

## **Monetary Policy Transmission - Shortfalls**

### **What is the issue?**

- Since February 2019, the Reserve Bank of India (RBI) has aggressively cut the repo rate.
- But, monetary policy transmission had not taken place, with banks' lending rates not proportionally coming down.

### **What is "monetary policy transmission"?**

- Repo rate is the interest rate that the RBI charges the banks when it lends them money.
- The banks' lending rate is the interest rates that banks charge from customers when they take a loan.
- By cutting the repo rate, the RBI has been sending a signal to the rest of the banking system that the lending rates in the system should come down.
- This process of repo rate cuts leading to interest rate cuts across the banking system is called "monetary policy transmission".

### **How is this working in India?**

- In India, the process of monetary policy transmission is rather inefficient.
- At no time in the past has monetary transmission been better than 50% (only half the rate cuts by RBI were passed through by the banking system).
- Between February and August 2019, the RBI cut repo rate by 110 basis points from 6.5% to 5.4% [100 basis points make a percentage point]
- But, the interest rate charged by banks on fresh loans that they extended during this period fell by just 29 basis points.
- This is just 27% of the amount by which the repo rate came down.

### **What was RBI's response?**

- In response to the sluggish transmission, the RBI decided to cut the repo rate by another 25 basis points in October 2019.
- It urged banks to link their lending rates to the repo rate.
- Yet, for the most part, the banking system has ignored the signalling.
- Only some banks have reduced lending rates on new loans by 10 basis points.
- Indeed, even though it is counter-intuitive, interest rates on existing loans

(not new loans) have actually gone up by 7 basis points.

## How does lowering interest rates help?

- Since February 2019, India's economic growth momentum has rapidly decelerated.
- Projections of GDP growth rate have come down from roughly 7.2%-7.5% in February to 5.8%-6.0% in October 2019.
- In this context, there are two key problems in the economy:
  1. people are not consuming at a high enough rate
  2. businesses are not investing in existing or new facilities
- A lower interest rate regime is expected to help in resolving both of these.
- **Consumption** - The prevalent argument is that if banks reduce their lending rates, they would also have to reduce their deposit rates.
- Reducing deposit rates will, in turn, incentivise people to save less and spend more i.e. increased consumption.
- [Deposit rate is the interest rate banks pay when consumers park their money in a savings bank deposits or a fixed deposit.]
- **Investment** - The low investment by businesses is partly because they have unsold inventories because people are not buying as much.
- But, part of the reason is also that the interest rate charged on loans is quite high.
- If interest rates are lowered, more businesses are likely to be enthused to borrow new loans for investment.
- This is particularly fitting as the government has recently cut corporate tax rates in the hope to boost investment and corporate sector's profitability.
- So, given that overall retail inflation too has been well within the comfort zone of 4%, the RBI's decision to cut repo rates was a justified move.

## Why are banks not reducing interest rates?

- Repo rates have little impact on a bank's overall cost of funds.
- Reducing lending rates just because the repo rate has been cut is not feasible for banks.
- This is because, for banks to be viable, there must be a clear difference between the lending rate (charged on loans) and the deposit rate (given on deposits).
- The difference between the two has to be not only positive but also big enough for the bank to make profits.
- Notably, to attract deposits, banks pay a high deposit rate.
- Such deposits make up almost 80% of all banks' funds from which they then lend to borrowers.

- On the other hand, banks borrow a minuscule fraction from the RBI under the repo.
- So even sharply reducing the repo rate does not change the overall cost of funds for the banks.
- In effect, unless banks reduce their deposit rates, they will not be able to reduce their lending rates.
- However, if a bank were to reduce its deposit rates, depositors would shift to a rival bank that pays better interest rates.
- Otherwise, they would park more of their savings in small saving instruments (public provident fund, Sukanya Samriddhi Yojana, etc) that pay much higher interest rates.
- Also, 65% of total deposits are “term” deposits (fixed for a certain duration) and take, on an average, up to 2 years to get repriced at fresh rates.
- So, banks cannot always reduce deposit rates immediately as deposits take longer to get repriced.
- Moreover, if banks are under pressure to reduce the interest rate they charge on new loans, they could possibly push up the interest rates on old loans that allow for such flexibility.

### **How does it work in developed countries?**

- In developed countries, the financial system is far more developed and diversified.
- Most importantly, the banking system there does not have to bear the burden of providing loans to everyone in the economy.
- Most demands for big loans are directed towards the corporate bond market.
- Here, a company floats bonds and borrows money from the public by paying whatever interest rate the market demands.
- Moreover, depositors are not in the habit of getting a fixed interest rate on their savings while expecting a variable interest rate on their loans.

### **What is the way forward?**

- At the current low levels of per capita income, the savers are far more risk-averse in India and unwilling to invest in higher-risk instruments other than bank deposits.
- For a repo-linked regime to work, the whole banking system in India would have to shift to that.
- In other words, along with banks’ lending rates, their deposit rates too must go up and down with the repo.
- But if such a regime were in place, depositors would have earned 1.10 percentage points less interest rate on their savings account.
- So, in many ways, linking the lending rate to the repo rate is not a viable

option.

**Source: Indian Express**

