SBI

# ECOWRAP

भारतीय स्टेट बैंक
STATE BANK OF INDIA

'Be the Bank of Choice for a Transforming India'

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## WILL THE JUNE RATE HIKE PERFORCE MORE HIKES BY THE RBI?

The June rate hike has found support across a cross-section of market clientele. Interestingly, even before the rate hike, it was vigorously argued that such a rate hike is warranted given the jump in core inflation to establish credibility of an inflation targeting central bank and also to support rupee. On both these counts, the data suggests otherwise.

First, credibility of a central bank is not only supported by rate hikes but also by inflation forecasts and frequent revisions. Second, the familiar textbook argument of rate hikes as a tool to fight rupee depreciation is not supported by data, as episodes of rate hike (as also rate cut) in India show rupee depreciation post a rate hike (as of now). We believe, once a rate hike is done, it becomes a self fulfilling prophecy and the market expects more rate hikes to perhaps satisfy its appetite of carry forward trade. Will this happen this time too?

In effect, increase in interest rate in India does not necessarily lead to exchange rate appreciation. Higher interest rates affect economy in various ways. First, they increase the fiscal burden of the Government through much higher borrowing costs as it is happening right now. Next, they reduce domestic investment and output in the economy because of higher working capital costs. These two will have depreciation impact on exchange rate.

We also find that beginning 1991, India witnessed 30 rate hikes, of which 23 were concentrated in 2 cycles (total of 6 cycles). This indicates that the other 4 rate hike cycles were shallow. Interestingly, if we strip out the period of 23 rate hikes that came during periods of global overheating and subsequent fiscal push and inflation spiraling, the average rate hikes come to around 2, the precise number of rate hikes that the markets expect now in the rate hike cycle.

As far as rate cut cycle is concerned, India witnessed a period of 34 rate cuts, the average being around 4, clearly the average rate cuts seems to have outpaced average rate hikes in any cycle. More interestingly, we also find that unlike developed countries like US rate hike or rate cut cycle in India is not entirely influenced by electoral cycles.

- RBI hiked the repo rate by 25 bps to 6.25% in Jun'18 after a gap of more than four years, with the last increase at the beginning of 2014. The day of the rate hike was associated with a modest appreciation of the Rupee (0.3%) and increase in yield by 8 bps. The yield on 10-year Government paper has remained on the upper end since then, however rupee has started depreciating soon after reflecting in part global uncertainties.

## INTEREST RATE DEFENCE OF EXCHANGE RATE IS OFTEN MISPLACED

- The June rate hike has found support across a cross-section of market clientele. Interestingly, even before the rate hike, it was vigorously argued that such a rate hike is warranted given the jump in core inflation (we have though argued that it also stems from a base effect and driven by Housing and Transport) to establish credibility of an inflation targeting central bank and also to support rupee. On both these counts, the data suggests otherwise.
- First, credibility of a central bank is not only supported by rate hikes, but also by inflation forecasts and frequent revisions. Second, the familiar textbook argument of rate hikes as a tool to fight rupee depreciation is not supported by data, as episodes of rate hike in India show rupee depreciation post a rate hike (as of now). We believe, once a rate hike is done, it becomes a self fulfilling prophecy and the market expects more rate hikes to perhaps satisfy its appetite of carry forward trade.
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## RATE HIKES AND EXCHANGE RATE IN INDIA

- Looking at the historical data, India has witnessed 6 rate hike cycles since 1990 (base rate is taken prior to April 2001, after which repo rate was taken).
- There were only 2 or 1 hike in each cycle before 2000, but the length of the cycles increased thereafter. The period from Oct'05 to Aug'07 witnessed 10 hikes and the rate was increased from 6.0% in Oct'05 to 9.0% in Aug'07.

Historical Rate Hike Cycles

| Rate Cycle | Jul'91-Oct'91 | Jan'98 | Jul'2000 | Oct'05-Aug'07 | Mar'10-Oct'11 | Sep'13-Feb'14 |
|---|---|---|---|---|---|---|
| No of rate hikes | 2 | 1 | 1 | 10 | 13 | 3 |
| bps increase | 200 | 200 | 100 | 300 | 375 | 75 |
| Change in Yield (bps) | - | - | 10 | 64 | 92 | 56 |
| % Change in INR/$ * | -11.7 | 2.7 | 0.6 | 11.2 | -8.9 | -1.2 |
| OMO (- Sales/ +Purchase) (Rs bn) | - | -44.88# | -62.99 (Jul'2000) | -89.62 | 672.31 | 318.21 |
| Government | Congress | NDA | NDA | UPA | UPA | UPA |
| RBI Governor | S. Venkitaramanan | Bimal Jalan | Bimal Jalan | YV Reddy | D Subbarao | Raghuram Rajan |

Source: SBI Research, * + appreciation & -depreciation, # Jan'98-Mar'98

- Next was between Mar'10 and Oct'11 during which the rate was increased 13 times from 4.75% in Mar'10 to 8.5% in Oct'11. And the last one ran for a small period from Sep'13 to Feb'14. During this period the rates were increased by 75 bps from 7.25% to 8.0%.
- Interestingly, during these rate hike cycles rupee appreciated in three cycles with the latest two periods showing depreciation of the rupee. Thus it seems that the hawkish stance has not necessarily led to exchange rate appreciation in India. Meanwhile, the Government 10-year yield increased with rate hikes during the periods for which the data is available.

## RATE CUTS ALSO LEAD TO DEPRECIATION

- If we look at the past rate cut cycles the yield declined in all the cases and the rupee depreciated against the US dollar in all episodes of rate cut, except the period during May'01-Mar'04. However, this period witnessed the maximum impact on yield, whereby 300 bps decline in the repo rate led to 495 bps decline in 10-year yield. Meanwhile the rupee depreciated steeply around 27% during the period of global financial meltdown.
- Thus, to decipher exchange rate movement from interest rate cycles is not correct. In our view, movements in exchange rate is primarily dictated by domestic fundamentals in India.

| Historical Rate Cut Cycles | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Rate Cycle | Apr'97-Oct'97 | Mar'98-Apr'98 | Mar'99-Mar'2000 | Feb'01-Mar'01 | May'01-Mar'04 | Oct'07-Apr'09 | Apr'12-May'13 | Jan'15-Aug'17 |
| No of rate cuts | 3 | 3 | 2 | 2 | 7 | 6 | 4 | 7 |
| bps decline | 300 | 200 | 200 | 100 | 300 | 425 | 125 | 200 |
| Change in Yield (bps) | - | - | -190 | -55 | -495 | -167 | -71 | -131 |
| % Change in INR/$ * | -0.8 | -0.5 | -2.7 | -3.2 | 7.5 | -26.9 | -4.3 | -2.4 |
| OMO (- Sales/ +Purchase) (Rs bn) | -30.43 | -46.75 | -342.83 | -0.41 | -1004.64 | 1115.85 | 1645.18 | 1391.82 |
| Government | Coalition | Coalition | NDA | NDA | NDA | UPA | UPA | NDA |
| RBI Governor | C Rangrajan | Bimal Jalan | Bimal Jalan | Bimal jalan | Bimal Jalan (till Sep'03), YV Ready | YV Ready (till Sep'08), D Subbarao | D Subbarao | Raghuram Rajan (till Sep'16), Urijit Patel |
| Source: SBI Research, * + appreciation & -depreciation | | | | | | | | |

- Additionally, if we look at the immediate 1-month post the first interest rate change, the interest rate increase has not necessarily led to exchange rate appreciation. During rate cut, Indian rupee depreciated in 1-month time after the first rate cut in majority of the cases. Change in yield, however, has been as expected, i.e. increase with rate hike and decline with rate cut.

| Yield and ER movements post 1-month of rate hike | | |
|---|---|---|
| Rate Cycle | Yield Change (bps) | % Change in ER* |
| Jul'91-Oct'91 | - | -12.0 |
| Jan'98 | - | 3.1 |
| Jul'2000 | 35.0 | -2.0 |
| Oct'05-Aug'07 | -7.2 | -1.7 |
| Mar'10-Oct'11 | 21.0 | 1.6 |
| Sep'13-Feb'14 | 40.7 | 0.4 |
| Jun'18- | -0.7 ** | -1.4 ** |
| Source: SBI Research, * - depreciation, ** till date | | |

| Yield and ER movements post 1-month of first rate cut | | |
|---|---|---|
| Rate Cycle | Yield Change (bps) | % Change in ER* |
| Apr'97-Oct'97 | - | 0.05 |
| Mar'98-Apr'98 | - | -0.31 |
| Mar'99-Mar'2000 | -19.2 | 0.13 |
| Feb'01-Mar'01 | -38 | -0.34 |
| May'01-Mar'04 | -32 | -0.28 |
| Oct'07-Apr'09 | -0.9 | 0.53 |
| Apr'12-May'13 | 5.5 | -5.43 |
| Jan'15-Aug'17 | -6.5 | -0.04 |
| Source: SBI Research, * - depreciation | | |

## INTEREST RATES & LIQUIDITY

- The liquidity situation during the rate cut cycles shows that the central bank purchased the Government securities, thereby injecting significant amount of liquidity in the system during the last three cycles. Even during the rate hike cycles there was injection in the last two periods but the amount was significantly less when compared to periods of rate cuts.

## ELECTORAL CYCLES

- If the electoral cycle is looked at, maximum rate cut of 500 bps were observed in 1999-04, followed by 425 bps cut in 2004-09. However, during 2009-2014 the interest rates went up steeply (450 bps).
- The rupee movement 2-months post the elections show that the exchange rate depreciated in all cases.
- However, the impact of elections on yield is not that straight forward. The yield increased in the two months post elections during the UPA Government period while it declined in the elections when NDA was elected.
- It seems unlike countries like US, rate hike or rate cut cycle in India is not entirely influenced by electoral cycles.

| Electoral cycle, rate hike/cut & yield (bps) | | | |
|---|---|---|---|
| | Government | Rate hike | Rate cut |
| 1991-1996 | Congress | 200 | - |
| 1996-1998 | Coalition Govt | 200 | 300 |
| 1998-1999 | Coalition Govt | - | 300 |
| 1999-2004 | NDA | 100 | 500 |
| 2004-2009 | UPA | 300 | 425 |
| 2009-2014 | UPA | 450 | 125 |
| 2014-2019 | NDA | 25 | 200 |
| 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!

## DISCLAIMER



## CONTACT DETAILS

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