

RBI Acts: Risks Inflation and Rupee

RBI has been very active in last one month. Since the new Governor D. Subbarao has taken over his post in September, RBI has cut CRR by 250 basis points (in three steps) and today as a somewhat surprise move it announced a cut in repo rate by 100 basis points, from 9 per cent to 8 per cent. It seems that RBI can cut interest again in near future.

The steps taken by RBI do not seem prudent for following reasons

1. Lowering interest rate when rupee has already depreciated by more than 20% makes position of rupee more vulnerable. In last one month the foreign reserves have come down significantly. During the fortnight from 26 September, 2008 to 10 October, 2008 the reserves went down from US 291 Bn to USD 274 Bn. This has happened when dollar did not appreciate by much against Euro and rupee fell somewhat. This means that RBI has been intervening in the currency market using substantial amount of reserves with no effect. Lowering interest rates makes the RBI's position more vulnerable.
2. Lowering rupee will lead to higher inflation. This will happen both through higher import prices and greater demand. At this point clearly higher import prices are much more of a concern. A 20% depreciation pushes the cost of all imported items by 20%. A number of other items which are not imported have prices set by import parity. Their prices will rise too.
3. It increase the risks in balance sheet of companies which in recent times have resorted freely to ECBs and FCCBs. The amount of money borrowed through ECBs and FCCBs would exceed \$ 50 Bn. The total amount could be close to \$ 100 Bn. A further fall in rupee when global credit markets are suffering from freeze will not be good for health of these companies. The list (which done ECBs and FCCBs) includes almost any large company having substantial amount of debt (except for PSUs).
4. It does not set a good precedent. It almost seems like the government has appointed a pliable person to the post of Governor. D Subbarao was finance secretary before assuming his current post. It seems like he is responding to wishes of Finance Minister. Independence of central is a pre-requirement for building a stable currency.

Steps like these reduce our confidence in current set up. It seems like Government has little concern for stability of rupee. We prefer to hold gold as a substitute of currency. In case the central bank continues to pander to corporate tunes our preference will become stronger.