

RBI Watch: Eating Frogs

"If it's your job to eat frogs, it is best to do it first thing in the morning. And if it's your job to eat two frogs, it is best to eat the biggest one first." - Mark Twain

- Arguably, **RBI hikes are a matter of "when", not "if"**. And *sooner rather than later* (at the August meeting), makes sense and **mitigates unnecessary pain**. Especially **from rupee pressures**.
- **Admittedly**, the **RBI prefers to tackle** problematic, and arguably overdone, **rupee depreciation with non-rate (hike) policy options** - as it already has with a suite of tools.
- But this is precisely why an out-of-consensus rate hike in June makes perfect sense.
- Most importantly, it would **assuage self-defeating concerns** of *draconian capital controls* and/or *FX reserve being squandered*.
- What's more, not all rate hikes are created equal.
- And a **sooner-than-expected hike**, *which strategically precedes a significant inflation run-up*, **tends to be most constructive for rupee**.
- Crucially, moving ahead of inflation is often the best way to **avoid having to overcompensate with rate hikes later**.
- Afterall, the *series of diesel and petrol price hikes* – four in just May – will inevitably have a **"long inflation reach"**, threatening to lift inflation to uncomfortably elevated levels.
- **More so, as it conspires with pipeline fertilizer shortage** (possibly exacerbated monsoon-related crop disruption) to **propel food inflation** - already set to rise from unsustainably low levels.
- Point being, April's **consumer inflation fairly steady at 3.5% despite WPI accelerating past 8%** (from sub-4%) is **not inflation immunity**, but **delayed inevitable pipeline risks exacerbated by rupee-import channel vulnerabilities**.
- Yes, **rate hikes do not solve shortages** - be it fuel or food.
- And they most certainly **don't end wars**.
- So, the **argument for looking through (US-Iran) war- induced inflation** and to **tackle rupee weakness separately is compelling**. And now understandably the **consensus**.
- **But rupee and rates** are **inextricably linked**.
- It is not just that rate hikes will likely *alleviate* (albeit *not necessarily eliminate*) *destabilizing reflexive rupee depreciation pressures*, which inflict a cost far higher than the drag from rate hikes.

- In addition, rate hike could *counterintuitively check the upside in long-end yields* by containing sharp rise in risk premia (at least partly associated with reflexive rupee sell-off).
- In any case, **with inflation potentially set to test 4.5-6.0% from sub-4% pre-Iran** (underlying) inflation **hiking by 50-75bp over the next 6-9 months** will **blunt the erosion in real yields**.
- And this **ought to pay valuable policy dividends** by *bolstering overall macroeconomic stability*.
- Our argument is that it's better not to delay the inevitable at the risk of incurring the "penalty" of more hikes down the road.
- So, the RBI might in fact do better to "eat the (rate hike) frog" upfront. And **better now than to wait till August or later**.
- *Even then, rupee may only stabilize 94-96 rather than surging to pre-Iran 90-92.*
- Especially as lagged supply disruptions continue to ripple through, with disproportionate pain for India.

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