Repo Rate Cut and its Implications

For Prelims: **Monetary Policy Committee (MPC)**, **Inflation**, **Personal Income Tax**, **Repo Rate**, **Interest Rate**, **Wholesale Price Index (WPI)**, **M3 Money Supply**.

For Mains: Repo rate and its impact on the economy.

Source: IE

Why in News?

The **Monetary Policy Committee (MPC)** of **Reserve Bank of India** cut the **repo rate to 6.25% from 6.5%** (25 basis points (bps)) for the **first time in 5 years** (since 2020).

- After the **Union Budget 2025-26** reduced **personal income tax** to spur consumption, this step aims to **revive economic growth** amid a slowdown.

What Factors Led to RBI's Decision to Cut the Repo Rate?

- **Growth-Stimulating Budget:** The **Union Budget 2025-26** introduced a **personal income tax cut** and **revised TDS limits**, increasing disposable income.
    - The RBI's repo rate cut **supports the government's tax reductions** by lowering borrowing costs and **sustaining demand**.
- **Declining Inflation: Consumer Price Index (CPI)** eased to **5.22% in December 2024**, a **four-month low**, down from **5.48% in November** that provides room for **monetary easing**.
- **Market Liquidity Enhancement:** The **RBI recently introduced measures** to improve **liquidity** in the banking system by injecting **Rs 1.5 trillion.**
    - Liquidity injection **eased tight credit markets**, while the repo rate cut ensured **liquidity and lower rates** to boost growth.
- **Global Economic Uncertainty:** The recent US **tariffs on Canada, Mexico, and China** sparked trade war fears, **weakening the rupee to 87.29 per dollar** and raising inflation risks.
    - A **repo rate cut** could help **cushion the impact of external shocks** and support domestic growth.

What is Repo Rate?

- **About: Repo rate (Repurchase Agreement Rate)** is the **interest rate** at which commercial banks **borrow money** from the central bank.
- **Purpose & Functioning:** It helps banks **meet short-term liquidity needs** by borrowing funds.
    - Banks provide **securities as collateral** and agree to repurchase them later at a higher price (including interest).
- **Impact on Borrowing Costs:**
    - **Higher repo rate** → Costlier loans for banks → **Higher interest rates for consumers & businesses** → Slower borrowing & spending.
    - **Lower repo rate** → Cheaper loans for banks → **Lower interest rates for borrowers** →

Increased borrowing & spending.

- **Role in Monetary Policy:** It is used by the central bank to **control money supply, inflation, and economic growth**.

What are the Implications of the Repo Rate Cut?

- **Economic Growth:** Lower borrowing costs make it easier for **businesses to expand and invest**, leading to **higher production and job creation**.
  - A repo rate cut reduces interest rates, making **loans cheaper, lowering EMIs**, and boosting borrowing and spending.
- **Strengthening Financial Markets:** Banks may **reduce interest rates on savings accounts and fixed deposits**, making savings **less attractive** that may drive consumers toward **stocks, mutual funds, or real estate.**
- **Export Competitiveness:** A lower repo rate may cut investment returns, leading to **capital outflows.** This may **weaken the currency**, raising import costs but enhancing export competitiveness.
- **Inflation: Increased spending** due to rate cuts may push up prices and inflation over time, breaching the **RBI inflation target (4% within a band of +/- 2%)**

Background of the 4% Inflation Target

- **Chakravarty Committee (1982-85):** It was set up by the then **RBI Governor Manmohan Singh** under **Sukhamoy Chakravarty** to review monetary policy. Its recommendations included:
  - Emphasized **price stability** as a core objective of monetary policy.
  - Proposed **4% average annual inflation in the Wholesale Price Index (WPI)** to balance economic priorities.
  - Recommended **market-driven government borrowing** and an **active government securities market** to reduce reliance on RBI funding.
  - Advocated **monetary targeting (M3 money supply control)** to manage inflation.
    - M3 = M1 (Currency held by the public+Demand Deposits held by commercial banks)+Net time deposits of commercial banks
- **Urjit Patel Committee (2014):** It **formalized** inflation targeting, setting the **4% target (±2% band)**, a target first proposed by the **Chakravarty Committee 40 years ago**.
  - India's inflation targeting framework, **adopted in 2016**, aligns India's monetary policy with global best practices.

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Monetary Policy Committee

Monetary Policy

- It is formed and managed by **Reserve Bank of India** to control a nation's overall money supply and achieve economic growth
- It is **different from Fiscal Policy** which is managed by the **Ministry of Finance** that measures the spending and taxation in Indian Economy

Monetary Policy Committee (MPC):

- **Ex-officio Chairperson:** RBI Governor
- **Objective:** To determine the policy rate required to achieve the inflation target (4+/- 2%, Urjit Patel Committee)

- **Legal Framework:** Under Section 45ZB of the amended RBI Act, 1934, the Central Government is empowered to constitute a six-member Monetary Policy Committee (MPC)
  - The MPC is required to meet at least four times in a year. 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.
- **Monetary Policy Report:** RBI once in every six months, releases Monetary Policy Report to explain the sources of inflation and the forecast of inflation for 6-18 months ahead

Click Here to Read: What is the Consumer Price Index?

Conclusion

The RBI's repo rate cut aims to **boost economic growth** by lowering borrowing costs. However, it may lead to **inflationary pressures**, challenging the 4% target set by RBI MPC. Balancing **growth and price stability** remains crucial, especially amid **global uncertainties**.

Drishti Mains Question:

Discuss the impact of repo rate cuts on economic growth and inflation.

UPSC Civil Services Examination, Previous Year Questions (PYQs)

Prelims

Q. Consider the following statements: (2020)

1. The weightage of food in Consumer Price Index (CPI) is higher than that in Wholesale Price Index (WPI).
2. The WPI does not capture changes in the prices of services, which CPI does.
3. The Reserve Bank of India has now adopted WPI as its key measure of inflation and to decide on changing the key policy rates.

Which of the statements given above is/are correct?

(a) 1 and 2 only

(b) 2 only

(c) 3 only

(d) 1, 2 and 3

Ans: (a)

Q. If the RBI decides to adopt an expansionist monetary policy, which of the following would it not do?(2020)

1. Cut and optimize the Statutory Liquidity Ratio
2. Increase the Marginal Standing Facility Rate
3. Cut the Bank Rate and Repo Rate

Select the correct answer using the code given below:

(a) 1 and 2 only

(b) 2 only

(c) 1 and 3 only

(d) 1, 2 and 3

Ans: (b)

Mains

Q. Define potential GDP and explain its determinants. What are the factors that have been inhibiting India from realizing its potential GDP? (2020)

Q. Do you agree with the view that steady GDP growth and low inflation have left the Indian economy in good shape? Give reasons in support of your arguments (2019)