A Study on Rbi’s Interest Rate Cuts and its Aftermath Effects in its Economy with Specific Reference to India

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ABSTRACT

In the present context, India’s economy is moving towards a sluggish growth trend where the increase in the inflation and reduction in the crude oil prices and an enhanced export bill causing India’s growth strategy under stranded in its way. Actually in the present case it is not a good sign for a developing nation like India to keep its inflation on its top where still developments are lagging. But the recent measures adopted by the country's central bank RBI has actually given ammunition to the economy by all means throwing lights to the sectors like automobiles sector, real estate sector, banking sector, etc. Giving a positive signal to all classes of public, corporate, traders, etc. This paper actually studies fully about the impact on economy after interest rate cuts and also its aftermath effects, disadvantages due to the interest rate cuts. This paper is purely based upon on conceptual one mainly emphasising upon the growth of Indian economy.

Keywords--- Banking scheme, BFS, Interest rate

I. INTRODUCTION OF RBI IN INDIA

The Reserve Bank of India is India's central banking institution, which controls the monetary policy of the Indian rupee. It commenced its operations on 1 April 1935 during the British Rule in accordance with the provisions of the Reserve Bank of India Act, 1934. The original share capital was divided into shares of 100 each fully paid, which were initially owned entirely by private shareholders. The central bank manages to reach different goals of the Foreign Exchange Management Act, 1999. The Reserve Bank of India (RBI) is the regulator and supervisor of the financial system and prescribes broad parameters of banking operations within which the country's banking and financial system functions. Its objectives are to maintain public confidence in the system, protect depositors' interest and provide cost-effective banking services to the public. The Banking Ombudsman Scheme has been formulated by the Reserve Bank of India (RBI) for effective addressing of complaints by bank customers. The RBI controls the monetary supply, monitors economic indicators like the gross domestic product and has to decide the design of the rupee banknotes as well as coins.

2. Regulator and supervisor of the financial system

The institution is also the regulator and supervisor of the financial system and prescribes broad parameters of banking operations within which the country's banking and financial system functions. Its objectives are to maintain public confidence in the system, protect depositors' interest and provide cost-effective banking services to the public. The Banking Ombudsman Scheme has been formulated by the Reserve Bank of India (RBI) for effective addressing of complaints by bank customers. The RBI controls the monetary supply, monitors economic indicators like the gross domestic product and has to decide the design of the rupee banknotes as well as coins.
circulation. The objectives are giving the public adequate sups of RBI are to issue bank notes, to maintain the currency and credit system of the country to utilize it in its best advantage, and to maintain the reserves. RBI maintains the economic structure of the country so that it can achieve the objective of price stability as well as economic development, because both objectives are diverse in themselves. For printing of notes, the Security Printing and Minting Corporation of India Limited (SPMCIL), a wholly owned company of the Government of India, has set up printing presses at Nashik, Maharashtra and Dewas, Madhya Pradesh. The Bharatiya Reserve Bank Note Mudran Private Limited (BRBNMPL), a wholly owned subsidiary of the Reserve Bank, also has set up printing presses at Mysuru in Karnataka and Salboni in West Bengal. In all, there are four printing presses. And for minting of coins, SPMCIL has four mints at Mumbai, Noida (UP), Kolkata and Hyderabad for coin production.

5. Banker's bank

RBI also works as a central bank where commercial banks are account holders and can deposit money. RBI maintains banking accounts of all scheduled banks. Commercial banks create credit. It is the duty of the RBI to control the credit through the CRR, bank rate and open market operations. As banker's bank, the RBI facilitates the clearing of cheques between the commercial banks and helps inter-bank transfer of funds. It can grant financial accommodation to schedule banks. It acts as the lender of the last resort by providing emergency advances to the banks. It supervises the functioning of the commercial banks and take action against it if need arises.

III. INTRODUCTION RBI’S BANK RATE

Bank rate

RBI lends to the commercial banks through its discount window to help the banks meet depositors' demands and reserve requirements for long term. The interest rate the RBI charges the banks for this purpose is called bank rate or Repo Rate. If the RBI wants to increase the liquidity and money supply in the market, it will decrease the bank rate and if RBI wants to reduce the liquidity and money supply in the system, it will increase the bank rate. The bank rate has lost its significance as a monetary policy tool as the central bank signals stance through changes in repo, the rate at which banks borrow short-term funds from RBI. The Bank Rate, which is the standard rate at which the RBI buys or re-discount bills of exchange or other commercial paper, is presently used in the country.

IV. REVIEW OF LITERATURE

According to Reinhart (2012), for about 35 years after the end of World War-II, real interest rates in advanced economies remained highly depressed, reflecting financial repression. Then came the wave of financial liberalisation, and real rates started rising, during 1981 to 2007. Since the global crisis, however, these economies are back to another phase of financial repression, with large monetised financing of fiscal deficits, new forms of repression such as macro-prudential measures, systemic risk regulation, and growing justification in intellectual debates for use of capital controls as a policy tool. In this third phase between 2008 and 2011, negative (or non-positive) real rates were observed in close to half of the observations, and real rates were less than 1 per cent in about 82 per cent of the observations (Table 1). Two important points to notice from this table are: (a) the third phase since the global crisis appears to be the most repressive, in terms of the levels of real interest rates, and this phase coincided with the great recession – not high growth, and (b) the second phase reflects coexistence of both high real rates and high growth. Thus, sustained ultra-loose monetary policy to deliver negative real rate as a means to spur growth is not always effective, and, high real rates that may result when a country moves from financial repression to reforms could actually deliver higher, not lower, growth. Besides financial repression/reforms, a central bank’s monetary policy response to inflation can also influence real interest rates, and thereby investment and growth.

| Table 1: Real interest rates in advanced economies (shares of observations at or below) |
|---------------------------------|---|---|---|
| <= 0 | 46.9 | 10.5 | 49.5 |
| <= 1 per cent | 61.6 | 25.2 | 82.1 |
| <= 2 per cent | 78.6 | 36.2 | 97.2 |
| <= 3 per cent | 88.6 | 55.0 | 99.5 |

Source: Reinhart, April 2012 (real ex-post Treasury Bill rates).
V. OBJECTIVES OF THE STUDY

1. To study the aftermath effects of RBI’s interest cuts.
2. To study the importance of interest cuts in Indian economy.

VI. RESEARCH DESIGN

This study is purely based upon conceptual one.

VII. RESEARCH METHODOLOGY

SOURCES OF DATA
This study is purely based upon secondary data’s including annual reports, websites, journals, newspaper articles, etc.

VIII. THE AFTERMATH EFFECTS OF INTEREST RATE CUTS

1. Interest rate on bank loans

There are two types of home loans: floating rate loans and fixed rate loans.

Floating rate loans are the ones that are market-linked and thus the interest payout on such loans keep fluctuating in tandem with the central bank’s policy rates and a subsequent revision by the lending bank. Whereas, under fixed rate loans the interest rate is fixed and the market fluctuations do not affect the interest payout on your borrowed capital.

According to experts view it states that an interest rate cut will affect the common man depending upon the type of home loan that the existing borrower has taken. And if one is looking to take a home loan then interest rates will be an important factor. The central bank has been cutting rates in its last three policy reviews. While a fall in crude prices and its impact on the country’s export bill has given the RBI some headroom, the central bank may reverse its policy as and a subsequent revision by the lending bank. Whereas, under fixed rate loans the interest rate is fixed and the market fluctuations do not affect the interest payout on your borrowed capital.

When interest rates on bank loans come down, more people will avail such loans to buy assets including real estate. The up-tick in the market continues until the seemingly ever-growing demand for land and housing causes an astronomical rise in prices to a point of having no takers. One has to keep in mind that price rise affects small transactions the most. Since the country’s real estate sector is still unorganised and a regulatory body for the sector is yet to be formed, there is no uniformity in prices. As a result, it is the common man looking to purchase a small piece of land who will have to shell out more money.

Lower interest rates are of little help to people who do not have enough funds to use the opportunity to invest in appreciating assets. They also lose out on a higher return as their savings or fixed accounts generate only a lower rate of interest.

A period of lower interest rates is a good time to build a long term investment portfolio. But then, those who are not savvy in the field may burn their fingers in the game of investing.

6. Economic Productivity

“The industry demands for the reduction in the interest rates, we see that the large scale benefits of a reduction in interest rate are on the entire economy as a whole. It has a 360 degree effect on the entire economy.
Everyone wants interest rates to come down. But when interest rates come down, a section of the society, such as the pensioners, who are dependent on interest income, are affected. When interest rate comes down, the earnings on their deposits go down.

It is unwise to park own funds with the bank when interest rates are trending down. It is because the earnings on customers fixed deposits will be negligible at a time when the economic activity is relatively high. So what to do with the surplus cash in hand? This is a good time for you to buy land, gold or invest in business. The rate of return is much higher on investments during these phases.

**IX. OTHER INVESTMENT AVENUES FOR WISE INVESTORS**

1. This is not the time to deposit in banks. Liquidate short term FDs and invest in less risky mutual funds or government infrastructure bonds. However, keep long term FDs safe.

2. Invest wisely. Do not put all eggs in one basket. A little of gold, real estate and mutual funds will not hurt so bad like a lot of money in just one of those things. Profit can be ensured from one of these investments according to the changing market.

**X. THE OTHER EFFECTS OF INTEREST RATE CUTS**

1. **Effect on corporations:** A drop in the interest rates will bring down the cost of capital, companies will borrow more to produce more, they will hire more workers reducing unemployment and increasing wage rates. This coupled with the reforms the NDA government is trying to bring in will increase industrial output and hence GDP.

2. **Effect on consumers:** This will also increase consumer spending and hence consumption. Increased consumption will add to aggregate demand which in due course of time will reflect in India's GDP. Household savings will reduce because the interest rate is less and hence there is no incentive to save and loans will go up because there is no downside to borrowing. The increased borrowing will boost up the real estate market as people will increasingly take advantage of the low interest rate to take home loans just like.

3. **Auto sector:** The rate cut will help auto sector meet 15-20 per cent sales growth in the festive season as 65 per cent of car sales are financed. A reduction in interest rates will reduce cost of ownership and help the automakers get more customers.

**XI. SOME OF THE DEMERITS OF INTEREST RATE CUTS**

All of the aforementioned benefits of reducing interest rates have one caveat, they increase inflation. Reduced unemployment is directly correlated with inflation through the Phillips curve.

A decrease in unemployment will increase inflation correspondingly. Increased consumer spending will increase price level of goods thereby increasing retail inflation. Everything will become expensive*. Inflation is something that has destroyed economies in the past if not controlled.
XII. CONCLUSION

After a detailed study upon the above mentioned factors that India needs to focus more upon the monetary policies before or while implementation. Since India is a developing nation and still many of sectors are unorganised and lagging in technology by all means, so an decrease in interest may lead to decrease in inflation rate, correspondingly the public’s purchasing power, approaching towards banks for loans, corporate sector expanding modes, the demand for houses/real estate sector will really grow towards upwards, similarly the rate of unemployment during these circumstances comes down, so the overall scenario of Indian economy moves towards higher productivity thus due to higher productivity and higher demand, higher purchasing power by individuals and households, again will drag India towards the previous scenario of high inflation, so ultimately the Indian economy will start facing heat of inflation. Whenever any policy is being inducted into the market the country’s central bank RBI has to analyse all forms of extraneous factors by all means before implementing the monetary policy.

REFERENCES