DECCAN HERALD

Wednesday, 17 December 2025

IN PERSPECTIVE

RBI's confidence, US Fed's caution

The rate cuts offer relief, but rupee volatility dominates market mood

T.K JAYARAMAN

On December 5, the Reserve Bank of India (RBI) in its scheduled bimonthly meeting, cut its policy interest rate, the repo by 25 basis points from 5.50% to 5.25%. On December 10, the United States Federal Reserve reduced the upper bound of its policy rate from 4.00% to 3.75%, setting a new range, 3.50%–3.75%, by 25 basis points,. Although the direction and magnitude of the two rate cuts were similar, the macroeconomic contexts of India and the U.S. were quite different.

The RBI had maintained a tightened monetary stance with the repo rate at 6.5% for nearly two years (from May 2023 to February 2025) to contain global inflationary pressures. These pressures stemmed from pent-up demand during the brief recovery from the COVID-19 pandemic, followed by disruptions from the Russia–Ukraine conflict in late 2022. As inflation began a steady decline from November 2024, reaching 3.61% in February 2025—below the RBI's 4% target—the central bank initiated an easing cycle. The repo rate was reduced to 6.25% in February, 6.0% in April, and 5.50% in June. Inflation fell further, reaching just 0.25% in October. However, rising capital outflows caused by uncertainty over trade relations with the U.S., prompted the RBI to make what appeared to be a terminal cut to 5.25%. This decision was supported by strong economic growth, with GDP expanding by 7.8% and 8.2% in the first two quarters of FY 2026 (April–June and July–September 2025). The rare combination of low inflation and high growth was the key reason for ending the easing cycle on December 5.

This year, the U.S. economy displayed resilience: a weak Q1 was followed by strong Q2 growth, with full-year GDP growth is expected at 3%. The trade deficit narrowed significantly due to tariffs and rising exports, while the dollar index (DXY) fluctuated between 100 and 107 throughout the year, reflecting dollar strength against major currencies.

A six-week federal government shutdown during October and November disrupted the availability of reliable inflation and employment data. This data gap hindered the Fed's ability to make fully informed decisions. Relying mainly on September inflation figures and anecdotal evidence—while noting that unemployment data was "overstated"—the Fed faced its dual mandate of keeping inflation below 2% and unemployment under 4%. With inflation at about 3% (slightly above target of 2%) and unemployment at 4.3% (above the acceptable level), the Fed acted pragmatically. It cut interest rates by 25 basis points, lowering the federal funds range to 3.50%–3.75% from 3.75%–4.00%. The Fed also signaled a higher threshold for future cuts, projecting only one additional reduction in 2026.

Mixed implications

The size of the cut in Fed Funds rate is favourable to India, since the interest rate differential remain unchanged.. However, US uncertainty in trade relations has continued to dominate as there is no sign of any bilateral treaty in the air. as outflows are still driven by uncertainty around trade. Importer dollar demand is also on the rise. Some expert opinions highlighted potential for dollar softness, how lower US yields can redirect flows to emerging market economies, including India; however, they also warned about global growth uncertainty and currency volatility.

India's path is data-dependent: strong real growth prints and a softening inflation. The experts agree India can ease gradually while guarding foreign exchange stability. The RBI's near-term focus remains to be on inflation pass-through from tariffs, imported price pressures, and liquidity management,

Capital outflows and corporate dollar demand are the most proximate pressures on the rupee. They cause volatility. RBI's intervention in the exchange market is a familiar act , for smoothening by selling dollars for rupees . In the process, dollar depreciates and rupee appreciates .

As rupee liquidity decreases, two independent reverse processes were introduced on December 5. One is a short term , confined to two dates, December 5 and 18: OMO purchase auctions of government securities totaling Rs one lakh crore. The other is a $5bilion US$/INR, buy /sell swap auction, whose primary goal to ensure banks have adequate rupee liquidity to meet rupee credit demand and to maintain smooth functioning of financial markets.

A day after US Fed reduction in its policy rate, the rupee fell to fresh lows breaching the Rs 90-against-dollar. Reports suggest RBI's intervention to moderate the slide, while weakness was attributed to importer dollar demand and foreign outflows. This the indicates still the same bias, negative-to-flat until the possibility of US-India bilateral trade treaty brightens up. Till then, the exchange rate volatility has to be reduced with RBI intervention. India's forex reserves position continues to be sound and secure. It was $687.26 billion as of week ending December 12.

The writer was a Senior Economist with the Manila based Asian Developed Bank