



ANALYSIS OF MONETARY POLICY TRANSMISSION IN INDIAN BANKING

DINESH MISHRA

Chief Manager

Union Learning Academy – People Excellence

Union Bank of India

Abstract: Monetary Policy Transmission (via banking channel) is the process through which the changes in RBI Repo rates transmit into various sections like retail, MSME segment via changes in banks deposits and advances rates. RBI ultimate monetary policy objective is to maintain inflation within tolerance level while supporting economic growth. Indian financial system is banking dominated, so it is important to analyse the nuances of monetary Policy transmission to gauge the ultimate impact and efficacy of Monetary Policy. Author observes that Monetary Policy rates affect deposits and advances rates differently therefore transmission is unequal as the banks efficiency and asset liability structure differ with one another. Historically lower transmission has been persistent, Even though RBI had taken several steps to ensure that better transmission takes place, most recently it has introduced EBLR to enhance Monetary Policy Transmission yet there is still lag in the transmission due to sticky nature of deposits and floating nature of advances to a large extent. In current financial year (FY 2023-24) so far, transmission is more on deposits than advances. This is possible due to CASA (Current & Saving deposits). Despite of increase in Policy Rates this financial year, banks are maintaining good margin, profitability owing to low cost CASA among other factors. As per RBI, approximately 48% of loans and advances are still linked to MCLR (Marginal cost of funding-based lending rate) i.e. good proportion of loans and advances are linked to MCLR, which is less transmittable rate. Author concludes that transmission through banking channel will further improve if banks deposits are also made floating and proportion of EBLR loans and advances rises in the Indian Banks.

Employee productivity; Public Sector Banks, PSBs, RBI, Monetary Policy, Transmission

INTRODUCTION

Past decade has been decade of corrections & transformations for banking sector in India, it was challenging in many counts. To name few challenges; Covid-19 impact, rising bad debts, capital inadequacy, competitive pressure from Fintech and new age private & small finance banks, rising operational & compliance risks at a times reputational risk too and last but not the least improving Profitability of Banks. Last few years shall also be remembered for RBI efforts to ensure banking sector is robust by ensuring Asset Quality Reviews, External benchmark for making monetary policy more impactful for real economy and also make monetary policy rates more transmittable to borrowers in RAM (Retail, Agriculture, MSMEs) sector.

In a country like India where the banking system constitutes a predominant segment of the financial system, efficient transmission to banks' deposit and lending interest rates is the key to achieving the ultimate objectives of monetary policy. However, transmission to banks' lending rates in India is impeded by a variety of factors viz banks efficiency, NPAs, unfavorable sticky deposits mix, competition from govt. small deposits schemes etc.

The prime objective of the paper is to analyse Monetary Policy Transmission in context of Indian banking sector and real economy. This paper is also an attempt to review Monetary Policy transmission critically from efficacy point of view.

BACKGROUND

The Reserve Bank of India (RBI) is vested with the responsibility of conducting monetary policy. This responsibility is explicitly mandated under the Reserve Bank of India Act, 1934. Monetary policy refers to the policy of the central bank with regard to the use of monetary instruments under its control to achieve the goals specified in the RBI Act, 1934.

In May 2016, the Reserve Bank of India (RBI) Act, 1934 was amended to provide a statutory basis for the implementation of the flexible inflation targeting framework. Prior to the amendment in the RBI Act in May 2016, the flexible inflation targeting framework was governed by an Agreement on Monetary Policy Framework between the Government and the Reserve Bank of India of February 20, 2015.

The amended RBI Act also provides for the inflation target to be set by the Government of India, in consultation with the Reserve Bank, once in every five years. Accordingly, the Central Government has notified in the Official Gazette 4 per cent Consumer Price Index (CPI) inflation as the target for the period from August 5, 2016 to March 31, 2021 with the upper tolerance limit of 6 per cent and the lower tolerance limit of 2 per cent.

Monetary transmission mechanism describes the routes through which a monetary Policy changes affects output and prices in other words it is the process by which asset prices and general economic conditions are affected by monetary policy decisions. For example, if the RBI cuts repo rate by 50 BPS, how much borrower to receive the rate cut benefit?

MONETARY POLICY FORMULATION PROCESS (In Brief)

Section 45ZB of the amended RBI Act, 1934 also provides for an empowered six-member monetary policy committee (MPC) chaired by RBI governor to be constituted by the Central Government by notification in the Official Gazette. Accordingly, the Central Government in September 2016 constituted the MPC.

Under the amended RBI Act, the monetary policy making is as under:

- ❖ The MPC is required to meet at least four times in a year.
- ❖ The quorum for the meeting of the MPC is four members.
- ❖ Each member of the MPC has one vote, and in the event of an equality of votes, the Governor has a second or casting vote.
- ❖ The resolution adopted by the MPC is published after conclusion of every meeting of the MPC in accordance with the provisions of Chapter III F of the Reserve Bank of India Act, 1934.
- ❖ On the 14th day, the minutes of the proceedings of the MPC are published which include:
 - The resolution adopted by the MPC;
 - The vote of each member on the resolution, ascribed to such member; and
 - The statement of each member on the resolution adopted.

Once in every six months, the Reserve Bank is required to publish a document called the Monetary Policy Report to explain:

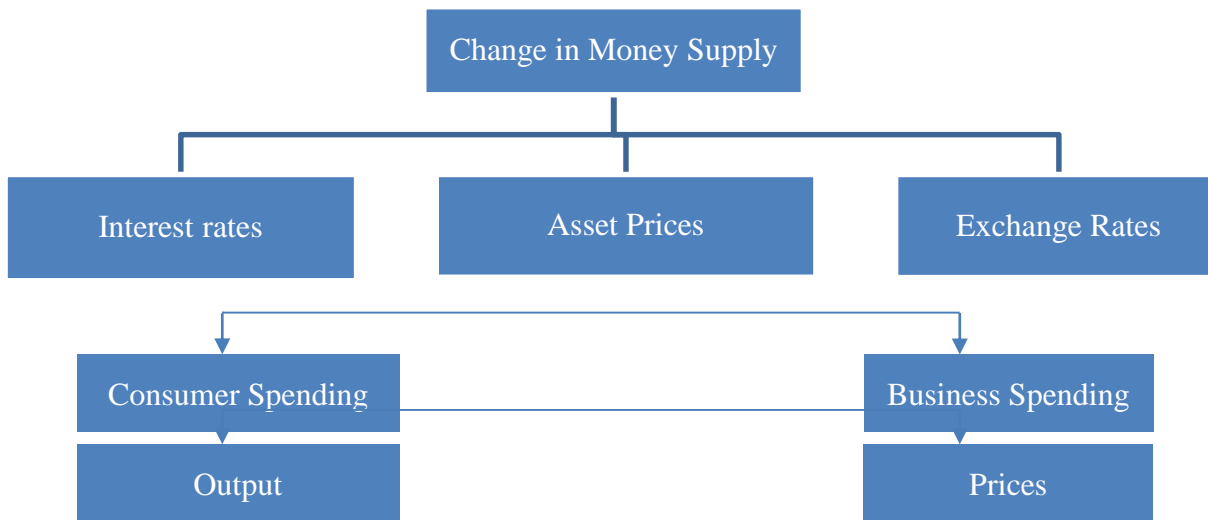
- a. the sources of inflation; and
- b. The forecast of inflation for 6-18 months ahead.

THE GOAL(S) OF MONETARY POLICY

The goals of monetary Policy in India have been growth with stability in the prices level. Depending upon the evolving situation, RBI tries to strike a balance between the two goals, with a broad accent on keeping inflation within a reasonable targeted level. Towards the pursuit of these goals, RBI has been in recent years also trying to maintain orderly conditions in the foreign exchange market by intervening in the market as and when necessary.

In sum objective of Monetary Policy Transmission is to regulate magnitudes such as interest rates, money supply and availability of credit with a view to achieving the ultimate objective of economic policy.

It can be better simplified through diagram below:



It shall be quite pertinent to elaborate upon the diagram mentioned above by connecting it from real economy. In few subsequent para it has been elucidated for developing insight into the subject matter.

HOW MONETARY POLICY TRANSMISSION HAPPENS?

Stage I: Monetary Policy Impact on Financial sector

The initial impact of monetary Policy is on financial variables. The first impact of change in monetary policy (change in money supply) is felt on the interest rates in the economy. If the monetary Policy stance is perceived to be temporary, the pressure is on short-term rates. If it sustained, the pressure may extend to long term as well.

Changes in interest rates caused by monetary policy changes in turn affect several financial variables in the market place though relative importance of these variable varies from time to time. In case of expansionary monetary Policy where an increase in money supply has resulted in a fall in the interest rates. If there is efficient transmission, than policy induced decrease in the interest rates results into cut in lending rates which translates into increase in value of assets like stocks, bonds and real estates. This increases net worth of individuals and businesses i.e. has positive wealth effect.

Depending on how free the movement of capital is between countries, a fall in the interest rates in one country relative to other country will make investment in the other country's markets more attractive. Capital will flow out of country if full capital account convertibility is allowed. Historically, impact of monetary policy on exchange rates have been minimal.

Stage II: Monetary Policy Impact on real economy

Consumer Spending

As discussed above, expansionary monetary policy changes in financial variables affects consumer spending in two ways. RBI interest rates cuts 'may' reduce interest outgo for consumers having loan liabilities thus resulting more disposable income for spending in goods and services. For those who are not in debt, a fall in the interest rates makes current consumption more attractive than future consumption.

An increase in the asset prices impacts consumption spending in the economy in two ways. Since, an asset prices rise increase the net worth of the individual, consumer spending goes up because the consume 'feels' wealthier (sentiment based) and because he now, 'actually' finds it easier to borrow and spend more on goods and services.

Similarly, currency depreciation makes imports relatively more expensive than before. The competitiveness of domestic producers of goods and services goes up. This encourages spending away from imports to domestically produced goods and services, thus overall domestic spending goes up.

Business Spending

Changes in market interest rates, asset prices and exchange rates that follow a monetary Policy change, affect business spending in the economy in a similar manner. As per macroeconomic theories, we understand that investment is inversely related to interest rates. A fall in interest rates enhanced new investment in plants and machinery and in expansion of labour force. This is because now the return that companies will require from new investment projects will be less. Also, companies who rely on loans will see their profits going up resulting from a lower interest outgo and will, therefore have more money to invest.

An increase in the asset prices also facilitates investment spending in the economy. Bank loans and other loans are usually secured on assets. If asset prices rise, the net worth of the company increases and it becomes easier for the company to borrow and invest more.

Finally, the effect of currency depreciation affects investment spending through two routes. As already discussed above, currency depreciation will shift the demand of domestic consumers towards domestically produced goods and services. A depreciation of the currency will also generate more demand for out goods and services by foreigners (exports) since now the price of our products to the foreigner has come down relative to their own.

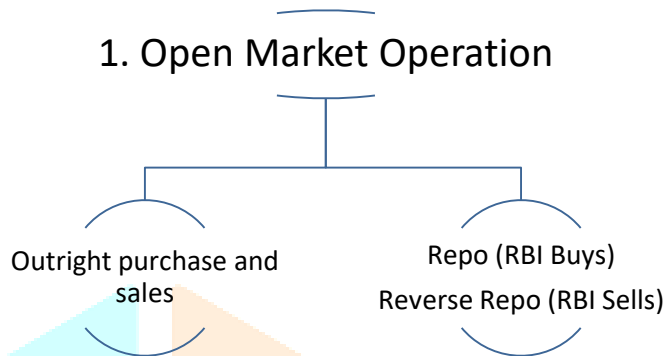
In the context of above, it is important to underline that Central banks are not providers of saving but are providers of liquidity (Money) in the economy. For example, when saving go up, interest rates fall because the supply of loanable funds goes up in relation to demand. At lower interest rates, more demand is generated. The economy produces more goods and services. Both actual GDP and the economy's productive capacity increases. On the other hand, when the central bank is following an expansionary monetary policy, it is increasing money supply in excess of saving in the economy. The saving remains the same. this is being done either because in practicality, there is a misalignment between liquidity and saving and/or the available saving is not getting translated into investment. Therefore, Central bank need to be thorough in approach to deal with this peculiarity

INSTRUMENTS OF MONETARY POLICY

The Central bank can control money supply in several ways:

- Through Open Market Operations
- By changing the bank rates
- By changing reserve requirements of the Banks (CRR)
- Through direct credit controls

Open Market Operation (OMO) can be explained better by way of diagram below:



Open Market Operations (OMO)

Open Market Operations are of two types:

- I. Outright buying/selling of government securities to either inject or absorb liquidity on a long term basis and,
- II. Repo transactions i.e. buying/selling of government securities to either inject or absorb liquidity for a short term with a repurchase obligation

The term repo refers to purchase of securities by RBI (injection of liquidity) with an agreement to sell them back at an agreed price on an agreed date. The interest rate at which RBI offers repurchase facilities is the Repo rate. the Repo rate is, therefore, the rate that RBI charges for lending money the banks and other participating institutions through purchase of securities. Similarly 'Reverse Repo' refers to sale of securities by RBI (absorption of liquidity) with an agreement to buy those back at an agreed price at n an agreed date. The interest rate at which this reverse repurchase facility is made available is the reverse repo rate. The reverse repo rate is the rate that RBI pays to the commercial banks and participating institutions for borrowing money from them against sale of securities.

Thus, RBI's Open Market Operation affects the banking system in two ways. First, through effecting a change if reserve and second, through signalling of interest rates based on the minimum and maximum interest rate set for the purchase and sale of government securities.

There are other several direct and indirect instruments that are used for implementing monetary policy.

Liquidity Adjustment Facility (LAF): The LAF consists of overnight as well as term repo auctions. Progressively, the Reserve Bank has increased the proportion of liquidity injected under fine-tuning variable rate repo auctions of range of tenors. The aim of term repo is to help develop the inter-bank term money market, which in turn can set market based benchmarks for pricing of loans and deposits, and hence improve

transmission of monetary policy. The Reserve Bank also conducts variable interest rate reverse repo auctions, as necessitated under the market conditions.

Marginal Standing Facility (MSF): A facility under which scheduled commercial banks can borrow additional amount of overnight money from the Reserve Bank by dipping into their Statutory Liquidity Ratio (SLR) portfolio up to a limit at a penal rate of interest. This provides a safety valve against unanticipated liquidity shocks to the banking system.

Corridor: The MSF rate and reverse repo rate determine the corridor for the daily movement in the weighted average call money rate.

Bank Rate: It is the rate at which the Reserve Bank is ready to buy or rediscount bills of exchange or other commercial papers. The Bank Rate is published under Section 49 of the Reserve Bank of India Act, 1934. This rate has been aligned to the MSF rate and, therefore, changes automatically as and when the MSF rate changes alongside policy repo rate changes.

RBI can influence the money supply growth by changing the bank rate from time to time. If RBI wants to inject more liquidity into the banking system, it will lower the Bank Rate. At lower rate banks will borrow more and this will increase monetary base. Exactly the opposite will happen, if the Central Bank wants to siphon off liquidity from the system. Bank Rate will be raised. Commercial Banks will find it more costly to borrow so they will borrow less which will result into fall in monetary base. Money supply growth will come down. Thus, a rise in the Bank rate signals monetary tightening and rise in the interest rates in the economy. And a fall in the bank rate signals monetary softening and a fall in the interest rates.

Cash Reserve Ratio (CRR): The average daily balance that a bank is required to maintain with the Reserve Bank as a share of such per cent of its Net demand and time liabilities (NDTL) that the Reserve Bank may notify from time to time in the Gazette of India. One way for the Central bank to control money supply is to increase (decrease) the CRR requirement depending on whether it wants to bring about a decrease (increase) the money supply. An increase in the reserve requirement will make it mandatory on the part of banks to hold larger proportion of deposits in the form of reserves with Central Bank. At present, It has been kept at lower rate of 3.00% to maintain good liquidity in system.

Statutory Liquidity Ratio (SLR): The share of NDTL that a bank is required to maintain in safe and liquid assets, such as, unencumbered government securities, cash and gold. Changes in SLR often influence the availability of resources in the banking system for lending to the private sector.

Market Stabilisation Scheme (MSS): This instrument for monetary management was introduced in 2004. Surplus liquidity of a more enduring nature arising from large capital inflows is absorbed through sale of short-dated government securities and treasury bills. The cash so mobilised is held in a separate government account with the Reserve Bank.

There are pros and cons of each instrument described and analysed above. Open Market Operations and change in Bank Rates keep the money multiplier unchanged and work through change in monetary base. Change in reserve ratios keeps the monetary base unchanged and works through money multiplier process. In the actual conduct of monetary policy, Central Banks use a combination of the instruments analysed above. OMOs are used most often by the central bank since those can be undertaken every business day, can be

undertaken to a large and small degree and can be easily reversed. Banks reserves are immediately affected to a desired degree with the initiative lying solely with the central bank.

Bank rate is no more significant monetary policy tool.

While changing the reserve ratio (CRR) is a swift way of reducing the growth of money supply, it has three problems. First, since the statutory reserve don't carry interest an increase in the reserve ratio imposes a tax on the banking system, which is not good for efficiency. Second, if the banks have excess reserves, which they usually do, they can circumvent the effect of rise in reserve ratio. Third, the impact of a rise in the reserve ratio on output may be too harsh.

Repo rate, Reverse Repo, Bank Rate, Margin Standing Facility rate are called Policy rates which RBI uses to signal a change in market rates. A rise in these rates in general raises funding costs for businesses across the board. On the other hand, Increasing the reserve ratio impacts excess liquidity in the banking system.

Selective credit controls are out of fashion but some central banks including RBI do use those to address specific conditions.

Now, it is pertinent here to relate these instruments with overall Monetary Policy Transmission mechanism to drive the main point that how transmission happens or doesn't happen? Every time money supply or liquidity goes up, banks find that they have more reserve than what they need. They buy bond or lend money. In case they invest in bonds, its prices increases and yields on bonds drop, bringing the interest rates down. In case of lending, banks lower the prices at which they can lend to lure customers. Once again, interest rates come down. The rest of the transmission mechanism follows. The opposite happens when the reserves come down.

ISSUES IN MONETARY POLICY

If we closely follow deliberations of MPCs and analyse monetary policy, we often come across some dilemmas the central bankers faces in the conduct of monetary policy, given conflicting goals.

There are uncertainties about how it impacts interest rates in the economy. And, even if interest rates change in the desired direction, its impact on GDP and prices may not be on expected lines if consumption and investment demand are not very responsive to changes in interest rates. Similarly raising CRR may not achieve the purpose if banks already have excess reserves, bringing the CRR down may also not ease credit availability to the commercial sector if banks decide to invest in G-Sec instead. These are uncertainties that the Central Banker has to constantly grapple with.

The speed and quantum at which the central bank's policy rate changes passes on to the real economy vary widely across countries. It mainly depends on two factors - the structure of the economy and the state of its financial system. In India, the Reserve Bank of India (RBI) has been ahead of the curve in monetary policy easing, reducing the repo rate by more than 250 bps since Feb 19 as inflation has remained within the target range since Aug 2018. Chart below depicts Monetary Transmission (through bank channel) in deposits and Lending Rate during the period of Feb-19 to Jan-20.

Transmission from the Repo Rate to Bank's Deposit and Lending Rates

(Variation in basis points)

| Period | Repo Rate | Term Deposits Rates | | | Lending Rates | | | |
|-------------------------------------|-----------|--------------------------------|--------------------------------------|-------------------------------|---------------|------------------------|--------------------------|-------------------------------|
| | | WADTD R (Fresh Retail Deposit) | WADTDR (Fresh Retail & bulk Deposit) | WADTDR (Outstanding Deposits) | EBLR | 1 - Year MCLR (Median) | WALR (Fresh Rupee Loans) | WALR (Outstanding Rupee Loan) |
| February 2019 to March 2022 | -250 | -209 | -259 | -188 | -250 | -155 | -232 | -150 |
| April 2022 to August/September 2023 | 250 | 168 | 224 | 157 | 250 | 158 | 184 | 110 |
| May 2022 to August/September 2023* | 250 | 168 | 233 | 157 | 250 | 154 | 196 | 112 |

Notes: 1. WALR: Weighted average lending rate; WADTDR: Weighted average domestic term deposit rate; EBLR: External benchmark-based lending rate; MCLR: Marginal cost of funds-based lending rate.

2. Data on EBLR pertain to 32 domestic banks.

* : Latest data on WALRs and WADTDRs pertain to August 2023.

Source: RBI.

To improve the transmission of the monetary policy to the bank lending rates, the RBI over the years have taken many measures which includes transitioning from the prime lending rate (PLR) system (1994) to the benchmark prime lending rate (BPLR) system (2003), the base rate system (2010), marginal cost of funds-based lending rate (MCLR) system (2016) and most recently to External Benchmark based rate to make banks lending rates more market driven.

RBI has increased Repo rate to 6.50% from 4.00% since May-22 yet we can observe in the table data that Monetary Policy transmission is more reflected in deposits compared to advances during the corresponding period. In contrast, earlier during FY 2019 to FY 22, transmission was better reflected in the advances thanks to introduction of external benchmark-based lending rates. To a large extent, EBLR translates Monetary Policy considering immediate resetting of the loan rates after change in the Policy Repo Rate.

While all these measures except implementation of external benchmark-based rate, have resulted in slow and muted pass-through of policy rate changes to bank lending rates, it has been observed that there has been a reduction in the lag in transmission of policy rate to the commercial rates in the recent period compared to the earlier decade.

According to a study by the RBI, the transmission of the policy rate to bank credit growth usually took about seven months during 2001-2011. This has come down to an average of four to six months. During Feb-Jun 2019, when the RBI reduced repo rate by 75 bps, there was a pass-through of 29 bps in a period of about two months.

However, there have been instances of incomplete pass-through and longer period of transmission, and uneven transmission, particularly, lower during the easing phase and higher during the tightening phase. Some of the reasons behind the inflexibility of the interest rates which prevailed a decade ago still exist today.

In FY20, sharp reduction in repo rate was not reflected in bank lending rates despite measures such as lowering interest rates on small savings schemes and reduction in CRR. The reasons for downward inflexibility in transmission were high average cost of deposits, limited flexibility to reduce interest rates in the short-run, relatively high non-performing assets (NPAs), higher cost of acquiring and servicing customers, non-interest operating expenses and procedural bottlenecks in recovery of dues by banks coupled with large borrowings by the government.

Close to a decade later, the problem of rigidity in the deposits rates and issue of NPAs still prevails. As per empirical researches, the major reasons behind weak transmissions are

- (i) **Rigidity in deposits of Banks;**
- (ii) **Competition from other financial saving instruments; and**
- (iii) **Deterioration in the health of the banking sector.**

These issues have been analysed further in subsequent para.

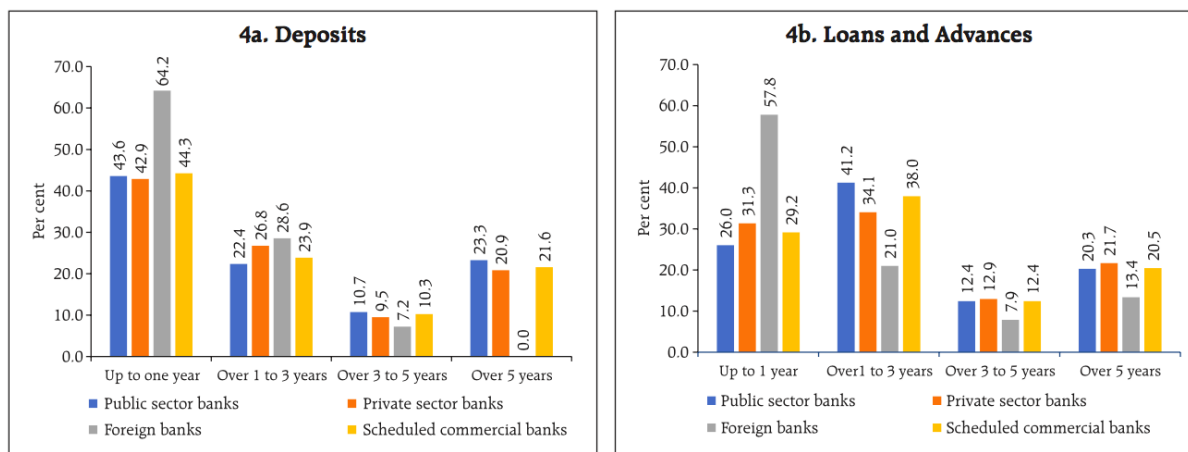
CHALLENGES IN MONETARY POLICY TRANSMISSION

Banking is essentially business of maturity transformation, wherein banks are required to manage acceptable AL (Asset-Liability) mismatches to stay afloat in business. At present, banks balance sheet is under pressure in deposits (funding) side as well as on credit side also, which has created pressure on Net Interest Margin (NIM). While **funding side is largely fixed** and **asset side is mostly floating** so funding strategy in banking has become more dynamic than ever to protect NIM. Banks are also in learning stage from Interest rate risk management from banking book perspective. It is pertinent to discuss here that banks have experimented with floating rate deposits but market for the same is yet to mature and floating rate deposits products have not generated interest among various segment of depositors including retail depositors. On RBI's direction, banks have shifted to external benchmark regime in case of Retail and MSE enterprises from present MCLR regime to ensure effective monetary policy transmission. There are divergent perspectives on this migration to external benchmarks; some argue that potential impact of benchmark volatility & fiscal risk underlying in external benchmarks, which may get transmitted to the credit market. Lack of depth in markets is also perceived as risk as it is potentially susceptible to manipulation.

One of the important issues is whether both sides of the bank's balance sheet can be made flexible so that transmission could be faster. Accepting bulk deposits at variable rates may make cost of funds marginally flexible as the size of such deposit is small compared to total deposits. But bulk deposits are not significant part of total deposits and this market is also not well institutionalised.

It can be clearly established that higher tenor of deposits and largely fixed rates are significant issues in monetary policy transmission. This can be observed in the chart below. As at end-March 2019, more than half of the deposits of commercial banks were in the maturity bucket of 'one year and above' and over 20 per cent were in the maturity bucket of 'five years and above'. This deposit maturity profile has been similar during FY 20 and during last Half yearly results and it is expected also that it may not change drastically in near future. It is important to note here from strategies adopted in Asset Liability Management functions across

Banks, Long maturity profile of deposits in itself does not impede monetary transmission provided interest rates on such deposits move in line with the policy rate. However, large portion of bank deposits are at fixed interest rates. This makes banks outstanding liability profile insensitive to changes in the policy rate. The transmission, in particular, is impeded more during the easing cycle than during the tightening cycle. In the tightening cycle when interest rates rise, depositors have the option to prematurely terminate their deposits and redeploy them at higher interest rates. Banks also have the incentive to raise their lending rates even before an increase in their deposit interest rates, as the demand for credit is strong. During the easing cycle, on the other hand, banks have to wait until old deposits contracted at higher interest rates mature and are renewed at lower rates, which delays the process of transmission to lending rates.



Source: Statistical Tables Relating to Banks in India, RBI, 2019.

Competition from other financial saving instruments: With an increased risk appetite, financial literacy, good performance of stock markets and well-structured products, households are diverting a part of their savings to risky assets like mutual funds. Risk-free instruments including public provident fund, national savings certificate, etc. also compete with bank deposits. Despite quarterly review of interest rates, movement in small savings rate has remained highly inflexible. There is an increased reliance of public sector enterprises (PSEs) to source funds from National Small Savings Fund to meet their expenditure for various social schemes of the government, the re-payment of which is done by the government.

High NPAs also hinders monetary policy transmission as banks charge additional credit risk premia on fresh loans for rising credit risk and to protect their NIM. Therefore, timely & effectively resolution of NPA will improve policy rate transmission considerably. As per RBI study during credit growth period when GNPA is low, policy rate transmission is better as compared to those during high NPA and slowdown.

RBI Researchers conducted a study on 72 banks – 26 PSBs, 19 Private and 27 Foreign Banks between Q-1 of 2010-11 and Q1 of 2017-18. The Study found that during periods of credit growth, the gross NPA ratio has positive effect when it was at a low level, because banks were able to charge an additional ‘Risk Premia’ that could compensate for the credit risk (Gross NPA). However, when the gross NPA ratio increased, it had significant and negative effect on monetary policy transmission, as banks could not shift the entire burden of rising NPA onto new borrowers, in the form of higher credit risk premiums. It is due to higher gross NPA

banks could not lower their lending rates in line with the reduction in their cost of funding despite of rates cut in Monetary policy.

CONCLUSION

There is need to reflect on whether objective of interest rate deregulation is achieved by way of deregulating interest rates of deposits and advances and now linking the lending rates with external benchmark. Earlier measure with respect to shift from BPLR to MCLR has not been flexible enough to transmit monetary policy signals at the desired speed and magnitude. Therefore, RBI came out with an internal working group report, which suggested the introduction of new methodology to link lending rates to external benchmark.

There is enough literature to suggest that monetary policy transmission has long and variable lags and Indian case is no different. On many occasions in past, we observe that RBI is nudging banks to cut lending rates in response to their rate cuts yet to many reasons banks are reluctant to pass on the benefit in proportion to RBI's reduction in Policy rate. It would not be fair to say that banks are not responding to the policy rates in the backdrop of challenges of twin balance sheet problem is also hindering transmission of Policy Rate.

The external benchmark is popular phenomena in western countries in setting lending rates as banks there depend largely on short term funds and also their funding model is not dependent on Banks lending. We need to wait for more data to gauge the impact of linking lending rate to external benchmark like Repo Rate, which is not market determined but decided by Monetary Policy Committee. Other external benchmarks viz CD rates, T-Bills do not satisfy all criteria for a suitable external benchmark. **If banks are asked to link their lending rate to external benchmark without any reference to the cost of funds that may have adverse impact on their NIM considering the inflexible nature of their liability side of balance sheet and it will defeat objective of transmission.**

The problem can be resolved if both side of balance sheet is made flexible so that transmission could be faster. accepting bulk deposit at variable rate may not be sufficient to impart cost flexibility as the size of such deposits is minuscule compared to total deposits. *An innovative way to make both asset and liability sides of banks balance sheet flexible is to link both deposits and lending rates to average inflation rate of previous quarter with appropriate mark up excluding idiosyncratic risk. To encourage bulk deposits, government deposits opt for inflation linked deposits some extra interest may added over deposit rate, similarly on fixed and floating loans same extra interest to be loaded for improving monetary policy transmission besides it will also assist banks to achieve more efficiency.*

Economic literature tells us that two levers of Policy namely monetary policy and fiscal policy need to work in tandem for better effect. The political imperatives, however make these two levers often work at cross purposes. Reason is economic cycle and political cycle not being concurrent. We have seen an important reform in this direction by government giving an inflation target to central bank and then constitution of Monetary Policy Committee to deliver on that target. The results so far has been a success as inflation has been under control largely.

Technically, grievance is about lags in Policy rate transmission. Regulator and banks have their version of challenges in ensuring outcomes, however well intended they are. Banks, for instance, argue that incremental

borrowing through overnight facilities make a very small part of their funding profile. The term structure of liabilities franchise means there is always a lag in re-pricing of deposits and thereby consequent lowering of loan rates. PSBs in particular are caught between the rock and hard place as they dutifully listen to both government and the RBI, trying to balance the competing expectations.

References:

- Acharya, V. V. (2017), “Monetary Transmission in India: Why is it important and why hasn’t it worked well?” Inaugural Speech delivered at the Aweek Guha Memorial Lecture organised by Tata Institute of Fundamental Research (TIFR) at Homi Bhabha Auditorium, Mumbai, November 16.
- John, J., Mitra, A.K., Raj, J. and Rath, D.P. (2016), “Asset Quality and Monetary Transmission”, Reserve Bank of India Occasional Papers, Vol 37 (1&2), 35-62.
- “Report of the Internal Study Group to Review the Working of the Marginal Cost of Funds Based Lending Rate System”
- Report of the Expert Committee to Revise and Strengthen the Monetary Policy Framework (Chairman: Urjit R. Patel) 2014, Reserve Bank of India.
- Shaktikanta Das (2020). Seven ages of India’s monetary policy. RBI Bulletin LXXIV(2), 11–16.
- Bernanke, Ben S., & Gertler, Mark (1995). Inside the black box: The credit channel of monetary policy transmission. *The Journal of Economic Perspectives*, 9(4), 27-48.
- Bhoi, B.K., Mitra, A.K., Singh, J.B., & Sivaramakrishnan, G. (2017). Effectiveness of alternative channels of monetary policy transmission: Some evidence for India. *Macroeconomics and Finance in Emerging Market Economies*, 10(1), 19–38.
- Macroeconomic Policy environment (second edition) by Shymal Roy