Syllabus subtopic: Indian Economy and issues relating to planning, mobilization of resources, growth, development and employment.

News: The RBI’s Monetary Policy Committee (MPC) unanimously decided to keep the key policy rate unchanged for the first time in 2019, as it worried about the rising inflation and felt that more time was needed for the impact of past rate cuts and more clarity on the fiscal policy and price fronts.

Prelims and Mains focus: About Monetary Policy Committee, repo rate, MCLR, various interventions by the RBI to sustain growth

Further action taken by RBI

Unveiling the fifth bi-monthly monetary policy, the Reserve Bank of India’s (RBI) policy panel also sharply slashed its gross domestic product (GDP) growth estimates for the fiscal 2019-20 to 5 per cent from 6.1 per cent earlier, citing a weak domestic demand, further slowdown in global economic activity and geo-political tensions. The government had last week said the GDP growth in September 2019 quarter had plunged to 4.5 per cent, the lowest since the three months ended March 2013.

While the decision to keep the repo rate at 5.15 per cent was unexpected, the MPC said it will “continue with the accommodative stance as long as it is necessary to revive growth, while ensuring that inflation remains within the target”. An accommodative stance typically means that the MPC will cut rates whenever it finds the space available to do so.

However, the RBI indicated there is monetary policy space for future action after considering the fiscal measures in the Budget and more clarity on inflation.

Inflation targeting is the MPC’s “primary mandate”. While the RBI had cut repo rates by 135 basis points (bps) in five policy reviews in 2019, the one-year median marginal cost of funds-based lending rate (MCLR) has declined by only 49 bps. The weighted average lending rate (WALR) on fresh rupee loans sanctioned by banks declined by only 44 bps.

The MPC raised its inflation projection for the second half of the current financial year to 4.17-5.1 per cent from 3.5-3.7 per cent earlier. Under the RBI’s inflation targeting mandate, the MPC is supposed to keep headline inflation within a 2-6 per cent range, but it has typically targeted the midpoint of 4 per cent.

Concerns of various stakeholders
The MPC’s decision to pause surprised the markets and bankers, as they had expected a 25 bps cut thanks to GDP growth plunging to 4.5 per cent in September quarter. Other high frequency indicators such as core sector output for October, which contracted 5.8 per cent, and November auto sales point to sluggish demand.

In October, consumer price inflation rose to a 16-month high of 4.62 per cent. While most economists expected the MPC to look through this rise as transient, the MPC said that “the upsurge in prices of vegetables is likely to continue in immediate months.” It also pointed to “incipient price pressures seen in other food items such as milk, pulses, and sugar are likely to be sustained, with implications for the trajectory of food inflation.”

The RBI panel also indicated that various high frequency indicators suggest that domestic and external demand conditions have remained weak. “Based on the early results, the business expectations index of the Reserve Bank’s industrial outlook survey indicates a marginal pickup in business sentiments in Q4 (January-March),” the MPC statement said.

The RBI Governor said the monetary policy easing since February 2019 and the government measures “are expected to revive sentiment and spur domestic demand.” The RBI expects growth to pick up in the first half of fiscal 2020-21 at 5.9-6.3 per cent.

The MPC also said it was waiting for more insights from the forthcoming Union Budget.

Addressing a press conference. The RBI said most banks had linked their lending rates to the policy repo rate of the Reserve Bank.

**Monetary Policy Committee (MPC)**

- The Monetary Policy Committee of India is responsible for fixing the benchmark interest rate in India.
- The meetings of the Monetary Policy Committee are held at least 4 times a year and it publishes its decisions after each such meeting.
- The committee comprises six members – three officials of the Reserve Bank of India and three external members nominated by the Government of India.
- Decisions are taken by majority with the Governor having the casting vote in case of a tie.
- The members need to observe a “silent period” seven days before and after the rate decision for “utmost confidentiality”.

**Composition of MPC:**
MCLR

Marginal Cost of Funds based Lending Rate (MCLR) is the **minimum lending rate below which a bank is not permitted to lend**. RBI can give authorization for the same in exceptional cases.

MCLR (Marginal Cost of funds based Lending Rate) replaced the earlier base rate system to determine the lending rates for commercial banks. RBI implemented MCLR on 1 April 2016 to determine rates of interests for loans. It is an internal reference rate for banks to determine the interest they can levy on loans. For this, they take into account the additional or incremental cost of arranging additional rupee for a prospective buyer.

**The Outcome of MCLR implementation**

After the implementation of MCLR, the interest rates are determined as per the relative risk factor of individual customers. Previously, when RBI reduced the repo rate, banks took a long time to reflect it in the lending rates for the borrowers. Under the MCLR regime, banks must adjust their interest rates as soon as the repo rate changes. The implementation aims at improving the openness in the structure followed by the banks to calculate the interest rate on advances. It also ensures the prospect of bank credits at the interest that is true to the consumers as well as the banks.

**How to calculate MCLR?**

MCLR is calculated based on the loan tenor, i.e., the amount of time a borrower has to repay the loan. This tenor-linked benchmark is internal in nature. The bank determines the actual lending rates by adding the elements spread to this tool. The banks, then, publish their MCLR after careful inspection. The same process applies for loans of different maturities – monthly or as per a pre-announced cycle.

The **four main elements of MCLR** are made up of the following:

**a. Tenor premium**

The cost of lending varies from the period of the loan. Higher the duration of the loan, higher will be the risk. In order to cover the risk, the bank will shift the load to the borrowers by charging an amount in the form of premium. This premium is known as the Tenure Premium.

**b. The marginal cost of funds**

The marginal cost of funds is the average rate at which the deposits with similar maturities were raised during a specific period before the review date. This cost will reflect in the bank’s books by their outstanding balance.
The marginal cost of funds has several components like the Return on Net Worth and the Marginal Cost of Borrowings. Marginal Cost of Borrowings takes up 92% while the Return on Net Worth accounts for 8%. This 8% is equivalent to the risk of weighted assets as denoted by the Tier I capital for banks.

c. Operating Cost
Operational expenses include the cost of raising funds, barring the costs recovered separately through service charges. It is, therefore, connected to providing the loan product as such.

d. Negative carry on account of CRR
Negative carry on the CRR (Cash Reserve Ratio) takes place when the return on the CRR balance is zero. Negative carry arises when the actual return is less than the cost of the funds. This will impact the mandatory Statutory Liquidity Ratio Balance (SLR) – reserve every commercial bank must maintain. It is accounted negatively as the bank cannot utilize the funds to earn any income nor gain interests.

How is MCLR different from Base Rate?
MCLR is set by the banks on the basis of the structure and methodology followed. To summarise, borrowers can benefit from this change.

MCLR is an improved version of the base rate. It is a risk-based approach to determine the final lending rate for borrowers. It considers unique factors like the marginal cost of funds instead of the overall cost of funds. The marginal cost takes into account the repo rate, which did not form part of the base rate.

When calculating the MCLR, banks are required to incorporate all kinds of interest rates which they incur in mobilizing the funds. Earlier, the loan tenure was not taken into account when determining the base rate. In the case of MCLR, the banks are now required to include a tenor premium. This will allow banks to charge a higher rate of interest for loans with long-term horizons.

What are the deadlines to disclose monthly MCLR?
Banks have the liberty to make available all loan categories under fixed or floating interest rates. Additionally, banks need to follow specific deadlines to disclose the MCLR or the internal benchmark. They could be one month, overnight MCLR, three months, one year or any other maturity as the bank deems fit.

The lending rate cannot be below the MCLR for any loan maturities. However, there are other loans which are not linked to MCLR. These include loans against customers’ deposit, loans to the bank’s employees, special loan schemes by Government of India (Jan Dhan Yojana), fixed-rate loans with tenures above three years.