Why PBI's Monetary Policy Matters

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"It influences the interest rate in the economy — which is the cost of money when you don’t have it, and the reward for parting with it when you have it."

In its monetary policy review Wednesday, the Monetary Policy Committee of the RBI decided to cut the repo rate by 35 basis points (bps). Repo rate is the rate at which the RBI lends money to commercial banks. 100 bps make a full percentage point. The RBI’s repo rate has now fallen 110 basis points since February. The RBI also announced some measures to boost economic activity.

Why does monetary policy matter?

In any economy, economic activity, which is measured by gross domestic product or GDP, happens by one of four ways. One, private individuals and households spend money on consumption. Two, the government spends on its agenda. Three, private sector businesses “invest” in their productive capacity. And four, the net exports — which is the difference between what all of them spend on imports as against what they earn from exports. At the heart of any spending decision taken by any of these entities lies the question: What is the cost of money?

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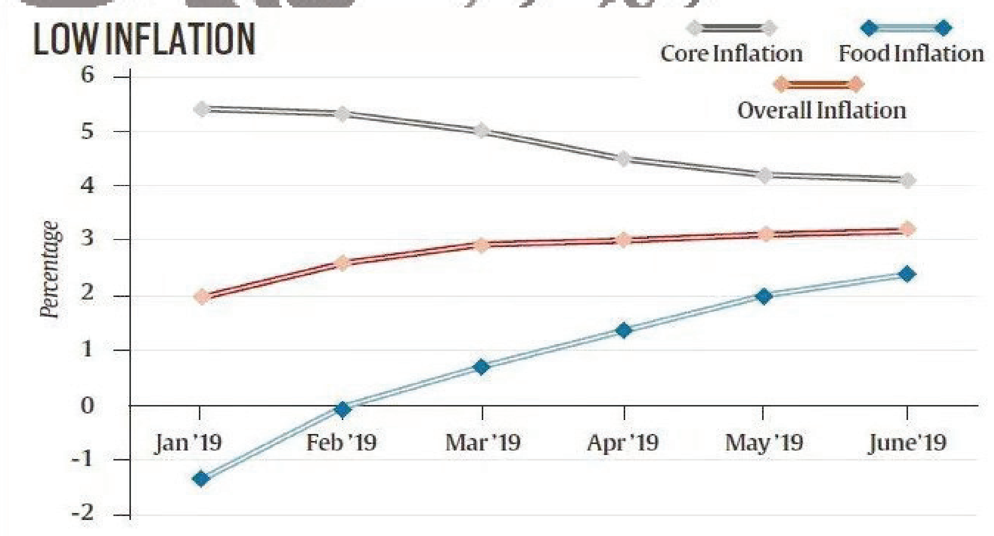
Monetary policy essentially answers that question. In every country, the central bank is mandated to decide the cost of money, which is more commonly



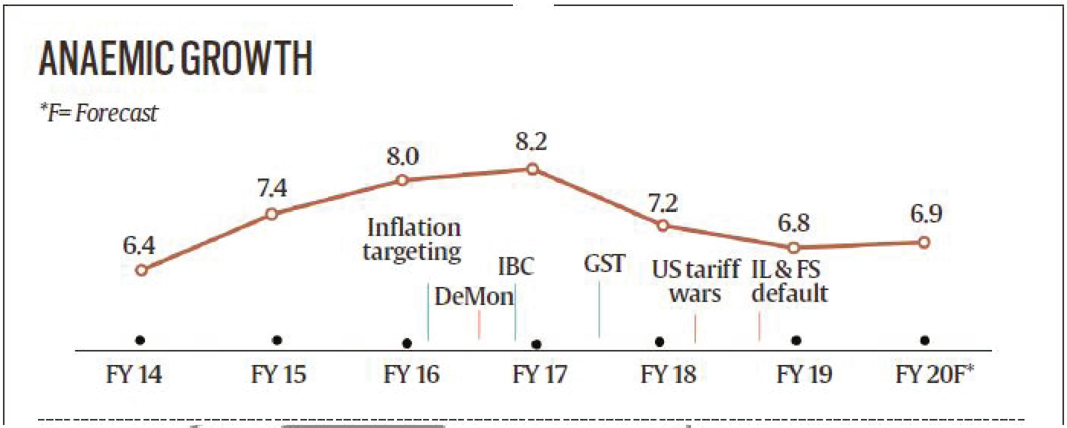
HIGH REAL INTEREST RATE

	FY14	FY15	FY16	FY17	FY18	FY19
Repo Rate (%)	8	7.5	6.75	6.25	6	6.25
CPI Inflation (%, y-o-y)	9.4	6	4.9	4.5	3.6	3.4
Real Interest Rate (%)	–1.4	1.5	1.9	1.8	2.4	2.9

Source: National Statistics Office (NSO), CRISIL Research known as the "interest rate" in the economy. While various factors make it difficult for a central bank to exactly dictate interest rates, as a thumb rule, RBI's decision on the repo rate sets the markers for the rest of the economy. In other words, the EMI for your car or home is determined by what the RBI decides.

What is the repo rate?

Repo and Reverse repo are short for repurchase agreements between the RBI and the commercial banks in the economy. In essence, the repo rate is the interest rate that the RBI charges a commercial bank when it borrows money from the RBI. As such, if the repo falls, all interest rates in the economy should fall. And that is why common people should be interested in the RBI's monetary policy.



But the interest rate for consumer loans has not reduced by 110 bps since February. Why?

In the real world, the "transmission" of an interest rate cut (or increase) is not a hundred per cent. And that is why, even though when the RBI cut by 35 bps on Wednesday, lay consumers may only receive a much lower reduction in the interest rate on their borrowings. This is due to a lot of factors — but primarily, it has to do with the health of the concerned commercial bank.

Over the past few years, almost all banks, especially the ones in the public sector, have seen their profits plummet because many of their past loans have turned out to be non-performing assets (in other words, they are not getting repaid). To cover for these losses, the banks have to use their existing funds, which would have otherwise gone to common consumers for fresh loans.

There is another key element that affects the banks' decision. The reduced repo rate applies only to new borrowings of banks. The banks' cost of existing funds is higher. Of course, funding costs would eventually come down — but this process would take time. This "lag" in monetary policy is a key variable in determining the efficacy of any rate cut by the RBI. It could take anywhere between 9 and 18 months for the full effect of an RBI decision to reflect in interest rates across the economy.

So, how does RBI decide the interest rate?

Any central bank has a few main concerns.

The first is to ensure price stability in the economy. Think of how chaotic life would be if there was no predictability about the prices of everyday items. The interest rate anchors the prices in an economy. The RBI continuously maps prices, inflation (which is the rate of increase in prices), and expectations of inflation (of households) to decide if it should increase or decrease interest rates.

For instance, the RBI announced some years ago that it would like the inflation rate to be 4%. So, every time the retail inflation rate rises above the 4% mark, the RBI realises that there is too much cash chasing too few goods in the economy. To set the matter right, it raises the cost of money — that is, the interest rate. When it does that, some people find it more advisable to put the cash out of the market and into banks. This way, inflation falls. The reverse process applies when the inflation is below the 4% mark.

The other related concern for a central bank is to take care of economic growth. For instance, economic growth is anaemic at present (see charts), and partly as a consequence, the inflation rate has been below 4% for several months now. The RBI is, therefore, cutting interest rates to incentivise people to consume more and businesses to invest more.

Will the rate cut bring investments?

Investments depend essentially on the "real" interest rate. The real interest rate is the difference between the repo rate and retail inflation. When making an investment decision, it is this interest rate that matters. As a variable, it allows an investor to compare the attractiveness of different economies. As can be seen in the third chart, real interest rates in India have been rising, and that is one of the biggest reasons why investments are not happening. The RBI's move on Wednesday would reduce the real interest rate and hopefully attract more investment.

GS World Team...

Monetary Policy Committee (MPC, MPC

Why in the News?

- The Reserve Bank of India (RBI) on Wednesday announced the third monetary review for the financial year 2019-20. After the Monetary Policy Review meeting, the RBI has cut the repo rate by 0.35% or 35 basis points.
- Now the repo rate has come down from 5.75 per cent to 5.40 per cent. This is the lowest in 9 years.
- At the same time, the reverse repo rate has come down to 5.15 percent. The lowest rate was 5.25% in April 2010.
- After the cut in interest rates by the Reserve Bank, along with the loan becoming cheaper, the expectation of home loan and auto loan EMI has come down.
- RBI has lowered its GDP growth forecast to 6.9% for the current financial year (2019-20).
- An estimate of 7% was released after the June meeting. At that time the growth projection was reduced from 7.2% to 7%.
- The RBI has expected the retail inflation rate to be 3.1% in the July-September quarter of this year.
- In the second half (October-March) of the current financial year, the retail inflation is estimated to be 3.5-3.7 percent. After the meeting of June, it had released the estimate of 3.4-3.7 percent.

What is it?

- The Monetary Policy Committee (MPC) is constituted by the Central Government under Section 45ZB.
- Monetary Policy Committee; Determines important policy rates like repo rate, reverse repo rate, marginal standing facility rate, bank rate, etc. for the development of different regions of the country.
- A 6-member Monetary Policy Committee (MPC) is constituted as per Section 45ZB of the RBI Act, 1934, as amended by the Central Government. The first meeting of the Monetary Policy Committee was held on October 3, 2016.
- The Reserve Bank's Monetary Policy Department (MPD) assists the MPC in formulating monetary policy.

Organizing committee

- The Monetary Policy Committee (MPC) consists of a total of 6 members, including the Chairman.
- This committee takes various policy decisions which are related to repo rate, reverse repo rate, MSF and liquidity adjustment facility etc.

Instruments of monetary policy

1. Quantitative Instruments: General or Indirect (Cash Reserve Ratio, Statutory Liquidity Ratio, Open Market Operations, Bank Rate, Repo Rate, Reverse Repo Rate, Marginal Standing Facility and Liquidity Adjustment Facility (LAF).
2. Qualitative Instruments: Selective or direct (change in margin money, direct action, moral pressure)

- It is noteworthy that all the above mentioned tools of monetary policy are used according to the requirement of the economy.
- These instruments maintain the flow of money supply in the economy so as to stabilize the rate of inflation to ensure the growth of the economy.

What is monetary policy

- Monetary policy describes the policy of the Reserve Bank of India through which the monetary policy of the country is regulated in such a way that the economic development of the country can be promoted without increasing inflation in the country.

- RBI; The Reserve Bank of India is authorized to make monetary policy under the Act, 1934.
- Therefore, monetary policy refers to the debt control measures adopted by a country's central bank.

Its objectives

- According to the Chakravarti Committee; Price stability, economic growth, economic equality, social justice, promoting and nurturing new monetary and financial institutions are important objectives of monetary policy in India.
- The RBI always tries to reduce the rate of inflation or keep it within a sustainable range, while the Indian government on the other hand focuses on accelerating the country's GDP growth.

Expected Questions (Prelims Exams)

1. Consider the following statements-

1. Repo rate is the rate at which Reserve Bank of India lends money to commercial banks.
2. The Monetary Policy Committee (MPC) of RBI has total 6 members, including the chairman.

Which of the above statements is/are correct?

(a) Only 1 (b) Only 2

(c) Both 1 and 2 (d) Neither 1 nor 2

Expected Questions (Mains Exams)

Q. 1 What is Repo Rate and Comment on the role of repo rate in the monetary Policy of RBI .

(250Words)

Q. 2 Evaluate the role of Reserve Bank of India (RBI) in stabilising Indian economy.

(250Words)

Note: Answer of Prelims Expected Question given on 7 Aug. is 1 (c), 2 (c).