



Effect of change of Repo Rate on Interest Rates and Inflation

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Abstract

One of the pivotal components adding to bank's execution is the interest rate offered by the bank on the fixed deposits. The present work examines the determinants of premium rates of fixed deposits offered by select banks in India. Repo Rate is an important asset of the Reserve Bank of India to control the level of inflation and liquidity in the market. Repo rate is the rate of interest charged by the central bank when other banks approach them for short term borrowings. The purpose of the study was to understand the working of the Repo rate, after effects of its increase and decrease, how they control inflation and liquidity in the market. Repo rate indirectly helps in maintaining the balance between the inflation and the liquidity in the market. How does Repo rate effects the bank interest loans and deposits interest rate is also discussed in the study. After discussing with the management of the banks, it was found that the banks decide the interest rates immediately after the RBI changes the CRR, repo rate, SLR, reverse repo rate considering their asset liability divergences and likely actions by other competitive banks. It was observed that banks like ICICI Bank respond to the RBI announcements faster than other banks and lead everyone by changing rates first. While other banks wait and observe the responses of banks like SBI/ICICI Bank before changing their rates.

Keywords: Repo Rate, Interest Rate, Inflation

Introduction:

There is a general recognition that monetary policy affects real economy at least in the short run. However, there is no general agreement on the channel through which monetary policy influences the behavior of output and prices. The theoretical explanations on monetary policy transmission have evolved over the years, with major episodes of crises playing an important role in prompting revaluations of earlier tenets. Keynes in his general theory of output and employment described the importance of interest rate channel of monetary policy transmission. Monetarist characterization of transmission mechanism by Friedman and Schwartz [1963] emphasized the role of money supply besides other assets. Life cycle hypothesis by Ando and Modigliani [1963] emphasized the wealth effect, while Tobin [1969] highlighted the importance of the cost of capital and portfolio choice in the transmission of monetary policy.

In the recent years, monetary policy transmission has been an issue of extensive research particularly since Bernanke's seminal article in 1986 which provided alternative explanations of real and nominal sources of prices for explaining money-income relationship. However, the findings on the efficacy of various channels of transmission remain an unresolved issue. Bernanke and Blinder [1988] pointed out the importance of credit channel of monetary policy transmission

in the US. However, Romer and Romer [1990] did not find support for credit channel of monetary transmission.

This lack of a consensus on the channels of monetary transmission can be clearly seen from the debate in a Symposium on 'The Monetary Policy Transmission' published in the Journal of Economic Perspectives in 1995. Taylor [1995] using a financial market prices framework reviewed the impact of monetary policy transmission on real GDP and prices, and found the traditional interest rate channel to be an important channel. Obstfeld and Rogoff [1995] emphasised the importance of exchange rate channel and concluded that the conduct of monetary policy has international implications. Meltzer [1995] re-emphasised transmission through multiple asset prices, extending beyond interest rates, exchange rate and equity prices.

Bernanke [2011] and Yellen [2011] argued that the transmission channels through which unconventional and conventional monetary policy affect economic conditions are quite similar. However, Yellen [2011] highlighted the importance of 'portfolio balance channel' and 'expectations' channel during crisis. Analysing the impact of quantitative easing adopted during recent global financial crisis on the UK economy, Joyce et al. [2011] have highlighted the importance of the different transmission channels, particularly asset prices which were expected to have conventional effects on output and inflation. In short, crisis has highlighted two important aspects of monetary policy transmission. First, due to information asymmetries and other inefficiencies across financial markets, the conventional channels of monetary policy transmission may not always work effectively. In this context, a number of studies have underscored the importance of financial intermediaries' stability to facilitate a smooth transmission of policy. Second, when the traditional interest rate channel of the monetary policy transmission mechanism broke down after policy rates reached the zero lower bound during crisis, the role of unconventional policy measures became more prominent which worked mainly through asset price and expectations channels.

A number of studies have also examined the importance of different channels of monetary policy transmission in India. Al-Mashat [2003] using a structural VECM model for the period 1980:Q1 to 2002:Q4 found interest rate and exchange rate channels to be important in the transmission of monetary policy shocks on key macroeconomic variables. Bank lending was not an important channel due to the presence of directed lending under priority sector. On the other hand, Alem [2010] studying credit channel, asset price channel and exchange rate channel of monetary policy transmission using VAR models for the period 1996:Q4 to 2007:Q4 found credit channel to be the only important channel of monetary transmission in India.

The RBI Working Group on Money Supply (Chairman: Y.V. Reddy, 1998) pointed to some evidence of interest rate channel of monetary transmission. RBI [2005] using a VAR framework for the period 1994-95 to 2003-04 found that monetary tightening through a positive shock to the Bank Rate had the expected negative effect on output and prices with the peak effect occurring after around six months. Monetary easing through a positive shock to broad money had a positive effect on output and prices with peak effect occurring after about two years and one year, respectively. Further, exchange rate depreciation led to increase in prices with the peak effect after six months and a positive impact on output.

Using cointegrated VAR approach, Singh and Kalirajan [2007] showed the significance of interest rate as the major policy variable for conducting monetary policy in the post-liberalised Indian economy, with CRR playing a complementary role. Patra and Kapur [2010] also found that

aggregate demand responds to interest rate changes with a lag of at least three quarters. However, they pointed out that the presence of institutional impediments in the credit market such as administered interest rates could lead to persistence of the impact of monetary policy up to two years. Bhaumik et al. [2010] highlighted the importance of bank ownership in monetary policy transmission through the credit channel. Pandit and Vashisht [2011] found that policy rate channel of transmission mechanism, a hybrid of the traditional interest rate channel and credit channel, works in India, as in other six EMEs considered by them.

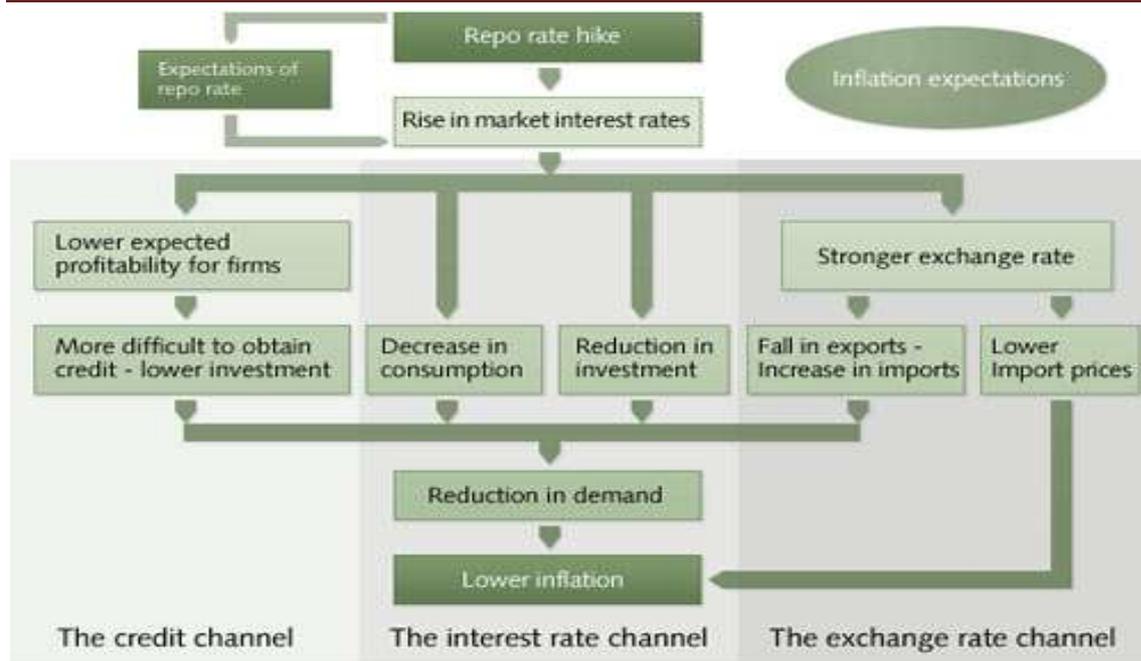
How changes in the repo rate affect inflation

The way in which changes in the repo rate affect inflation and the rest of the economy is known as **the transmission mechanism**. The transmission mechanism is actually not one but several different mechanisms that interact. Some of these have a more or less direct impact on inflation while others take longer to have an effect. It is generally held that a change in the repo rate has its greatest impact on inflation after one to two years.

The first thing that happens when the central bank changes the repo rate is that the so-called overnight rate is affected. The overnight rate is the rate at which the banks lend and borrow money to one another during the day. The size of the effect that a change in the repo rate has on interest rates with a longer duration depends on how expected the adjustment is. The central bank aims to make its monetary policy foreseeable. The central bank tries to affect outlooks of future monetary policy by regularly broadcasting forecasts for the repo rate. In this way it is easier to avoid changes in the repo rate coming as an amazement.

Both the actual and expected repo rate affects the bank's lending rates and interest rates on securities. If a increase in the repo rate is fully predictable, market rates can begin to escalate before the repo rate itself is raised up. Then, when the repo rate is actually raised, it will not essentially have any further effect on market rates if it simply confirms market anticipations.

Interest rates the general public face is effected by monetary policies and thereby also effecting the total demand and total supply in the economy. The channels that mean that market interest rates affect supply and demand can be divided into the Interest rate channel, the credit channel and the exchange rate channel.



Credit channel

The way in which monetary policy affects demand via banks and other financial institutions is defined by the credit channel. Banks choose to decrease their lending and instead buy bonds in case the interest rate rises. Households and companies find it more difficult to borrow money due to this. Businesses that are either unable or reluctant to borrow must cut back their deeds, reschedule outlay of money and so on, and this reduces movement in the economy.

Interest rate channel

The demand for goods and services is affected by interest rate channels. Higher interest rates generally lead to a decline in domestic consumption. This takes place for several reasons. Higher interest rates help in increasing the will to save, in other words to delay consumption, thus dropping present consumption. More cost of existing loans in terms of interest payments is also a reason behind the fall in consumption. Finally, higher interest rates mean that the price of both financial and real assets - shares, bonds, property, etc. - falls in that the present value of future returns drops when interest rates rise. When faced with diminishing wealth, households become less enthusiastic to consume.

An ascent in interest rates likewise makes it more costly for firms to back venture. Subsequently, higher interest rates typically reduce speculation. On the off chance that consumption and investment fall, so does total demand.

Lesser aggregate demand leads to lesser resource utilisation. When resource utilisation is less, rates and wages ordinarily rise at a more uncertain rate. In any case, it takes time when a decline in utilisation of resources leads to a decrease in inflation. This is halfway in light of the fact that wages don't change from month to month yet more sometimes than that.

Exchange rate channel

The exchange rate channel defines in what way the value of the currency is affected by the monetary policy. Normally, an increase in the repo rate leads to a solidification of the Indian National Rupee. In the short term, this is because higher interest rates make Indian assets more attractive than investments denominated in other currencies. This results in a capital inflow and amplified demand for rupee, which again strengthens the exchange rate.

Monetary policy also plays a significant part for the exchange rate in the long term. By definition, the exchange rate is the price of a country's currency stated in relationship with another country's currency, which means that it is affected by variations in inflation amongst countries. Tougher monetary policy leads to lower inflation, which can be expected to be reflected in a stronger exchange rate in the long run.

A stronger exchange rate – an appreciation – has an influence on the economy in two key ways. First, foreign goods become cheaper when compared with locally produced goods. This results in a decline in exports and rise in imports. Lower demand for the local goods adds to a reduction in resource utilisation and diminishes inflationary pressure.

Second, changes in the rupee prices of goods for cross-border trade also leads to the inflation affected by the exchange rates. Firms that import goods to India pay a lower price in rupee for their imports. In this way, a stronger rupee tends to lower the inflation rate, as imported goods and import-competing goods become cheaper. This strengthens the diminishing effect on inflation of falling demand.

Inflation expectations

Inflation desires are essential to the route in which organizations set costs and to how wage arrangement capacities and in this manner to inflation. On the off chance that everybody assumes that inflation will stay low and that costs will just climb incidentally, this will lead organizations to consider that they don't have to change their costs as frequently. An employee may reason in the same route as to wage requests, which implies that the result from compensation bartering rounds is at a sensible level. Both of these occasions make it simpler for the national bank to accomplish value soundness.

However, the fact that inflation outlooks are firmly attached at the inflation target is no purpose for the central bank to leave the repo rate unaffected. Rather, this should be taken as a symbol that the public expects the central bank to do what is needed to confirm that inflation is 2 per cent. In other words, inflation outlooks can be seen as a degree of the public's confidence in the central bank to accomplish the inflation target.

However, if inflation anticipations stray from the target, it may direct that the public does not have confidence that the central bank will succeed to keep inflation under control. The central bank may then need to alter the repo rate at a diverse speed than is reflected in anticipations of future monetary policy. In this way, different methods of inflation anticipations and market anticipations of monetary policy serve as an enhancement to the central bank's own forecasts for inflation and the interest rate. The central bank therefore regularly tracks improvements in various methods of inflation outlooks and announces them in its Monetary Policy Report.

How CRR and Repo Rates affect Liquidity?

The Reserve Bank of India has various means of controlling and maintaining liquidity in the market. Two amid them are the CRR and Repo rate.

CRR: Cash reserve Ratio (CRR) is the amount of money that the banks have to preserve with the RBI. If the central bank chooses to increase the CRR, the accessible amount with the banks comes down. The RBI uses the CRR to flush out unnecessary money from the system. It's obligatory for scheduled banks to maintain with the RBI an average cash balance, that amount shall not be less than 4% of the total of the Net Demand and Time Liabilities (NDTL), on a fortnightly basis. Cash Reserve Ratio (CRR) is the ratio of deposits banks must maintain with the Reserve Bank of India. This means that if a person deposits Rs 1,000 in his bank account, the bank can use it to lend to other customers, but the bank has to deposit a fixed percentage of that amount with the RBI. Hence, if CRR is 5%, the bank or lender will deposit Rs.50 with the RBI and can use Rs.950 for further lending.

Repo Rate: The repo or repurchase rate is the interest which RBI charges to banks when they approach it for short term loans.

The repo rate is linked to the interest rate borrowers pay when they take loans from banks because the banks always charges interest which is higher than the prevailing repo rate. Hence, lower repo rates could persuade lenders into lowering the interest rates they charge from individual borrowers too, thereby making credit more reasonably priced.

Reverse Repo Rate: Reverse Repo rate is the rate which commercial banks charge when RBI borrows money from them. Banks are always willing to lend money to the RBI since their money are in safe hands with a good interest. An increase in reverse repo rate can result in banks keeping more funds with the RBI in order to earn higher earnings on idle cash. It is also an important tool which is used by the RBI to flush excess money out of the banking system.

CRR determines bank interest rates: If a man had deposited Rs.1,000 in his account at the time when the CRR was 5%, the bank will have Rs.950 at its disposal after depositing Rs.50 as CRR. The bank in return lends the Rs.950 to a borrower who will ultimately repay the bank.

The bank will once again lend this amount (Rs.950) to another borrower after depositing 5% of the amount (Rs.47.5) to the RBI. In this manner, the money will keep exchanging hands, or it continues to be created and available for subsequent borrowers. This means that Rs.1,000 is helping generate a far higher amount in the economy in an indirect manner. Therefore, even if the CRR were to be increased by only 1%, the money generated in the economy would reduce drastically.

Repo rate and inflation: When the repo rate is elevated, banks are required to pay higher interest to the RBI which in turn stimulates them to raise the interest rates on loans they offer to customers. The customers then are discouraged in taking credit from banks, leading to less liquidity and shortage of money in the economy. So, while on the one hand, inflation is under controlled as there is less money to spend, growth suffers as businesses evade taking loans at high rates, leading to a shortage in production and expansion.

The RBI revises CRR and repo rates in their quarterly and mid-quarter policy reviews to sustain an optimum balance between growth and inflation. The past two years have been evident of this practice as the central bank tried to first tame the monster of inflation with violent rate hikes, and once it saw growth taking a hit, reduced key rates to recover the economy.

Repo rate hike – Impact on loans and deposits

Reasons why RBI's repo rate policy have impacts on fixed deposits, loans and other areas of life for the common man.

Understanding Repo Rate:

Before getting into the reasons why the increment in repo rates may be awful news for the normal man with increased credit EMIs, it is crucial to comprehend what repo rates are and how they affect the banking system. In simple term, Repo rate is the rate at which the Reserve Bank of India gives cash to commercial banks. The increment in repo rates for 7.75% to 8% would imply that the RBI would charge a higher rate of interest for all cash offered out to different commercial banks. The bank thus would be compelled to charge its clients a higher rate of premium with regards to home and car advances to counterbalance the higher premium rate.

Immediate Term Impact on Deposit and Lending Rates:

Most money related specialists are of the supposition that the prompt effect of the increment in repo rates may not so much get deciphered into higher deposit and premium rates offered by the banks. The banks effectively battling a frail advance development rate because of a drowsy land part are unrealistic to pass on the increased rates to the clients quickly. Contingent upon the liquidity state of the banks, the changed premium and deposit rates may be passed on once banks investigate their expense of funds through the following few days.

Brace Yourself for Higher EMIs:

When the banks dissect their expense of funds and their general liquidity condition, the higher premium rates would need to be passed on to the end client or the retail client. This would adequately mean higher EMIs on home credits, car advances and individual credits.

The home credit fragment is prone to face the brunt of this increment in repo rate. Monetary specialists accept that since the auto advance business sector is overwhelmed by different plans, financiers are liable to ingest the rate climb by increasing rebate offers. Greater part of auto credits are on settled rate premise contrasted with home advances with lion's share offered on skimming rate premise. Any rate affect because of the repo rate increment would not so much effect the vehicle advance market as much as it would affect the home credit fragment. Land organizations and designers officially confronting the brunt of lazy deals are baffled with this rate climb as it is prone to hose enthusiasm for the land section.

Repo Rate and Home Loans:

The inquiry concerning whether banks would really expand the giving rates in the midst of the climb in the repo rates remains an open one. Once finished with dissecting their expenses of funds and bank liquidity conditions, the banks would have no alternative yet to build their interest rates in the advancing months.

For instance, accepting the investment rate on a 20 year housing advance of Rs 75 Lakh is expanded from 11 to 11.25 %, it will decipher into an increment of give or take Rs 1279 every month in the EMI.

Repo Rate and Fixed Deposits:

The fleeting effect of such a climb is does not forecast well for financial specialists stopping their cash in settled stores. Being a race year, the banks may decrease retail store rates marginally for beneath one-year fixed deposits basically to keep their edges in place. The long haul approach of the RBI is presently gone for battling retail inflation. Once the inflation rates are generously brought down, the possibility of putting resources into fixed deposits over the long haul offers lucrative increases. The prompt effect on little fixed deposits may be a damper however banks are unrealistic to lower premium rates in all cases starting now offering alleviation to a tremendous area of fixed deposit account holders.

Conclusion

Reserve Bank of India (RBI) is the national bank of India. Its primary objective is to secure financial solidness in the nation. For this, it is outfitted with freedom in forming and executing financial approaches keeping in mind the end goal to keep up value dependability and sufficient cash supply in the framework.

RBI takes different expansionary and contractionary steps to achieve its goals and utilizes its tools such as Cash Reserve Ratio (CRR), Statutory Liquidity Ratio (SLR), Bank Rate, Open Market Operation (OMO) and Liquidity Adjustment Facility (LAF) for this.

Amongst all the rates, Repo rate is the rate which impacts most of the given money supply in the economy. Repo rate is the rate at which RBI grants short term funds to the bank. It is a borrowing which is secured in nature similar to a loan against fixed deposits or property availed by people during emergencies. To increase the overall cost of funds in the banking system RBI increases the Repo Rate. The demand for funds will be under control because of higher costs. It becomes costly for banks to borrow money from RBI, if the RBI increases its Repo Rate, so in order to compensate for the hike in Repo Rate banks increase the rates at which they grant loans to general public.

The policy of reducing Repo and Reverse Repo rates is basically not good for the economy in the long-run as it greatly aids the creation of the business cycle. It also hurts the pockets of the ordinary people by sending interest prices soaring. However, in the short term, both industry and banking system derive great benefits from it. This explains a lot why a policy of reducing repo and reverse repo rates finds fairly broad-based backing from the banking industry and general industry as well.

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