Article:
https://indianexpress.com/article/business/economy/rbi-governor-shaktikanta-das-live-updates-inflation-7900659/

Inflation finally hits RBI, pushes it to raise key policy rate, sudden and sharp

By hiking the Repo rate and CRR, the RBI is aiming to keep inflation – which is already close to 7 per cent — at its desired level and control and monitor money flow into the banking system.

Bringing an end to the low interest rate regime, the Reserve Bank of India (RBI) on Wednesday jacked up the Repo rate, the main policy rate, by 40 basis points to 4.40 per cent and the cash reserve ratio (CRR) by 50 basis points to 4.50 per cent to bring down the elevated inflation and tackle the impact of geopolitical tensions.

In an unscheduled meeting of the Monetary Policy Committee, the central bank, however, retained the accommodative monetary policy. The sudden RBI move — the first hike after August 2018 — is expected to push up interest rates in the banking system. Equated monthly instalments (EMIs) on home, vehicle and other personal and corporate loans are likely to go up. Deposit rates, mainly fixed term rates, are also set to rise.

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The hike in Repo rate – the key policy rate of RBI or the rate at which it lends to banks – means the cost of funds of banks will go up. This will prompt banks and NBFCs to raise the lending and deposit rates in the coming days. Analysts say that consumption and demand can be impacted by the Repo rate hike. From the 8 per cent level in January 2014, Repo rate had fallen to 4 per cent by May 2020 after the RBI slashed the rates over the years to boost growth – the last cut was by 40 basis points in May 2020 to tackle the negative impact of Covid pandemic.

The 50 bps hike in CRR will suck out Rs 87,000 crore from the banking system. CRR is the percentage of depositors' money that commercial banks have mandatorily to park with the Reserve Bank. The lendable resources of banks will come down accordingly. It also means the cost of funds will go up and banks' net interest margins could get adversely impacted. If the RBI wants to infuse more liquidity into a system, it lowers the CRR and leaves banks with more liquidity to lend to their customers. On the other hand, if it wants to take out liquidity from the system, it increases the CRR rate.

Unveiling the policy, RBI Governor Shaktikanta Das on Wednesday said the hike in Repo rate and cash reserve ratio was aimed at reining in elevated inflation amid the global turbulence in the wake of the Ukraine war. "As several storms hit together, our actions today are important steps to steady the ship," Das said in his statement. Inflation must be tamed in order to keep the Indian economy resolute on its course to sustained and inclusive growth, he said. In the April 2022 policy review, the RBI had kept the

Repo rate unchanged at four per cent but the situation, especially on the global and inflation fronts, has gone from bad to worse. There was a spike in the headline CPI inflation to 6.95 per cent in March 2022 as anticipated in the April policy statement. The inflation print for April is also expected to be elevated. “There is the collateral risk that if inflation remains elevated at these levels for too long,” Das said, justifying the rate hike.

“I would, therefore, like to emphasise that our monetary policy actions today – aimed at lowering inflation and anchoring inflation expectations – will strengthen and consolidate the medium-term growth prospects of the economy,” he said.

“We remain mindful of the possible near-term impact of higher interest rates on output. Our actions will, therefore, be calibrated,” Das said. “I would like to further stress that monetary policy remains accommodative and our approach will be to focus on a careful and calibrated withdrawal of pandemic-related extraordinary accommodation, keeping in mind the inflation-growth dynamics.”

“It is necessary for monetary policy to focus on the withdrawal of accommodation,” Das said. The RBI had kept the Repo rate unchanged for the last two years and infused huge liquidity into the system to boost the growth. “I take this as a strong message from the RBI that it’s taking inflation very seriously,” Kotak Mahindra Bank Vice Chairman and MD Uday Kotak said.

Analysts are now expecting more rate hikes by the RBI in the coming months. “The sharper than expected rate increase by the RBI today paves the way for a more aggressive rate hike cycle than we earlier expected,” said Abheek Barua, Chief Economist, HDFC Bank.

Commentary:

The above article discusses the contractionary monetary policy implemented by the Reserve Bank of India (RBI) on June 8th, 2022. Pursued during inflation, this policy entails intervention by the central bank in the form of increasing interest rates to lower investments and consumption. Intervention is defined by regulatory actions taken by the government to influence decisions made by agents, in hopes of benefiting the whole economy. In this scenario, the RBI intervened and increased interest rates by 0.4% and the cash reserve ratio (CRR) by 0.5%. This policy was carried out to reduce aggregate demand (AD) and the lending capacity of banks to, by extension, counter the inflation rate of 6.95% in the Indian economy.

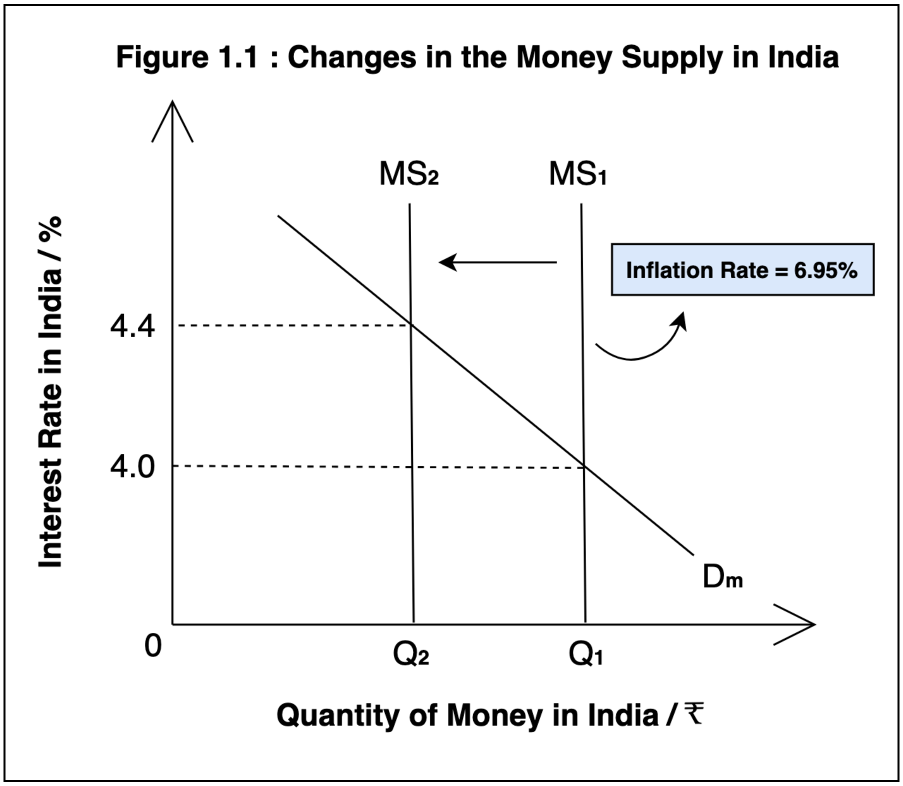
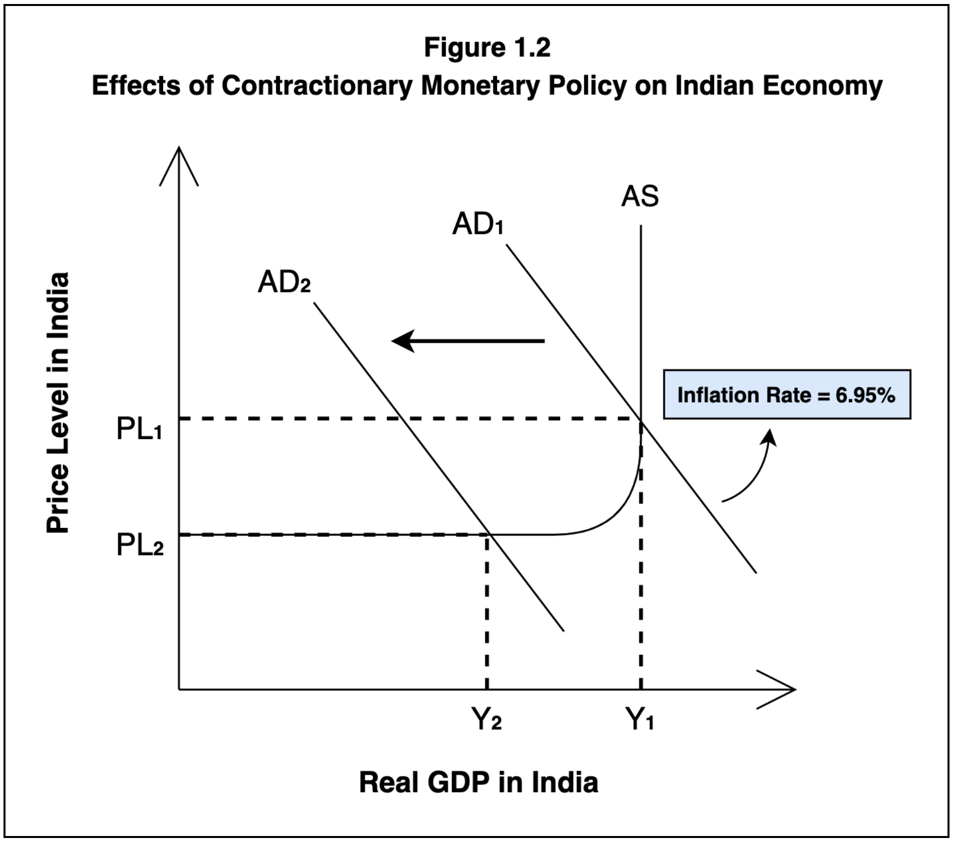


Figure 1.1 depicts how the contractionary monetary policy impacted the money supply in the Indian economy. As shown in the graph, at 6.95% inflation, the interest rate in India was 4.0% where MS_1 represents the money supply and Q_1 is the quantity of money. At MS_1, there is high consumer expenditure, borrowing and liquidity. This means that assets can easily be converted to cash and there is a rapid flow of money in the economy. However as the article reads, the RBI aimed to “monitor money flow” and “take out liquidity from the system”. In order to achieve this, the central bank increased interest rates to 4.4%, decreasing money supply to MS_2 and the quantity of money in India to Q_2. The new money supply decreases investments and the purchasing power of consumers, discouraging spending. In other words, there is a decrease in AD in India. Overall, the contractionary monetary policy slows down Indian economic activity, fulfilling the macroeconomic objective of limiting inflation.



As aforementioned, the RBI increased interest rates and the CRR by 40 and 50 basis points respectively. As displayed in Figure 1.2, this contractionary monetary policy was executed to decrease AD from AD_1 to AD_2, further decreasing price levels from PL_1 to PL_2 and real GDP from Y_1 to Y_2. This is called inflation targeting. As inflation is the persistent increase in the average price level of all goods and services in the economy, these changes would combat its high rate at AD_1. At 6.95% inflation in India consumers have low purchasing power due to the high prices of goods and services. They are further discouraged to spend as the uncertainty associated with inflation causes a loss in consumer confidence. This is the initial reason for AD_1 to decrease to AD_2. Moreover, as the value of cash is depreciating, lenders and savers are worse off too. Additionally, the high price levels make exports expensive, adversely affecting international trade. Wholly, the Indian economy is negatively impacted by the steep inflationary gap, forcing the RBI to intervene.

Firstly, the 0.4% rise in interest rates increases the cost of borrowing, discouraging consumers from taking out loans. Moreover, as stated in the article, “Equated monthly installments (EMIs) on home, vehicle and other personal and corporate loans” become more expensive. AD is defined by the equation C+I+G+(X-M) where C represents consumer expenditure and I is investment. Therefore, reduced consumption and investment spending decreases AD as a whole. However, high interest rates incentivize saving as deposits are more yielding.

Next, the 0.5% increase in the CRR indicates that banks must send more cash to the central bank reserve, lowering their lending capacity. This makes it harder for borrowers to obtain loans and diminishes the value of the money multiplier: a factor by which GDP changes following a change in an injection or leakage. Nevertheless, these changes will slow down Indian economic activity and reduce inflation to “keep the Indian economy resolute on its course to sustained and inclusive growth”.

Although this contractionary monetary policy decreases AD and price levels in hopes of disinflation, it comes with its drawbacks. Firstly, as prices are sticky in the short run, it will take time for this policy to impact AD. Additionally, a liquidity trap can form due to the stark decrease in interest rates and consumers that now prefer saving after losing confidence in the economy. This will reduce the efficacy of any monetary policy implemented by the RBI in the future. Furthermore, inflation targeting reduces the government’s ability to follow other macroeconomic objectives. This is explained by the following example. As aforementioned, low interest rates cause a decrease in foreign investments. A possible solution for this would be to strengthen the exchange rate by, for instance, selling foreign assets. However, this would clash with the balance of payments objectives of the government.

Alternatively, a contractionary fiscal policy could be implemented to battle inflation. A higher rate of income and corporate tax could reduce spending and hence, inflationary pressures. This would create a stable economic environment as there would be lesser business cycle fluctuations, increased investments and more research and development. Long run aggregate supply would increase, favoring the economic growth of India.