RBI Raises Interest Rates by 25 bps

The Reserve Bank of India in its third bi-monthly policy raised the repo rate by 0.25 per cent to 6.5 per cent because of inflationary concerns.

One basis point (bps) is a unit equivalent to 0.01% i.e. 1/100th of a percent. Thus 10 bps means 0.10% and 100 bps means 1%. If RBI reduces Repo rate by 25 bps, this means thatit has been reduced by 0.25%.

The reasons for this hike are:

- The need to **contain retail inflation** after it quickened to 5% in June, 2018,
- Mounting domestic and global **uncertainties,**
- **HRA (House Rent Allowance) revisions** by state governments likely to push housing inflation,
- **Uncertainties** in Global financial markets,
- Risk of **fiscal slippage** by the Centre or States.
- The larger-than-average **increase in minimum support price (MSP)**, and
- **Volatility** in crude oil prices.

NOTE:

- The 2016 amendment of RBI Act, 1934 provides for the inflation target to be set by the Government of India, in consultation with the Reserve Bank, once in every five years. Accordingly, the Central Government has notified 4 per cent Consumer Price Index (CPI) inflation as the target for the period from August 5, 2016 to March 31, 2021 with the upper tolerance limit of 6 per cent and the lower tolerance limit of 2 per cent.
- The same amendment also created the Monetary Policy Committee, to bring transparency and accountability in deciding monetary policy.

The Monetary Policy Committee

- MPC is a committee of Reserve Bank of India (RBI), headed by its Governor, which is entrusted with the task of fixing the benchmark policy interest rate (repo rate) to contain inflation within the specified target level.
- The committee comprises **six members** - three officials of the Reserve Bank of India and three external members nominated by the Government of India
- The MPC is required to meet **at least four times** in a year.
- The quorum for the meeting of the MPC is **four members**.
- Each member of the MPC has one vote, and in the event of an equality of votes, the Governor has a second or **casting vote.**
- The Reserve Bank of India (RBI) is vested with the responsibility of conducting monetary policy, explicitly mandated under the **Reserve Bank of India Act, 1934.**

- The increase will push up the cost of loans for all borrowers as banks are likely to increase interest rates on loans in tandem. This is because a hike in repo rate will mean that banks' marginal cost based lending rate (MCLR) in all likelihood will go up.
- This is now the first time since October 2013 that the repo rate has been raised at two consecutive policy meetings.
- The committee kept its policy stance neutral, keeping its options open for further rate hikes. The reason it cited for the neutral stance was the potential impact of trade tensions between the US and China and a possibility of a **currency war.**

Currency War

- Also known as **"competitive devolution"**, it is a situation when number of Nations **simultaneously** seek to **deliberately "depreciate"** the value of their domestic currencies in order to stimulate their economies.
- In the current era of "floating exchange rates", which is decided by market forces, currency depreciation is engineered by respective Central Bank through their economic policies.

Growth Outlook

- The RBI retained the GDP forecast for the current fiscal at 7.4 per cent because of:
  - **Robust corporate earnings** especially that of fast moving consumer goods (FMCG) companies,
  - Buoyant **rural demand** due to MSP hike,
  - **Favourable monsoon** and
  - Rising **investments**.
- It also forecasted the GDP at 7.5-7.6 per cent in the second half of the current fiscal.

Few Instruments of Monetary Policy:

- **Liquidity Adjustment Facility (LAF)**: Allows banks to borrow money from RBI through repurchase agreements. LAF consists of repo and reverse repo operations. This arrangement allows banks to respond to liquidity pressures and is used by governments to assure basic stability in the financial markets.
- **Repo rate**: It is also known as the benchmark interest rate and it is the rate at which the RBI lends money to the banks for a short term. If RBI wants to make it more expensive for the banks to borrow money, it increases the repo rate similarly, if it wants to make it cheaper for banks to borrow money it reduces the repo rate.
- **Reverse Repo rate**: It is the short term borrowing rate at which RBI borrows money from banks. The Reserve bank uses this tool to tighten liquidity in the banking system. An increase in the reverse repo rate means that the banks will get a higher rate of interest from RBI.
- **Marginal Cost of funds based Lending Rate (MCLR)**: It refers to the minimum interest rate of a bank below which it cannot lend, except in some cases allowed by the RBI.

  The MCLR methodology for fixing interest rates for advances was introduced by the Reserve Bank of India with effect from April 1, 2016. This new methodology replaces the base rate system introduced in July 2010.