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