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Global central banks actions in retrospect

Ever since the Covid-19 pandemic, the role of monetary policy has gained prominence in both political as well as social debates across the world. In recent times, there have been arguments over the impact of global monetary policy decisions, especially the Fed, on domestic monetary policy. However, the RBI has always maintained that its monetary policy decisions are governed by domestic price and financial stability considerations and not influenced by what other global central banks are doing. In the last few years, global monetary policy underwent a significant set of challenges in the form of Covid-19 and low inflation, and then a complete reversal of the inflation trajectory. This called for a proactive and often synchronized policy response of monetary policy.

With this background, in this study we are tracing the movement in global monetary policy decisions in the last few years. It must be mentioned here that most countries faced a similar set of challenges during each of these periods, marked by aggressive policy easing during the peak of pandemic followed by aggressive policy tightening as inflation accelerated and then a period of a pause in policy rates. This information has been summarized in Table 1. It must be mentioned here that Bank of Japan remained an outlier all throughout each of these phases, standing pat on its ultra-dovish policy stance. However, with inflation in the region creeping up considerably in the last few months, the central bank recently raised its policy rates for the first time in last 17-years. China too remained an outlier as its economy continued to struggle post the Covid-19 pandemic and the property sector crisis. As a result, People's Bank of China (PBOC) has been cutting rates to support domestic growth.

Phase 1: Covid-19 pandemic

When the Covid-19 pandemic broke out, economic activity practically came to a standstill, curtailing growth severely. Global central banks responded by cutting policy rates aggressively, to spur growth and investment. This was a period of synchronized monetary policy easing across the globe, one which the world had not seen since the global financial crisis.

By Mar'20-Apr'20, most major global central banks had already cut their respective policy rates to multi-year lows. The US was the first major central bank to cut rates, to a low of 0.25% in Mar'20. Even in the UK, the Bank of England slashed its policy rate to as low as 0.1% in Mar'20 from 0.75% at the end of 2019. In Europe, the policy rate was already at 0%.

In China, the 1Y loan prime rate or LPR was reduced to 3.85%. In India, RBI reduced the policy rate successively from 5.15% at the end of 2019 to 4% by Mar'20. At this point, India's policy rate differential with UK stood at 390bps and with US at 375bps.

Table 1: Policy rates of major central banks

Country	Low		Start of policy tightening		Peak	
	Month	Rate (%)	Month	Rate (%)	Month	Rate (%)
Australia	Nov'20	0.10	May'22	0.50	Nov'23	4.35
Brazil	Aug'20	2.00	Mar'21	2.75	Jul'23	13.75
Canada	May'20	0.25	Mar'22	0.50	Jul'23	5.00
China*	Apr'20	3.85	Dec'21	3.80	Aug'23	3.45
Europe	NA	0.00	Jul'22	0.25	Sep'23	4.50
India	May'20	4.00	May'22	4.40	Feb'23	6.50
Mexico	Feb'21	4.00	Jun'21	4.25	Mar'23	11.25
New Zealand	Mar'20	0.25	Oct'21	0.50	May'23	5.50
Russia	Jul'20	4.25	Mar'21	4.50	Mar'22	20.00
South Africa	Jul'20	3.50	Nov'21	3.75	May'23	8.25
South Korea	May'20	0.50	Aug'21	0.75	Jan'23	3.50
UK	Mar'20	0.10	Dec'21	0.25	Aug'23	5.25
US (Upper bound)	Mar'20	0.25	Mar'22	0.50	Jul'23	5.50

Source: Bloomberg, Bank of Baroda Research | Note: For China, interest rates have been declining since the Covid-19 pandemic

Phase 2: Return of inflation

Towards the middle of 2021, as economic activity started to normalize, global central banks were confronted with the resurgence of inflation. With demand increasing and supply chains still constrained, inflation started to increase at a rate faster than anticipated. By the end of 2021 there was a sharp increase in prices of oil, food, electricity etc. To bring inflation under control, higher policy rates were warranted. However, monetary policy response differed across countries. EM countries were the first to respond, with central banks in Brazil, Mexico and Russia starting to raise rates between Mar-Jun’21.

On the other hand, central banks in advanced economies (AE) such as US, UK, Europe were slower to respond. The Russia-Ukraine war acted as a catalyst, leading to a sharp pickup in commodity prices, especially oil. This was also fed into prices of other goods and services, which led to a significant pass-through into core inflation. Amongst major central banks, the Fed (Mar’22) and the European Central Bank (Jul’22) were amongst the last to raise rates. In India, the policy tightening commenced from May’22, with the repo rate being increased to 4.4%.

During this phase, India’ policy rate differential with US, UK and Europe increased as RBI front loaded its first rate hike and raised repo rate by 40bps.

Phase 3: Peak of interest rates

While inflation in several developed and emerging markets trailed much above the central banks’ targets, tightening labor market conditions also impinged on price stability. Worries over the second-round effect of price shocks and inflation becoming increasingly entrenched, elicited a prolonged phase of policy tightening by global central banks. As a result, central banks globally moved quickly to increase rates to a sufficiently restrictive level and keep them there, until policymakers were sure that inflation would return to target. This marked the peak in the interest rate cycle.

For most of the central banks, this point was reached during H2CY2023. For the US, the policy rate peaked in Jul’23 to 5.5%, starting from Mar’22. For the UK, the policy rate took 20 months to reach its peak. On average, it took global central banks about 20 months to achieve the peak policy rate. In comparison, in India policy rate was at its peak within 9 months from the start of the rate cut cycle.

In terms of the magnitude of rate hikes, India has been at the lower end, increasing policy rate by only 250bps (from Covid-19 low). In fact, the increase in case of India has brought the policy rate to the average in the last ten years or so. On the other hand, the policy rate in the US has been increased by 525bps, in the UK by 515bps and Europe by 450bps. Amongst emerging markets, policy rate in Mexico was increased by 725bps, in Brazil by 1,175bps and Russia by 1,575 bps.

As a result, interest rate differential between India and other major economies has narrowed considerably. With the US, the interest rate differential stands at 1%, with the UK at 1.25% and Europe at 2%.

How do real policy rates look?

With these peak rates being achieved, the real policy rate which is the central bank minus CPI inflation merits some discussion. For India it is 1.4%. For the USA it is 2.3%, UK 1.25%, China 2.75%, and Euro 1.9%. Here, India’s real repo rate looks well below some of the developed nations. For the emerging economies it was 2.85% for South Africa and over 9% for Brazil.

<u>Where are policy rates headed?</u>

While commodity prices started to ease during 2023, policy rates remained elevated as central banks assessed the pass through to the real economy. Policy rates in major economies are currently at a peak even as inflation is slowly returning to targeted levels. However, given that economic activity and labor market have so far not shown much deceleration, central banks do not want to rush into policy easing. Some EM countries such as Brazil have already started to cut rates. On the other hand, AEs have adopted a much more cautious approach.

<u>What does this mean?</u>

As has been mentioned above, the policy rate differential between India and US stands at 100bps which is considerably lower than historical levels. This is because the Fed was much more aggressive than the RBI to raise rates. A lower rate differential inter alia implies a lower premium for foreign investors and hence lesser foreign inflows. However, this does not seem to hold in relation to India. FPI inflows into India have remained buoyant, as India’s growth momentum is expected to remain strong. Furthermore, while the Fed has already indicated that policy rates are likely to be reduced in the coming months, the growth and inflation dynamics in India suggests that RBI may just keep rates elevated for longer than that. In any case, the Fed is likely to cut interest rates much more than the RBI which will ensure that the interest rate differential settles somewhere close to the historical trend.

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