# Monetary policy's impact on inequality

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**Why is in news?** Monetary Policy Committee (MPC) of India's central bank, the RBI will deliberate whether interest rates should be hiked further or not in the forthcoming meeting

**Rationale behind RBI raising interest rates**

The RBI has been increasing interest rate in its bid to contain inflation. RBI hopes that a higher EMI on an existing loan or a costlier new loan would dissuade enough people from borrowing money to fund future economic activity.

The resultant slowdown in activity and demand for money will likely bring down inflation, which is essentially described as "too much money chasing too few goods".

Since the RBI, which is the main agency charged with the responsibility of maintaining price stability in the Indian economy, cannot increase the supply of goods and services such as crude oil, cabbage and haircuts, it acts in a manner that reduces the demand for all goods and services.

This week, too, it is expected that the RBI will end up raising the repo rate by 25 basis points. But just like the past two repo rate hikes — in February and December — this decision is unlikely to be a unanimous one; more importantly, it will likely be widely debated for soundness.

That's because both within the MPC and outside, many believe that any further rate hikes will result in crimping India's economic growth and worsening unemployment.

**Pros and Cons of raising interest rates**

**Pros**

Raising rates is an instrument to control the inflation. It achieves the goal of containing prices by killing growth and employment.

A central bank does this not only to address the actual inflation which it can't control if it is driven by supply constraints but also to prevent the so-called "second-order effects" of high inflation.

The second-order effects refer to a spike in people's expectation of future inflation. This matters because if people do not see inflation as a minor blip and instead view that inflation is here to stay and likely to worsen, they will do what any normal person should be expected to do

**Cons**

The main problem with hiking interest rates to contain inflation that may be getting caused by costlier crude oil (due to a war or some geopolitical tension) or costlier vegetables (due to some unseasonal rains) is that the hike per se cannot improve the supply of those goods and services.

If workers are allowed to demand higher wages in anticipation of higher inflation, then businesses will start charging higher prices in anticipation of higher input costs. It has been shown that once inflation expectations become “unanchored” in this manner, policymakers find it quite tough to bring down inflation.

**Impact on Inequality**

Inflation control by this method relies heavily on denying the common people, who are most affected by high prices, the chance to raise their wages in line with the already high prices of the first round.

Higher interest rates make it difficult for the relatively worse off to get cheap credit to buy a home and create wealth.

When the central bank raises interest rates, it places something as basic as home ownership out of the reach of common people. This reduces the people’s ability to have access to an asset that creates wealth and this “wealth inequality” (relative to the wealthy) hits the poorer people with a lag.

Since the 2008 Global Financial Crisis until the war between Russia and Ukraine, most central banks, most notably the US Fed, practised an expansionary or loose monetary policy.

Essentially, this meant interest rates were kept low (almost near zero in the case of the US Fed) while flooding the economy with additional money in a bid to spur economic activity.

But during this period, there was growing criticism that low interest rates were leading to higher wealth inequalities.

When interest rates are low, savers barely get any rewards even as cheap credit fuelled spending, profiting the companies of different kinds. Under the circumstances, most of the capital appreciation happens in the stock markets.

**The Way ahead**

Widening inequalities is a very long-term trend, one that has been decades in the making and depends on deep structural changes in any economy such as globalisation, technological progress, demographic trends etc. By comparison to the influence of these long- term factors, the effects of monetary policy on inequality are almost certainly modest and transient

Monetary policy, if properly managed, promotes greater economic stability and prosperity for the economy as a whole, by mitigating the effects of recessions on the labor market and keeping inflation low and stable