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An Empirical Analysis: RBI'S Repo Rate and Reverse Repo Rate

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Abstract: Reserve Bank of India, the central bank, formulates, implements, and monitors the monetary policy of India. Established to maintain reserves with a view to securing monetary stability, RBI stood at the centre of India's Financial System. RBI acts as a banker and debt manager to central government and state governments and also plays the crucial role of banker to the banks. In addition to its traditional central banking functions, the Reserve Bank performs certain non-monetary functions of the nature of supervision of banks and promotion of sound banking in India. Infusion and absorption of liquidity on a daily basis is maintained by RBI through Repo and Reverse Repo rates. Reverse repo rate is the rate at which the central bank of a country (Reserve Bank of India in case of India) borrows money from commercial banks within the country. It is a monetary policy instrument which can be used to control the money supply in the country. Banks are always happy to lend money to Reserve Bank of India since their money is in the safe hands with good interest. Banks find it more attractive to have their money with the Reserve Bank of India when the reverse repo rate is increasing and hence money is drawn out of the system.

Keywords: Reserve Bank of India, Repo Rate, Reverse Repo Rate, Financial System, Monetary Stability, Liquidity Adjustment Facility.

I. INTRODUCTION

Repo rate is the rate at which the central bank of a country (Reserve Bank of India in case of India) lends money to commercial banks in the event of any shortfall of funds. Repo rate is used by monetary authorities to control inflation. Reduction in Repo rates helps the commercial banks to get money at a cheaper rate and increase in the Repo rate discourages the commercial banks to get money as the rate increases and becomes expensive. In the third quarter review of monetary policy 2013-14, statement issued by Dr. Raghuram G Rajan, Governor, RBI there has been an increase in repo rate by 25 basis point resulting in the repo rate to be 8.00% and Consequent to the change in the Repo rate, the Reverse Repo rate under the LAF will stand automatically adjusted to 7.00 per cent with immediate effect. The RBI has agreed in principle with the recommendation of the second Narasimham Committee (1998) that the RBI's support to the market should be through a Liquidity Adjustment Facility (LAF). In line with the recommendations of the Narasimham Committee II, the RBI decided in June 2000 to introduce a liquidity adjustment facility to set a corridor for money market rates. Liquidity Adjustment Facility (LAF) replaces the Interim Liquidity Adjustment Facility (ILAF) introduced in April 1999. Liquidity Adjustment Facility is a facility that banks should be using as a resource to moderate their daily fluctuations to liquidity requirements rather than a window where they should be borrowing every day in large amounts. These rates under the Liquidity Adjustment Facility (LAF) determine the corridor for short-term money market interest rates. In turn, this is expected to trigger movement in other segments of the financial market and the real economy.

RBI as the central bank of country is the centre of Indian Financial System and monetary system. It was established in 1935 with a share capital of Rs. 5 Crores on the basis of the recommendations of the Hilton young Commission. The Reserve Bank of India Act of 1934 provides the statutory basis of the functioning of the bank.

II. CLASSIFICATION OF RBI'S FUNCTIONS

The monetary functions also known as the central banking functions of the RBI are related to control and regulation of money and credit, i.e., issue of currency, control of foreign exchange operations, control of bank credit, banker to the government and to the money market. Monetary functions of the RBI are important as they control and regulate the volume of money and credit in the country.

In addition to the monetary functions, RBI also performs non monetary functions in the context of India's economic backwardness. The supervisory function of the RBI may be regarded as the Non monetary function although many consider this as a monetary function. The promotion of sound banking in India is an important goal of the RBI, the RBI has been given wide and drastic powers, under the Banking Regulation Act of 1949, these powers relate to licensing of banks, branch expansion, liquidity of their assets, management and methods of working, inspection, amalgamation, reconstruction and liquidation. Under the RBI's supervision and inspection, the working of banks has greatly improved.

Banker's Bank and Lender of the last resort

The scheduled banks are eligible for financial facilities from the RBI. In return, they bear certain obligations to the RBI. They are required to submit to the bank a weekly statement showing their position in the prescribed form. Failure to submit a return makes a bank liable to penalties. Also, if it fails to maintain the required amount of reserves as specified, it has a penal rate of interest to the RBI and is prohibited from accepting fresh deposits during the period of default. Under the Banking Regulation Act, it has been made obligatory on the non-scheduled banks also to maintain the same percentage of cash reserves.

Banker to the Government

Under sections 20, 21 and 21 A of the RBI Act, the RBI is charged with the duty of acting as a banker to the government. It is entrusted with the banking business of the Government of India free of charge. Accordingly, it undertakes to accept money on account of the government, to make payments on its behalf and also to carry out its exchange remittance and other banking operations including the management of public debt and the issue of new loans and treasury bills. In places where RBI has no branch or office, it has appointed agents to transact government business. The act also requires the RBI to maintain currency chests at places prescribed by the government and to keep the chests supplied with sufficient notes and coins.

The RBI also acts as the banker to the state governments. The relationship of the Bank with the state governments is governed by agreements between the Bank and the respective state governments.

The bank's advice is often sought by the Central Government and the state governments on various financial and economic problems and also to assist them generally in the formulation of some of their economic and financial policies.

Exchange Control

For the effective administration of exchange control, the Exchange Control Department of the RBI was constituted in 1939. It deals with the work relating to the control of foreign transactions in exchange, bullion and securities. This work was delegated to the bank by the Central Government under the Defence of India Rules.

RBI and Commercial banks has a very close relationship, but RBI always has the upper hand and dictate the terms based on the Economic trends. Having said that, RBI and Indian monetary policy has been appreciated many times in the past by the world and has so far not resulted in failure of any bank or banking system as seen in many other countries. Banks may get support from the RBI when they require and RBI can also ask for support based on the key rates which is under its control.

III. OBJECTIVE OF THE STUDY

The objective of this study is to study the empirical data of RBI's Repo rate and Reverse repo rate.

1. To find out the impact of changes in the rate has affected the banks.
2. To study the effect on the ordinary people.
3. To study the effect on the industry.
4. To study the effect on the broader economy.

IV. ANALYSIS

To understand the impact of a cut in Repo and Reverse Repo Rates on banks, it is important to understand the role they play in banking. Repo and Reverse Repo are basically instruments used by the RBI to influence the total monetary base of banks.

To get a grip on this, it is important to understand how banks work and what the term *monetary base* means. Banks engage in a practice called Fractional Reserve Banking (FRB). As explained in the linked article, under FRB, a bank lends many multiples of the actual cash in hand. This cash they have is what I mean by monetary base. Clearly, any addition to the monetary base adds to the bank's ability to make loans by creating money from nothing (as explained in the linked article).

In India, banks' monetary base takes 2 forms – CRR (Cash Reserve Ratio) and SLR (Statutory Liquidity Ratio). CRR is the amount of actual cash that banks need to hold with the RBI. SLR refers to the amount (by value) of approved securities (government bonds, gold and approved, privately issued financial instruments) that banks are mandated to hold. Currently, CRR is 4% and SLR is 23%. Together, they constitute the monetary base of the Indian banking system.

However, what CRR and SLR do not cover is the extent to which the RBI can lend to banks. That is covered under the Repo and Reverse Repo. In a **Repo** or a *repurchase agreement*, the Repo seller (the bank) sells an approved security to the RBI with the understanding that at a certain date in the future, the bank will buy the security back from the RBI. The bank gets cash and the RBI the security.

One would expect that this would not influence the monetary base because while the bank gets cash and adds to its CRR base, it loses possession of the security and falls behind on its SLR base and can therefore not lend more. The interesting part is that this problem in the way of expanding bank lending is eliminated by the way the Repo system works.

Very interestingly, during the term of the Repo, the bank is allowed to count the security thus sold to the RBI as part of its investments to fulfill the SLR requirement. So, the net effect of a Repo transaction is an addition to the bank's cash reserves without falling behind on SLR requirements. With this, the bank can now engage in much more lending.

At the end of the term of a Repo, the bank buys the security back from the RBI at a price higher than the original sale price. The difference expressed as a percentage of the original sale price is the **Repo Rate**. Thus, Repo Rate is used to calculate the price at which the security is bought back by the bank. It is the equivalent of an interest paid by the bank to RBI.

It might seem that at the time the bank buys the security back, its cash reserve falls. However, the bank can then enter into a fresh Repo transaction and sell the security back to the RBI, bringing the cash reserve back to the higher level. In this manner, Repo becomes a means for the RBI to maintain a steady level of lending to banks.

But all this additional lending would mean more purchases of securities to meet SLR requirements. This would mean the need to deploy cash for the same. That cash would go outside the system of lending and reduce the system's lending potential. This problem is *solved* by what is called the **Reverse Repo**.

In a Reverse Repo, the RBI sells an approved security to the bank with the understanding that it will buy it back at a future date at a higher price. The difference between the 2 prices expressed as a percentage of the original selling price (per annum) is

called the **Reverse Repo Rate**. The Reverse Repo Rate thus becomes the interest rate received by the bank for lending cash to the RBI.

The important point for us to note is that a bank may show securities bought from the RBI through the Reverse Repo window as part of its SLR commitments. Further, as in the case of the Repo, at the end of the term of the Reverse Repo, the bank can enter into a fresh Reverse Repo with the RBI.

Repo Rate	Effective From	Repo Rate	Effective From
6.00	March 31, 2004	5.25	April 20, 2010
6.25	October 26, 2005	5.50	July 2, 2010
6.50	January 24, 2006	5.75	July 27, 2010
6.75	June 9, 2006	6.00	September 16, 2010
7.00	July 25, 2006	6.25	November 2, 2010
7.25	October 31, 2006	6.50	January 25, 2011
7.50	January 31, 2007	6.75	March 17, 2011
7.75	March 31, 2007	7.25	May 3, 2011
8.00	June 12, 2008	7.50	June 16, 2011
8.50	June 25, 2008	8.00	July 26, 2011
9.00	July 30, 2008	8.25	September 16, 2011
8.00	October 20, 2008	8.50	October 25, 2011
7.50	November 3, 2008	8.00	April 17, 2012
6.50	December 8, 2008	7.50	March 19, 2013
5.50	January 5, 2009	7.25	May 3, 2013
5.00	March 5, 2009	7.50	September 20, 2013
4.75	April 21, 2009	7.75	October 29, 2013
5.00	March 19, 2010	8.00	January 28, 2014

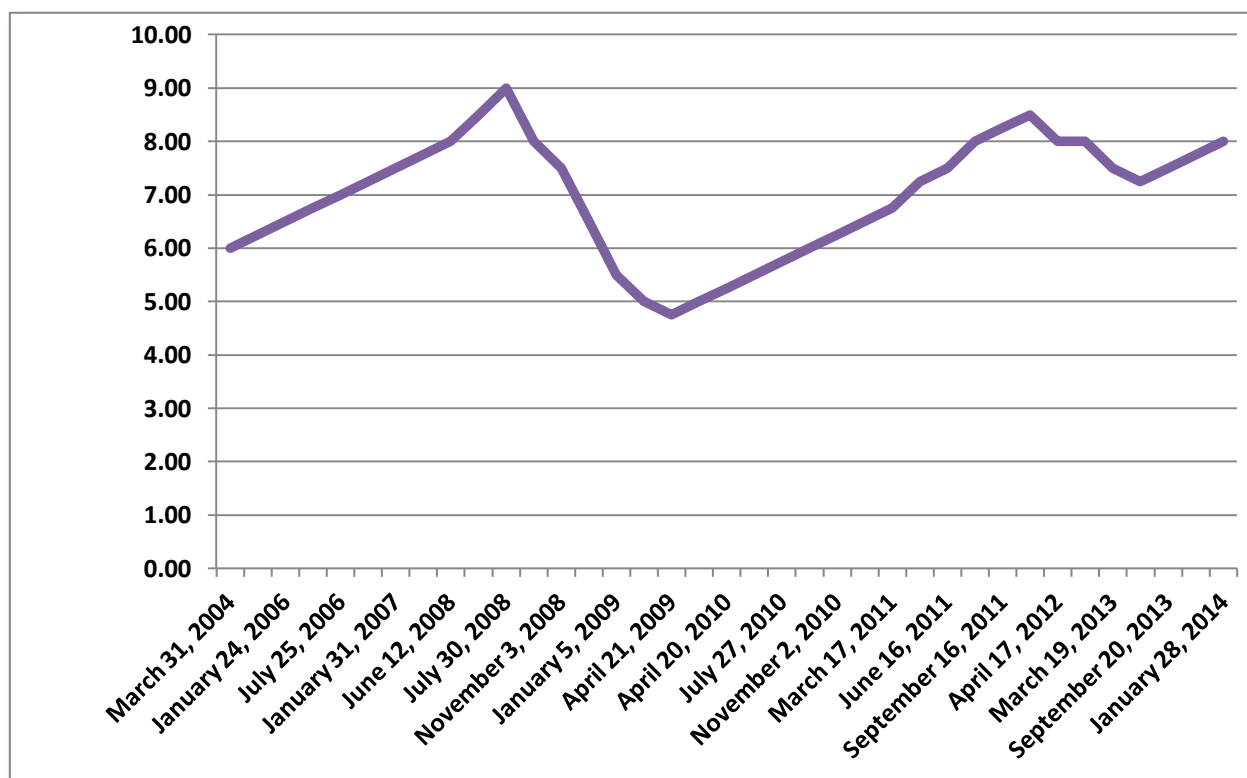


Fig 1. Trends of Repo Rate

Reverse Repo Rate	Effective From	Reverse Repo Rate	Effective From
4.75	October 27, 2004	5.25	November 2, 2010
5.00	April 29, 2005	5.50	January 25, 2011
5.25	October 26, 2005	5.75	March 17, 2011
5.50	January 24, 2006	6.25	May 3, 2011
5.75	June 9, 2006	6.50	June 16, 2011
6.00	July 25, 2006	7.00	July 26, 2011
5.00	December 8, 2008	7.25	September 16, 2011
4.00	January 5, 2009	7.50	October 25, 2011
3.50	March 5, 2009	7.00	April 17, 2012
3.25	April 21, 2009	6.75	January 29, 2013
3.50	March 19, 2010	6.50	March 19, 2013
3.75	April 20, 2010	6.25	May 3, 2013
4.00	July 2, 2010	6.50	September 20, 2013
4.50	July 27, 2010	6.75	October 29, 2013
5.00	September 16, 2010	7.00	January 28, 2014

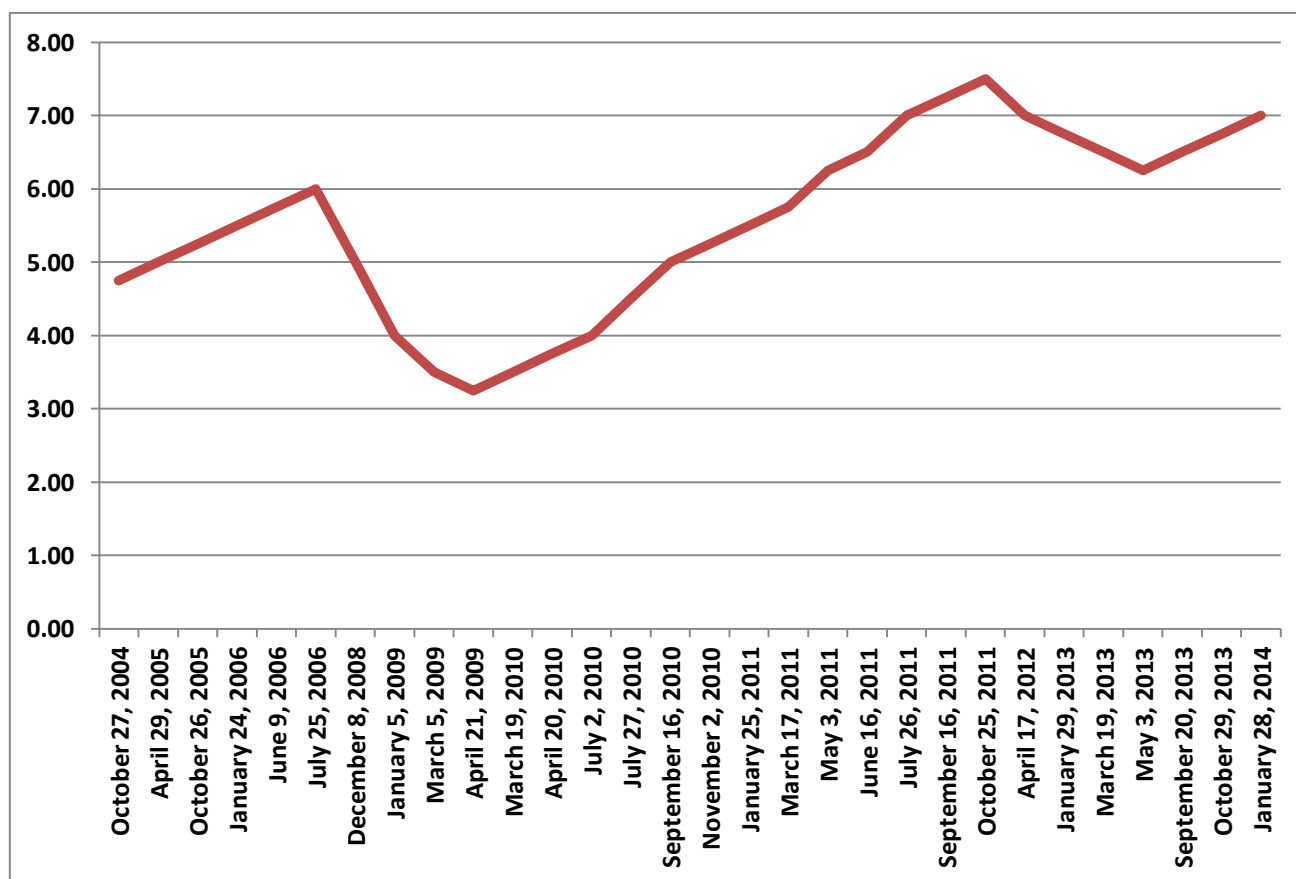


Fig 2. Trends of Reverse Repo Rate

Impact of Repo Rate hike to consumers may result in increase in Interest Rate charged by the companies for the following

1. **Housing Loan:** Housing Loan becomes costly because of this event although not every bank pass this to consumer every time. e.g. If the Current home loan you have is at 10%, then because of 25 basis point hike in Repo rate by RBI, Your bank will increase your Interest rate to 10.25%.

2. **Auto and Personal Loans:** Banks might increase the Auto and Personal loan interest rate for fresh loans. Rate cut will have opposite impact.

Industries take huge amount of loan from the banks and because of these changes, Banks increase the Interest rate at which they give loan to them and it puts pressure on the Industry balance sheet. Apart from this direct impact, It is impacted indirectly when lesser people buy Auto or Home because of higher interest rates. Any event which results in lesser liquidity in system will mean that banks will give lesser loans to Industry for new ventures and expansion thus impacting growth. Rate cut will have opposite impact

It is widely believed that Repo rate hike help in reducing the growth and the money available in the system and eventually decreases the demand. Decrease in demand will mean people will have lesser purchasing power and will result in lower inflation. Rate cut will have opposite impact.

V. FINDING

A cut in Repo and Reverse Repo rates basically reduces the bank's cost of borrowing from the RBI to add to its reserves. It enables banks to either increase the interest rate spread on loans made by the bank or offer borrowers lower rates of interest without eating into its own interest rate spread. Thus, a cut in Repo and Reverse Repo Rates increases the banking system's potential by expanding more loans in a profitable manner.

Impact on Industry

With lower repo and reverse repo rates, industry gets to borrow more and even gets to pay lower interest rates on its borrowing. Therefore, those businesses that are in a position to secure additional lending from the banking system will benefit from lower repo and reverse repo rates.

Impact on ordinary people

The impact on ordinary people can be felt in 2 ways. In the nearer term, greater lending to businesses will lead to more business investment and employment opportunities. In the medium and longer term, however, the dominant factor influencing ordinary people will be the increased money supply (inflation), which will send prices of consumers' goods soaring, resulting in future pressure to raise interest rates thus forcing the pricking of the inflationary bubble and the onset of the depression.

Impact on the broader economy

In the long-run, reducing Repo and Reverse Repo rates is harmful for the economy as it is just a means to lend reserves to banks, enabling them to engage in far bigger inflation to undertake much more credit expansion through FRB. While this lending will have some short-term positive effects, in the long-run, it creates and worsens the inflationary boom of the familiar boom-bust cycle. It also sets the conditions for the inevitable raising of interest rates thus pricking the inflationary bubble and triggering the depression.

VI. CONCLUSION

Reserve Bank of India (RBI) is the central bank of India. Its main function is to establish monetary stability in the country. For this, it is equipped with independence in formulating and implementing monetary policies in order to maintain price stability and adequate money supply in the system.

RBI takes different expansionary and contractionary steps to achieve the same and utilizes its tools such as Cash Reserve Ratio (CRR), Statutory Liquidity Ratio (SLR), Bank Rate, Open Market Operation (OMO) and Liquidity Adjustment Facility (LAF) for this.

Amongst all the rates, it is the Repo rate which influences most the given money supply in the economy. Repo rate is the rate at which the banks borrow short-term funds from the RBI. It is a secured nature of borrowing similar to a loan against fixed deposits availed by individuals during emergencies. RBI raises repo rate to increase the overall cost of funds in the banking system. Higher costs will keep in check the demand for funds. If the central bank hikes its repo rate, it becomes costly for banks to borrow money from RBI so they in turn hike the loan interest rates at which customers borrow money from them to compensate for the hike in repo rate.

The policy of reducing Repo and Reverse Repo rates is essentially bad for the economy in the long-run because it greatly aids the creation of the business cycle. It also hurts ordinary people by sending prices soaring. Industry and the banking system, however, benefit in the short run. This explains why a policy of lowering repo and reverse repo rates finds fairly broad-based support from the banking industry and general industry as well.

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