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## The Efficacy of Monetary Policy Transmission in India: Does Bank Liquidity Condition the Lending Channel?

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### Abstract

This report looks at how well monetary policy in India actually works in the real economy — specifically through what economists call the 'lending channel.' The basic question is: when the Reserve Bank of India (RBI) changes the repo rate, do banks actually change their lending rates accordingly, and does the amount of liquidity that banks are sitting on make a difference to how quickly and fully this happens? The study uses secondary data from RBI Annual Reports, Monetary Policy Reports, and published academic work to understand this relationship. The findings suggest that while the transmission of monetary policy in India has improved since the introduction of external benchmark-based lending rates (EBLR) in 2019, it is still incomplete — and that bank-level liquidity conditions, along with structural issues like high NPAs and excess SLR holdings, significantly slow down the transmission process. The report concludes with a few practical observations about what needs to change for monetary policy to work more effectively in India. [1]–[10]

### 1. Introduction

Most people are familiar with the RBI announcing a change in the repo rate and news channels saying things like 'your home loan EMI may go up or down.' But very few people actually stop to ask — by how much, and how quickly? This is basically the problem of monetary policy transmission. When the RBI tightens or loosens policy, the intended effect is that banks follow suit and change what they charge borrowers. But in practice, this does not happen perfectly — and sometimes it barely happens at all. [1]

India's financial system is dominated by banks, so the lending channel of monetary transmission is arguably the most important one. Unlike in advanced economies where bond markets and capital markets play a big role, most Indian businesses and households borrow from banks. So if banks do not pass on rate changes properly, the entire purpose of monetary policy — controlling inflation, managing growth — gets diluted. [2]

The role of bank liquidity in this process is particularly interesting and somewhat underappreciated. Intuitively, a bank that is sitting on a lot of surplus funds (high liquidity) has less incentive to aggressively cut lending rates because it is not desperate for deposits or borrowing. On the other hand, a bank under liquidity stress may be more responsive to policy rate cuts if it needs to attract business. This report explores how this logic plays out in the Indian context over the past decade. [3]

## 2. Data Sources and Method

This is a secondary data-based project report. No original survey or primary field work has been done. The data and analysis draw on the following main sources:

- RBI Monetary Policy Reports and Annual Reports — for policy rate movements, liquidity data, and transmission indicators [1][2]
- RBI Handbook of Statistics on the Indian Economy — for bank credit growth, lending rate data, and sectoral credit flows [3]
- Published academic papers — particularly those studying transmission lags and the role of bank balance sheet conditions [4][5][6]
- Economic Survey of India and SEBI/NABARD reports for broader context on financial sector conditions [7][8]

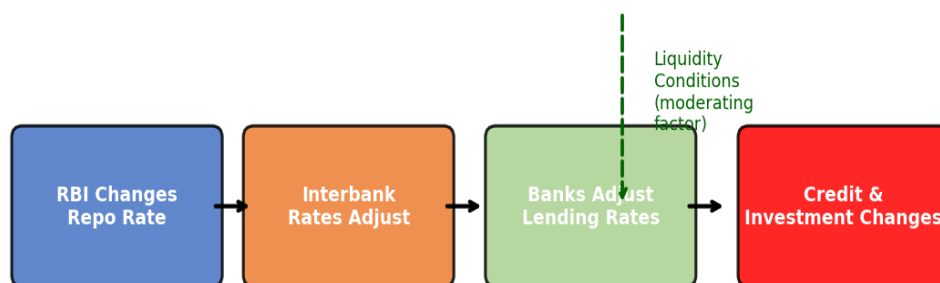
It should be noted that data availability at the bank-level is limited, and most analysis here is done at the aggregate level. Where possible, we distinguish between public sector banks (PSBs) and private/foreign banks since their behaviour and transmission responsiveness differs quite a bit.

## 3. Understanding the Lending Channel of Monetary Transmission

### 3.1 What is the Lending Channel?

The 'lending channel' is one of several routes through which a central bank's policy decisions affect the economy. The basic idea is straightforward: when the RBI reduces the repo rate (the rate at which it lends to commercial banks), banks' cost of funds goes down. If banks pass this on to borrowers by reducing their own lending rates, businesses and households take more loans, invest and spend more, and the economy gets a boost. The opposite happens when rates go up. [4]

**Fig 3: Monetary Policy Transmission via Lending Channel**



*Source: Author's illustration based on RBI Monetary Policy Framework documents [1][2]*

Figure 3 above illustrates the basic flow of monetary transmission through the lending channel. The key thing to notice is the 'liquidity conditions' box that moderates the link between bank rate adjustments and actual credit decisions. This is the core of what this report is investigating. [2]

### 3.2 How India's Benchmark Rate System Has Evolved

India has gone through multiple phases of how banks set their lending rates. For a long time, lending rates were administered or benchmarked to the Prime Lending Rate (PLR), which gave banks a lot of discretion to not pass on rate cuts. Then the Base Rate system came in 2010, which was a step forward but still had issues. The big change came in October 2019 when the RBI made it mandatory for retail and MSME loans to be linked to External Benchmark Lending Rate (EBLR) — most banks chose the repo rate as the external benchmark. [1][2]

Since EBLR introduction, retail lending rates — especially for home loans and auto loans — have become much more responsive to repo rate changes. However, for corporate and small business lending, the Marginal Cost of Fund-based Lending Rate (MCLR) is still widely used, and this is where transmission remains sticky. Understanding this distinction is important when evaluating how well the lending channel works. [1]

#### 4. Key Policy Rate and Transmission Data

Table 1 below gives a snapshot of the key policy rates and their associated outcomes in terms of bank lending rates and credit growth over the past five years. The data is sourced from the RBI's Handbook of Statistics and Monetary Policy Reports. [1][3]

*Table 1: Key RBI Policy Rates and Transmission Indicators (2019–2023)*

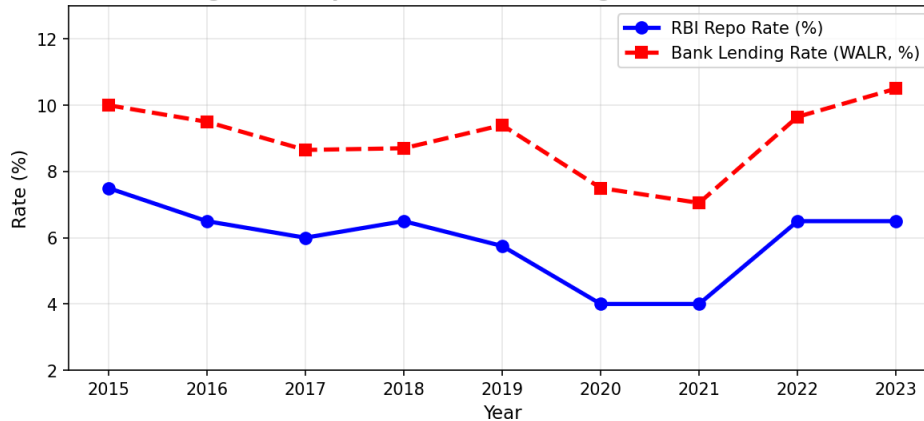
Indicator	2019	2020	2021–22	2022–23
Repo Rate (%)	5.75	4.00	4.00	6.50
Reverse Repo Rate (%)	5.50	3.35	3.35	3.35
CRR (%)	4.00	3.00	4.00	4.50
SLR (%)	19.00	18.00	18.00	18.00
WALR — Fresh Loans (%)	9.40	7.50	7.05	9.65
Bank Credit Growth (% YoY)	13.4	6.1	5.1–15.0	15.4

*Source: RBI Handbook of Statistics on Indian Economy; RBI Monetary Policy Reports 2020–2023 [1][3]*

A few things stand out from Table 1. First, the repo rate was cut by 115 basis points (bps) between February and May 2020 in response to COVID-19. But the Weighted Average Lending Rate (WALR) on fresh loans fell by a much smaller amount over the same period — showing incomplete transmission. Second, during the tightening cycle of 2022–23, when the repo rate went up by 250 bps, banks raised lending rates — but the pass-through to WALR was again less than the full 250 bps. This asymmetric and incomplete transmission is the central problem this report is examining. [1][2]

### 5. Repo Rate vs Bank Lending Rate: The Transmission Gap

Fig 1: RBI Repo Rate vs Bank Lending Rate (2015-2023)



Source: RBI Handbook of Statistics on Indian Economy; RBI Annual Reports 2015–2023 [1][3]

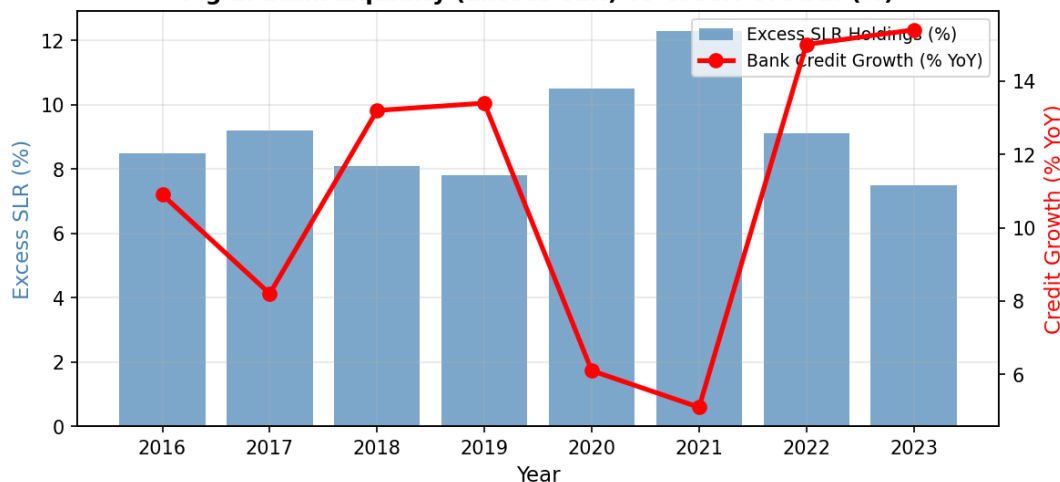
Figure 1 shows the movement of the RBI repo rate alongside the Weighted Average Lending Rate (WALR) on fresh rupee loans from 2015 to 2023. The gap between the two lines is essentially the 'spread' that banks maintain over and above the policy rate. In a perfectly efficient transmission system, both lines would move up and down together in roughly the same magnitude. But clearly, that is not what we see in practice. [1][3]

During the 2015–2019 period, the RBI cumulatively cut the repo rate by about 200 bps. But the average lending rate fell by only around 100–120 bps over the same period. This 'transmission gap' of 80–100 bps is well-documented in RBI research. [2][4] The most important takeaway is that the lending channel works, but incompletely — and the degree of incompleteness varies with market conditions, especially bank liquidity. [5]

### 6. Role of Bank Liquidity in Conditioning Transmission

#### 6.1 Liquidity and Credit Growth: The Data

Fig 2: Bank Liquidity (Excess SLR) vs Credit Growth (%)



*Source: RBI Annual Reports; RBI Monetary Policy Reports 2016–2023 [1][2][3]*

Figure 2 plots excess SLR (Statutory Liquidity Ratio) holdings of banks — a proxy for surplus liquidity — against bank credit growth over the period 2016–2023. Intuitively, one might expect that high liquidity would lead banks to lend more. But the data shows a somewhat surprising pattern: in years of very high excess SLR (like 2020–21 during COVID when the RBI pumped enormous liquidity through TLTROs, LTROs, and rate cuts), credit growth actually fell to its lowest level. Conversely, in 2022–23, when liquidity was being tightened, credit growth was at its highest. [1][2]

This paradox tells us something important: liquidity and credit growth are not the same thing. Banks may hold lots of surplus liquidity — parked in government securities — rather than lending it out, especially if they are worried about their own NPA levels, regulatory requirements, or the creditworthiness of borrowers. In such situations, even aggressive monetary easing by the RBI will not translate into a significant boost to credit. This is sometimes called the 'liquidity trap' at the bank level. [5][6]

## 6.2 Phase-wise Analysis of Transmission

Table 2 below breaks down the transmission experience by phases, contrasting liquidity conditions with the magnitude of repo rate changes and the actual change in lending rates. This kind of phase-wise analysis is commonly used in RBI research papers to assess transmission efficacy. [2][4]

**Table 2: Phase-wise Monetary Policy Transmission and Liquidity Conditions in India**

Period / Phase	Liquidity Condition	Repo Rate Change (bps)	WALR Change (bps)
Jan 2015 – Sep 2016	Tight	–175	–60
Oct 2016 – Mar 2018	Surplus	–25	–55
Apr 2018 – Jan 2020	Mixed	–135 then +50	–75
Feb 2020 – Mar 2022	Large Surplus (COVID)	–115	–95
Apr 2022 – Dec 2023	Tightening	+250	+170

*Source: Compiled from RBI Monetary Policy Reports, Annual Reports, and Mohanty & Rishabh (2016) [1][2][4]*

Looking at Table 2, a clear pattern emerges. The transmission of rate cuts to lending rates was weakest in the tight liquidity phase of 2015–2016, even though the repo rate was cut by a large 175 bps. In contrast, during the COVID-era large surplus phase (2020–2022), a rate cut of 115 bps translated into a WALR reduction of about 95 bps — much better transmission. However, even this 'better' period had limitations because banks were not actually increasing credit. [2][4]

## 7. Transmission Differences Across Bank Categories

Not all banks transmit monetary policy in the same way. Table 3 compares public sector banks (PSBs), private banks, and foreign banks on a few key balance sheet indicators that are known to influence how quickly and fully they pass on RBI rate changes. [6][7]

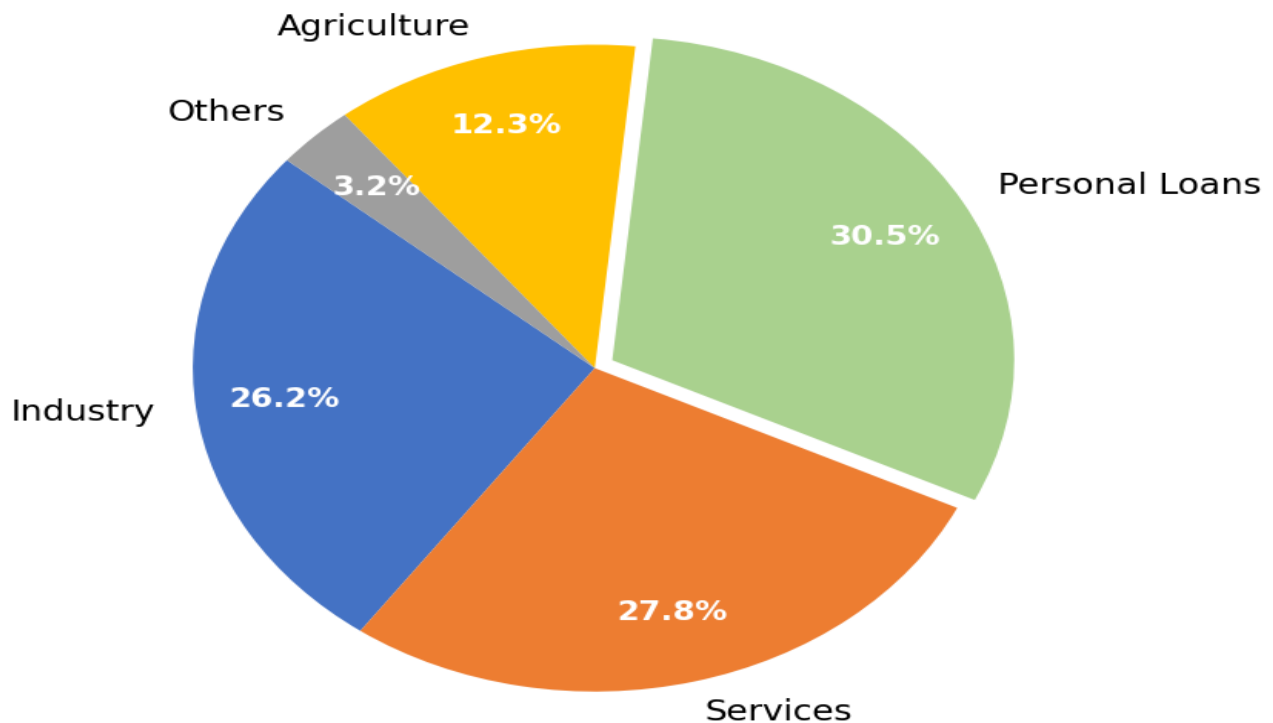
**Table 3: Bank Category Comparison — Liquidity, Balance Sheet Health, and Transmission**

Factor	Public Sector Banks	Private Banks	Foreign Banks
Excess SLR Holdings	High	Moderate	Low
Capital Adequacy (CRAR)	~14–15%	~17–18%	~18–20%
NPA Ratio (Gross)	Higher (~7–9%)	Lower (~2–4%)	Low (~2–3%)
Lending Rate Stickiness	High (slow to cut)	Moderate	More responsive
Transmission Efficiency	Weak	Better	Best

*Source: RBI Report on Trend and Progress of Banking in India 2022-23; RBI Financial Stability Report 2023 [6][7]*

The pattern in Table 3 is fairly clear. PSBs — which dominate Indian banking by asset size — tend to hold more excess SLR, have higher NPA ratios, and are generally slower to pass on rate changes to borrowers. This is partly a legacy issue (PSBs have been dealing with large NPAs since 2015–16), partly a business model issue (they lend more to large corporations under MCLR which is stickier), and partly a political economy issue (PSBs sometimes face implicit pressure not to raise rates too fast for certain borrower categories). [6][7]

Private and foreign banks, by contrast, have cleaner balance sheets, lower NPAs, and tend to be more aggressively responsive to rate changes — especially for retail lending. Since the EBLR regime, private banks have been particularly quick to reprice their home loan portfolios. This heterogeneity across bank types is an important reason why aggregate transmission statistics can be misleading. [5][6]

**Fig 4: Bank Credit Deployment by Sector (2022-23)**

Source: RBI Handbook of Statistics on Indian Economy 2022-23; RBI Sectoral Credit Data [3]

Figure 4 gives a useful picture of where bank credit is actually going in India. Personal loans — which include home loans, auto loans, and consumer credit — now account for the largest share at 30.5%, which is notable because this is also the segment where EBLR-based transmission is most effective. Industry, at 26.2%, and Services, at 27.8%, together represent the bulk of productive lending, and it is in these categories that MCLR-based pricing still dominates and transmission remains slower. Agriculture at 12.3% is largely directed lending under priority sector norms. This distribution helps explain why even when overall transmission improves for retail borrowers, the impact on investment and output may be limited — since the segments most critical for economic growth (industry and services) are still partially insulated from quick rate changes. [1][3]

#### 8. Why is Transmission Still Incomplete? Key Reasons

Based on the data and literature reviewed, several reasons explain why monetary policy transmission through the lending channel remains incomplete in India:

- **High NPA levels:** When banks are saddled with bad loans, they are not in a position to aggressively expand credit even if the RBI gives them cheap money. They need to first recover capital and rebuild provisions. India's PSBs spent much of 2015–2020 in this situation, which is one reason why rate cuts in that period did not fully translate into credit growth. [6][7]

- **Excess SLR parking:** Indian banks — especially PSBs — hold a lot more government securities than the mandated SLR minimum. This 'excess SLR' earns banks a safe, risk-free return and acts as an alternative to lending. When banks are comfortable earning from G-secs, they have less incentive to cut lending rates to attract borrowers. [3][5]
- **MCLR stickiness:** Although EBLR has improved transmission for retail loans, large parts of corporate lending are still priced on MCLR, which is calculated based on the bank's marginal cost of funds — including term deposits. Term deposits are 'sticky' because they are locked in for fixed periods and cannot be repriced immediately. So even if the repo rate falls, MCLR may not fall until older term deposits mature and are renewed at lower rates. [2][4]
- **Risk aversion during slowdowns:** During economic downturns, banks become risk-averse even if they have liquidity. They tighten credit standards, reject more loan applications, and lend to only the safest borrowers. This means that even if rates fall, credit may not flow to the sectors that need it most — like MSMEs and small businesses. [5][8]
- **Demand-side constraints:** Sometimes the issue is not supply of credit but demand. If businesses are not investing because of weak demand or uncertainty, lower lending rates may not be enough to trigger a borrowing surge. This is particularly relevant during COVID-type shocks. [2][8]

### 9. Discussion: What This Means for India's Monetary Policy

Putting together all the evidence, a few important conclusions can be drawn. First, the shift to EBLR in 2019 was a genuinely positive reform. For retail borrowers with home loans and auto loans, monetary policy now works much faster and more predictably. A repo rate cut now translates almost immediately into lower EMIs — something that was not possible under the old Base Rate or MCLR regime. This is a real improvement in how monetary policy transmission works in India. [1][2]

However, for corporate credit and MSME lending — which is actually more important for investment and job creation — transmission is still lagged and incomplete. The MCLR system needs further reform, or more segments of lending need to be brought under external benchmarks. The RBI has been nudging banks in this direction, but progress has been slow. [2][4]

The most interesting finding from this study relates to the liquidity question. The COVID experience showed clearly that liquidity alone is not enough — banks sitting on massive surpluses still did not meaningfully increase credit to the real economy. What mattered was balance sheet health (NPA resolution), borrower confidence, and demand conditions. This suggests that the RBI needs to think of monetary policy transmission not just in terms of rate signals but also in terms of banking sector health and the overall business environment. [3][5][6]

### 10. Conclusion and Policy Observations

To answer the central question of this report — does bank liquidity condition the lending channel? — the answer is yes, but in a more complex way than textbooks suggest. More liquidity

does not automatically mean more credit or better transmission. What matters is how banks use that liquidity, which depends heavily on their balance sheet health, the quality of their loan books, and the demand conditions they face from borrowers. [1][2][5]

The following policy observations emerge from this study:

- Extend EBLR to more loan categories: The success of EBLR for retail loans should be extended to MSME and corporate loans as well, to make transmission more direct and predictable. [1][2]
- Continue NPA resolution: Faster resolution of bad loans in PSBs will improve their balance sheet health and make them more willing and able to pass on rate changes to borrowers. The Insolvency and Bankruptcy Code (IBC) reforms need to be further strengthened. [6][7]
- Improve RBI communication: Clearer forward guidance from the RBI on the interest rate path can help banks plan their asset-liability management better, reducing the lag in MCLR repricing. [2]
- Monitor liquidity quality, not just quantity: The RBI's liquidity management framework should focus not just on how much liquidity exists but where it is going — whether it is being productively deployed into credit or parked in excess SLR. [3][5]

In conclusion, India's monetary policy transmission has come a long way — but still has a distance to go. Bank liquidity is a necessary but not sufficient condition for effective transmission. Structural reforms in the banking sector, combined with the right regulatory nudges, are needed to make the lending channel work as smoothly as it should. [1][2][5]

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