

Does Fed decision impact those of other central banks?

Fed recently delivered a super-sized rate cut of 50bps, bringing its policy rate down to 4.75-5%. The dot plot shows that another 50bps cut can be expected in the remainder of CY24 and then a cumulative 100bps cut in CY25. While this is more hawkish than expected, the view appears to be originating from targeting unemployment rate at 4.4% even next year, and headline and core PCE at targeted 2% mark. Latest projections have lowered GDP and inflation numbers, but indicated increase in unemployment rate estimates.

In this study, we examine the relation between Fed actions on global central banks. Historical data shows that most central banks move according to domestic conditions and are not necessarily linked with decisions taken by the Fed. As such, we do not expect RBI to change its course following this development and maintain our view that the earliest possibility of a rate cut is in Dec'24. We also believe the stance will be kept unchanged in the Oct'24 policy. Further, as major central banks have embarked upon rate cut cycles, we have also highlighted the real rates and widening spread between US and India 10Y G-Sec yields from the point of view of investor decisions. Resilience in domestic economy, and relatively attractive rates will imply that India remains a key market for foreign investors.

How Fed moved

Fed action: The Federal Reserve Bank of US (Fed), decided to lower the policy rate by 50bps in its latest meeting in Sep'24, thus bringing the policy rate down to 4.75-5%. Before the meeting, analysts were split between possibilities of 25bps or 50bps cut, as macro data points provided mixed signals. On one hand, while labour market was showing signs of cooling down, on the other hand, core CPI noted some build up in pressure in Aug'24. Non-farm payrolls in the US rose by 142k in Aug'24 (+114 in Jul'24) versus estimated increase of 160k. Manufacturing sector saw 24k decline in payrolls, following 1k increase in the previous month. On the price front, while headline CPI followed the expected trajectory and rose by 0.2% (MoM) in Aug'24, unchanged from Jul'24, core CPI inched up by 0.3% (est.: 0.2%) from 0.2% last month. Even headline PPI rose, by 0.2% (est.: 0.1%), following flat growth (0%) in Jul'24.

So what helped Fed move?: In the press conference, Chairman Powell highlighted that since the Jul'24 policy meeting, the central bank took into account two inflation and employment reports (Jul and Aug), and a Quarterly Census of Employment and Wages (QCEW) report which indicated that past payroll numbers may get revised downward in the coming months. Further, Fed also got much needed support as CPI in YoY terms eased to 2.5% in Aug'24 from 2.9% in Jul'24, moving closer to their targeted 2% mark on a durable basis. Another reason for a super-sized rate cut was that the central bank didn't want to be behind the curve. The Chair admitted that if inflation report was available at the time of Jul'24 policy then Fed might have opted for a rate cut earlier. The change in economic projections also supports their view. The bank now expects GDP growth at 2% in CY24, down from 2.1% estimated in Jun'24. Unemployment rate projection was significantly revised upward from 4% in Jun'24 to 4.4%. Both headline and core PCE inflation projections have been lowered to 2.3% (2.6% in Jun'24) and 2.6% (2.8%) respectively.

Fed cycles: We analysed how other central banks moved, when Fed delivered a rate hike or a cut. For the purpose of our analysis, we benchmarked the time period according to US Fed rate action. Looking at the data for almost past 10 years, we note that while Fed action is an important guidance factor for other central banks, it is not a deciding factor. The decision to cut or hike rates is driven more by domestic factors.

For instance, between 2015 and 2019, when Fed was seen hiking rates, ECB, BoE and RBI had mostly lowered rates. Before Fed began hiking rates in 2015, it had been on hold since Dec'08, post the financial crisis. Similarly, just before Covid-19 struck global economies, Fed had begun lowering rates, while other central banks were on hold. During Covid-19, in India, RBI delivered pre-emptive cuts to support the economy, even as other bank were either on hold or announced smaller quantum of rate cuts. Post Covid-19 all central bank moved in sync and began hiking rates. Most recently, while Fed, BoE and ECB have announced cautionary rate cuts, RBI has maintained its rates steady so far.

Table 1: Central Bank rate cycles

Cycles	US Fed	ECB	BoE	RBI
Dec'15-Jun'19	225bps hike	5bps cut	50bps hike, 25bps cut	100bps cut
Jul'19-Feb'20	225bps cut	status quo	status quo	60bps cut
Mar'20-Feb'22	100bps cut	status quo	65bps cut, 40bps hike	115bps cut
Mar'22-Jul'23	525bps hike	425bps hike	450bps hike	250bps hike
Aug'23-Aug'24	status quo	25bps hike, 25bps cut	25bps hike, 25bps cut	status quo
Sep'24	50bps cut	60bps cut	status quo	status quo

Source: Bloomberg, Bank of Baroda Research

Path ahead: The dot plot shows that Fed Governors expect room for another 50bps cut in the remainder of this year, taking the cumulative cut in CY24 to 100bps. Further, next year also, members expect rates to be lowered by another 100bps on a cumulative basis, bringing the terminal rate down to 3.5%. This is in view to keep the unemployment rate stable at 4.4% even next year. This year, there are two remaining meetings, one in November and one in December. Whether Fed will deliver another jumbo 50bps cut in Nov'24 and then a pause in Dec'24, or it will deliver two 25bps cuts, will depend on how the labour market evolves. In case a notable slowdown is visible in the run up to Nov'24 meeting, then a 50bps cut can be expected. However, most recent labour market data shows that initial jobless claims for the week ending 14 Sep fell by 12k to 219k (lowest since May'24). The 4-week moving average of continuing claims for the week ending 7 Sep also fell to 1.84mn from 1.85mn in the previous week, indicating that less people are relying upon unemployment benefits.

Real Rates

Now with Fed embarking upon a rate cut cycle, investments may be expected to move towards countries which have higher real rates. The table below compares the existing policy rates and prevailing inflation rates to arrive at real rates. Data shows that amongst some of the major global economies, Brazil and Indonesia have the highest real rates. India also has relatively higher real rates. However it faces competition with China and UK, which have similar real rates. On comparing the economic fundamentals of these economies, India remains the most attractive market, as it continues to hold the title of the fastest growing major economy. High frequency data also shows that domestic growth remains resilient, at a time when all other economies are facing significant headwinds. This is expected the help attract capital inflows into the country and support domestic yields and currency.

Table 2: Real rates

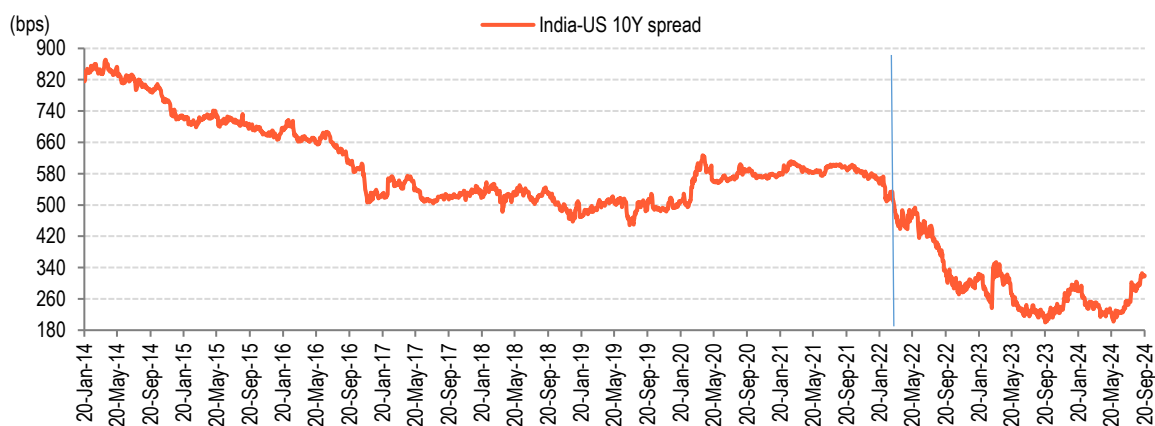
Country	Current policy rate (%)	Latest CPI (%YoY)	Real rate (%)
India	6.50	3.65	2.85
US	5.00	2.50	2.50
ECB	3.65	2.20	1.45
Japan	(0.10)	3.00	(3.10)
UK	5.00	2.20	2.80
Brazil	10.75	4.24	6.51
China	3.35	0.60	2.75
Australia	4.35	3.80	0.55
Indonesia	6.00	2.12	3.88
Thailand	2.50	2.12	0.38
Malaysia	3.00	2.00	1.00

Source: Bloomberg, Bank of Baroda Research

India-US 10Y rate differential

Over the last 10 years, the spread between India and US 10Y G-Sec has come down from the high of 871bps (Apr'14) to a low of ~200bps (Sep'23). The movement can be divided to two phases. In phase 1, policy divergence between Fed and RBI between Dec'15 and Jun'19 implied that spread between the two averaged ~558bps. After this, as Covid-19 struck and both economies lowered rates until Feb'22, the spread remained steady, averaging ~560bps. During this period, both RBI and Fed lowered rates. In the phase 2, as major central banks started hiking rates, more aggressive stance of Fed compared with RBI, led to narrowing of yields (avg: ~346bps) between India and US 10Y G-Sec. This narrow spread remained until the end of last month. Only recently it has once again gone up, as US Fed delivered a significant rate cut, while RBI is likely to maintain rates on hold for now.

Figure 1: Spread between India and US 10Y G-Sec rates



Source: Bloomberg, Bank of Baroda Research

RBI action

As we have previously seen, Fed action is more of a guiding factor for other central banks. Governor has also repeatedly clarified that RBI actions are based on domestic factors. We thus, continue to believe that RBI will maintain policy rates unchanged in the upcoming Oct'24 meet. The earliest possibility of a rate cut emerges only in Dec'24, as MPC members are likely to monitor the impact of

excess rains and food inflation before deciding to lower rates. We believe the stance will also be kept unchanged in Oct'24, as there still remains liquidity surplus in the system.

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