28 July 2022

Aditi Gupta
Economist

US Fed hikes rate again

In line with market expectations, US Fed hiked policy rate by 75 bps in its latest meeting. Hence, Fed funds rate now stands in the range of 2.5%-2.75%. The FOMC statement noted that inflation remains elevated and labour market conditions remain tight thus necessitating the rate action, even though economic activity appears to have slowed down. Against this backdrop, the RBI meets next week to deliberate on the monetary policy. We believe that the MPC may hike rates by only 25 bps, instead of a front-loaded hike of 50 bps or higher. Inflation trajectory has evolved much in line with RBI's projections, and in absence of any fresh shocks is likely to moderate in the coming quarters. Softening oil prices and a stabilizing currency will also help ease pressure on the inflation outlook.

Fed statement:

In its latest policy meet the Federal Reserve Open Market Committee (FOMC), raised policy rates by 75 bps. This followed a 75 bps increase in the last policy meet and was the 4th rate hike this year. Cumulatively in CYTD22, the Fed has now raised rates by 225 bps, to combat record-high inflation. It must be noted that US inflation surged to a more than 40-year high of 9.1% in Jun'22. It further noted that, labour conditions remain tight and economic momentum has softened.

Some important observations are:

- FOMC seeks to achieve maximum employment and inflation at the rate of 2% over the longer run.
- In addition, the Committee will continue reducing its holdings of Treasury securities and agency debt and agency mortgage-backed securities, as described in the Plans for Reducing the Size of the Federal Reserve's Balance Sheet that were issued in May.
- The Committee is strongly committed to returning inflation to its 2% objective.
- In assessing the appropriate stance of monetary policy, the Committee will continue to monitor the implications of incoming information for the economic outlook.
- It would be prepared to adjust the stance of monetary policy as appropriate if risks emerge that could impede the attainment of the Committee's goals.

Impact on RBI policy:

While the Federal Reserve has raised by 225 bps in CY22, RBI has raised repo rate by 90 bps. Aggressive rate hike by Fed are feeding expectations that the RBI may also front load its rate hikes. *However, conditions in India do not warrant an aggressive stance by RBI.* This is because domestic inflationary pressures have shown signs of stabilization. Retail inflation in India surged to 7.3% in Q1FY23 and is likely to remain elevated in Q2FY23, led by base effect. Further, risks to the inflation outlook have subsided. Global commodity prices including oil, have moderated from their peaks. Further, after depreciating sharply in Jun and Jul'22, INR is showing signs of stabilization which also bodes well for the inflation outlook. Overall, in the absence of any fresh shocks, India's inflation trajectory is likely to evolve in line with RBI's projections. Hence we expect that RBI may hike rates by only 25bps in Aug'22, followed by another 25bps rate hikes in the next two meetings.

For further details about this publication, please contact:

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