Why interest rates aren't falling

Writer - Udit Misra (Editor)

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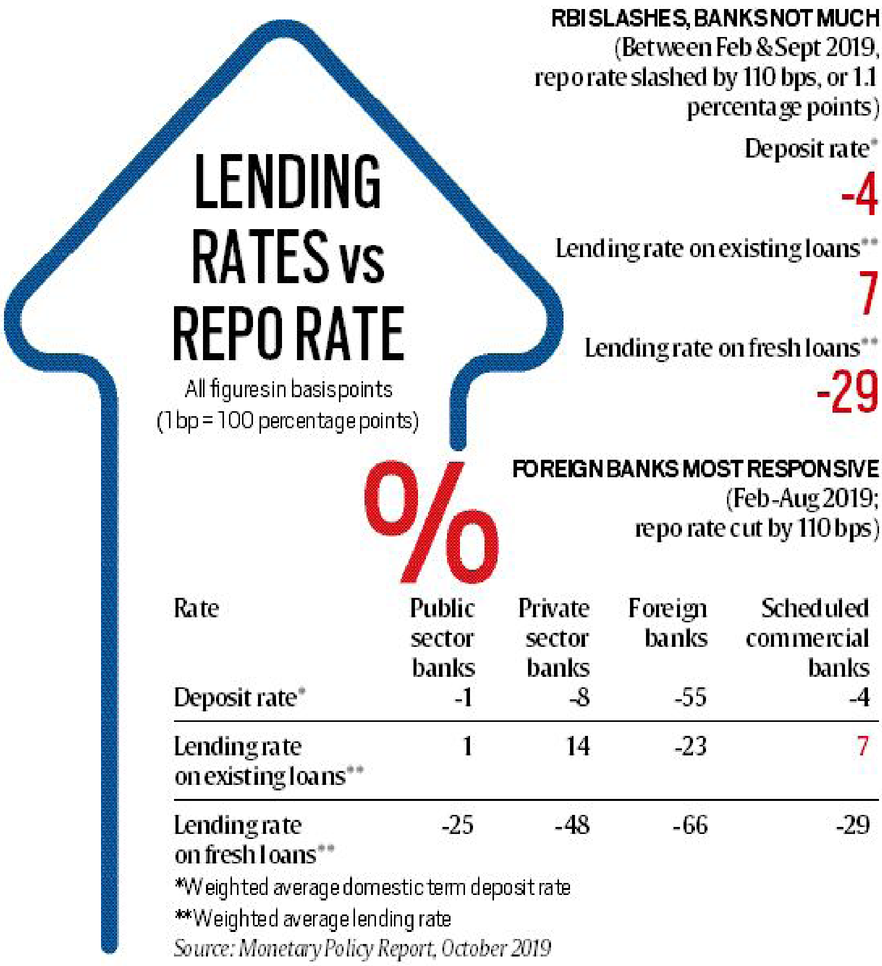
"Since February, RBI has cut its interest rate by 135 basis points. Yet, bank lending rates for new loans have not fallen by much while interest rates on many existing loans have actually gone up. What explains this?"

Since February, the Reserve Bank of India (RBI) has aggressively cut the repo rate. This is the interest rate that the RBI charges the banks when it lends them money. By cutting the repo rate, the RBI has been sending a signal to the rest of the banking system that the lending rates in the system – the interest rates that banks charge from you and me when we take a loan – should come down. This process of repo rate cuts leading to interest rate cuts across the banking system is called "monetary policy transmission".

The trouble is, in India, this process is rather inefficient. For example, between February and August, the RBI cut repo rate by 110 basis points — 100 basis points make a percentage point — from 6.5% to 5.4%. But, the interest rate charged by banks on fresh loans that they extended during this period fell by just 29 basis points – that is just 27% of the amount by which the repo rate came down.

Frustrated by the sluggish transmission, the RBI decided to cut the repo rate by another 25 basis points in October and urged banks to link their lending rates to the repo rate. Yet, for the most part, the banking system has ignored the signalling and only some banks have reduced lending rates



Rate	Public sector banks	Private sector banks	Foreign banks	Scheduled commercial banks
Deposit rate*	-1	-8	-55	-4
Lending rate on existing loans**	1	14	-23	7
Lending rate on fresh loans**	-25	-48	-66	-29

*Weighted average domestic term deposit rate

**Weighted average lending rate

Source: Monetary Policy Report, October 2019 on new loans by 10 basis points. In essence, while the RBI has cut its lending rate to the banks by 135 basis points (or 1.35 percentage points) in the nine months since February, the interest rates being charged to the common consumer this Diwali have come down by only about 40-odd basis points.

Indeed, even though it is counter-intuitive, interest rates on existing loans (not new loans) have actually gone up by 7 basis points.

Why does RBI want lower interest rates?

Since February, India's economic growth momentum has rapidly decelerated. Projections of GDP growth rate have come down from roughly 7.2%-7.5% in February to 5.8%-6.0%. There are two key problems in the economy and a lower interest rate regime is expected to help in resolving both.

The main issue is that people are not consuming at a high enough rate. On paper, the argument is that if banks reduce their lending rates, they would also have to reduce their deposit rates (the interest rate banks pay when we park our money with them in a savings bank deposits or a fixed deposit). This, in turn, will incentivise people to save less and spend more.

The other problem in the economy at present is that businesses are not investing in existing or new facilities. Part of the reason is that they have unsold inventories because people are not buying as much; as such, they argue, what is the point of borrowing money and investing. But part of the reason is also that the interest rate charged on loans is quite high. If banks reduce the interest rates on loans, more businesses are likely to be enthused to borrow new loans for investment. This is particularly so as the government has recently cut corporate tax rates in the hope that it will boost the corporate sector's profitability and get it thinking of investing more.

So, no matter which way one looks at it, RBI's decision to cut repo rates was a justified move, especially since overall retail inflation has been well within the RBI's comfort zone of 4%.

So, why aren't interest rates coming down?

Because repo rates have little impact on a bank's overall cost of funds, and reducing lending rates just because the repo has been cut is not feasible for banks.

Here's why. For any bank to be viable, there must be a clear difference between the interest rate it charges from borrowers on loans it provides and the interest rate it gives to consumers on deposits it accepts. The difference between these two sets of interest rates has to be not only positive but also big enough for the bank to make profits.

To attract deposits, banks pay a high deposit rate. Such deposits make up almost 80% of all banks' funds from which they then lend to borrowers. Banks borrow a minuscule fraction under the repo. So even sharply reducing the repo rate doesn't change the overall cost of funds. Unless banks reduce their deposit rates, they will not be able to reduce their lending rates.

Why are banks not reducing their deposit rates?

That's because if a bank were to reduce its deposit rates, depositors would shift to a rival bank that pays better interest rates or park more and more of their savings in small saving instruments such as public provident fund, Sukanya Samriddhi Yojana etc that pay much higher interest rates.

There is another aspect. Even if banks wanted to reduce their deposit rates, they can't always reduce them immediately. Miren Lodha, Director, CRISIL Research, said 65% of total deposits are "term" deposits (fixed for a certain duration) and take, on an average, up to two years to get repriced at fresh rates. "Therefore, banks generally go slow on reducing the interest rates on advances as deposits take longer to get repriced." But why are interest rates going up on existing loans?

This, too, has to do with the banks trying to manage their finances. If they are under pressure to reduce the interest rate they charge on new loans, then one of the things they could do is to push up the interest rates on old loans that allow for such flexibility. It also has to do with the financial health of a bank; weaker banks would be forced to raise rates to cover for past losses, explained Suvodeep Rakshit of Kotak Institutional Equities.

What hasn't linking the lending rate to the repo rate worked?

Because it is not a viable solution. The banks cannot link their lending to the repo rate because repo doesn't determine their cost of funds.

For a repo-linked regime to work, the whole banking system would have to shift to that – in other words, along with banks' lending rates, their deposit rates too must go up and down with the repo. But if such a regime were in place, depositors would have earned 1.10 percentage points less interest rate on their savings account.

Is this problem of weak transmission new?

No, it is not. Rakshit of Kotak Institutional Equities said that at no time in the past has monetary transmission been better than 50% (that is, only half the rate cuts by RBI were passed through by the banking system). The reason for weak transmission, too, has been largely the same.

Why doesn't this happen in developed countries?

That's because the financial system is far more developed and diversified, Rakshit explained. Most importantly, the banking system there doesn't have to bear the burden of providing loans to everyone in the economy – from a small personal loan to buy a refrigerator to large business loan to set up a factory. Most demands for big loans are directed towards the corporate bond market – wherein a company floats bonds (or IOUs) and borrows money from the public by paying whatever interest rate the market demands.

Moreover, depositors are not in the habit of getting a fixed interest rate on their savings while expecting a variable interest rate on their loans. At the current low levels of per capita income, the savers are far more risk-averse in India and unwilling to invest in higher-risk instruments other than bank deposits.

Lastly, the overall borrowing by the public sector – that is the government and government-owned institutions – is not so high so as to drive up the interest rates in the economy as it happens in India.

Expected Questions (Prelims Exams)

1. Consider the following statements in the context to repo-linked system of RBI.

1. For the repo linked system to work, the entire banking system has to be transferred to it.
2. Under this, banks have to link their lending rates with the repo rate.
3. If this system comes in to force then depositors will get 2.1% less interest rate on their savings account.

Which of the above statements are correct?

(a) 1 and 2

(b) 1 and 3

(c) 2 and 3

(d) 1, 2, and 3

Expected Questions (Mains Exams)

Q. Interest rates have been reduced by the Reserve Bank of India through continuous monetary policy, but its real benefit are not reaching the public. What is the reason for this? What steps need to be taken by commercial banks? Discuss (250 words)

Note: Answer of Prelims Expected Question given on 19 Oct., is 1 (d).