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Market Watch

ET Explains: What's making the pass-through of RBI's policy decisions sticky

BY ET ONLINE | DEC 11, 2019, 03.18 PM IST

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One of the reasons why the Reserve Bank of India paused its rate cutting cycle is because of inadequate [monetary transmission](#). The [Monetary Policy Committee](#) has cut the benchmark [repo rate](#) five times in a row totalling 135 basis points. The RBI's rate-setting committee said that optimisation of previous rate cuts is essential and it will wait for the full pass-through of earlier cuts.

The move shocked almost everyone as the RBI was expected to cut the rates for sixth time owing to GDP growth slipping further to a more than 26-quarter low of 4.5 per cent in the second quarter compared to 5 per cent in the first quarter of current fiscal.

The issue of lack of monetary transmission hasn't cropped up suddenly and is something that has been a matter of concern for the RBI in ensuring the pass-through of its policy decisions. The matter snowballed in the last few months after the RBI observed that the effects of its rate cuts are not being felt in terms of interest rates coming down.

The RBI governor reminded that the mandate of the central bank is primarily to maintain price stability while keeping in mind the objectives of growth. In that context, a creeping [headline inflation](#) which breached the RBI's medium-term target of 4 per cent played on the MPC's mind even as it brainstormed over the effectiveness of its earlier rate cuts on a slowing economy.



The RBI ordered banks to link the interest rates charged on all new floating rate personal or retail loans as well as loans to micro and small enterprises with an external benchmark.

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What is monetary transmission?

Monetary transmission is the process through which RBI's policy actions reach its effective end goal of tackling inflation and addressing growth concerns.

The transmission happens primarily through four different channels: interest rates, credit creation, exchange rates and asset prices. All four channels are inter-linked and do not operate in silos as explained by former deputy governor of RBI, Dr [Viral Acharya](#), in a lecture on monetary transmission.

In fact, in the same lecture, Dr Acharya said that the interest rate is found to be the strongest channel of transmission, quoting from the report of the expert committee to revise and strengthen [monetary policy](#) framework.

How does transmission happen?

Transmission through interest rates happens through reduction in the cost of funds for banks and subsequent reductions in lending and deposit rates.

For instance, in the present scenario, the RBI has cut rates by 135 basis points with the expectation that the banks will reduce their lending rates which in turn will boost credit demand in the economy, resulting in higher consumer durable and housing loans. This translates into more demand for raw materials and labour and helps in kick-starting the economy.

But the transmission through the formal banking channel has been anaemic so far. However, transmission has happened swiftly through various money market instruments like the inter-bank lending rates as well as the [corporate bond](#) market.

Internal and external benchmarks

The RBI ordered banks to link the interest rates charged on all new floating rate personal or retail loans as well as loans to micro and small enterprises with an external benchmark. Under the order, benchmarking was to be done to one of the following:

- Reserve Bank of India policy repo rate

- Government of India 3-Months Treasury Bill yield published by the Financial Benchmarks India Private Ltd (FBIL)
- Government of India 6-Months Treasury Bill yield published by the FBIL
- Any other benchmark market interest rate published by the FBIL.

The rationale behind external benchmarking is that the Internal Study Group (ISG) constituted by the RBI to examine the Base rate/MCLR framework found the prevailing mechanism inefficient in delivering monetary transmission. Under the external benchmarking system, banks are free to decide on the spread over the external benchmark.

Small savings interest rates

The RBI has conveyed its concerns over small savings rate to the government. High interest rates offered by small savings scheme hinder transmission as banks can't bring down the deposit rates offered on FDs below the small savings rate like PPF, post office savings among others. The government revises the small savings rate quarterly and a higher rate of interest offered on them prevents banks from bringing down their rate of interest offered on term deposits, thereby limiting the impact of transmission.

The RBI has kept the window open for one more rate cut in the current fiscal year by keeping its stance accommodative. However, the effectiveness of its policy action on the growth-inflation dynamics seen through the prism of transmission will act as a guide for deciding on further policy moves.

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