India's central bank leaves rupee on the path to free fall

By keeping the policy on hold, it seems the central bank of India has dumped the rupee, which leaves the ball in the government's court for more substantial currency stabilisation measures. We just revised our year-end USD/INR forecast to 75.0 from 73.5, though now it seems, maybe it wasn't enough

Source: Shutterstock

6.50%

RBI repurchase rate, unchanged

Worse than expected

RBI surprises by keeping rates unchanged

The Reserve Bank of India's monetary policy committee voted 5-1 to keep the repurchase and reverse repurchase rates unchanged at 6.50% and 6.25% respectively at today's meeting. One dissenter vote was in favour of a 25bp rate hike. Even as most MPC members voted to change the stance to a calibrated tightening, there was an evident lack of action on their part despite time running out to stop the rupee's worst fall in last five years.

The decision was surprising for us and many others as only nine out of 49 participants in the Bloomberg poll had predicted no change, which seemed to be impacted by domestic liquidity concerns rather than currency weakness, even as a depreciating rupee remains a constant threat to the RBI's inflation target. We thought the RBI would give some thought to supporting the rupee in a pre-emptive move to curb future inflationary pressures, however, in the end, we and many others were wrong.

The stable policy might be consistent with inflation within the policy target of 2-6%, however, as we have noted earlier this is more of a transitory low inflation phase rather than an ever-lasting trend. And we don't have to wait for too long to see the recent dip in inflation being reversed. We anticipate a bounce back in inflation above the 4% mid-point of the policy target next Friday, thanks to the double whammy of rising oil prices and the weak currency.

After a moderate slippage in July and August, oil has caught up with the steady upward momentum, and this will eventually come through in domestic fuel prices. Even the move earlier this week to cut retail fuel prices (1 rupee per litter) appears too small to make an impact on overall inflation, let alone satisfy consumer or the markets.

Ball is now firmly in the government's court

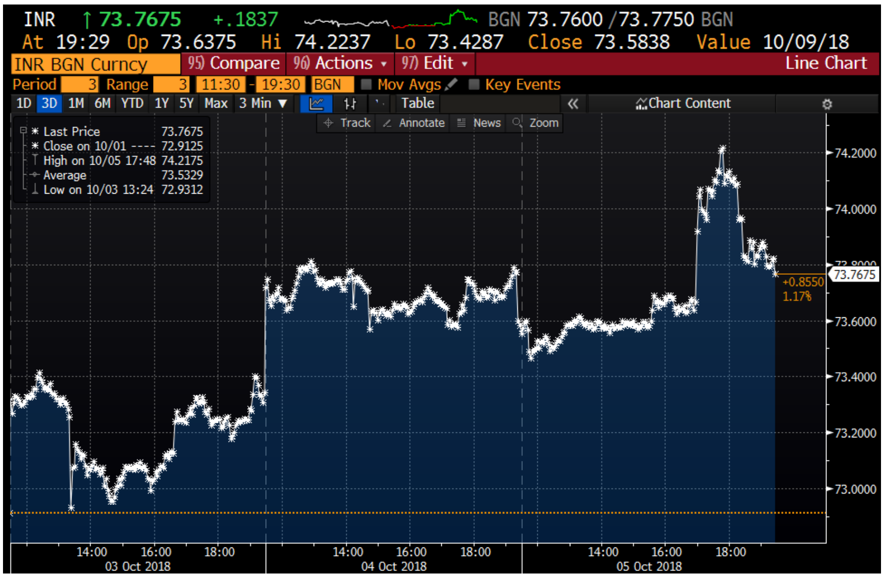
Not only the central bank, but the government also appears to have taken a backseat on the currency. And today's decision shifts the onus to the government for substantial currency stabilisation measures.

While the measures announced by the government so far have proved to be insufficient, the authorities seem to be dragging their feet on the other required actions. Such a policy backdrop leaves the rupee on the path to a free fall, the first test of which came as the USD/INR spiked above the 74 level in a knee-jerk reaction to the RBI announcement, although it retraced to 73.8 as of this writing.

Ahead of the RBI meeting, we revised our end-2018 USD/INR forecast from 73.5 to 75.0 based on the view that even if the central bank tightened by a 50bp rate hike, it wouldn't be enough to support Asia's most stressed currency. We now feel that wasn't enough of a push and are now looking to downgrade further.

Meanwhile, we continue to expect an RBI rate hike at the December policy meeting.

USD/INR spikes above 74 in a knee-jerk reaction to RBI decision



Source: Bloomberg