Monetary Transmission

January 30, 2021

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 reporate.
- 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.