International Commentary — April 8, 2022

Reserve Bank of India's Time to Focus on Inflation

Summary

In our view, the Reserve Bank of India's (RBI) April meeting signaled in a stark shift in the central bank's stance on monetary policy. Policymaker actions and commentary, along with the official statement and forecast revisions, indicate to us the time has arrived for the RBI to initiate its tightening cycle. The April meeting reinforced our view that RBI policymakers will lift interest rates starting in June; however, tighter monetary policy is likely not enough to prevent rupee weakness and we continue to forecast modest rupee depreciation through the end of 2022.

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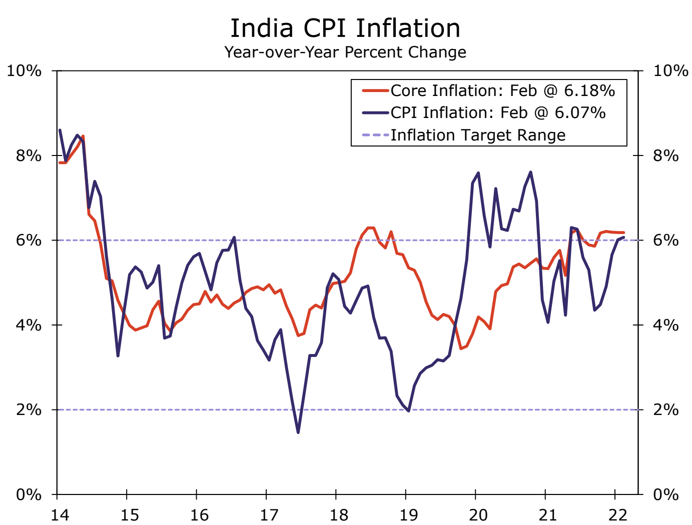
Did The RBI Just Raise Rates?

Since mid-2021 emerging market central banks have, for the most part, been some of the more hawkish institutions in the world. Latin American and EMEA central banks have raised interest rates aggressively to stave off inflationary pressures, and with few exceptions, these policymakers have generally maintained a bias toward even tighter monetary policy. Emerging Asia, however, has been a notable exception to the tighter monetary policy trend. Most of the major central banks across the region have opted not to raise interest rates, but rather keep policy settings accommodative to support growth. With the exception of the Bank of Korea, none of the major emerging Asian central banks have lifted rates, while the Peoples Bank of China (PBoC) has actually lowered interest rates and recently pledged to continue easing policy. Within emerging Asia, in our view, the Reserve Bank of India (RBI) has been on the more dovish end of the spectrum. In February, RBI policymakers pushed back against a market-priced and economist-expected rate hike, and maintained their stance to prioritize growth rather than contain rising inflation. However, **we believe the April RBI meeting signaled a key shift in how the central bank is approaching monetary policy, and we now have greater confidence policymakers will initiate a tightening cycle in June**.

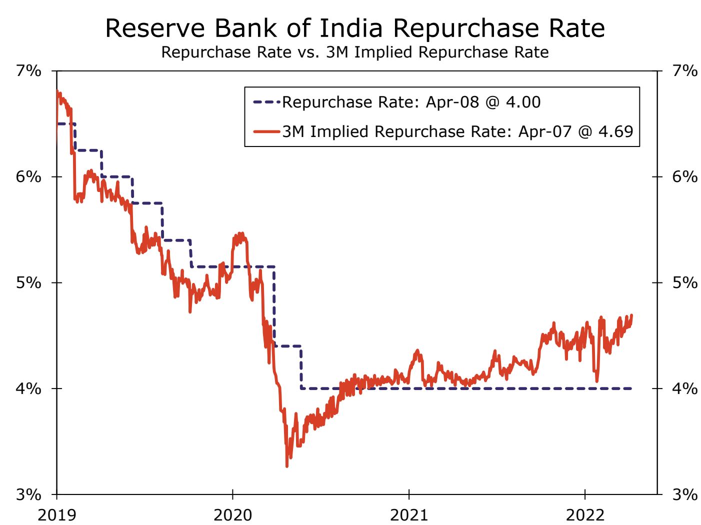
In fact, one could argue the RBI may have just raised rates, but in a stealthier form. While the central bank chose to hold its main Repurchase Rate at 4.00%, it opted to introduce a new policy rate, the Standing Deposit Facility (SDF). India operates with multiple interest rates and policy tools, the Repurchase Rate being the main policy rate, while the Cash Reserve Ratio and Reverse Repurchase Rate are also used by the RBI to set overall monetary policy. Typically, the Cash Reserve Ratio is directed at local banks and dictates the share of a bank's total deposits that must be held as liquid reserves. The Reverse Repurchase Rate is the interest rate commercial banks receive on deposits held at the RBI, and is a way to control the overall money supply in India. Historically, the Reverse Repurchase Rate has been set lower than the Repurchase Rate and acts as a floor for interest rates across the country. According to RBI Governor Das, the SDF will essentially replace the Reverse Repurchase Rate and the SDF will set the new floor for RBI interest rates. Starting in April, the SDF will be set at 3.75%, while the Reverse Repurchase Rate is currently 3.35%. **By introducing the SDF and setting the rate 40 bps higher than the Reverse Repurchase Rate, RBI policymakers narrowed the rate corridor by 40 bps and effectively tightened monetary policy at the April meeting.**

Figure 1



Source: Bloomberg Finance L.P. and Wells Fargo Economics

Figure 2



Source: Bloomberg Finance L.P. and Wells Fargo Economics

RBI Setting The Stage For June

In addition to introducing the SDF, Governor Das along with the official statement included noteworthy language that, in our view, signals the central bank is preparing to more formally and explicitly raise policy interest rates at its June meeting. First off, the RBI stated that geopolitical developments related to the Russia-Ukraine conflict are likely to have an impact on the economic outlook for India. Governor Das stated that India's growth outlook is less robust amid the sharp rise in commodity prices; however, commodity price spikes represent sizable risks to the inflation trajectory.

Against that backdrop, **Governor Das stated the central bank is now prioritizing inflation as opposed to growth, and revised the central bank's inflation forecast sharply higher**. Also, embedded in the official statement is a line stating that RBI policymakers will look to "withdraw policy accommodation to ensure inflation remains within the RBIs target band going forward, while also supporting growth." In our view, Das's comments and the official statement suggest a key shift in language and forward guidance. As mentioned, RBI policymakers previously prioritized GDP growth, and the growth focus was the primary justification for keeping interest rates steady in February. Now that policymakers have shifted their primary focus to inflationary pressures, and given inflation is already above the upper bound of the RBIs inflation target band (Figure 1), we believe policymakers are signaling interest rate hikes are imminent come June. **The April statement coupled with Governor Das' comments reinforces our view that the RBI will begin its tightening cycle in June with a 25 bps Repurchase Rate hike.**

But, **despite a view for higher policy rates we continue to believe the rupee can weaken against the U.S. dollar going forward**. Even if the RBI delivers 25 bps of rate hikes in June, the central bank will still be lagging the pace of tightening in the United States. Our U.S. economics team believes the Federal Reserve is likely to raise interest rates 50 bps in May and also begin shrinking its balance sheet. In our view, Fed actions should result in broad-based capital flows toward the U.S. dollar and place depreciation pressure on most emerging market currencies, including the rupee despite a newly hawkish RBI. In addition, financial markets are currently priced for 69 basis points of RBI tightening over the next 3 months (Figure 2). We believe current RBI pricing is too aggressive, and as markets scale back the magnitude of tightening, the rupee should weaken. With that said, we believe any rupee weakness will be rather gradual as the RBI would likely utilize its stockpile of foreign exchange reserves to limit rupee volatility. Going forward, **we expect the USD/INR exchange rate to reach INR76.75 by the end of 2022, a weakening in the rupee of a little over 1% from current levels.**

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