Focus on inflation — on RBI interest rate

This article is related to Paper-III (Indian Economy)

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The Hindu

"The RBI chooses to stick to its core mandate, ignoring other pressures such as on the rupee."

The Reserve Bank of India pulled a surprise on the markets on Friday by keeping its benchmark interest rate unchanged at 6.5%.

The decision to stand pat comes even as the central bank changed its policy stance from “neutral” to “calibrated tightening”, indicating that rates could either go up or stay steady in the coming months.

The consensus on the street was that the RBI would raise rates by at least 25 basis points to support the rupee, with some even predicting a hike of 50 basis points. Not surprisingly, the rupee weakened past the 74-mark to the U.S. dollar for the first time ever after the news of the RBI holding rates steady hit the markets.

Stocks, which have been on a downtrend since September, also took a hit on Friday while bond yields fell. What is obvious is that, through its surprise decision, the RBI has chosen to stick to its primary mandate of keeping domestic inflation just around 4%, notwithstanding other risks facing the economy.

Notably, the Monetary Policy Committee’s decision to keep rates steady was strongly endorsed by its members, with just a lone member voting against the decision.

And its dedication to strict inflation-targeting was further reiterated during the press conference after the review meeting where RBI officials termed inflation control as their legal mandate.

With its strict focus on inflation, the challenge now will be whether the RBI can simultaneously manage the various other risks to financial stability.

For now, the RBI seems to prefer piecemeal measures, such as easing foreign investment norms and mild intervention in the forex market, to address the financial risks posed by the weakening rupee.

To be fair, the decision to keep rates unchanged, particularly after two consecutive increases since June, can be perceived as a strategy to keep the powder dry just in case external risks get out of hand. In this sense, the RBI’s decision could be termed prudent.

The decision to keep rates steady might also work in favour of the government, which will prefer to borrow at cheaper rates in the run-up to the general elections next year.

Bond yields have been on a steady rise since last year as investors have been spooked by fears over the fiscal deficit and the shift in global interest rates.

The RBI's decision to not raise rates may lift the sentiments of consumers and businesses at a time when the economy enters the busy season and festival demand kicks in.

Going forward, the biggest challenge facing the RBI will be the prospect of further rate hikes by the U.S. Federal Reserve and central banks in other developed economies, which could force the central bank to look beyond its inflation mandate. The RBI will clearly have to juggle multiple challenges in the coming months.

GS World Team...

Monetary Policy Committee (MPC)

Why in the discussion?

- Recently, the Reserve Bank of India has not made any major changes in policy rates. Repo rate is 6.5 percent and reverse repo rate is 6.25 percent.
- Earlier, repo rates had been increased in two consecutive monetary policy reviews.
- Considering the possibility of rising inflation due to the sharp rise in crude oil and the continuous decline in rupee against the dollar, experts expected that policy rates can be increased in monetary policy review.

The key points of the fourth bimonthly monetary review

- The Reserve Bank kept the main policy rate (repo) at 6.50 percent.
- Reverse repo rate is 6.25 percent; bank rate is 6.75 percent and CRR 4 percent.
- Estimates of retail inflation rising from 3.8 to 4.5 percent during October-March.
- For the current financial year, the growth rate of Gross Domestic Product is maintained at 7.4 percent.
- Reduced retail inflation on petrol, diesel will reduce retail inflation.
- The central bank insisted on further strengthening the domestic macro-economic base. .
- The next meeting of the MPC will be held on December 3-5.

Worries

- Increase in oil prices will have an impact on cost-effective income, profit margins of companies will also be affected.
- Pressure of crude oil prices going up.
- Global, domestic financial conditions will be hard, investment activities will be affected.
- Lack of fiscal goals at the level of the Center and states will have an impact on the scenario of inflation. It will also increase market volatility.
- The need to keep a closer look at the inflation scenario during the next few months, many risks are there if it increases.
- Risks on the rise and inflation scenario due to business stress, fluctuation and rising prices of crude oil and due to the global financial conditions that are going to be tough.

What is repo rate?

- Banks often require such a amount for their daily work, which does not last more than a day.
- The most common among the options taken by banks, is to take overnight loans from Central Bank (Reserve Bank of India) for the night.
- The rate that the Reserve Bank has to be paid on this loan is called repo rate.
- With lowering of repo rates, it is cheaper to get loans by banks from the RBI, and banks therefore reduce interest rates, so that the maximum amount can be given as loans.
- Increasing the repo rate means that borrowing from RBI for night would be costly for banks.

What is the reverse repo rate?

- According to the name, the reverse repo rate is the reverse of the above mentioned repo rate. Banks have a large amount of money left over after the daily works.
- Instead of keeping the money in the bank, the bank can keep it in the Reserve Bank, on which they also get interest from the Reserve Bank. The rate at which the interest is received is called a reverse repo rate.
- If the Reserve Bank thinks that there is a lot of cash in the market, then it increases the reverse repo rate, which encourages the bank to keep its money with the Reserve Bank, and thus, in the market less money to is left.

What is monetary policy committee?

- The Monetary Policy Committee (MPC), constituted under section 45ZB by the Central Government, determines the policy interest rate necessary to achieve the inflation target.
- Earlier this work was done by the Governor of the Reserve Bank.
- The Department of monetary policy of the Reserve Bank assists the committee in monetary policy formulation.
- Contributions from all stakeholders of the economy and the decision of the Reserve Bank of India contributes to the decision-making process on repo rate policy determination.

Objectives of Monetary Policy

- The main purpose of monetary policy is to maintain price stability in view of economic growth, because price stability is the inevitable condition of sustainable development.
- Increasing inflation in an economy means the increase in the prices of essential commodities. It is an indication that inflation is increasing rapidly.
- The most importance of repo rate in monetary policy is to reduce inflation. If the Reserve Bank wants that the money supply and liquidity increase in the market, then it reduces the bank rate.
- If the market needs to reduce the supply and liquidity of the money, then it increases the repo rate. When inflation increases, the central bank generally raises the repo rate and reduces inflation.
- It is said that monetary policy is a type of tool, on the basis of which the supply of money is controlled in the market.
- The monetary policy determines the rate at which the Reserve Bank will give loans to the banks, and at what rate it will withdraw money from those banks.

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Expected Questions (Pre Examination)

1. Which of the factors are responsible for the depreciation of Indian Rupee-

1. Cost of Crude Oil
2. Trade Deficit
3. Retreat of Foreign Portfolio Investment
4. Current Account Deficit

Choose the correct answer using the code given below-

(a) 2 and 4

(b) 2, 3 and 4

(c) 1, 2 and 4

(d) All of the above

2. Which of the following factors will unfavourably impact the economic development of India?

1. Protectionism
2. Currency War
3. Change of policy by America

Choose the correct answer using the code given below-

(a) Only 1

(b) 1 and 2

(c) 1 and 3

(d) All of the above

3. Which of the following elements have impact on determination of Interest rate?

1. Cost of Oil
2. Exchange rate of Rupee
3. Current acount deficit

Choose the correct answer using the code given below-

(a) 1 and 2

(b) 2 and 3

(c) 1 and 3

(d) All of the above

Note :
The answer of the pre-examination (expected questions) on 5 Oct is 1(c), 2(c) and 3(d).

Expected Questions (Mains Examination)

Q. "In Current global economic scenario is presenting a major challenge infront of India's financial stability and growth. (250 Words)