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Dipanwita Mazumdar
Economist

Update on India and US rates:

India and US 10Y yield differential is seen inching up since March'23. This is on account of faster pace of decline in US 10Y yield compared to India's 10Y yield, which is less elastic. Several factors have been at play.

- There has been synchronized drop in US CPI since Jan'23 both on sequential and YoY basis. The PCE and core PCE index (closely tracked by Fed for inflation) have showed continuous moderation. Producer prices have fallen on sequential and YoY basis.
- The average hourly earnings have also fallen on a sequential basis, non-farm payroll numbers have also fallen since Jan'23, signaling some degree of slowdown in the economy.
- Slowdown in industrial production (both sequential and YoY), ISM manufacturing index also indicates that US economy is losing some stem.
- Fed's Beige Book also highlighted that signs of stress are visible in manufacturing activity and lending volumes.
- Market is pricing in a 25bps in the next policy and thereby a pause either from May/Jun onwards. Further slowing of the economy may even call for an easing policy space towards next year.

Table 1: India and US 10Y yield differential have inched up

Average for	US 10Y yield	India 10Y yield	Yield Differential, bps
Jan-23	3.54	7.33	379
Feb-23	3.75	7.35	361
Mar-23	3.66	7.36	369
Apr-23	3.45	7.22	377

Source: Bloomberg, bank of Baroda Research Average for the month taken for computation of yield

- The policy rate differential between India and US has fallen on the other hand. This is because of faster pace of increase in policy rate of US (+50bps increase in the past three months) compared to India (+25bps increase in the past three months).

Table 2: India and US 10Y policy differential have fallen

	US Fed fund rate (mid-point)	India's repo rate	Policy rate Differential, bps
Jan-23	4.375	6.25	188
Feb-23	4.625	6.50	188
Mar-23	4.712	6.50	179
Apr-23	4.875	6.50	163

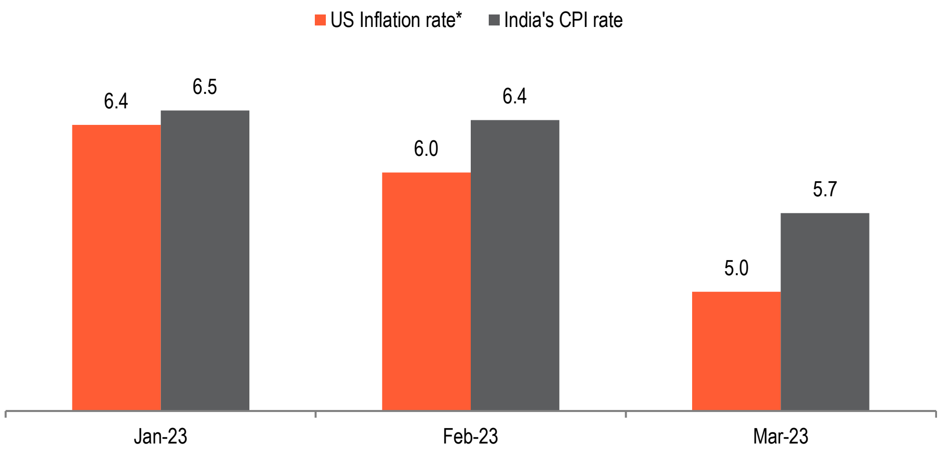
Source: Bloomberg, bank of Baroda Research, Average for the month taken for computation of policy rate

So how interest rate and policy rate differential between India and US is would pan out?

This is contingent on the underlying inflation and growth dynamics:

Inflation dynamics: Currently the inflation differential between India and US is rising, due to faster pace of falling US inflation rate. Going forward, this would be the guiding trajectory. For India, we expect some degree of moderation in CPI rate at around 5.5-5% range in the coming fiscal, where US CPI is likely to settle around 2.5%, which would translate to around 250-300bps inflation differential between India and US. In fact, the faster pace of decrease in US inflation (due to slowdown in the economy) compared to India's inflation (shocks to food inflation and considerably buoyant demand conditions), would keep the differential elevated.

Fig 1: India and US inflation differential rising



Source: Bloomberg, bank of Baroda Research *US CPI is used

Growth dynamics: On growth front, India's high frequency indicators are favourable. On the other hand, macro indicators in the US are showing some softening on account of the impact of past policy transmission, as Fed rate hike cycle is steeper compared to India's. In India, the lag impact of past policy transmission is likely to materialize from Q1FY24 onwards. However, the catch up to slowdown will be slower. Hence this is likely to keep growth differential between India and US higher which will in fact keep policy rate differential between India and US at an elevated level.

Table 3. High frequency indicators in the US showing some degree of slowdown

% YoY	Jan-23	Feb-23	Mar-23
US CPI	6.4	6	5
Core CPI	5.6	5.5	5.6
PCE	5.3	5	
US PPI	5.9	4.9	2.7
Retail sales (MoM,)	3.1	-0.2	-1
Unemployment rate	3.4	3.6	3.5

% YoY	Jan-23	Feb-23	Mar-23
Change in Non farm Payroll (MoM, 000s)	472	326	236
Avg. hourly earnings	5.2	5.3	5.1
Industrial production	1.4	1.0	0.5
ISM manufacturing	47.4	47.7	46.3
Exports	13.5	8.1	
Imports	3.8	0.7	

Source: Bloomberg, bank of Baroda Research, For ISM, it is the index value

Table 4. High frequency indicators in India are still positive

(% YoY)	Jan-23	Feb-23	Mar-23
Domestic Tractor sales	16.0%	11.8%	10.1%
Two Wheeler Sales	10.1%	14.8%	12.4%
IIP: Manufacturing	4.0%	5.3%	
Auto Retail Sales	13.6%	16.0%	13.9%
Passenger Vehicle sales	21.9%	11.0%	14.4%
Vehicle Registration	18.7%	-6.6%	14.3%
Air Passenger (All airports)	101.0%	64.4%	
Rail Freight Traffic	3.8%	3.6%	3.8%
Port cargo volume	12.2%	12.0%	
Credit growth	16.3%	15.5%	15.0%
Exports	1.6%	-0.4%	-13.9%
Imports	-0.5%	-4.8%	-7.9%
Manufacturing PMI	55.4	55.3	56.4
Services PMI	57.2	59.4	57.8

Source: Bloomberg, bank of Baroda Research, PMI is the Index value

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For further details about this publication, please contact:

Economics Research Department
Bank of Baroda
chief.economist@bankofbaroda.com