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Effectiveness of RBI Monetary Policy on Commercial Banks

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ABSTRACT

Through its monetary policies, the Reserve Bank of India (RBI) significantly influences the development of the nation's financial system. These regulations have an impact on commercial banks' operations, stability, and expansion, all of which have an impact on the economy as a whole. With an emphasis on credit creation, liquidity management, interest rates, and banking profitability, this study examines how well the RBI's monetary policies have worked for India's commercial banks. The study illustrates how well monetary policies accomplish their stated goals and how they affect the banking industry through an examination of policy measures, case studies, and difficulties.

KEYWORDS

Monetary Policy, Repo Rate, CRR, SLR, Transmission Mechanism, Commercial Banks, RBI.

INTRODUCTION

The primary objective of monetary policy is to maintain price stability while keeping in mind the objective of growth .one essential tool that central banks utilize to regulate the money supply and interest rates in an economy is monetary policy. The Reserve Bank of India (RBI) is charged with creating and carrying out monetary policy in India with the dual goals of preserving price stability and guaranteeing a sufficient supply of credit for economic expansion. Changes in monetary policy have a direct impact on commercial banks, which are the main lending intermediaries. These banks' lending and deposit patterns are impacted by changes to the repo rate, cash reserve ratio (CRR), statutory liquidity ratio (SLR), or open market activities. The degree to which the RBI's monetary policy produces tangible results in the commercial banking system—like lending trends, profitability,and credit availability—is frequently used to assess its efficacy.

The Monetary Policy Report: Once in every six months, the Reserve Bank publishes the Monetary Policy Report containing the following elements:

a) Explanation of the recent six months' inflation patterns and the inflation forecast for the near future.

b) Projections of inflation and growth and the balance of risks;

c) An assessment of the state of the economy, covering the real economy, financial markets and stability, fiscal situation, and the external sector, which may entail a bearing on monetary policy decisions;
d) A revision to the monetary policy operational method.
e) An assessment of projection performance.
Meeting Schedule of the Monetary Policy Committee
April 7-9, 2025
June 4-6, 2025
August 4-6, 2025
September 29-30, 2025 and October 1, 2025
December 3-5, 2025
February 4-6, 2026

RESEARCH OBJECTIVES

1. To research how the RBI formulates monetary policy.
2. To examine the impact of monetary policy tools on Indian commercial banks.
3. To assess how well these measures are working to keep inflation under control and spur growth.
4. To determine the difficulties commercial banks encounter while adjusting to policy modifications.
5. To offer recommendations for enhancing the system by which policies are transmitted.

MONETARY POLICY FRAMEWORK IN INDIA

Quantitative Tools

Repo Rate, Reverse Repo Rate, CRR, SLR, OMO, MSF, LAF, Bank Rate.

1. Repo Rate- The rate at which commercial banks obtain short-term funding from the RBI is known as the repo rate. A rise in the repo rate reduces market liquidity by making borrowing more expensive.

2. Reverse Repo Rate - The rate at which the RBI borrows money from commercial banks in order to absorb surplus liquidity is known as the reverse repo rate.

3. CRR (Cash Reserve Ratio) - The percentage of deposits that banks must maintain with the RBI is known as the cash reserve ratio, or CRR. A higher CRR lowers the amount of money that can be lent.

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4. SLR (Statuary Liquidity Ratio) - The percentage of deposits that banks are required to keepin liquid assets is known as the Statutory Liquidity Ratio, or SLR. Higher SLR restricts banks abilityto lend.

5. OMO-To control liquidity, open market operations (OMO) involve the purchase or sale of government securities.

6. Marginal Standing Facility (MSF) Rate: The penal rate at which banks can borrow, on an overnight basis, from the Reserve Bank by dipping into their Statutory Liquidity Ratio (SLR) portfolio up to a certain threshold of 2%. This acts as a safeguard against unforeseen shocks to the banking system's liquidity. The policy repo rate is 25 basis points lower than the MSF rate.

7. Liquidity Adjustment Facility (LAF): The LAF refers to the Reserve Bank's operations through which It brings liquidity into and takes it out of the banking system. It includes SDF and MSF, as well as overnight and term repos and reverse repos (fixed and variable rates). Apart from LAF, instruments of liquidity management include outright open market operations (OMOs), forex swaps and market stabilisation scheme (MSS).

8. **Bank Rate:** The rate at which the Reserve Bank is ready to buy or rediscount bills of exchange or other commercial papers. When banks fail to achieve their reserve requirements (statutory liquidity ratio and cash reserve ratio), they are penalized with the bank rate. Section 49 of the RBI Act of 1934 governs the publication of the bank rate. The MSF rate and this rate are in sync, and this rate automatically adjusts when the MSF rate and the policy repo rate do.

Instrument	Rate
Policy Repo Rate	5.25%
Standing Deposit Facility Rate	5.00%
Bank Rate	5.50%
Fixed Reverse Repo Rate	3.35%
CRR	3.00%
SLR	18.00%
Base Rate	8.35% - 10.00%
MCLR (Overnight)	7.70% - 7.95%
Savings Deposit Rate	2.50%
Term Deposit Rate > 1 Year	6.00% - 6.50%

QUALITATIVE TOOLS

1. Limiting loans to specific industries is known as credit rationing.
2. Moral Persuasion: Convincing banks to adhere to regulations.
3. Taking direct action: Penalizing non-compliance.

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IMPACT OF MONETARY POLICY ON COMMERCIAL BANKS

1. Credit Creation and Lending Behavior

The ability of banks to create credit is directly impacted by monetary policy. For example, by making loans more costly, an increase in the repo rate deters people from borrowing. Commercial banks thus cut back on lending to both individuals and companies. On the other hand, a drop in the repo rate promotes lending and investment.

Case Example: During the COVID-19 pandemic, RBI reduced the repo rate significantly to ensure banks had cheaper access to funds. This move helped banks extend loans to businesses struggling with liquidity.

2. Liquidity Management

The RBI affects banks' liquidity status through CRR, SLR, and OMO. Banks must keep larger reserves with the RBI when CRR is increased, which lowers the amount of money they may lend. On the other hand, reducing CRR brings liquidity into the economy.

Case Example**:** In 2020, RBI reduced CRR from 4% to 3% to enhance liquidity in the banking system, enabling commercial banks to provide more credit to industries.

3. Interest Rates and Profitability

Bank profitability is impacted by changes in interest rates. Banks can borrow money more cheaply when the repo rate is lower, but they may also have to drop lending rates, which would reduce their net interest margin (NIM). In a similar vein, higher repo rates may boost deposit inflows while decreasing lending demand.

4. Investment in Government Securities

Banks are forced to invest a percentage of their deposits in government assets due to high SLR requirements. Although safety is guaranteed, this limits profitability by lowering the amount of money available for commercial lending.

5. Transmission of Monetary Policy

Banks' ability to promptly and effectively pass on changes in RBI rates to their clients determines how effective monetary policy is. This is frequently called the transmission mechanism for monetary policy. High non-performing assets (NPAs) and strict deposit contracts are two structural problems that cause delays in this process in India.

CHALLENGES FACED BY COMMERCIAL BANKS

Non-Performing Assets (NPAs): High levels of bad loans weaken banks' ability to respond to monetary policy changes.Dual Mandate of RBI: Balancing between inflation control and growth promotion creates policy dilemmas.Global Factors: Foreign exchange fluctuations, global commodity prices, and capital flows limit the effectiveness of domestic monetary policy.Delayed

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Transmission: Commercial banks often delay passing on rate cuts to borrowers, reducingpolicy impact.Regulatory Compliance: Frequent changes in CRR, SLR, and capital adequacy norms createoperational challenges for banks.

The success of RBI monetary policies in influencing commercial banks can be assessed underdifferent economic conditions.

1. Controlling Inflation

RBI uses contractionary policies (higher repo, CRR, SLR) to control inflation. By making credit costlier, demand is reduced, which eventually lowers price pressure. This has worked effectively in many instances, though food inflation often remains outside the scope of monetary policy.

2. Promoting Economic Growth

During periods of slowdown, expansionary policies (lower repo, reduced CRR/SLR) encourage banks to lend more, thus stimulating growth. For example, RBI's accommodative stance during 2020–2021 supported liquidity and helped banks support businesses.

3. Financial Stability

By regulating credit, RBI ensures that banks do not over-lend, which could create asset bubbles. Prudential measures like SLR and CRR maintain financial stability.

4. Challenges in Transmission

Despite RBI's measures, the actual transmission to borrowers is often slow and incomplete. Reasons include:

6. HIGH NPAS LIMITING BANKS' WILLINGNESS TO LEND.

7. STIFF COMPETITION FOR DEPOSITS.

8. STRUCTURAL RIGIDITIES IN THE BANKING SYSTEM.

SUGGESTIONS FOR IMPROVEMENT

Strengthening Transmission Mechanism: Encourage banks to link lending rates more directly to repo rates.

Reducing NPAs: Better credit appraisal and recovery mechanisms to free up resources for effective policy transmission.

Digital and Technological Integration: Using fintech solutions to improve efficiency and Responsiveness.

Coordination with Fiscal Policy: Monetary policy alone cannot drive growth; better alignment with government spending and taxation policies is required.

Transparent Communication: RBI should provide clear guidance on policy direction to help banks plan accordingly.

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CONCLUSION

The monetary policy of the Reserve Bank of India is essential for controlling commercial banks and maintaining the stability of the financial system. NPAs, delayed transmission, and global uncertainty diminish the overall effectiveness of measures like the repo rate, CRR, and SLR, which have a significant impact on banks' lending behavior and liquidity. Despite this, the RBI has shown flexibility in implementing creative solutions, particularly in times of crisis such as the COVID-19 war. Stronger transmission mechanisms, monetary and fiscal policy coordination, and banking reforms are necessary for increased efficacy.

The effectiveness of the Reserve Bank of India's monetary policy is deeply reflected in the functioning and performance of commercial banks. As the primary financial intermediaries, commercial banks serve as the main transmission channel through which monetary policy decisions influence the broader economy. Instruments such as the repo rate, CRR, SLR, OMO, MSF, and LAF significantly shape banks' liquidity positions, cost of funds, lending capacity, and profitability. Over time, the RBI has demonstrated a dynamic and responsive policy approach—tightening measures to control inflation and adopting accommodative stances during economic slowdowns, particularly during the COVID-19 crisis to maintain financial stability and ensure credit flow.

However, the study also reveals that the overall effectiveness of monetary policy is not determined solely by policy formulation but largely by the efficiency of its transmission through the banking system. Structural rigidities, high levels of Non-Performing Assets (NPAs), delayed rate pass-through, and external global pressures often dilute the intended impact of policy measures. While contractionary policies have contributed to inflation control and expansionary policies have supported growth, the results are sometimes uneven due to sector-specific inflation, deposit competition, and cautious lending behavior by banks.

Despite these challenges, the RBI's monetary framework—especially after the introduction of the Monetary Policy Committee (MPC) and inflation targeting regime—has strengthened transparency, accountability, and credibility in policy implementation. The alignment of interest rate mechanisms such as MCLR and external benchmark-linked lending rates has further improved transmission, though gaps remain.

In conclusion, RBI monetary policy has been largely effective in guiding commercial banks toward maintaining liquidity discipline, financial stability, and controlled credit expansion. Yet, for sustained and enhanced effectiveness, structural banking reforms, stronger NPA management, technological modernization, and closer coordination between monetary and fiscal policies are essential. A resilient banking sector combined with a transparent and proactive central bank will ensure that monetary policy continues to support India's macroeconomic stability and long-term economic growth.

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