Monetary policy – The basis and its effect on the economy

The Reserve Bank of India (RBI) in its last monetary policy meeting has decided to increase the repo rate by 25 basis points to 6.25%. The decision to raise rates for the first time since 2014 was driven by rising inflationary pressures and an indication of strong economy. However, the RBI has maintained "Neutral" stance giving it flexibility to move in either direction in the future depending upon the macro and micro economic data. Let us examine various parameters that formed the basis of the last monetary policy.

Indian economy once again has been showing signs of improvement. Moving past the disruptions caused by the implementation of Goods and Services Tax (GST) in mid-2017 and demonetization in November 2016, it has demonstrated growth of 7.7% in Q4 of 2017-18, the fastest pace in the last 7 quarters. The RBI expects India's economic growth rate to strengthen to 7.4% in the current fiscal, from 6.6% in 2017-18, on account of revival in investment activity, as reflected in the sustained expansion in capital goods production. Overall, GDP growth is projected to strengthen from 6.6% in 2017-18 to 7.4% in 2018-19. It is expected that it would be in the range of 7.3-7.4% in first half of the year and 7.3-7.6% in second half, with risks evenly balanced.

Retail inflation, measured by the year-on-year change in the CPI, rose sharply to 4.6% in April, driven mainly by a significant increase in inflation excluding food and fuel. Inflation in the transport and communication sub-group accelerated due to the firming up of international crude oil prices, even though the domestic pass-through to petrol and diesel was incomplete. The resulting pick-up in the momentum of inflation excluding food, fuel and HRA has imparted persistence into higher CPI projections for 2018-19.

Additionally, among domestic factors which lead RBI's decision to hike rate is liquidity in the system which remained generally in surplus during April-May 2018.

It can also be said that RBI's rate hike is guided not only by domestic factors but also by the global monetary tightening policies adopted by developed and developing countries. Inflation pressures have emerged in key advanced and emerging economies driven by the rising commodity prices, especially those of crude oil and petroleum. Along with USA, some of the Asian countries have also increased their interest rates due to which there could have been dollar outflow which would hamper the country's economy where 80% of crude oil requirements are imported. Rising oil prices not only threaten to stoke inflation, but also worsen the nation's trade deficit, putting more pressure on the currency. The rupee is the worst performing currency in Asia this year, down more than 5 per cent against the dollar, and coupled with surging oil prices, is a major threat to inflation.

Some relief has come from the output of OPEC meeting in which OPEC countries have decided to increase the output of oil to reduce the prices to some extent. Still, it is expected that crude oil prices would continue to be volatile in the near future imparting considerable uncertainty to the inflation outlook – both on the upside and the downside.

While this has been the basis for an increase in repo rate, let us understand the implications of the same on the economy.

Impact: Monetary policy influences the supply of money, the cost of money (rate of interest) and the availability of money. The RBI maintains the balance between two factors, cost of capital (investment) and goods prices which runs the economy, through monetary policy. Currently, rising oil prices, currency volatility, large scale selling by FPIs (Foreign portfolio investors), falling foreign exchange reserves and inflation expectations are some of the worrying factors for the economy and hence are evaluated on a continuous basis by Monetary policy committee (MPC) members. Based on such an evaluation, the policy rate is decided.

The policy rate not only impacts domestic demand through a change in lending rates but also influences the exchange rate and the debt dynamics. Emerging market currencies have by and large got depreciated against the US dollar. The geopolitical risks, financial market volatility and trade protectionism will further impact domestic growth.

Indian bonds have already been hit by rising crude oil prices, a widening fiscal deficit and tighter cash conditions. Overseas funds are selling domestic debt at a record pace, while local state-run banks -- the biggest buyers of sovereign bonds -- are shunning the securities as they face mounting losses on their investments. The benchmark 10-year yield rose 43 basis points in the previous two months. Currently, domestic currency is coming under pressure primarily due to a trade dispute between USA and its trading partners, and hawkish commentary by the US Federal Reserve forcing foreign investors and funds to pull out their funds from the

Indian capital markets, leading to depreciation of rupee. High interest rates will encourage capital flows into the debt market, which might lead to an appreciation of the rupee.

Additionally, higher interest rates will push up refinancing costs and put more bonds at risk of default by lowering companies' interest coverage ratio which is used to gauge how easily a company can pay interest on its debt.

Considering Indian households, in overall, they park more than half of their financial savings into deposits (bank and non-bank), which are directly linked with policy repo rate. Higher policy repo rate leads to higher deposit rate and hence would increase deposits with the financial institutions. The increase in repo rate comes as a bad news for those who have borrowed from banks because it is likely to lead to an increase in the interest they pay on loans, be it home loan, car loan or personal loan as banks usually pass on the rate burden to the customers.

Due to neutral stance of the RBI on monetary policy, we can say that this rate hike is not the sign of tightening the rate cycle and we need to wait and watch for the global and domestic economic data for predicting further moves.