RGICS

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RGICS BRIEF ANALYSIS

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RBI Rate Cuts

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Introduction

Repo rate is the rate at which the central bank of a country (RBI in case of India) lends money to commercial banks in the event of any shortfall of funds. In the event of inflation, central banks increase repo rate as this acts as a disincentive for banks to borrow from the central bank. The increase in the Repo rate increases the cost of borrowing and lending of the banks which discourages the public to borrow money and encourages them to deposit. As the availability of credit and demand decreases, there is a decrease in inflation.

When the repo rate is reduced, the resultant reduction in cost of credit encourages investment and consumption demand. This eventually gets reflected in an increase in output and prices. Against a background of relatively low inflation, repo rate reduction may aid in stimulating investment and growth. Table 1 gives the repo rates set by the RBI from the year 2011 to March, 2015, along with the corresponding monthly Consumer Price Index inflation rates (in percentage).

Table 1. Repo Rates of RBI, CPI inflation figures

Effective date	Repo Rate (%) *	Change (basis points)	CPI inflation rate (in %) (combined) **	
04-03-2015	7.50	-25	5.37 (provisional)	
07-02-2015	7.75		5.37 (provisional)	
15-01-2015	7.75	-25	5.19	
09-08-2014	8.00		6.46	
14-06-2014	8.00		7.46	
28-01-2014	8.00	+25	8.79	
29-10-2013	7.75	+25	10.17	
07-10-2013	7.50		10.17	
20-09-2013	7.50	+25	9.84	
15-07-2013	7.25		9.64	
03-05-2013	7.25	-25	9.31	
19-03-2013	7.50	-25	10.39	
09-02-2013	7.75		10.91	
29-01-2013	7.75	-25	10.79	
03-11-2012	8.00		9.90 (prov.)	
22-09-2012	8.00		9.73	
11-08-2012	8.00		10.03	
17-04-2012	8.00	-50	10.26	
10-03-2012	8.50		9.38	
13-02-2012	8.50		8.83	
28-01-2012	8.50		7.65	
25-10-2011	8.50	+25	9.36[1]	-
16-09-2011	8.25	+25	9.43[1]	10.06[2]
26-07-2011	8.00	+50	9.03[1]	8.43[2]
16-06-2011	7.50	+25	9.32[1]	8.62[2]
03-05-2011	7.25	+50	9.63[1]	8.72[2]
17-03-2011	6.75	+25	9.14[1]	8.82[2]
25-01-2011	6.50		8.67[1]	9.30[2]

Source: *Reserve Bank of India
** Ministry of Statistics and Programme Implementation of India (MoSPI)
Labour Bureau, Government of India

[1] Inflation based on Consumer Price Index for agricultural labourers (Labour Bureau, GoI)
[2] Inflation based on Consumer Price Index for industrial workers (Labour Bureau, GoI)

Context

- India has faced untamed inflation since 2009. Against this backdrop, the RBI kept the cost of funds high, to combat price rise, and therefore did not cut repo rates substantially as that would add to inflationary pressures.
- **Inflation in India was persistently high during 2010 and 2011. In response, monetary policy was progressively tightened beginning March 2010. (RBI, 2012) The Reserve Bank raised its policy repo rate 13 times between March 2010 and October 2011 by a cumulative 375 basis points. The policy repo rate increased from a low of 4.75 per cent to 8.5 per cent. (RBI, 2013)**. However, even this did not help contain inflation.
- Over this period, domestic growth of GDP slowed down, while inflation remained relatively sticky. **The slowdown in growth was not only due to the monetary stance, but also the global economic recovery losing momentum over euro area sovereign debt concerns and domestic policy and regulatory concerns**. (RBI, 2012)

However in, post the BJP-led NDA Government took over, **between June 2014 and January 2015, the price of Brent crude oil benchmark dropped by around 60%** plunging to a six-year low of $47 per barrel in January. Accruing to the slump in oil prices, **India's annual fuel and power inflation declined to 3.4% in December 2014 from 6.5% in January 2014, resulting in a drop in Consumer price Index (CPI) inflation to 5% from 8.8% during the period.**

Falling oil prices allowed the government to bring about a slew of fuel subsidy reforms in October 2014, including diesel price deregulation and announcement of a new gas price. (Business Standard, 2015) A lower fuel subsidy bill will reduce the government's fiscal deficit. India benefitted from lower oil prices through lower inflation (seen from Figure 1), an improved trade balance and lower fuel subsidy costs.

Amidst this favourable environment, the RBI cut the repo rate by 25 basis points on January 1st, 2015. It announced that the next cut would be dependent on the quality of fiscal consolidation, and would hence come post the Union Budget 2015-16. Post the Budget, the RBI cut the repo rate further by 25 basis points as on 4th March, 2015. (Reuters, 2015) [3]

A slew of factors were taken into consideration by the RBI for cutting the rates unexpectedly. These include:

1) The rebased consumer price inflation rate for January, which came in lower than expected at 5.11% (below the March target of 6%). (The Economic Times, 2015).
2) The Union budget 2015-16 which, according to Mr. Raghuram Rajan, has relatively realistic projections and attempts to ease supply-side pressures.
3) The disinflationary effect of a stronger rupee was also factored in by the RBI. (Livemint, 2015)
4) The international factor was also accounted for. Since RBI policy rate cut on 15 January, the central banks of China, Indonesia, Turkey, Australia, Russia, Pakistan and Egypt all cut their policy rates. Several central banks in Europe have pushed their rates below zero. The European Central Bank is going in for quantitative easing.
5) While the next bi-monthly policy statement will be issue on April 7th, 2015, the still weak state of certain sectors of the economy as well as the global trend towards easing pushed the RBI for the cuts.

Impact

The International Monetary Fund's 2014 annual review of the Indian economy, released on March 11, 2015, gave promising forecasts for India. Commentators focused mostly on the growth forecast for 2014-15 and for 2015-16, which pointed towards a rapidly growing economy. IMF expects India's GDP to grow by 7.2% during fiscal 2014-15 and by 7.5 per cent during 2015-16.
Based on this endorsement of higher growth forecasts, analysts argued for rate cuts citing it as the only hurdle between India and double digit growth. The RBI thus cut rates twice, in January and March, 2015. **Ideally, a cut in the Repo rate should signal banks**

[3] •RBI cut banks' Statutory Liquidity Ratio (SLR) by 50 basis points to 21.5% of total deposits from fortnight starting February 7, 2015.
•However, the SLR cut is not of much significance as most banks hold heavy quantities in SLR as there are no significant lending opportunities. (U.R. Bhatt, Managing Director, Dalton Capital, Mumbai)

to reduce their respective base rates, making loans cheaper for consumers. [4] **Additionally, cheap loans should encourage corporate to take advantage of cheaper money and invest in their businesses. Cheap availability of credit may also work well for India's investment starved infrastructure sector.** (Market Realist, 2015)

However, a document released along with the Indian economy review, by the IMF, called Selected Issues (as background documentation) has given some important points on monetary transmission in India. **On the basis of an internal model, this document says that the two-stage transmission between a repo rate cut to bank lending rate cut, via the weighted average call money rate, takes a total of 32 months. The impact on deposit rates is faster at 23 months. Translated, that means the RBI's repo rate cut in January 2015 is likely to result in lower bank lending rates only by September 2017.** The final impact on economic output and price levels, and hence growth impetus, will take even longer to feed through the relevant economic linkages. **Therefore, the transmission time between RBI's rate action and banks cutting their lending rates is undeniably long, fraught with uncertainties and resistant to any mapping or measurement.** (The Hindu Business Line, 2015)

Post the January repo rate cut of 25 basis points, the United Bank of India actually did reduce its base rate hours after this rate action by the RBI. However, **the cumulative 50 basis points reduction since January has not provided relief to consumers struggling under heads like high EMIs. This is because none of India's big commercial banks, including state-run SBI and private sector lender ICICI bank have yet cut their base rates in response to RBI's repo rate cuts.** Dr. Saumya Kanti Ghosh, chief economic advisor at SBI thinks that, banks are flush with funds, so a change in repo rate will have no significant impact on liquidity and cost of funds. It is for this reason that none of the big lenders have slashed lending rates. (NDTV Profit, 2015)

The failed transmission of RBI's rate cuts has prompted some economists to expect a reduction in cash-reserve ratio ahead of RBI's next policy meeting on April 7, 2015. Additionally, economists are betting for a further 75 basis points to hundred basis points repo rate cut through the year to boost credit offtake at a time when growth continues to be sluggish. (NDTV Profit, 2015) In the face of the conflicting transmission time periods provided by the IMF and the RBI, as well as the existence of numerous structural road blocks that hinder smooth diffusion of monetary policy, there are legitimate questions about the efficacy of the monetary policy arrangement between the RBI and the government. (The Hindu Business Line, 2015)

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[4] The base rate is the rate below which a bank cannot lend, and it includes all lending rates that are common to all kinds of borrowers.

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