Reverse repo normalization

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In news-In a recent report, State Bank of India has stated that the stage is set for a reverse repo normalization.

What is monetary policy normalization in India?

- The Reserve Bank of India, keeps tweaking the total amount of money in the economy to ensure smooth functioning.
- As such, when the RBI wants to boost economic activity it adopts a so-called "loose monetary policy".
- There are two parts to such a policy i.e., injecting more money (liquidity) into the economy and **RBI also lowers the interest rate it charges banks when it lends money to them;** this rate is called the ***repo rate.***
- The reverse of a loose monetary policy is a "tight monetary policy" and 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 any central bank finds that a loose monetary policy has started becoming counterproductive (for example, when it leads to a higher inflation rate), the central bank "normalizes the policy" by tightening the monetary policy stance.
- Under normal circumstances, that is when the economy is growing at a healthy pace, the repo rate becomes the benchmark interest rate in the economy.
- However, the reverse repo had become the benchmark rate in India since the start of the Covid pandemic.

What is reverse repo normalization?

- Reverse repo normalization means the reverse repo rates will go up.
- Over the past few months, in the face of rising inflation, several central banks across the world have

either increased interest rates or signaled that they would do so soon.

- In India, too, it is expected that the RBI will raise the repo rate. But before that, it is expected that the RBI will raise the reverse repo rate and reduce the gap between the two rates.
- This process of normalization, which is aimed at curbing inflation, will not only reduce excess liquidity but also result in higher interest rates across the board in the Indian economy — thus reducing the demand for money among consumers (since it would make more sense to just keep the money in the bank) and making it costlier for businesses to borrow fresh loans.

Repo vs Reverse repo rate-

Repo rate is the rate at which the Central Bank grants loans to the commercial banks against government securities. Reverse repo rate is the interest offered by RBI to banks who deposit funds with them.

Parameters	Repo Rate	Reverse Repo Rate
Meaning	Repo rate is the rate at which the Central Bank grants loan to the commercial banks against government securities.	Reverse repo rate is the interest offered by RBI to banks who deposit funds with them.
Rate of interest	Higher than the reverse repo rate.	Lower than the repo rate.
Mechanism of operation	RBI grants funds to commercial banks against government bonds as collateral.	Commercial banks deposit their excess funds with RBI and receive interest on their deposits.
Controls	Inflation	Money supply in the economy
Purpose	To fulfill the deficiency of funds.	To ensure liquidity in the economy
Borrower's objective	To manage short term deficiency of funds.	To reduce overall supply of money in the economy
Impact of higher rate	Cost of funds increase for commercial banks and hence loans become expensive.	Money supply in the economy decreases as commercial banks park more surplus funds with RBI.
Impact of lower rate	Cost of funds reduce for commercial banks and loans become cheaper for them.	Money supply increases in the economy as banks lend more and reduce their deposits with central bank.
Charged on	Repo rate is charged on Repurchase agreement.	Reverse repo rate is charged on Reverse Repurchase agreement.