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Dipanwita Mazumdar
Economist

India-US rate differentials through the year

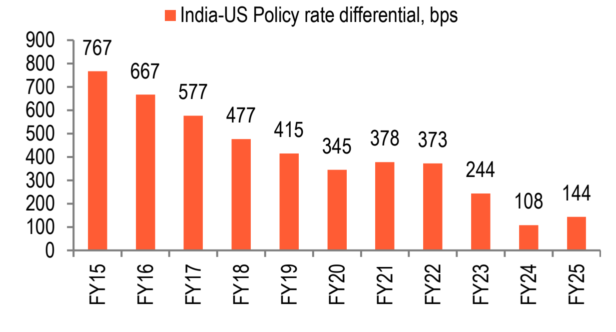
As another financial year passes by, we assess how the spread of interest rates in India vis-à-vis the US has played out. This becomes crucial in determining the direction of investment flows besides affecting currency movements. In terms of key policy rate, the differential between India and US has widened as US rate cut cycle began much earlier compared with India. The higher quantum of cuts by the Fed has resulted in this differential increasing. On the other hand, the yield differential (reflective of market rates) between India and US has exhibited some bit of deviation compared to policy differential. This spread has fallen on account of stickiness in US 10Y yield due to higher debt levels and expectations of high inflation amidst a volatile geopolitical environment. However, going forward, we expect some stickiness in yield differential in favour of India, which will be further supportive of buoyant FPI flows which will aid the rupee.

Policy rate differential

The policy rate differential between India and US underwent some correction in FY25. It started with the easing cycle of Fed which came in earlier compared with India. The turnaround in inflation in favour of the US and weakening growth indicators resulted in the same. This led to increase in policy rate differential between India and US from Sep'24 onwards. The differential widened in Dec'24 with the frontloading of monetary easing by Fed happening at a fast pace. Thus, in the current fiscal, US Fed with a total cut of 100bps compared with RBI's rate cut of 25bps has kept the policy rate differential between India and US slightly elevated compared to FY24.

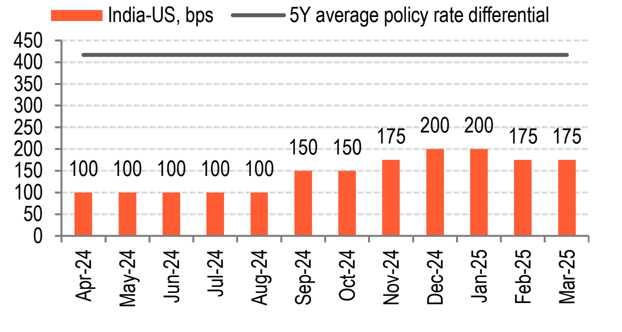
However, if we compare it to long run averages, the policy rate differential is far lower. Hence mean reversion levels might call for faster pace of easing by Fed compared to RBI. The recent Fed commentaries have also been considerably dovish hinting at inflation bump due to tighter tariff norms being transitory. The Fed projections have priced in two rate cuts of 25bps each this year. We are expecting cumulative cut by RBI of another ~ 50bps, thus policy rate differential is expected to exhibit some bit of firmness in FY26.

Figure 1: Charting India-US policy differential…



Source: Bloomberg, Bank of Baroda Research

Figure 2: …How FY25 panned out

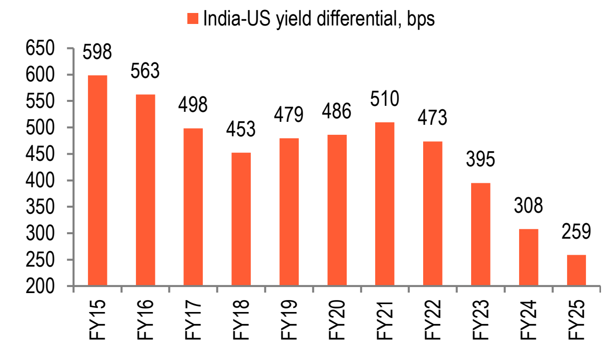


Source: Bloomberg, Bank of Baroda Research

Yield differential

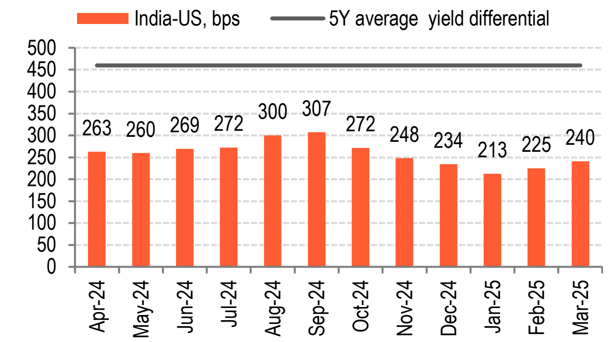
10Y yield differential between India and US has witnessed significant decline. Here a bit of an anomaly has been witnessed as the easing policy by Fed has not been translated into 10Y yield. The stiffening of the US 10Y yield is a result of higher fiscal spending and inflation expectations getting entrenched under the shift in administration. As seen in **Figure 4**, from Oct'25 onwards (just ahead of the elections), the gap has started falling due to faster pace of pickup in the US 10Y yield compared with almost range bound domestic yields. Here as well, the yield differential is far lower compared to long run averages, which signal some rebound in the same. With RBI's rate cut cycle expected to be in place as inflation is already on the downside, we estimate India's 10Y yield in the coming year to trade terminally closer to 6.5%. Risk off sentiments on the other hand is expected to put downside pressure on US 10Y yield and with largely capped domestic yields, we expect that the yield differential between India and US to widen.

Figure 3: India-US 10Y yield differential…



Source: Bloomberg, Bank of Baroda Research

Figure 4: …How FY25 panned out

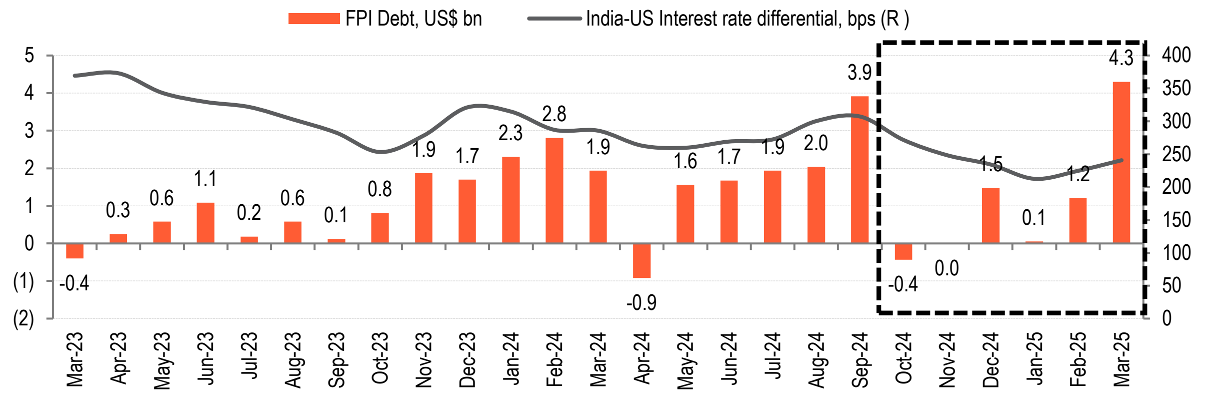


Source: Bloomberg, Bank of Baroda Research

Higher yield differential to support capital flows

As per the theory of interest rate parity, the widening spread between India and US yield is expected to attract higher capital flows. However, this is contingent on the evolving domestic growth and inflation scenarios. Ceteris paribus, data shows that since Oct'24 onwards, with the moderation in yield spread between India and US, FPI flows (debt) have slowed down. Further, if we discount the FAR debt flows, the FPI moderation in flows is even sharper. It is important to mention that capital outflows have been affected by factors such as interest rate spread, currency volatility and inflation among other factors.

Fig 5. Falling yield differential between India and US and moderation in FPI debt flows have gone hand in hand in recent times

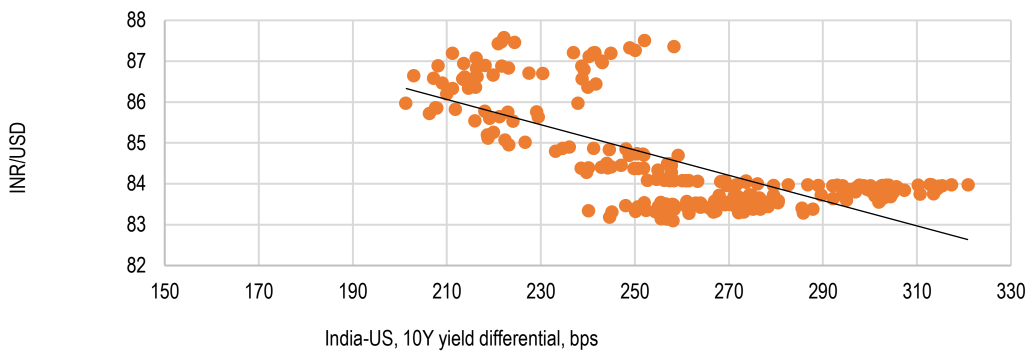


Source: Bloomberg, Bank of Baroda Research

The volatility in FPI debt flows have also had an impact on the rupee which has tended to depreciate. Further, during this period the dollar has been strengthening due to the policies articulated by the US President.

Fig 6 shows a negative relationship between yield differential between India and US and INR/USD. (Please note: a higher INR/USD implies a depreciating currency). Hence a falling interest rate differential tilted in favour of the US implies a depreciating currency. Interestingly, **Fig 5 and Fig 6** holds similarity.

Fig 6. A strong negative relationship exists between spread and INR/USD in FY25

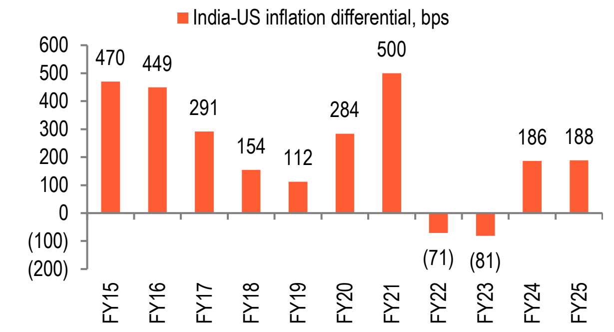


Source: Bloomberg, Bank of Baroda Research

Inflation differential:

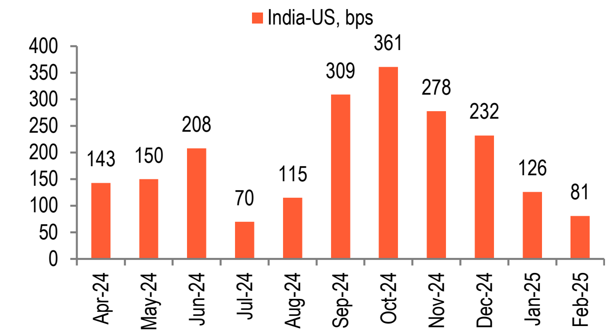
The inflation differential between India and US was largely maintained at the FY24 levels. The major loss of momentum has been seen since Jan'25 onwards as inflation in India softened considerably driven by correction in food prices. Going forward, we expect inflation differential between India and US to be ~ 200bps. Inflation in the US is likely to exhibit some bit of firmness on account of the tariff related issues. For India, since CPI basket has limited pass through in terms of imported inflation, we do not foresee major risks.

Figure 7: India-US 10Y inflation differential…



Source: Bloomberg, Bank of Baroda Research

Figure 8: …How FY25 panned out



Source: Bloomberg, Bank of Baroda Research

US and India growth picture:

US high frequency indicators are giving at times conflicting signals. There is some moderation on producer pricing power though consumer prices remain relatively firm. Labour market conditions of the region are stable. However, earnings are still sticky. Consumption demand is showing some blip as retail sales, new home sales and consumer confidence data are softening compared with earlier months. Manufacturing and services data remained supportive. Recent commentaries of Fed officials also hint at caution going ahead. Hence, the future course of action by the Fed would be interesting. The upcoming rate action will not only be contingent on tariff impact of inflation but its spillover effect on other parameters such as growth and employment conditions.

Table 1: High frequency data of the US

% YoY	Sep-24	Oct-24	Nov-24	Dec-24	Jan-25	Feb-25	Mar-25
CPI	2.4	2.6	2.7	2.9	3.0	2.8	
Core CPI	3.3	3.3	3.3	3.2	3.3	3.1	
PCE	2.7	2.8	2.8	2.9	2.6		
PPI	-0.8	0.9	2.0	2.7	2.9	2.1	
Retail sales (MoM)	2.0	3.0	4.0	4.4	3.9	3.1	
Unemployment rate	4.1	4.1	4.2	4.1	4.0	4.1	
Change in Non-farm Payroll (MoM, 000s)	240	44	261	323	125	151	
Avg. hourly earnings	3.9	4.1	4.2	4.0	3.9	4.0	
Industrial production (IP)	-0.4	-0.3	-0.2	1.1	0.3	0.8	
Core Capital goods orders non-defense (excl. Air)	-0.1	0.4	0.2	0.3	-0.2	0.9	
ISM manufacturing	47.5	46.9	48.4	49.2	50.9	50.3	
ISM services	54.5	55.8	52.5	54.0	52.8	53.5	
Trade Balance, US$ bn	-85.0	-73.7	-78.2	-98.1	-131.4		
Conf Board Consumer Confidence	99.2	109.6	112.8	109.5	105.3	100.1	92.9
New home sales	726	623	676	713	664	676	

Source: Bloomberg, Bank of Baroda Research, Note: Green scale: Improvement, Yellow scale: Median range, Red scale: decline, IP & core capital goods orders in MoM SA, ISM and Conf Board Consumer Confidence data is in index, Trade Balance is SA, New home sales data in Total SAAR

High frequency data of India as well showed mixed picture. The rural recovery is underway as seen in domestic tractor sales. However, some indicators of urban consumption demand such as auto sales and vehicle registration remain muted. Credit demand remains buoyant. Production in the manufacturing sector is showing recovery, while the services sector holds ground. Going forward, some upward correction in growth fundamentals will be visible supported by favourable domestic policies. However, stricter tariff regime remains key risks for India's exports.

We expect monetary easing and liquidity conditions to be growth inducing in the near term. However, for India, conducive inflation numbers, less dependence of food basket on imported commodities and late start to the easing cycle gives more headroom for RBI to give growth the desired impetus. For the Fed, a more cautious approach seems to be the way forward.

Table 1: High frequency data of India

(% YoY)	Sep-24	Oct-24	Nov-24	Dec-24	Jan-25	Feb-25	Mar-25
Domestic Tractor sales	2.4	21.0	-0.9	13.3	11.1	30.9	
Two Wheeler Sales	-8.5	36.3	15.8	-17.6	4.2	-6.3	
IIP: Manufacturing	4.0	4.4	5.5	3.4	5.5		
Auto Retail Sales	-9.3	32.1	11.2	-12.5	6.6	-7.2	
Passenger Vehicle sales	-18.8	32.4	-13.7	-2.0	15.5	-10.3	
Vehicle Registration	-8.6	33.4	11.9	-11.9	7.5	-6.9	
Air Passenger (All airports)	8.1	9.8	13.2	10.5	13.5	11.2	
GST E-way bill (in mn)	109.1	117.3	101.8	112.0	118.1	111.6	
Port cargo volume (tn mn)	65.7	68.2	67.5	72.3	76.9	72.4	
Diesel consumption	-1.9	0.1	8.5	6.0	4.2	-1.3	
Credit growth	13.0	11.5	10.6	11.2	11.4	11.0	11.1*
Exports	-0.2	16.6	-5.1	-1.2	-2.4	-10.9	
Imports	7.3	1.1	16.0	1.9	10.3	-16.3	
Manufacturing PMI	56.5	57.5	56.5	56.4	57.7	56.3	57.6
Services PMI	57.7	58.5	58.4	59.3	56.5	59	57.7

Source: Bloomberg, Bank of Baroda Research, Note: Green scale: Improvement, Yellow scale: Median range, Red scale: decline, PMI is the index value,*: Latest fortnight

What to conclude?

Putting all the pieces together, the following can be said:

- Policy rate differential between India and US has widened in FY25. This is on account of steeper rate cut cycle by Fed till now, compared to RBI. On the other hand, RBI's rate cut cycle came much later as inflation was the major barrier. Going ahead as well, we expect policy rate differential between India and the US to show some upward bias but the extent would dependent on underlying geopolitical dynamics and its impact on future monetary policy decisions.

- Yield differential in an ideal situation should mirror policy rate differential. However, the similar was not observed in FY25. Yield differential between India and US has softened in contrast to stiffening of policy differential between India and US. This is on account of firmness in US 10Y yield due to expectation of higher inflation. However, we expect some firmness in India and US yield differential since risk off sentiment will keep US 10Y yield capped to some extent. For India, the benchmark yield has largely been rangebound.

- The higher yield differential between India and US in the near term will be supportive of FPI flows and hence is expected to provide currency some support.

- Inflation differential will also be tilted in favour of India as domestic food prices are largely contained. This will give RBI further headroom for more policy space to support growth.

For further details about this publication, please contact:

Economics Research Department
Bank of Baroda
+91 22 6698 5143
chief.economist@bankofbaroda.com
dipanwita.mazumdar@bankofbaroda.com