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1993 - 2018

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Celebrating 25 Years of Economics @ Sacred Heart College, Chalakudy, Kerala

ISBN: 978-93-5578-226-7

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A STUDY ON THE IMPACT OF RBI POLICY RATES ON INFLATION UNDER DR. RAGHURAM G RAJAN'S TENURE

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Abstract

One of the major thrust of the monetary policy is to reduce the annual inflation rate. Since the year 2009 the inflation in India has crossed historical records and reached to unprecedented levels and lying in the range of 9-14 %. The monetary authorities are striving hard to curb the inflation by adopting several monetary policy measures, the important amongst which are changes in CRR, repo and reverse repo rate, which directly influence the money supply in the market with immediate effect without creating any severe distortions in the economy. That is the reason, they are perceived to be the most appropriate by the monetary authorities to curb the existing inflation, and hence changed 16 times during the year 2009 to 2011. Over a period of time the repo and reverse repo rates set by the RBI have become a sort of signaling rates along with the bank rate and these rates provide a corridor for the call money market. Repo and reverse repo rates are also used as a part of Liquidity Adjustment pressure on marginal liquidity in the system. These rates constitute the interest rate corridor under Liquidity Adjustment Facility (LAF) and, hence, any variation in these rates is perceived by the market as short-term interest rate signal arising from change in the stance of the RBI when the bank rate has remained unchanged. Hence are taken as a part of the study.

Keywords: *Economy, Liquidity, Monetary Policy, Rates, RBI*

Introduction

Reserve Bank of India, the central bank, formulates, implements, and monitors the monitory policy of India. Established to maintain reserves with a view to securing monetary stability, RBI stood at the centre of India's Financial System. RBI acts as a banker and debt manager to central government and state governments and also plays the crucial role of banker to the banks. In addition to its traditional central banking functions, the Reserve Bank performs certain non-monetary functions of the nature of supervision of banks and promotion of sound banking in India. Infusion and absorption of liquidity on a daily basis is maintained by RBI through Repo and Reverse Repo rates. Reverse repo rate is the rate at which the central bank of a country borrows money from commercial banks within the country. It is a monetary policy instrument which can be used to control the money supply in the country. Banks are always happy to lend money to Reserve Bank of India since their money is in the safe hands with good interest. Banks find it more attractive to have their money with the RBI when the reverse repo rate is increasing and hence money is drawn out of the system. Repo rate is the rate at which the central bank of a country lends money to commercial banks in the event of any shortfall of funds. Repo rate is used by monetary authorities to control inflation. Reduction in Repo rates helps the commercial banks to get money at a cheaper rate and increase in the Repo rate discourages the commercial banks to get money as the rate increases and becomes expensive.

Objective of the study

- ✓ To analyse the variations in repo and reverse repo rates on curbing the inflation in India under Dr. Rajan's period as RBI governor.
- ✓ To examine the major economic achievements of Dr. Rajan as an RBI governor.

Role of repo and reverse repo in an economy

To understand the impact of a cut in Repo and Reverse Repo Rates on banks, it is important to understand the role they play in banking. Repo and Reverse Repo are basically instruments used by the RBI to influence the total monetary base of banks.

To get a grip on this, it is important to understand how banks work and what the term *monetary base* means. Banks engage in a practice called Fractional Reserve Banking (FRB). Under FRB, a bank lends many multiples of the actual cash in hand. This cash they have is the monetary base. Clearly, any addition to the monetary base adds to the bank's ability to make loans by creating money from nothing.

In India, banks' monetary base takes two forms – CRR (Cash Reserve Ratio) and SLR (Statutory Liquidity Ratio). CRR is the amount of actual cash that banks need to hold with the RBI. SLR refers to the amount (by value) of approved securities (government bonds, gold and approved, privately issued financial instruments) that banks are mandated to hold. Together, they constitute the monetary base of the Indian banking system.However, what CRR and SLR do not cover is the extent to which the RBI can lend to banks. That is covered under the Repo and Reverse Repo.

In a *Repo*or a *repurchase agreement*, the Repo seller (the bank) sells an approved security to the RBI with the understanding that at a certain date in the future, the bank will buy the security back from the RBI. The bank gets cash and the RBI the security.Very interestingly, during the term of the Repo, the bank is allowed to count the security thus sold to the RBI as part of its investments to fulfill the SLR requirement. So, the net effect of a Repo transaction is an addition to the bank's cash reserves without falling behind on SLR requirements. With this, the bank can now engage in much more lending.At the end of the term of a Repo, the bank buys the security back from the RBI at a price higher than the original sale price. The difference expressed as a percentage of the original sale price is the Repo Rate. Thus, Repo Rate is used to calculate the price at which the security is bought back by the bank. It is the equivalent of an interest paid by the bank to RBI.

It might seem that at the time the bank buys the security back, its cash reserve falls. However, the bank can then enter into a fresh Repo transaction and sell the security back to the RBI, bringing the cash reserve back to the higher level. In this manner, Repo becomes a means for the RBI to maintain a steady level of lending to banks.But all this additional lending would mean more purchases of securities to meet SLR requirements. This would mean the need to deploy cash for the same. That cash would go outside the system of lending and reduce the system's lending potential. This problem is solvedby what is called the Reverse Repo**.**

In a Reverse Repo, the RBI sells an approved security to the bank with the understanding that it will buy it back at a future date at a higher price. The difference between the two prices expressed as a percentage of the original selling price (per annum) is called the Reverse Repo Rate. The Reverse Repo Rate thus becomes the interest rate received by the bank for lending cash to the RBI.The important point for us to note is that a bank may show securities bought from the RBI through the Reverse Repo window as part of its SLR commitments. Further, as in the case of the Repo, at the end of the term of the Reverse Repo, the bank can enter into a fresh Reverse Repo with the RBI.

State of the Indian economy when Dr. Rajan took his charge as the RBI Governor

On 4th August 2013 it was announced that Dr. Raghuram G Rajan would take over as the Reserve Bank of India Governor for a term of 3 years, succeeding Duvvuri Subbarao. On 5th September 2013 he took charge as the 23rd Governor of the Reserve Bank of India. As the governor of RBI, Rajan made curbing inflation his primary focus. When Dr. Rajan took office as RBI Governor India's retail inflation hovering at an eye-watering 10.70 per cent

 ISBN: 978-93-5578-226-7

level. Two months before Rajan took office, the domestic currency had depreciated by a staggering 10.4 per cent as India faced its worst currency crisis in recent memory. Thus the rupee was in bad shape. When Dr. Rajan took over as the RBI chief in September 2013, the rupee was trading near a record low of 68.85 per dollar. Moreover India was battling double-digit inflation in 2013, which forced the central bank to keep interest rates high. Lending rate, or the rate of interest banks charge from borrowers, stood at 10.3 in September of 2013. By all means the growth of the Indian economy was anemic.

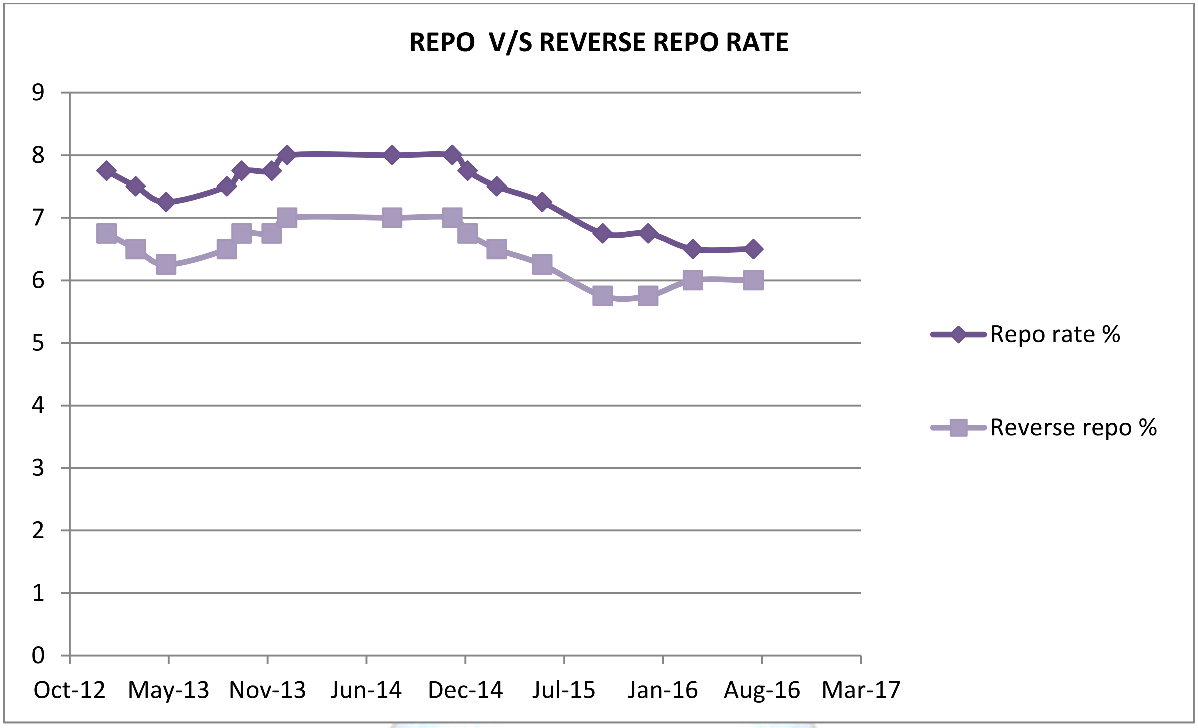
Repo rates and reverse repo rates under Dr. Raghuram Rajan

Following table shows the various repo and reverse repo rates from January 2013 to August 2016.

Repo rate %	Reverse repo %	Effective from
7.75	6.75	January 2013
7.50	6.50	March 2013
7.25	6.25	May 2013
7.50	6.50	September 2013
7.75	6.75	October 2013
7.75	6.75	December 2013
8.00	7.00	January 2014
8.00	7.00	August 2014
8.00	7.00	December 2014
7.75	6.75	January 2015
7.50	6.50	March 2015
7.25	6.25	June 2015
6.75	5.75	October 2015
6.75	5.75	January 2016
6.50	6.00	April 2016
6.50	6.00	August 2016

Source: www.inflation.eu

ISBN: 978-93-5578-226-7



Source: www.inflation.eu

During the period 2013-2016 the rate of repo and reverse repo created a significant impact in the Indian economy. As an initial step Dr. Rajan increased the repo and reverse repo in October 2013 from 7.5 to 7.75 and 6.5 to 6.75 respectively. As inflationary pressure in the economy pushed the rates upward in the begging of 2014, both repo and reverse repo had been increased by 0.25%. Moreoverrepo rate stood at 8% and reverse repo stood at 7% for the entire year 2014.Since July 2014, inflationary pressures (measured by changes in the consumer price index) have been easing. The path of inflation, while below the expected trajectory, has been consistent with the assessment of the balance of risks in the Reserve Bank's bi-monthly monetary policy statements. To some extent, lower than expected inflation has been enabled by the sharper than expected decline in prices of vegetables and fruits since September, ebbing price pressures in respect of cereals and the large fall in international commodity prices, particularly crude oil. Crude prices, barring geo-political shocks, are expected to remain low over the year. Weak demand conditions have also moderated inflation excluding food and fuel, especially in the reading for December. Finally, the government has reiterated its commitment to adhering to its fiscal deficit target. Thus smooth condition from January 2015 onwards the RBI Governor was ready to decrease the rates. Dr. Rajan presented his final monetary policy in August 2016 and kept policy rate unchanged at 6.50%.

Effects of various rates on inflation during Dr. Rajan's tenure

Inflation rate refers to a general rise in prices measured against a standard level of purchasing power. The most well-known measures of Inflation are the CPI which measures consumer prices, and the GDP deflator, which measures inflation in the whole of the domestic economy. From 1969 until 2010, the average inflation rate in India was 7.99 percent reaching an historical high of 34.68 percent in September of 1974 and a record low of -11.31 percent in May of 1976.

Let us see the average inflation rate in India as per the Consumer Price Index (CPI) from 2011 to 2016.

Average inflation India (CPI) by year	
Average Inflation	Inflation
CPI India 2011	8.87 %
CPI India 2012	9.30%
CPI India 2013	10.92 %
CPI India 2014	6.37 %
CPI India 2015	5.88 %
CPI India 2016	5.71 %

Source: www.inflation.eu

The current rise in inflation started from July 2009 (-0.62 per cent) from when it started to accelerate while the economy was still recovering from the significant global slowdown. From July 2009 it continued to show rising trends before reaching its recent peak of 14.86 percent in the month of April 2010. Thereafter, moderating for some time, it again accelerated in the last three months. Inflation for the month ending March 2011 stood at 8.82 percent. There were arguments that as a higher base effect factors in, inflation will moderate from the first quarter of the 2011. In the month of October 2011 again inflation reach to 10.06 percent on that time again RBI revised their rate. As a result of this now the inflation is declining. Thus the average inflation for the year 2011 stood at 8.87 percent. But the situation was again worst in 2013. In September 2013 the inflation rate was unmanageable with an ever threatening rate of 10.7. Higher inflation is not the only factor that is disturbing but it is also its stickiness that is frustrating.

 ISBN: 978-93-5578-226-7

It was a challenge to the new RBI Governor, Dr. Rajan, to curb the inflation and smooth the economy. The immediate action was an increase in the repo and reverse repo by 0.25 percent, i.e., revised repo and reverse repo were 7.75 and 6.75 respectively. As a result there was a sharp decline in the average inflation from 10.92 percent in 2013 to 6.37 percent in 2014. Further reduction in repo rate to 6.75 and reverse repo to 5.75 lead to a favorable inflation rate of 5.88 percent in 2015. Rajan faced a lot of criticism on this RBI measures. But as a strategic move Dr. Rajan again curtailed the repo and reverse repo to 6.5 and 6.00 percent respectively in April 2016 and maintained the same rates until his retirement on 5 September 2016. Then average rate of inflation stood at 5.71 percent in 2016. The current inflationary situation is way above the central bank's comfort zone of 5-6 percent.

Here is the summary how Dr. Rajan fared on seven key parameters during his tenure.

Parameter	September 2013	August 2016
CPI Inflation	10.70%	5.71%
Repo rate	7.50%	6.50%
Rupee	68.85	66.83
Lending Rate	10.3	9.3
Nifty50	5,680	8,711
Current Account Deficit (CAD)	4.10%	.10%
Gross Non Performing Assets (NPAs)	Rs 2.52 lakh crore	Rs 5.94 lakh crore

Source: www.tradingeconomics.com

Conclusion

When Dr. Rajan took over as the RBI chief in September 2013, the rupee was trading near a record low of 68.85 per dollar. But within days of him assuming charge of the RBI, the rupee staged a remarkable comeback. Moreover India was battling double-digit inflation in 2013, which forced the central bank to keep interest rates high. Dr. Rajan also increased rates when he took over to tackle the menace of inflation, but sustained policy focus helped the RBI bring inflation to below 5 per cent. Under Dr. Rajan, a new monetary framework that focused on bringing inflation down was formalized. When Dr. Rajan took over as RBI chief, India was reeling under high fiscal and current account deficits in a slowing economy. India was then clubbed with "Fragile Five" countries, a term used for countries with high inflation, currency volatility and weak growth. When he was leaving, India became the fastest-growing big economy in the world. Lower inflation and stability in the currency markets has helped Dr. Rajan bring down the key repo rate to a five-year low. After initially raising nominal interest rates by 50 basis points, or 0.50 per cent, to quell inflation, RBI embarked on a journey of rate cutting. When Dr. Rajan took office, repo rate stood at 7.5 per cent, which then rose to 8 per cent in January 2014. Post-January 2015, repo rate has been slashed by 1.5 per cent to 6.5 per cent, which is the lowest level in four-and-a-half years. This has helped the economic growth and consumer spending. Under Dr. Rajan, public sector banks have embarked on an ambitious plan to clean up their balance sheets. The Reserve's Bank's Asset Quality Review (AQR) has forced PSU lenders to recognize non-performing loans, which augurs well for future economic growth. In short it has been a fairly smooth ride for the RBI Governor, except for the political storm that he faced in the final year of his tenure. Dr. Rajan’s performance should be measured more in terms of economic parameters than anything else.

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