# Monetary Transmission

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**In News:** Banks with higher capital ratios transmit monetary policy actions more smoothly than banks with lower capital base according to recent study by RBI .

**Concept**

- The RBI study attempts to understand the link between bank capital and monetary transmission by looking at the relationship between bank capital and loan growth/cost of funds.
- It states that for each one percentage point increase in CRAR, there is a 7.8 percentage points rise in loan growth rate. On the contrary, one percentage point increase in GNPA ratio reduces the loan growth rate by 0.9 percentage points.
- In effect, while rise in capital ratio helps in better monetary policy transmission, a significant amount of stressed assets could limit credit supply.

**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"

**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.

## How does lowering interest rates help?

- 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 deposit 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.