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Why monetary transmission remains weak in the current rate cycle?

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Reserve Bank of India's (RBI) Monetary Policy Committee (MPC) in its October bi-monthly policy, unanimously decided to keep the key policy rate, the repo rate unchanged at 6.5 percent while maintaining the 'withdrawal of accommodation stance'. The MPC had a hawkish incline in the policy announcement given heightened uncertainties on global growth, geo-political tensions, consequent upside risk to inflation, and uneven monsoon spell. Apart from the deliberations on growth and inflation, RBI specifically emphasized accelerating monetary transmission by the banks for the intended results. Even as the MPC hiked the repo rate by 250 basis points (bps) since May 2022, the indicators underscore a delayed transmission, impacting the price stability efforts of the central bank. RBI flagged that the transmission remains incomplete in tune with the substantial hike in the repo rate, implying the banks have not yet subsequently revised lending and deposit rates in tandem with the repo hike (RBI, 2023.). Further with a resonance of hawkish pause, the central bank reiterated its determined fight against inflation and the need to keep liquidity conditions under check. Given the sluggish transmission, RBI reiterated the need for managing short-term liquidity concerns through Open Market Operations (OMOs). The announcement pushed up 10-year Government bond yields by 12 bps at 7.34%, a 7-month high post-monetary policy meeting on 6th October (Trading Economics, 2023). Therefore, the present article discusses the pattern of monetary transmission during the current repo rate tightening cycle and examines the factors driving a slower transmission.

With renewed macroeconomic uncertainties, especially at the global level, and surging prices domestically monetary tightening is desirable. A tightening interest rate is primarily for achieving price stability as inflation exceeds the target levels. The key factor influencing the price stability objective is the extent of policy transmission or how RBI's rate changes are passed through in the economy. In a banking-dominated financial system, monetary policy

impulses are transmitted largely through the banks, wherein high-interest rates generally get translated into higher costs of borrowing for the public by way of higher lending rates. However, the current banking system is passing through a paradoxical phase, wherein lending and deposit rates stay lower than desired level despite key policy rates staying at elevated levels with a hawkish tilt.

Monetary transmission during the current tightening cycle

The current tightening cycle kick-started in May 2022 amid increased input costs due to prolonged supply chain disruptions, volatile oil prices, and climate change factors. Consequently, the inflation trajectory reversal, increased pent-up demand, and roll-back of stimulus post-pandemic marked the beginning of the current rate cycle in tandem with the global monetary tightening. As per Table 1, the duration (in months) and quantum of hike (in bps) are not as deep as in previous cycles. However, with escalating geopolitical tensions, energy and commodity prices, and climate change challenges, there is an upside risk to inflation, which may further elongate the tightening cycle.

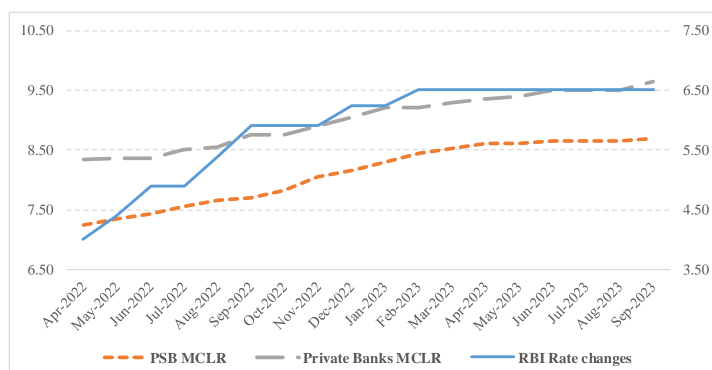
Table 1: Previous interest rate tightening cycles in India

Date	Duration of hike (months)	Quantum of hike (bps)	Rate at the beginning of the cycle	Rate at the end of the cycle
October 2005-October 2008	36	300	6.00%	9.00%
March 2010-March 2012	24	325	4.75%	8.00%
September 2013-August 2014	11	75	7.25%	8.00%
June 2018-January 2019	7	50	6.00%	6.50%
May 2022- Current	17	250	4.00%	6.50%

Source: RBI

Indicators such as Marginal Cost of Lending Rates (MCLR), the Weighted Average Domestic Term Deposit Rate (WADTDR), and the Weighted Average Lending Rate (WALR) indicate the strength of the monetary transmission in an economy. The marginal cost of borrowing determined by prevailing deposit rates influences the MCLR calculation and is a crucial determinant of the lending rate. With a cumulative hike of 250 bps in repo rate, Public Sector Banks (PSBs) responded with 145 bps whereas Private Sector Banks increased 132 bps in MCLR during the current hiking cycle. However, the private banks' MCLR aligns more with the policy rate than PSBs (Figure 1).

Figure 1: Banking system's response to change in repo rate

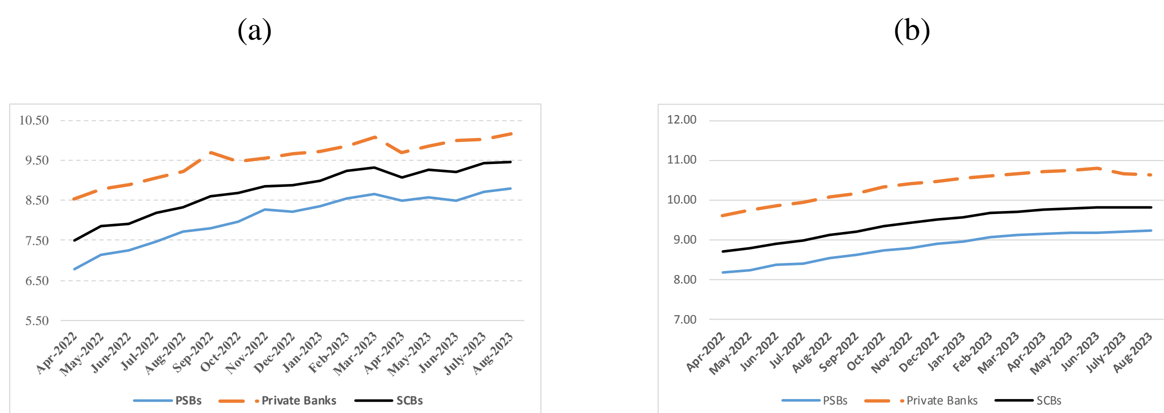


Source: RBI

During the current cycle, while the cumulative hike accounts for 250 bps, the WALR on fresh and outstanding loans increased by only 196 bps and 110 bps, respectively for all Scheduled Commercial Banks (SCBs). The rates are evidently higher for private banks than SCBs, implying transmission is faster among private banks than PSBs in lending rates. Although PSBs hiked WALR for fresh loans by 203 bps, the rates are higher for private banks with 163 bps (Figure 2). During the easing interest rate cycle, the private banks were slow in reducing the rates, which may be the plausible reason for the trend. Similar is the case with outstanding loans, wherein the hike amounts to 104 bps and 102 bps for PSBs and private banks respectively.

Figure 2: WALR on fresh (a) and outstanding loans (b) (In percentage)

(a) (b)



Source: RBI

Private banks hike the lending rates faster than deposit rates vis-à-vis public sector banks in tandem with policy hikes

Similarly, the adjustment in deposit rates is necessary to keep the asset-liability balance in the banks. The Weighted Average Domestic Term Deposit Rate (WADTDR) on fresh and outstanding deposits is revised higher. However, the deposit rates are not revised as higher as lending rates, notably by the private banks. PSBs are vigorously hiking the deposits in tune with policy rates for fresh deposits. For outstanding deposits, the rates are in consonance across all banks. The banks hiked WADTDR on fresh deposits to 233 bps wherein, PSBs hiked 242 bps and private banks by a mere 195 bps, Figure 3.

Figure 3: WADTDR on fresh (a) and outstanding deposits (b) (In percentage)

Source: RBI

Poor transmission of monetary policy or less effectiveness of repo as a monetary policy tool has been in question for a long time. Generally, monetary transmission occurs faster during the tightening cycle than during easing cycles, as loans are mostly at variable rates and can be re-priced faster. However, even with the hiking cycle transmission appears slow which is paradoxical.

Factors influencing monetary transmission

Given the complexities involved in the transmission mechanism, an array of factors influences the pass-through. The gap in deposit and lending rates is an important factor influencing transmission. Overall, lower deposit rates in the banking system than desired in the tightening cycle had restricted a considerable hike in the MCLR and kept the lending

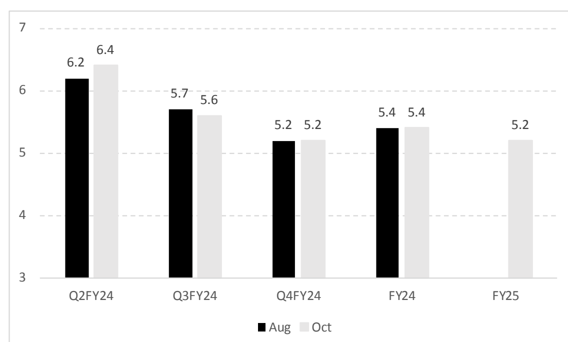
rates lower than expected even when RBI hiked its policy rate. This case is true for PSBs as against private banks.

The asset-liability mismatch of the banks is a crucial factor limiting policy transmission. Scheduled Commercial Banks' credit growth outpaced deposits, increasing by 16% year on year (y.o.y) in Fiscal Year 2024's (FY 24) first quarter while deposits grew by 12.6% y.o.y. The deposit growth in banks is mainly driven by term deposits rather than the increase in Current and Saving Accounts (CASA), creating increased liability for the banks. Parallely, a sharp rise in lending rates in line with key policy rates may hamper the credit volume, disturbing the asset–liability balance. The surplus liquidity in the banking system until mid-September due to high Currency in Circulation (CIC), an uptick in government spending following the surplus transfer by the RBI, and capital inflows hampered the rate transmission. However, recently, liquidity fell into deficit, hovering around Rs. 3.4 trillion owing to advance tax payments and Goods and Service Tax (GST) payments despite the reversal of the Incremental Cash Reserve Ratio (I-CRR), indicating a transient tightening in liquidity conditions (RBI, 2023.). The liquidity conditions may revert, implying a widening as the festival season begins. Therefore, RBI was emphatic on the OMO armors to be on the anvil for keeping a tab on liquidity conditions while keeping key policy rates intact. Banks' asset quality is closely associated with transmission, meaning less Non-Performing Assets (NPA) ideally make transmission faster due to reduced financial stress (Mint, 2023). As of June 2023, the Gross NPA of banks reduced by 25.6% y.o.y due to lower slippages, steady recoveries and upgrades, and write-offs (FSR, 2023). Despite the improvement in NPAs, the transmission remained slow, which is contradicting.

Way forward

RBI may not change its stance in the near term primarily for two reasons. Firstly, there is enough room to complete the transmission as shown by all the important indicators. The other important reason is that persisting uncertainties over price surges have not ebbed away. The policy statement reiterated continued vigilance on inflation, invariably aligning its rate to 4%. Growth and inflation estimates have also been retained at 6.5% and 5.4% respectively, for the current financial year.

Figure 4: Changes in inflation forecast, August vis-à-vis October policy (In Percentage)



Source: RBI

However, the quarterly inflation trajectory has been slightly revised. Q2 projection has been revised upward by 20 bps to 6.4%. On the other hand, Q3 projections have been revised downward by 10 bps to 5.6% estimated in August 2023 while Q4 projection has been retained at 5.2%. For FY25, CPI is expected to moderate to 5.2% as per RBI estimates, Figure 4. The policy statement reiterated that 4% is the target band for inflation and MPC will be vigilant towards achieving the same (RBI, 2023.). The upside risks highlighted are lower sowing and building price pressure on pulses and oilseeds. Apart from this, a lower reservoir level might deter Rabi sowing in the future. The central bank expected a near-term moderation in inflation before the outbreak of Israel–Hamas tensions, however, the correction in food and energy prices remains skeptical under the changing macro-geo-political landscapes. Continued stress in price levels cannot be ruled out. Factors such as lower area sown under the pulses category, reduction in reservoir levels, El- Nino conditions are associated with food price trajectory and volatile energy prices pose upside risks to inflation.

Table 2: Growth outlook unaltered (In Percentage)

Q2FY24	**Q3FY24**	**Q4FY24**	**FY24**	**Q1FY25**
6.5	6.0	5.7	6.5	6.6

Source: RBI

Economic growth projections have been retained at the same level, with Q2 at 6.5%, Q3 at 6.0%, Q4 at 5.7% and Q1FY25 at 6.6%, Table 2. Amidst global turmoil, the policy remained bullish on economic growth, citing its resilience. However, the major downside risks are

tightening global financial conditions and geopolitical tensions. Stronger government capex and domestic financial stability are the positive factors driving growth.

Conclusion

While keeping policy rates untouched and mentioning the weak transmission so far, RBI emphasized OMOs to manage short-term shifts in liquidity conditions. Softening of core inflation is referred as a silver lining in the policy document which may lead to a durable fall in the inflation going ahead. Therefore, the RBI's average forecast of inflation for FY25 stands at 4.5%. However, apart from interest rates, RBI must manage other variables for a comprehensible monetary policy response. Liquidity management is crucial for RBI to manage short-term hick-ups while transmission remains weak.

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