With repo rate hike, RBI has done what's Necessary

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It may have surprised the markets, but the move was prudent. More hikes are likely to follow.

The RBI has decided to take the bull by the horns. It has raised the repo rate by 40 basis points and the cash reserve ratio (CRR) by 50 basis points to fight inflation. We believe these simultaneous policy announcements of adjusting both the rate and quantum of liquidity is a clever ploy. Interestingly, research clearly shows that the credibility and reputation of the central bank is best recognised only when the market response to central bank liquidity operations is stronger. To that extent, the RBI seems to have killed two birds with one stone and has emerged stronger as an inflation targeting central bank. In fact, the surprise mid-term announcement by the RBI Governor today is a clear departure from past practices. It also signals the extraordinary times we live in.

The most interesting aspect of the rate hike today is the continuation of the accommodative policy stance. While the markets seem to have been taken aback, we believe today's rate hike should be seen more from a strategy perspective, rather than as a change in the monetary policy stance. We believe this is a pragmatic decision as the CRR hike may be just an attempt to build up a war chest on the liquidity front.

To be more precise, liquidity inflows to the financial system could be either policy induced by the central bank (for example changes in reserves, open market operations etc) or non-policy induced (foreign exchange reserves, government cash balances, and currency in circulation). Given that non-policy induced liquidity inflows have been recently impacted (outflows of portfolio capital) and given the huge size of the government borrowing programme, the RBI also needs to support the market through some means. Impounding bank reserves through the CRR (Rs 87,000 crore) could give some space to the central bank to conduct open market purchases of bonds from banks and thus inject concomitant liquidity some time in the future if the need so arises.

The RBI had followed a similar strategy during 2003-08 when the market stabilisation bonds were introduced, the CRR was also hiked. The CRR rate hike is thus an important tool to possibly manage G-sec yields. The markets may have missed the fine print of this move.

Across the world, major central banks have of late gone on a rate hike spree, waking up to the realisation of inflationary pressures not being transitory in nature. The US Fed has been on the offensive battling a 40-year high surge in prices. It has tapered its bond purchase programme drastically while suggesting in no uncertain terms the pace of rate hikes needed to combat inflation. The European Union has been slow to respond but voices are growing to correct the path at the earliest. Banks like the Central Bank of Brazil or Russian Central Bank have almost jumped the gun (in keeping the benchmark or key rates in double digits.)

Emerging economies have been doubly hit — the days of easy liquidity are well behind them even as their economic resources remain constrained to support an uneven proportion of population coming out of the strains induced by successive waves of the pandemic. To this extent, the decision by the RBI to frontload the rate hikes ahead of the Fed decision is again an attempt to stem capital outflows.

Including the RBI's decision today to push the benchmark rate to align with the current market realities, 21 countries have increased interest rates so far. Of these, 14 countries have hiked rates more than or equal to 50 bps. Markets are also expecting a 50-bps rate hike by the US Fed in its policy meeting concluding today – the biggest since 2000. It would also be the first time in 16 years that the US Fed will hike borrowing costs at two consecutive meetings.

A historical disaggregation of India's retail inflation (as measured by CPI) to ascertain the various macro-factors that drove inflation dynamics, indicates that the inflationary pressures can be attributed mainly to adverse cost-push factors, coming from supply-side shocks in food and fuel prices, even as weak aggregate demand conditions continued to exert downward pressure on inflation. The RBI statement thus cites food inflation as a major source of discomfort.

Additionally, nominal rural wages for both agricultural and non-agricultural labourers picked up during the second half 2021-22. However, such wage growth has remained soft. The weighted contribution of wage growth in CPI build-up remains modest and this is a good sign as far as anchoring of inflationary expectations is concerned.

Measures to ameliorate supply-side cost pressures would be thus critical at this juncture, especially in terms of a calibrated reduction of taxes on petrol and diesel. On the policy side, however, it would mean that even after rate hikes, inflation may continue to remain high for some time.

As retail loans have increasingly been benchmarked to the external rate (mostly to RBI's repo rate) with quarterly reset clause, the loans benchmarked to the repo rate may increase in the range of 35-40 bps, passing on the hike in full, as banks don't keep a wider spread in retail loans to remain competitive in the market. As of December 2021, around 39.2 per cent of the loans are benchmarked to external benchmarks, so the increase in repo rate will increase interest costs on consumers and may impact them from the next quarter onwards.

The MCLR (Marginal Cost of Funds based Lending Rate) linked loans have a share of around 53 per cent in the overall loan kitty. With the rise in CRR and expected future hikes in the benchmark rates, there would be an increase in MCLR due to a negative carry. Furthermore, if banks raise the deposit rates then the cost of funds will also increase and subsequently the MCLR will increase too.

The RBI, in our view, has acted prudently in responding to market forces that could impact India's growth prospects if inflationary concerns were not addressed now. At the same time, by pledging to remain accommodative to spur, and reinvigorate growth, it has reaffirmed its commitment to being a trusted partner in the growth of the country. We also believe the rate hike will be beneficial for the banking sector as the risk will get re-priced properly. However, be prepared for a series of rate hikes now.

GS World Team Input

IN THE NEWS

Repo rate

Why in news?

- Recently, Reserve Bank Governor Shaktikanta Das suddenly announced a hike in the repo rate.
- The Reserve Bank has now increased the repo rate from 4 per cent to 4.40 per cent.
- Although the reverse repo rate remains at 3.35 per cent, but the CRR has been increased by 50 basis points.

What is Repo Rate?

- In simple words, repo rate means the rate of loan given by the Reserve Bank to other banks. The bank provides loan to its customers with this charge.
- Lower repo rate means that customers will now get cheaper loan rates for loans like home loans and vehicle loans even at lower prices.

Reverse repo rate

- It is opposite to the repo rate. When banks have a large amount left after a day's work, they keep that amount in the Reserve Bank. RBI gives them interest on this amount. The rate at which the Reserve Bank gives interest on this amount is called Reverse Repo Rate.

Cash reserve ratio

- Under banking rules, every bank has to keep a certain part of its total cash reserve with the Reserve Bank, which is called Cash Reserve Ratio or Cash Reserve Ratio (CRR).
- These rules have been made so that if at any time a large number of depositors in any bank need to withdraw money, then the bank cannot refuse to repay the money.

SLR

- SLR is used to keep the liquidity of cash under control.
- When the RBI wants to reduce the liquidity of cash without changing the interest rates, it increases the CRR, this leaves less amount with the banks to lend.

Expected Question (Prelims Exams)

Q. Consider the following statements-

1. Recently, the Reserve Bank has increased the repo rate from 4 percent to 4.50 percent.
2. SLR is used to keep the liquidity of cash under control.
3. Currently CRR is 4% and SLR is 18%.

Which of the above statements is/are correct?

(a) Only 2

(b) 2 and 3

(c) 1 and 3

(d) All of the above

Expected Question (Mains Exams)

Q. What do you mean by repo rate? While highlighting the positive and negative effects on the Indian markets due to the recent increase in the repo rate by the RBI, discuss how relevant is the decision to hike rates? (250 Words)

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Note: - The question of the main examination given for practice is designed keeping in mind the upcoming UPSC main examination. Therefore, to get an answer to this question, you can take the help of this source as well as other sources related to this topic.