

RBI's lending push amid inflation to crimp fixed deposit (FD) returns

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Soon after the RBI monetary policy review earlier this month, banks dropped their fixed deposit rates. Mint explains the implications of the RBI action

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Soon after the Reserve Bank of India's (RBI) monetary policy review earlier this month, banks dropped their fixed deposit rates. Higher inflation means that in real terms the interest rates have become negative. Mint explains the implications of the RBI action.

What has the central bank announced?

For a variety of reasons, banks have been parking their surplus funds with RBI instead of lending. As a result, credit growth has gone down to 7%, which is below nominal gross domestic product growth. The monetary policy committee (MPC) is constrained in lowering interest rates due to quickening inflation. Therefore, RBI announced long-term repo operations (LTROs), an instrument outside the

framework of MPC aimed at lowering the cost of lending of banks. Under this, RBI will lend up to ₹1 trillion funds to banks for one-year and three-year durations at its policy repo rate of 5.15%.

What are LTROs expected to do?

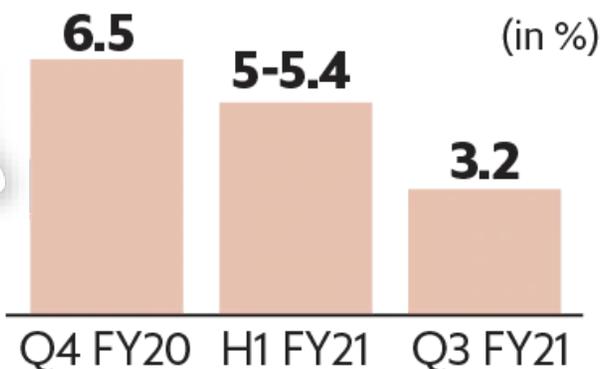
If the cost of funds is what's holding up lending, banks will make more loans with money borrowed cheap under LTROs. As credit growth is weak due to many reasons, no significant pick-up in lending will take place. One, demand for loans is low, given that the investment sentiment is poor. Two, lending is weak as bankers fear that overzealous probe agencies are looking to blame them for loan defaults, including those due to economic reasons. If banks park the money borrowed cheap from RBI in government bonds, the Centre's cost of borrowing will decrease, making it the biggest beneficiary of LTROs.

Savings set to take a hit

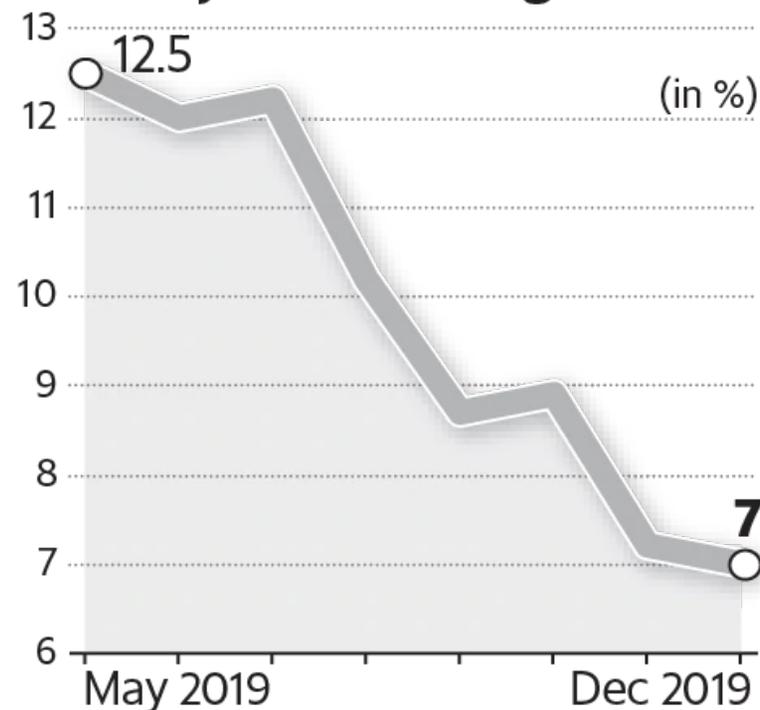
Even as RBI makes it cheaper for banks to lend, its projections suggest inflation will remain nearly equal to, if not exceed, fixed deposit rates. So, real returns from these savings instruments will suffer and may even turn zero or negative.

Repo rate
5.15%
(6 Feb)

RBI's inflation expectations



Monthly bank credit growth



EVEN as bank credit growth slid to 7%, MPC was constrained in lowering interest rates because of quickening inflation.

RBI revised its retail inflation forecast upward to 6.5% for the March quarter and 5-5.4% for April-September.

Source: RBI

Savings set to take a hit

What did the central bank say about inflation?

The central bank revised its consumer price inflation forecast upward to 6.50% for the March quarter and 5-5.40% for April-September. The revision was driven by spikes in the prices of vegetables and food items such as milk, pulses, meat and eggs. The revision was also on account of the one-time effect of the hikes in custom duties on some items in the budget.

Why have lenders reduced deposit rates?

The weighted cost of deposits of banks is between 4.80% and 5%, already lower than the 5.15% repo rate. Still, as banks can use RBI's LTRO window to raise significant funds at the repo rate, they need not incrementally raise deposits at higher rates. So, deposit rates are likely to decrease. After the RBI policy, State Bank of India (SBI) and others cut their fixed deposit (FD) rates. For FDs maturing in less than a year, SBI cut the rate from 5.80% to 5.50%. For FDs maturing in 1-10 years, the interest rate was cut to 6% from 6.10% earlier%.

What happens to real deposit rates?

Inflation erodes the real value of money over time: What a rupee could purchase 50 years ago, it can no longer buy today. RBI's projections suggest inflation is likely to remain nearly equal to, or in some cases even exceed, interest rates on deposits. So, real returns from these savings instruments will suffer and may even turn zero or negative. This is especially because RBI's LTRO window will not let banks offer higher rates. On the contrary, the rates may drop.

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