MPC Recent Decisions: Repo, Inflation Projection, I-CRR

For Prelims: Monetary Policy Committee, Reserve Bank of India, Headline inflation, **Incremental Cash Reserve Ratio (I-CRR),** Reverse repo operations, Inflation Targeting, Open Market Operations.

For Mains: Implications of Excess Liquidity in India, Measures Adopted by RBI to Suck Excess Liquidity, Ways to Manage High Inflation and High Liquidity Simultaneously.

Source: TH

Why in News?

The **Monetary Policy Committee (MPC) of the** Reserve Bank of India (RBI) has recently opted to **maintain the** policy repo rate **at 6.5%,** while simultaneously revising its projection for retail inflation in the current fiscal year (2023-24).

- Additionally, a **temporary 10% Incremental Cash Reserve Ratio (I-CRR)** is imposed on banks to absorb excess liquidity.

What are the Key Decisions of the MPC?

- **Repo Rate Unchanged:** The RBI decided unanimously to **keep the policy repo rate unchanged at 6.5% to balance economic growth and inflation control.**
- **Inflation Projection Increased:** The projection for retail inflation in the **current fiscal year has been raised by 30 basis points to 5.4%.**
  - This adjustment **acknowledges the upward trend in** headline inflation, driven in part by rising vegetable prices.
  - While the spike in vegetable prices is expected to be temporary, **external factors like possible** El Nino **weather conditions** and global food prices pose potential risks.
- **Projected GDP Growth:**The MPC retained its projection for real GDP growth in 2023-24 at **6.5%.**
- **Incremental Cash Reserve Ratio (I-CRR):** Effective from 12th August 2023, **scheduled banks are required to maintain an I-CRR of 10% on the net increase in their demand and time liabilities** between May 19, 2023, and July 28, 2023.
  - This move aims to **absorb surplus liquidity**, particularly due to the recent demonetisation of Rs. 2000 notes.
  - The RBI opted for **I-CRR over a general** CRR **increase to prevent penalizing banks for their current deposits** and to limit impacts on credit growth and the economy.
    - A CRR rise would have restricted loan funds and raised borrowing costs. **I-CRR only targets excess liquidity from demonetization** without disrupting regular banking operations.
      - The existing **CRR remains unchanged at 4.5%.**
    - Also, the RBI clarified that the **I-CRR is a temporary measure. In 2016,** during the **time of demonetisation, a 100% I-CRR was employed.**

Is the Recent RBI's Move Related to the HDFC Ltd-HDFC Bank Merger?

- **Speculation:** The speculation is that the RBI's decision to introduce this additional CRR could be **an attempt to offset any potential profits that HDFC Bank** might have made during the grace period after the merger.
- **Background: HDFC Ltd was not a bank**, but it could raise deposits. However, it **was not subject to the CRR rule.** HDFC Ltd then merged with HDFC Bank, bringing in **large amounts of deposits into the banking system.**
    - After the merger, HDFC Bank was **granted a grace period during which it did not have to deposit the usual 4.5% CRR** on its newfound deposits.
    - This grace period allowed the bank to potentially invest these significant deposits elsewhere and **earn profits from these investments.**
    - The RBI's recent move of **incremental CRR** implies that **banks, including HDFC Bank,** have to keep an **extra 10% of these deposits with the RBI.**

What are the Other Measures that RBI can Adopt to Suck Excess Liquidity?

- **Reverse Repo Operations:** The RBI can conduct **reverse repo operations,** where it absorbs excess liquidity from banks by offering them government securities in exchange for funds.
    - However, recently RBI opted for using I-CRR instead of raising the reverse repo rate because **increasing the reverse repo rate would have also increased the repo rate which would have** tightened monetary policy and hampered economic recovery.
- **Foreign Exchange Operations:** Selling foreign exchange reserves can reduce liquidity in the domestic currency market.
    - This approach can be used cautiously, **as it can impact the** exchange rate **and international trade.**
- **Moral Suasion:** The RBI can communicate with banks and financial institutions to encourage them to voluntarily manage their liquidity positions and curtail excessive lending.

Note:

- **CRR:** Cash Reserve Ratio, a percentage of **Net Demand and Time Liabilities,** banks must keep with the central bank (RBI) to control liquidity.
    - **Incremental CRR**: Additional requirement imposed by RBI on banks' liabilities to manage excess liquidity and stabilize the economy.
- **Repo Rate:** It is the interest rate set by the RBI for **short-term loans to commercial banks.** It's a tool used to control inflation and stimulate economic growth.
- **Inflation:** It refers to the **sustained increase in the general price level of goods and services in an economy over a period of time,** leading to a decrease in the purchasing power of money.
    - **Headline Inflation:** It is the total inflation for the period, **comprising a basket of commodities.**
        - The **food and fuel inflation** form one of the components of headline inflation in India.
    - **Core Inflation:** It excludes volatile goods from the basket of commodities tracking Headline Inflation. These volatile commodities mainly comprise food and beverages (including vegetables) and fuel and light (crude oil).
        - **Core inflation =** Headline inflation – (Food and Fuel) inflation.
- **Inflation Targeting:** It is a monetary policy framework aimed at maintaining a specific target range for inflation.
    - The **Urjit Patel Committee** recommended **CPI (Consumer Price Index) over WPI (Wholesale Price Index)** as a measure for inflation targeting.
        - The current inflation target also aligns with the committee's recommendation to establish a **target inflation rate of 4%**, accompanied by an acceptable range of deviation of **+/- 2%.**
        - The central government, in consultation with the RBI, sets an inflation target, and an upper and lower tolerance level for retail inflation.
- **Liquidity** refers to the **ease with which an asset or security can be quickly bought or sold** in the market without significantly affecting its price.
    - It signifies the **availability of cash or liquid assets** to meet financial obligations or make

investments. **In simpler terms, liquidity is to get your money whenever you need it.**

What are the Implications of Excess Liquidity in India?

- **Positive Implications:**
  - **Lower Interest Rates:** Excess liquidity can lead to **lower interest rates in the economy.**
    - When there is an abundance of funds, banks and financial institutions tend to lower their lending rates to attract borrowers.
    - This can stimulate borrowing and investment activities, promoting economic growth.
  - **Stimulating Investment:** With lower interest rates, **businesses may find it cheaper to borrow and invest in expanding their operations,** launching new projects, and creating jobs.
    - This can have a **positive impact on economic activity and job creation.**
- **Negative Implications:**
  - **Inflationary Pressure**: Excess liquidity can contribute to inflationary pressures in the economy.
    - When there is too much money chasing a limited supply of goods and services, prices can rise.
    - This can **erode the purchasing power of consumers** and reduce their overall standard of living.
  - **Exchange Rate Volatility:** Sudden inflows of foreign capital can lead to currency appreciation, **making exports more expensive** and imports cheaper.
    - On the other hand, **outflows can lead to currency depreciation**, which can **impact trade balances and external debt.**
  - **Asset Price Bubbles:** While excess liquidity can boost asset prices, it can also lead to the formation of **speculative bubbles.**
    - If the increase in asset prices is not supported by fundamentals, it **could result in a sudden collapse of prices, leading to financial instability.**
  - **Income Inequality:** The benefits of excess liquidity, such as increased asset prices, **might disproportionately benefit the wealthy who have more exposure to these assets.**
    - This can exacerbate income inequality in the economy.

How can High Inflation and High Liquidity be Managed Simultaneously ?

- **Interest Rate Adjustment:** The RBI can consider a cautious approach to interest rate adjustments.
  - While **high liquidity might suggest lowering interest rates, the focus should also be on curbing inflation.**
  - A balanced approach might involve incremental interest rate hikes to manage both liquidity and inflation concerns.
- **Open Market Operations (OMOs)** :The RBI can engage in **controlled** Open Market Operations**,** which involve **selling government securities to counterbalance the liquidity** injected into the system.
  - This can help mitigate the inflationary effects of excessive liquidity.
- **Targeted Fiscal Measures:** The Indian government can **adopt targeted fiscal policies to address sectors contributing to inflation.**
  - For instance, **investing in agricultural infrastructure and supply chain improvements** can help **stabilize food prices**, a current major driver of inflation in India.

UPSC Civil Services Examination, Previous Year Question (PYQ)

Prelims

Q. Consider the following statements: (2020)

1. The weightage of food in Consumer Price Index (CPI) is higher than that in Wholesale Price Index (WPI).
2. The WPI does not capture changes in the prices of services, which CPI does.
3. Reserve Bank of India has now adopted WPI as its key measure of inflation and to decide on changing the key policy rates.

Which of the statements given above is/are correct?

(a) 1 and 2 only
(b) 2 only
(c) 3 only
(d) 1, 2 and 3

Ans: (a)

Q. The RBI decides to adopt an expansionist monetary policy, which of the following would it not do? (2020)

1. Cut and optimize the Statutory Liquidity Ratio
2. Increase the Marginal Standing Facility Rate
3. Cut the Bank Rate and Repo Rate

Select the correct answer using the code given below:

(a) 1 and 2 only
(b) 2 only
(c) 1 and 3 only
(d) 1, 2 and 3

Ans: (b)

Mains

Q. Do you agree with the view that steady GDP growth and low inflation have left the Indian economy in good shape? Give reasons in support of your arguments. **(2019)**