 yr G-sec and Change in Yield (bps)**




Source: SBI Research

## ABOUT US

The Economic Research Department (ERD) in SBI Corporate Centre is the successor to the Economic and Statistical Research Department (E&SRD). The latter came into being in 1956, immediately after the State Bank of India was formed, with the objective of "tendering technical advice to the management on economic and financial problems in which the Bank has interest and which required expert analysis".

After the first reorganization of the Bank, when specialized departments like Management Science, Management Information Systems, Planning and Market Segment Departments took over the statistical work of E&SRD, the Department was renamed as ERD.

However, with the ERD team now taking on multidimensional functionalities in the area of risk management , corporate analytics, strategy and so on, who knows, the time may have come to rename it again!

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