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WHY RBI'S POLICY RATE SHOULD NOT DROP BELOW 4%

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Banking, NPAs and RBI

No doubt, our covid-battered economy needs all the help it can get, but there is good reason for the Reserve Bank of India (RBI) to resist a reflex rate cut this week. For one, banks are not short of money to lend. For another, after a series of slashes, the current rate at which it lends money to regular banks is already down to 4%. Arguably, this is a level that ought to serve as a floor.

An interest rate is a price charged on money lent, and what matters is the real rate, minus inflation. The latest readings suggest that RBI's real repo rate is already negative. Admittedly, inflation of around 6% could be a blip, or even off the mark, given the data fog of our corona crisis. Yet, it's above RBI's central target of 4%. This figure is now known widely enough in the country to serve as a benchmark of sorts. Thus, an RBI rate below the inflation target would strike people as odd and alarm depositors of a penalty being paid on savings kept with banks—which typically pay only 1-2% more.

Saving deposits earning less than inflation amounts to financial repression, and it could send depositors fleeing to risky investments. Of course, only if negative returns bother them. Drop the repo rate below 4%, and it may serve them an alert.

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