Reserve Bank of India and Inflation

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Reserve Bank of India (RBI) like any other Central Bank performs important functions to govern economic and banking activity in the country. On a macro basis, the responsibilities of RBI can be classified under the following broad categories :

1. Monetary Management of the economy to balance growth and inflation.
2. Regulation of Foreign Exchange market, Foreign Exchange reserves management.
3. Regulation and management of Government securities market.
4. Supervision and regulation of banking and non-banking financial institutions.
5. Bankers to Central and State Government and their debt manager.
6. Advisor to the Government on financial and banking related matters.
7. Issuer and administrator of national currency.
8. Role in economic development e.g. setting up of organizations to improve financial infrastructure and increasing access to financial systems.

The role of Central Government with respect to economy is mainly in forming the fiscal policy. This policy determines the sources of receipts of funds for the Government (e.g. on Health, Education, Defence, Security, etc. etc.). The shortfall between uses and receipts, which is always the case in a growing economy (and even for many developed economies like U.S.) is plugged by borrowings, which are managed by RBI.

Clearly, each of these functions are extremely important for our economy. However, in this article I intend to focus on the first one in this list i.e. Monetary Management. The reason I have chosen Monetary Management is because this is the most visible tool deployed by RBI to general public, whereas the other interventions by RBI are generally not visible to public. Also, monetary policy directly effects common man as well as corporates and Central Government due to the effect it has on them as explained below. Ever since the disruption caused by Covid, globally Monetary policy by Central banks has become even more visible and important with massive increase in interest rates everywhere ostensibly to curb inflation.

Let me start by giving some background and tools for such Monetary Management by RBI.

For this, RBI comes out with a Monetary policy at least four times a year. This is the responsibility of Monetary Policy Committee (MPC) of RBI which is chaired by Governor RBI and consists of 7 members with each member having one vote. MPC came into force on 27th June, 2016 under the then Governor of RBI, Mr. Urjit Patel and held its first meeting on 3rd October, 2016.

MPC uses several direct and indirect instruments used for implementing the monetary policy objectives. The most important ones being the following:

- **Repo Rate** i.e. interest rate at which RBI lends money to Commercial Banks against securities.
- **Reverse Repo Rate** i.e. interest rate that RBI pays to Commercial Banks for the deposits with RBI.
- **Bank Rate** i.e. Rate charged by RBI on loans given by RBI to Commercial Banks without collaterals.
- **Cash Reserve Ratio (CRR)** means percentage of a bank's total deposits that it needs to maintain as liquid cash.
- **Statutory Liquidity Ratio (SLR)** i.e. Minimum percentage of deposits that a Commercial Bank has to maintain in the form of cash, gold or other securities.
- **Open Market Operations (OMOs)** which are actions that a Central Bank takes to control the money supply such as open market sales and purchases of short term treasury securities and other securities.
- **Market Stabilization Scheme (MSS)** is the intervention by RBI to withdraw excess liquidity i.e. money supply by government securities in the market.

Monetary Management by the various tools deployed by RBI as listed above aims at regulating the amount of money supply available in the market and the rate at which it would be available. This is achieved by :

(i) Managing the actual supply of money by using tools like CRR, SLR, OMOs and MSS. For example, if RBI wants to restrict money supply it would increase CRR and SLRs and reduce them if it intends to increase money supply.

AND

(ii) Govern the lending rates by using tools like Repo rate and Bank rate. For instance, if it wants lending by banks to be more expensive, it would increase the Repo and bank rate and vice versa if it wants banks to lend at lower rates.

The reasons why RBI has to do monetary management are the following :

(a) To control inflation since it is a settled economic principle that more money supply leads to higher inflation as there is more spending power in the economy. As a result, the interest rates globally have touched record highs in several decades to control inflation.

(b) Ensure that the borrowings by Government to plug fiscal deficit are at reasonable rate so that the interest burden on economy is manageable.

AND

(c) Simultaneously, the Central Bank also needs to ensure that there is adequate money supply in the banking system to fund the growth requirements of the economy.

These aims are clearly contrary to each other since growth requires high money supply at low rates of interest and control of inflation requires low money supply at high rates of interest. However, high interest rates to curb inflation have an adverse effect on government borrowings with increase in interest burden.

Interest rates and Inflation in India:

Take RBI as a case in point. RBI has increased Repo rates six times since April 2022 whereby the rate of 4% till 8.4.2022 has now gone up to 6.50%, the last hike being on 8.2.2023, with the stated principle objective of controlling inflation. The corresponding inflation rate in 2022 was 6.70% as against 5.13% in 2021 and 6.62% in 2020. The latest inflation data for July 2023 reveals some interesting facts. The overall inflation rate during this period of 12 months was 7.44%. However, the inflation for Food & Beverages (F&B) was 10.57%. Since Food & Beverages have a weightage of 45.86% in the CPI overall index, the simple mathematics shows that for the rest of constituents of the index, the inflation was 4.79%. Even within F&B, a few items stand out :

	Inflation	Weightage
Cereals	13.04%	9.67%
Vegetables	37.34%	6.04%
Pulses	13.27%	2.38%
Spices	21.63%	2.50%

It is obvious that all these products become expensive solely on account of ‘supply side constraints’ and their inflation had nothing to do with ‘money supply’. Excluding these items, the balance inflation for items with approx. 80% cumulative weightage in CPI index was 3.87% only – certainly not beyond control and within RBI target of 4%.

In fact, if we look at the composition of CPI index, one can easily say that the following items which overall have a combined weightage of over 60% in the index are not effected by money supply considerations and are purely or mainly dependent on supply constraints or surpluses :

Description	Weightage in CPI index
Food & Beverages	45.86%
Fuel & Light	6.84%
Transport & Communication	8.59%
Total	**61.29%**

The above data suggests that the increase in Repo rate between April 2022 and March 2023 from 4% to 6.5%, with the stated aim of containing inflation, was not warranted. Perhaps RBI chose to do the hikes to keep pace with Fed rate increases from 2% in 2022 to 5.25% in this period. Similar trend has been seen elsewhere in the world where high inflation is largely attributed to supply side challenges – e.g. Brexit effect for U.K., global effect on food grain prices due to Ukraine war, etc.

I accordingly feel that it is imperative that RBI and other Central Banks carefully analyze the inflation causes by separating inflationary pressures due to supply side issues like food and oil and those which can be linked to money supply. To indiscriminately raise interest rates at the first sign of inflation as the specified cure for inflation perhaps needs to be reconsidered. It is heartening to note that in last two MPCs, RBI has held the rate despite increase by Fed. I do hope this continues and that over time interest rates soften and liquidity improves so that much needed adequate funding at low interest cost is available to the industry and trade for India to become and remain the fastest growing economy.