



RBI Working Paper on Asset Quality and Credit Channel

Why in News

Recently, a [Reserve Bank of India \(RBI\)](#) working paper on 'Asset quality and credit channel of monetary policy transmission in India' has been released.

- RBI introduced the RBI Working Papers series in March 2011.

Key Points

▪ Credit Channel:

- The credit channel of monetary policy transmission is **robust in India** and **operates through changes in lending**.
 - There are **two ways** the credit channel can work: by affecting overall bank lending (the **bank lending channel**) and by affecting the allocation of loans (the **balance sheet channel**).

▪ Credit Deceleration:

- Credit growth deceleration in India **since 2013** is explained by **asset quality stress** in the banking system, **slowdown** in economic activity and **moderation in bank deposits**.
- The **growth rate in credit offtake** has steeply **declined to 5.8% in November 2020**, as against **14.2% in 2013**.
- A **wide divergence** has also been observed in **credit growth of public and private sector banks**.

▪ Potential Determinants of Credit Growth:

◦ Asset Quality Stress:

- Since the **early 2010s**, asset quality of banks in India **has worsened gradually**, impacting their profitability.
- Asset quality of Scheduled Commercial Banks (SCBs) is **measured as a ratio of gross [non-performing assets](#) (GNPAs) to gross advances**.

◦ Nominal GDP Growth:

- **Higher growth** in nominal Gross Domestic Product (GDP) **increases the demand for credit**.
- The decline in credit growth post 2013 was mainly due to a surge in bad loans, accentuated by a slowdown in GDP.
- Nominal GDP is an assessment of economic production in an economy that includes current prices in its calculation.

a. Nominal **differs from** [real GDP](#) in that it includes changes in prices due to inflation, which reflects the rate of price increases in an economy.

◦ Deposit Growth:

- Deposit growth has **remained highly volatile**, especially from the second half of 2015.
- It needs to be noted that **a financial institution with a greater availability of funds** will be in a better position to provide **more credit to borrowers**.
- **Investment Growth:**
 - The **surge in investment growth** has also added to the **slowdown in credit growth**.
 - To the extent **banks invest in securities, lower resources** would be available for **extending as credit**.
 - In India, **investments by banks** include both investment in government securities as prescribed under the statutory obligations ([statutory liquidity ratio](#) or SLR) and voluntary investments held in government securities and bonds/debentures/shares of corporate bodies.
- **Interest Rates:**
 - **Higher** the interest rates, **higher will be the cost of borrowing** and hence, **lower would be the demand for credit**.
- **Other Bank-specific Characteristics:**
 - Such as the **size of the bank and capitalisation** (an estimation of the value of a business).
- **Measures Taken:**
 - The **accommodative stance of monetary policy** and **reduction in the policy repo rate** (starting from 2019) helped cushion the credit deceleration.
 - An accommodative stance means **a central bank will cut rates to inject money** into the financial system whenever needed.
 - **Repo Rate**, or repurchase rate, is the key monetary policy rate of interest at which the central bank or the Reserve Bank of India (RBI) lends short term money to banks.
 - a. Everything from interest rates on loans to returns on deposits is influenced by this crucial rate set by the RBI.
 - b. The central bank [has slashed policy repo rate](#) by 350 basis points to 4% now from 7.50% in March 2013.
 - After the Asset Quality Review (AQR), since 2015, many hidden bad loans had surfaced, forcing the government to enact the [Insolvency and Bankruptcy Code \(IBC\)](#) for resolution of bad loans.
 - Despite the lockdown, layoffs and closure of many units in the wake of the [Covid-19 pandemic](#), **gross NPAs of 31 banks witnessed a decline of 5.25%** in absolute terms as the **RBI allowed relaxation in the computation of bad loans** and announced **a loan restructuring scheme**.

Way Forward

- In a **bank-dominated financial system** such as India, the **credit channel plays a critical role** in transmitting monetary policy impulses to the credit market and from thereon to the real economy.
- Controlling for asset quality, in the short-run, the credit channel of monetary transmission of **public sector banks is stronger** relative to that of private sector banks.
- For monetary policy actions to have their full impact on the credit channel, it is imperative that the **asset quality concerns of banks are addressed** and that their **capital positions are strengthened**.

[Source: IE](#)

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