Reverse Repo Normalisation

Why in news?

In a recent report**,** State Bank of India, which is the largest public sector bank in the country, has stated that they believe the stage is set for a reverse repo normalisation.

What is monetary policy normalisation?

- India's central bank, the RBI, keeps changing the total amount of money in the economy to ensure smooth functioning by following two approaches.
    1. Loose monetary policy
    2. Tight monetary policy
- **Loose monetary policy**- It is adopted when the RBI wants to boost the economic activity.
- The RBI buys government bonds from the market and pays back money to the bondholders, thus injecting more money into the economy.
- The RBI also lowers the interest rate it charges banks when it lends money to them (repo rate) to incentivise them.
- **Significance**
    - **Boosts consumption**- For a consumer, it would now pay less to keep the money in the bank thus incentivising current consumption.
    - **Boosts production-** For firms and entrepreneurs, it would make more sense to borrow money because interest rates are lower.
- **Tight monetary policy-** It involves the RBI raising interest rates and sucking liquidity out of the economy by selling bonds (and taking money out of the system).
- When a central bank finds that a loose monetary policy has started becoming counterproductive (leading to a higher inflation rate), it normalises the policy by tightening the monetary policy stance.

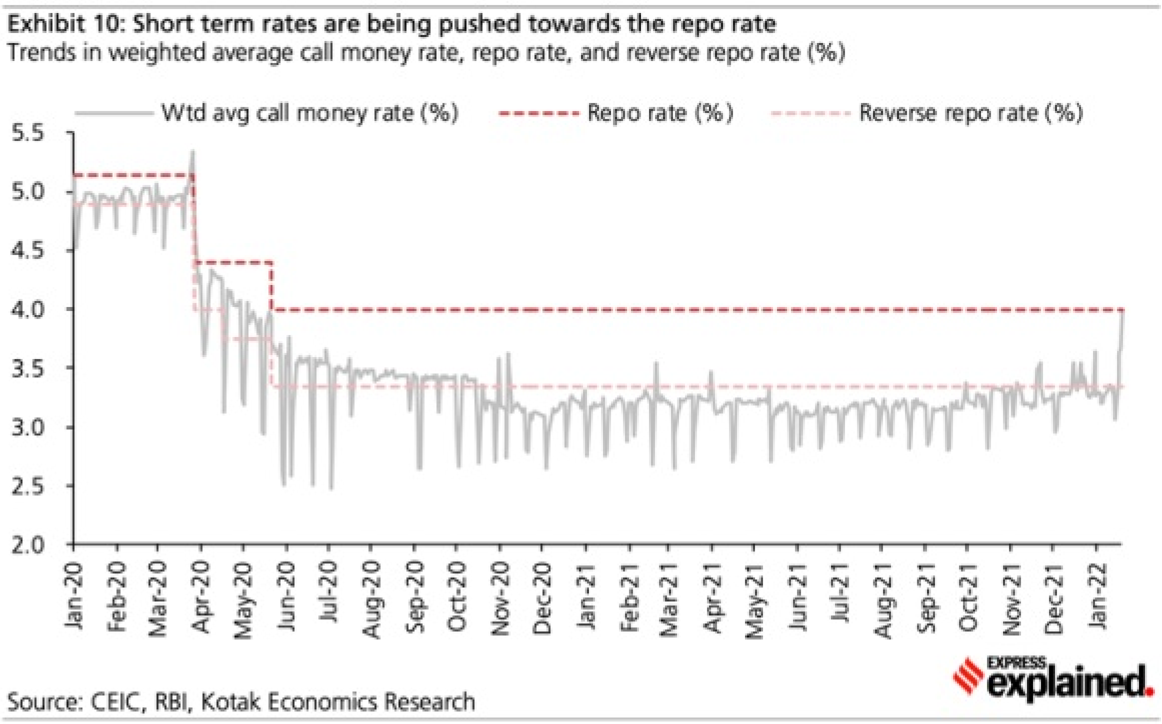
What is reverse repo and how does it fit into policy normalisation?

- The reverse repo is the interest rate that the RBI pays to the commercial banks when they park their excess liquidity (money) with the RBI.
- **Usage of repo rate**- Under **normal circumstances** (when the economy is growing at a healthy pace), the repo rate becomes the benchmark interest rate in the economy.
- That's because it is the lowest rate of interest at which funds can be borrowed.
- The repo rate forms the floor interest rate for all other interest rates in the economy such as the interest rate for a car loan or a home loan or the interest you earn on your fixed deposit.
- **Usage of reverse repo rate-** It is adopted when the RBI pumps more liquidity into the market but there are **no takers of fresh loans**, either because the banks are unwilling to lend or because there is no genuine demand for new loans in the economy.
- The action shifts to reverse repo rate because banks are no longer interested in borrowing money from the RBI rather they are more interested in parking their excess liquidity with the

RBI.
- This is how the reverse repo becomes the actual benchmark interest rate in the economy.

What is the situation now?

- The reverse repo had become the benchmark rate in India since the start of the Covid pandemic.
- The RBI had widened the gap between repo rate and reverse repo rate in order to make it less attractive for banks to simply park their funds at the RBI.
- A lower reverse repo rate pushed banks to extend more fresh loans in the economy.



What does reverse repo normalisation mean?

- Reverse repo normalisation means the reverse repo rates will go up.
- **Reason**- Rising inflation
- It is expected that the RBI will raise the reverse repo rate and reduce the gap between the two rates.
- SBI first expects the reverse repo to go up from 3.35% to 3.75% while the repo rate continues to be 4%.
- Doing this will incentivise commercial banks to park excess funds with RBI, thus sucking some liquidity out of the system.
- The next step would be raising the repo rate.
- This process of normalisation will not only reduce excess liquidity but also result in higher interest rates across the board in the Indian economy.

Reference

1. https://indianexpress.com/article/explained/explained-reverse-repo-normalisation-rbi-7746913/