Repo Rate Hike

Why in news?

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- The monetary policy committee (MPC) of the RBI has decided to increase the repo rate by 25 basis points.
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What is a repo rate?

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- Repurchase rate or the repo rate is the rate at which the RBI lends money to commercial banks.
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- This is availed by the banks in the event of any shortfall of funds.
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- Reverse repo is the rate at which the RBI borrows money from commercial banks within the country.
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- RBI has now increased the repo rate by 25 basis points to 6.5% in the recent MPC meet.
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- The Reverse repo is adjusted to 6.25 per cent.
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What are the driving factors?

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- **Inflation** - Fear of rising inflation rates has been a major factor for raising the policy rates.

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- According to the RBI, inflation outlook is likely to be shaped by several factors:
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- 1) The foremost is the government's decision to increase the minimum support price (MSP) for kharif crops.
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- MSP hike may have a direct impact on food inflation and eventually on headline inflation.
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- 2) The gradual impact of HRA (house rent allowance) revision by state governments could push inflation further up.
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- 3) There is a continuing volatility in crude oil prices and is also vulnerable to geopolitical tensions.
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- The resultant supply disruptions is one of the main risks to the inflation outlook.
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- 4) Rainfall has so far been 6% below the long-period average and deficient over a wider area than last year.
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- This has resulted in a drop in the total sown area under kharif.
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- Regional imbalances in rainfall could pose risks to paddy output and eventually reflect in CPI inflation.
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- 5) The recent round of the RBI's survey of households also reported a rising inflationary trend.
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- 6) Moreover, RBI's inflation projection stands at 5% in the first quarter of 2019-20.
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- It has projected inflation at 4.6% in Q2 and 4.8% in the second half of the financial year 2018-19, with risks evenly balanced.
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- So the overall inflation trend demands that India opt for a tight policy (higher rates).
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- **Currency** - The recent global trade war has resulted in competitive currency devaluation.
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- In the event of a currency war, the domestic currency has to give way for depreciation pressure of the region.

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- But depreciation is likely to contribute to the vulnerability of the economy. Click here to know more
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- Thus, avoiding such risks is essential for ensuring macroeconomic stability.
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- It is also crucial for maximising the chances of a growth profile of 7 to 7.5% in India.
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- A rate hike by the central bank thus attempts to strengthen the currency and avoid getting affected by the currency war.
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- **Recovery** - The MPC was for long wary of an interest rate hike due to the impact it could have on growth prospects.
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- However, there was an increased output of the eight core industries in the recent period.
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- This suggested that the economic recovery was back on track.
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- It was thus convincing for MPC to now focus on containing headline inflation.
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- Given all these, the rate hike seems to be a right measure at the right time to ensure growth as well as avoid risks.
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Why a neutral stance?

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- Given the projected inflationary risks, there were widespread demands for higher policy rates.
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- But the RBI has maintained fairly a neutral policy stance.
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- This means that RBI has made only a marginal increase which is proportionately lesser to the inflation projections.
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- One of the reasons is that the risks that are cited as the factors for the rate hike are not well established.
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- Primarily, the CPI inflation risks are only a projection, though informed, with a fair bit of uncertainty.

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- Hence a neutral stance would help accommodate the upcoming domestic and external uncertainties.

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- This could be in relation with the

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i. impact of government’s policies

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ii. oil price direction

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iii. trade disputes and impact on global growth

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iv. US rate trajectory

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- So according to RBI, a neutral stance would keep the policy options open for any future economic scenario.

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Source: The Hindu, Business Standard, BusinessLine

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