Reverse Repo Rate - Benchmark Interest Rate

What is the issue?

- To meet with the economic slowdown due to the spread of COVID-19, the RBI has cut interest rates to boost the economy.
- However, unlike in the past, it is the reverse repo rate that is effectively setting the benchmark. Here is why.

What is the current economic scenario?

- Over the last couple of years, India's economic growth has decelerated sharply.
- This has happened for a variety of reasons and apparently, the consumer demand is lower.
- In response, businesses are cautious in making fresh investments and so, do not ask for as many new loans.
- The pre-existing incidence of high non-performing assets (NPAs) within the banking system is another factor as banks are too risk-averse to lend.
- In all, the banks' demand for fresh funds from the RBI has diminished.
- This whole cycle has acutely intensified with the ongoing lockdown due to the Coronavirus.
- In effect, the banking system is now flush with liquidity for two broad reasons:
    1. the RBI is cutting interest rates and other policy variables like the CRR to release additional and cheaper funds into the banking system
    2. banks are not lending to businesses

What is the normal benchmark rate?

- The repo rate is the rate at which the RBI lends money to the banking system (or banks) for short durations.
- The reverse repo rate is the rate at which banks can park their money with the RBI.
- Under normal circumstances, the repo rate is the benchmark interest rate in the economy.
- Because, it is the lowest rate of interest at which funds can be borrowed.
- So, it also forms the floor rate for all other interest rates in the economy.
- So the RBI usually uses the repo rate as the main instrument to tweak the

interest rates.

Why is reverse repo becoming significant now?

- The sources of lending to businesses for commercial banks are primarily two.
- One is the money that banks receive from common people who maintain savings deposits with the banks, and the other is the Repo option.
- As mentioned earlier, there is now excess liquidity in the banking system.
- This has meant that during March and the first half of April 2020, banks have been using only the reverse repo (park funds with the RBI) instead of the repo (borrow).
- As of April 15, 2020 RBI had close to Rs 7 lakh crore of banks’ money parked with it.
- In other words, the reverse repo rate has become the most influential rate in the economy.
- Recognising this and the current economic scenario, the central bank has cut the reverse repo rate more than the repo.

What is the RBI's rationale?

- Banks doing nothing with their funds hurts the economy and starves the businesses that genuinely need funds.
- The idea is thus to make it less attractive for banks to just park their funds and not lend.

Will the move help revive the economy?

- More than the availability of funds with banks, it all now depends on the revival of consumer demand in the country.
- If the lockdown and disruptions due to the novel coronavirus continue for a long time, the above is less likely to happen.
- Consumer demand, which was already quite weak, is likely to stay muted and businesses might not borrow heavily to make fresh investments.
- On the other hand, it is important for the banks to be confident about new loans not turning into NPAs.
- So for cuts in reverse repo rates to fructify, reviving consumer demand as well as banks being confident about economic prospects is crucial.

What could be done?

- Banks could be offered credit guarantee, say 10%, for fresh loans given to micro, small and medium (MSME) enterprises.

- The government has done a similar thing to encourage banks to lend to the stressed non-banking financial companies.
- It can do that for the MSME segment, affected the most by Covid-19 and most critical for bringing the economy back on the growth path.

Source: Indian Express, Business Standard