India: Market stability isn't enough for central bank to pause tightening

Will the Indian central bank take comfort in the current market stability, and not disturb the poise? We don't think so. The RBI tightening cycle has just begun and has a leg to run further, even beyond the meeting next week

Source: Shutterstock

We share the consensus view that the Indian central bank will tighten monetary policy by another 25bp next week which may lend some more stability to the Indian rupee. The excessive currency weakness was the trigger for the previous rate hike in June, though the recent currency stability provides no reasons for the central bank to pause tightening.

But key headwinds to currency appreciation are unlikely to disappear and include high inflation, widening current account and fiscal deficit and rising political uncertainty in the run-up to general elections in early 2019.

We maintain our forecast of USD/INR rate trading toward 71.5 by the end of the year. (spot 68.6)

Some market stability

July turned out to be a better month for Indian financial markets in comparison to the last four months, as reduced confidence-sensitive capital outflows from equity and government bond markets offered some stability to the rupee (INR).

However, this was in sync with the broader stability observed in the global emerging market space, which is surprising given that this is the month when the trade war rhetoric moved to onslaughts, thereby intensifying downside growth risk and financial risk aversion.

6.5%

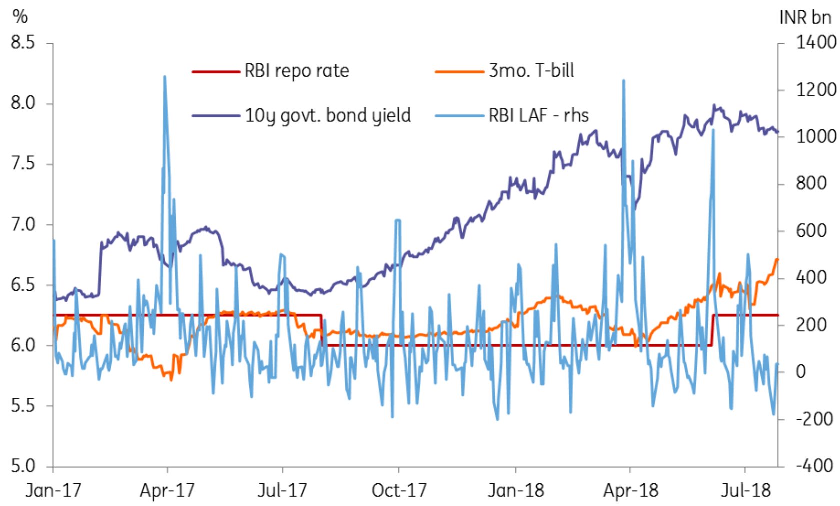
Forecast for RBI repo rate

25bp increase

That said, we don't believe the worst is over just yet.

Tight domestic liquidity continues to pressure the market interest rates higher as the next bi-monthly central bank meeting approaches. But only eight out of 28 forecasters in the Bloomberg survey think the RBI monetary policy committee will take comfort in the current market stability and not disturb the poise. We are in the majority forecasting a 25bp policy rate hike next week, the second hike this year and markets have clearly priced the same.

Tight liquidity is pressuring market rates higher



Source: Bloomberg, ING

More policy tightening ahead

However, we don't think this will be the last policy move in the current tightening cycle. In fact, we anticipate one more rate hike at the October meeting and the reason for our call of two rate hikes in the current cycle are explained in detail here.

Just as the previous rate hike in June, we expect the upcoming policy decision to be unanimous by all six monetary committee members -most of whom have warned about continued upward inflationary pressures.

Read why we're looking for two interest rate hikes in India this year