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A good decision not to lower rates

However, the operating procedure for monetary policy needs to be reviewed

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It is a relief to all depositors, especially senior citizens, that there is no reduction in interest rates. It is also a relief to those who feared that the stock markets would become even more 'irrationally exuberant' with any drop in policy rates. With enormous leverage already in the system, no sign of any significant credit offtake and huge liquidity of nearly ₹ 4 lakh crore parked with RBI for the last few months, it is not clear how a reduction in policy rate would have stimulated credit and growth.

Rightly, the RBI has left rates unchanged and has focused on the twin balance sheet problem to get growth back on an even keel. It has also used a counter cyclical regulatory tool of reduction in risk weights and provisioning for certain categories of the housing sector that has forward and backward linkages. This can have a positive effect on growth.

RBI has admitted that the surprises in the data on inflation and revisions in the data on growth pose considerable challenges for the monetary policy. These are the two key data that drive policy making. The RBI has been repeatedly overshooting on both the growth and inflation forecasts. The projection for growth for 2016-17 was revised downward from 7.6 per cent in October 2016 to 6.9 per cent in February 2017. RBI's GVA projection for 2017-18 was kept at 7.4 per cent in both the February and April policies. Despite the CSO estimate of 6.6 per cent for growth in 2016-17 and 6.1 per cent for Q4, the Reserve Bank has projected only a one bps drop from 7.4 to 7.3 per cent in GVA projection for 2017-18. On the other hand, the RBI has dramatically changed its inflation projection from 5 per cent for March 2017 (held constant since February 2016) to 2.0 -3.5 per cent for the first half and 3.5 to 4.5 per cent for the second half of 2017-18. The uncertainty on inflation outlook and perceived upside risks to inflation have however prevented any policy change in the repos rate.

Liquidity surge

There has been much talk of transmission of monetary policy — bankers feel that the lending rates have come down by 200 bps that is more than what the policy rates have come down by. There are several reasons why the transmission mechanism does not work in India, the chief one being that banks garner deposits without much thought on their deployment — interest rates on deposits are usually based on follow the leader rather than any conscious strategies on balance sheet growth or asset liability management. Thus any decline in interest rates takes a while to transmit till the banks are rid of their higher cost deposits. As the lower interest rates on the more recently acquired deposits kick in, the reduction is much faster and this is what happened when the liquidity surged following demonetisation.

There could also be another factor affecting the transmission. The market is in an enduring surplus liquidity mode since demonetisation evident from the chart below. (Chart 1).

RBI reduced the corridor between repos and fixed rate reverse repos from 50 bps to 25 bps in April 2017. Even prior to that RBI was actually absorbing most of the surplus liquidity at variable reverse repos at just one or two bps below the repos rate. What is interesting is that, at the same time, the overnight call money rates, CBLO rates and market repos rates have been closer to the fixed rate reverse repos (currently 6 per cent). The question to ask is—how do banks get this cool 20-24 bps arbitrage opportunity? Mostly lenders in CBLO, market repos and call market are mutual funds, insurance companies and cooperative banks, who do not have access to RBI LAF. Banks are able to borrow from them at rates in the call etc markets close to fixed rate reverse repos and place the funds with RBI at rates close to the policy rate.

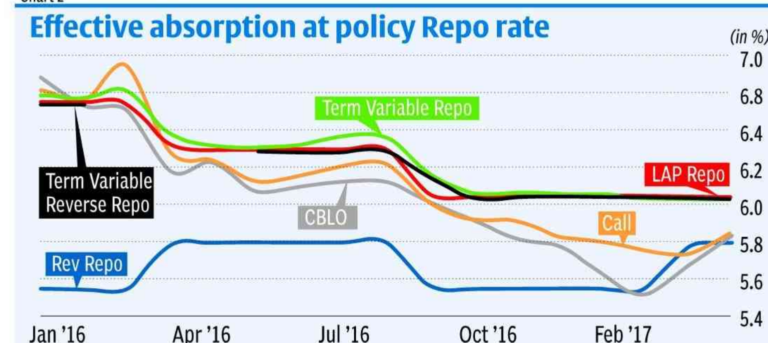
If the opportunity to place funds with RBI close to the policy rate (through variable reverse repos) was not available to the banks, they may have had to push down lending rates further even earlier. This would have perhaps helped the transmission mechanism better (Chart 2).

RBI may also need to review whether continuing to target the call rate is appropriate considering that the call money volumes have been dropping significantly in the recent period and overnight moneys are mostly lent and borrowed through the market repos and CBLO markets.

Chart 1

Source: RBI/ Golaka Nath, Clearing Corporation of India

Chart 2



Source: RBI/ Golaka Nath, Clearing Corporation of India

The writer is a former Deputy Governor of the RBI. Through The Billion Press