

# Don't blame banks for sticky loan rates

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It is the RBI and the government, not banks, that need to act for efficient monetary policy transmission

It is a fact that in a developing economy a lower interest rate regime drives up consumption and consequently triggers the investment cycle, contributing to higher economic growth. And it is for precisely this reason that the Narendra Modi government was at loggerheads with the Reserve Bank of India when the latter, with its inflation-targeting priority, refused to cut the policy repo rate.

Many bi-monthly monetary policy meetings and resignation of an RBI Governor later, when the central bank finally deemed it fit to cut rates, the private and public sector banks are refusing to play ball. Since February, the RBI has cut repo rate by 50 basis points (bps) but all that the banks have passed on to their customers is a 15 bps cut in lending rates.

Even this marginal transmission of monetary policy rate cuts have come after immense pressure from the government and the central bank. In fact, RBI Governor Shaktikanta Das met with heads of private and public sector banks, within days of a 25 bps cut in repo rate by the Monetary Policy Committee, urging them to pass on the rate cut to the consumers. The banks obliged with a token 10 bps cut in interest rate.

Two months later in the press conference soon after the April policy meeting which saw another 25 bps cut in repo rate, Das again emphasised the need for effective transmission saying “more important than rate cuts was their transmission by banks.” The banks listened but obliged him with just a 5 bps reduction in the lending rates.

This is not the first time banks have been cagey about passing on the repo rate cuts. Between April 2012 and June 2013, the RBI had cut repo rate by 125 bps and CRR by 200 bps. Still the banks reduced their lending rates by only 50 bps. Monetary policy transmission in India has been, at best, partial with long and variable lag.

This clearly points to a larger problem. Governor Das did the right thing by listening to banks' concerns in cutting lending rates when he met them in February. They were many and the inescapable truth is that a smoother and more efficient transmission of policy rates is entirely in the hands of the RBI and the government.

## Pricing of deposits

To start with, the RBI needs to reform the way deposits are priced. Today, interest rates paid by banks for deposits are fixed. In fact, for as much as 50 per cent of bank liabilities (mostly deposits), the rates are fixed for one to three years.

If banks cut lending rates, immediately after a repo rate cut by the RBI, without commensurate reduction in deposit rates their margins will be squeezed. One way that has been suggested is to link deposit rates to the repo rate. That way both deposit rates and lending rates can move in tandem with policy rate.

Even if this system is adopted, the larger question is whether banks can afford to reduce deposit rates when government continues to keep small saving rates high. A five-year National Savings Certificate fetches an interest of eight per cent while the Sukhanya Samridhhi scheme, a government-backed saving scheme targeted at parents of girl children, offers 8.5 per cent.

Even the interest paid on provident fund is around 8 per cent. That apart, debt mutual funds are also offering attractive returns. Under the circumstances any reduction in deposit rates will see depositors moving away from bank deposits. This is something banks cannot afford. Deposits account for a large share of a bank's resources today and in the absence of an active bond market, they are critical for their lending needs. Banks are already feeling the pinch. Growth in deposits at 10 per cent is trailing a 14 per cent growth that bank lending has registered. This, at a time when credit-deposit ratio has risen sharply to 78 per cent.

Thus it is important for the government to take a hard look at the small savings rates and reduce them in line with the market. If that does not happen, ability of banks to reduce deposit rates is greatly impaired and the inefficiency in the monetary policy transmission will continue.

Also, tight liquidity conditions work against a reduction in lending rates. The liquidity deficit in the banking system as of April 6 was to the tune of about ₹70,000 crore. It is expected to touch ₹1-lakh crore by end-April. The RBI has been undertaking open market purchase of government bonds and, more recently, rupee-dollar swap to boost liquidity.

It is estimated that the dollar swaps have infused ₹69,435 crore worth of liquidity in the system. But the central bank continues to stay away from cutting Cash Reserve Ratio (CRR), which remains at 4 per cent of net demand and time liabilities of banks. It was last cut in February 2013.

Now that banks are maintaining 100 per cent liquidity coverage ratio, experts say there is a space to even cut CRR by 50 bps which will release ₹60,000 crore into the system. Strong liquidity will mean more funds chasing lesser borrowers and lending rates will automatically drop.

## Populist schemes

This will work only if the government lives within its means. While the government's borrowing programme in FY19 appears to be under control, the populist measures announced both by the BJP and the Congress in their

election manifesto raises concerns for the current fiscal. The BJP's Pradhan Mantri Kisan Samman Nidhi, which offers farmers direct cash benefit of ₹6,000 per year, and the Congress' Nyunatam Aay Yojana (NYAY), which promises a minimum income guarantee of ₹72,000 a year to the poor, could blow a hole in the government coffers forcing it to borrow heavily and suck up liquidity. This will again make monetary policy transmission inefficient.

Thus the next government and the RBI have their work cut out. Otherwise, retail borrowers will continue to wonder why their home loan interest continue to remain high despite the RBI cutting repo rates repeatedly.

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