

The Apex Bank's Rate Mechanism

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ABSTRACT

The apex bank of a country (central bank) tackle inflationary and deflationary situations by using the policy rate. The policy rate is lowered when there is a fear of recession/deflation or when the inflation is below the target level. The policy rate is increased/hiked when there is excessive inflation i.e., the inflation is above the central bank's target level. It helps to control inflation, stabilize currencies, and prevent economic imbalances. However rate cut or hike though done with proper research and thought may lead to adverse outcomes, an excessive rate cut can lead to inflation, asset bubbles, or reduced savings incentives, whereas too aggressive hike can trigger a recession. Thus, rate is increased or decreased depending on the circumstances with an intent to maintain financial stability, however, both of them has certain adverse effects, i.e., it cannot be said that only good comes out of both of them. The rate cut as well as rate hike carry their own risks and adverse effects.

Keywords: Policy Rate, Rate Cut, Rate Hike

Policy Rate

The central bank is one of the apex institutions in a country, the interest rate set by it is often called the policy rate or benchmark rate. The policy rate is one of the most crucial tools in monetary policy and the apex bank's most important asset. It is used to tackle inflation and deflation; it assists in influencing economic activity and to maintain financial stability. A country's economy is significantly influenced by the benchmark interest rate set by its central bank, it acts as a lever to control money supply, inflation, borrowing costs, and overall economic activity.

The benchmark rate is increased and decreased time to time by the country's central bank to tackle inflation and deflation.

Rate Cut

The central bank of a country typically implements a rate cut under specific economic conditions to stimulate economic activity; rate cut lowers the benchmark interest rate set by the central bank. When the economic growth of a country slows down or the economy enters into a recession, the central bank may cut rates. These cuts are carried out with an intent to encourage borrowing, an increase in borrowing will increase the money supply as a result people will have more money at their disposal for spending and investments purposes. When the rate is reduced by the central bank people borrow more because rate cut reduces the cost of borrowing as result borrowing money becomes cheaper because the interest outflows will be lower than earlier. This induces people to borrow money for investment, expansion of business and spending.

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Factors leading to rate cut:

The interest rate can be lowered under various circumstances-

1. Low Inflation or Deflation - When inflation is persistently below the target level set by the central bank or when there is a risk of deflation, a rate cut can help in increasing the money supply and demand which will push the inflation towards the target level.
2. High Unemployment - Rate cut is also done to tackle the problem of unemployment, because of the rate cut borrowing becomes cheaper which induces businesses to borrow money for expansion, such expansion will lead to more employment directly and indirectly.
3. Global Economic Weakness - When the global economy is weak and it could lead to adverse effects on the domestic economy, the central bank may cut rates to protect its domestic economy from those external shocks and maintain competitiveness.
4. Financial Market Stress - During periods of financial instability like a banking crisis or stock market crash, the central bank may cut rates to ease financial conditions and support liquidity in the system.
5. Exchange Rate Considerations - When a country's currency becomes too strong it may lead hurting its exports, in such a case a rate cut can weaken the currency, making exports more competitive internationally.
6. Pre-emptive Action - The Central bank may cut the rates pre-emptively to mitigate the impact of foreseen economic risks.

Examples:

- The U.S. Federal Reserve cut rates to near zero during the 2008 financial crisis to support the economy.
- The European Central Bank (ECB) has used rate cuts to combat low inflation and stimulate growth in the Eurozone.

Benefits of rate cut:

Rate cut helps to boost the economic activity in many ways, some of the benefits are as under:

1. Helps to tackle increasing unemployment - As discussed earlier, lowering the interest rate leads to an increase in borrowing which leads to more spending and investment, an increase in spending and investment lead to generation of employment opportunities which helps to tackle the problem of increasing unemployment.
2. Helps to promote exports - A strong exchange rate hurts a country's exports because its products are expensive for other countries; by lowering the interest rate the country weakens its currency against the others with an intent to boost its exports,
3. Real estate and Housing - Lower rate often leads to higher real estate prices as investors seek better returns. Lower interest rate reduces mortgage rates, making home loans more affordable. This boosts demand for housing and can lead to higher home prices. Homebuilders, real estate developers, and real estate investment trusts (REITs) are some of the key players.

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4. Stock market - Lower rate makes equities more attractive as compared to fixed-income investments like bonds and fixed deposits, this increases the money inflow into the security market and an increase in demand for the equities, which leads to higher stock prices across the board. Growth stocks, which are sensitive to interest rates, often see significant gains and are the key beneficiaries.
5. Financial sector/Banks and Lending Institutions - Though lower rate squeezes banks' net interest margins, it often leads to increased borrowing activity, which can boost loan volumes. Commercial banks, mortgage lenders, and consumer finance companies are some of the key players.
6. Consumers - Lower rate reduces the cost of financing, this makes financing items like cars, appliances, and electronics cheaper and thereby encourage the consumers to spend more and thereby boosting the economic activity while simultaneously satisfying their wants. Automakers, retailers, and leisure/travel companies are some of the key players.
7. Utilities - Enterprises engaged in utilities like electricity, water and gas require extensive amount of capital and often carry high levels of debt. Lower interest rate reduces their borrowing cost and interest outflows thereby improving profitability. Electric, gas, and water utility companies are some of the key players.
8. Technology and research and development - Companies engaged in research and development often rely on borrowings to fund their plans and programmes. Lower rate reduces their cost of capital, making it easier to invest in growth. Software, hardware, and semiconductor companies are some of the key players.
9. Industrials and Infrastructure - Lower rate reduces financing cost, as a result it becomes cheaper and more feasible to finance large projects and purchase of expensive equipment. This encourages businesses to invest more money in infrastructure and machinery. Construction companies, machinery manufacturers, and engineering firms are some of the key players.
10. Materials and Commodities - As discussed earlier, lower rates can weaken the country's currency which makes the country's products more competitive in global market and thus helps in boosting demand for its commodities like metals and raw materials. Mining, steel, and chemical companies are some of the key players.
11. Consumer Staples (Indirect Benefit) - Although consumer staples like food, drinks (including alcoholic beverages), tobacco, and household and personal care items are less sensitive to rate cuts, they are benefitted indirectly by these rate cuts, because lower rate leads to an increased consumer spending and improved economic conditions. Food, beverage, and household product companies are some of the key players.
12. Small and Medium-Sized Enterprises (SMEs) - SMEs rely on borrowings to fund their operations and expand their business. Lower rate makes it easier and cheaper for them to access credit.
13. Gross Domestic Production - A rate cut by the central bank can stimulate a country's GDP as it lowers the borrowing cost which leads to a boost in spending and investment and an increased spending and investment leads to more production activity.

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Further the benefits derived by the other sectors contribute towards boosting the GDP either directly or indirectly. For example, the period following the 2008 financial crisis in the U.S. saw a deep recession, significant job losses, and a decline in household wealth, to tackle this the Fed slashed rates to near 0%, fuelling recovery. The GDP grew as housing, autos, and corporate investments rebounded.

Thus, lowering of interest rate benefits the economy and the benefits derived by certain sectors tends to be more than others due to the impact of lower borrowing costs, increased consumer spending and improved economic sentiment. However, there are the sectors also which suffer due to the rate cut, e.g. -

1. Savings-Dependent Sectors - Sectors that rely on high savings rates, such as insurance companies, suffers due to reduced rate of return on their fixed-income investments.
2. Currency-Sensitive Importers - If rate cut weakens the domestic currency too much, import-heavy sectors (e.g., airlines, manufacturers relying on foreign inputs) face higher costs.

Briefly, sectors like real estate, financials, consumer discretionary, and technology tend to benefit the most from a central bank's rate cut, as they are highly sensitive to borrowing costs and consumer spending. However, the overall impact depends on the broader economic context and how businesses and consumers respond to the rate cut. If the economy is in a severe downturn or facing deflationary pressures or fearing recession, rate cuts may not immediately lead to inflation. Instead, they aim to stimulate growth and prevent deflation. The central bank generally decreases rate to combat deflation or stimulate economic growth, but it can lead to inflation if the economy overheats or if the rate cuts are excessive. In case of liquidity traps if the rates are near zero and the economy remains weak, rate cuts lose their impact. Therefore, there is downside also to rate cuts, excessive rate cuts can lead to inflation, asset bubbles, or reduced savings incentives.

Rate Hike or Increase in Rate

Central banks increase interest rates primarily to control inflation and maintain economic stability, an increase in rate makes borrowing money from and other financial institutions expensive which discourage people to borrow money, a reduction in borrowing leads to a reduction in public spending and investment.

Factors leading to rate hike:

The interest rate can be increased under various circumstances-

1. To tackle increasing inflation - A high demand and low supply typically leads to inflation because when the demand for goods and services exceeds the available supply, prices tend to rise as consumers are willing to pay more to obtain scarce items. An increase in rate makes borrowing unattractive leading to decrease in money supply in the economy, which ultimately leaves people with less money to spend i.e. limits people's budget. Due to limited budget the demand for product decreases and this decrease in demand helps to tackle increasing inflation.
2. To tackle asset bubble - Prolonged low rates can fuel speculation in real estate (housing bubbles) and stocks (overvaluation), as people borrow a lot of money to invest in real estate

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and stocks, an increase in interest rates makes it expensive for people to borrow money as a result borrowing decreases. Further, Asset prices reflect future cash flows discounted by interest rates, a higher rate means a lower present value, thereby tackling the bubble in their valuations.

3. To Stabilize the Currency and reduce the outflow of financial assets and capital - Lower interest rate leads to a weaker currency which makes imports expensive which can lead to a rapid outflow of financial assets and capital from the country and thus hurting its financial position. An increase in the interest rate makes it attractive for foreign investors to invest their funds in the country which will lead to an appreciation in the currency value, an appreciated currency makes the imports cheaper which ultimately reduces the outflow of financial assets and capital from the country.
4. To cool an Overheating Economy - When the GDP grows faster than its potential and demand grows faster than supply it leads to a rising inflation, labour shortages, and asset bubbles, this is termed as an overheating economy. An increase in interest rate cools demand to prevent unsustainable growth and restore balance and prevent long-term damage.

An overheating economy causes wage-price spirals. Because of lower interest rate, businesses have access to cheaper borrowing and are in a position to afford hiring more workers resulting in reduction of unemployment. In turn, the workers demand higher wages in the situation of lesser unemployment and companies are compelled to increase the prices of their products and services to cover up the increase in costs causing the inflation. An increase in interest rate makes borrowing expensive and unattractive forcing the businesses to do some retrenchments thereby causing unemployment. In case of increased unemployment the workers tend to reduce their salary demands as well as the higher rate slows down the hiring and business expansion, preventing runaway wage growth.

Thus, it can be said that raising interest rates is the primary tool to cool an overheating economy as it reduces demand, stabilizes prices and prevent financial bubbles.

5. To restore rate to pre-crisis level - During emergencies/crises central banks cut rates to near zero. Once recovery is stable, they raise rates to restore it to the pre-crisis level
6. Global Spillovers - If a major central bank of another country (e.g., Fed, ECB) hike rates, others may follow to prevent capital outflows and avoid excessive currency weakness.

Benefits of increase in rates:

An increase in interest rates tends to benefit certain sectors due to changes in borrowing costs, consumer behaviour, and investment flows. The following sectors are the one's which typically gain from increase in the interest rates:

1. Banking & Financial Services - Higher rates increase the net interest margins of the banks and financial institutes enabling them to record more profit.
2. Insurance Companies - Insurance companies invest the premiums they receive in bonds and other fixed interest income investments which boost their fixed-income returns and more stability.

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3. Value Stocks & Dividend Payers - Stock prices reflect future cash flows discounted by interest rates. A higher rate hurts these valuations and stable or constant dividend payers becomes more attractive to growth stock. This makes the investors shift from growth to value stocks.
4. Cash-Rich Corporations - Companies that have a low debt and high cash reserves earn more interest on idle cash from higher short-term rates.

On the other hand, increasing the rate also has certain side effects, like:

1. Slower GDP growth - When interest rates are increased the GDP growth slows down due to reduced spending and investment.
2. Higher unemployment - Due to increase in rates the money supply decreases, businesses have less money at their disposal and borrowing is expensive because of which they cut some costs. In course of cost cuttings, some of the workforce is laid off resulting in increase in unemployment.
3. Debt stress - Rising interest rates make it more expensive to repay existing debts, leading to financial strain and potentially impacting economic stability.
4. Stock market declines - Stock prices reflect future cash flows discounted by interest rates, a higher rate means a lower present value, i.e., higher interest rate hurt valuations.

Therefore, it can be said that central banks raise rates primarily to control inflation, stabilize currencies, and prevent economic imbalances. An aggressive hikes can trigger a recession. Timing and magnitude are significant factor.

In short, the policy rate or benchmark rate is a great tool to drive, monitor and regulate the eco-financial conditions of a nation.

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