Indian Economy · GS - III

Explain the monetary policy transmission mechanism through which an increase in the repo rate can control inflation. What are its implications for borrowers and economic growth?

EXAM YEAR	PAPER	SUBJECT
DAILY PRACTICE 28/11/2026	GS - III	Indian Economy

MARKS	WORD LIMIT
15	~250 words

Answer Hint

Repo rate, monetary transmission, borrowing costs, aggregate demand, inflation control, EMI, investment, growth

Model Answer

The repo rate is the rate at which the Reserve Bank of India lends short-term funds to banks against eligible securities. An increase in this rate represents a contractionary monetary policy measure intended to moderate inflationary pressures.

Transmission mechanism

1. **Higher funding costs:** An increase in the repo rate can raise banks' borrowing costs and influence their lending rates.
2. **Costlier credit:** Home, vehicle and other floating-rate loans may become more expensive.
3. **Reduced demand:** Higher EMIs or longer repayment periods can discourage consumption and investment.
4. **Inflation moderation:** Lower aggregate demand can reduce demand-side price pressures over time.

Economic implications

For borrowers, higher interest rates increase repayment burdens, particularly for households with floating-rate loans. Businesses may postpone expansion due to costlier credit.

However, tighter monetary policy can help anchor inflation expectations and protect purchasing power. Its impact on growth depends on the intensity and duration of the rate increase and the broader economic environment.

Thus, the RBI must balance price stability with sustainable economic growth while ensuring effective transmission of monetary policy.

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