DSP CONVERSE

THE TRANSMISSION PARADOX

In this note, we examine the reasons why RBI's ability to stimulate the economy via rate cuts is being countered by the banking system's need for deposits at an appropriate cost, and hence effective transmission is being hampered.

Between Feb and Nov'25, the RBI cut the policy repo rate by a sharp 100 bps. However, this had not effectively been transmitted to the real economy. As of Nov'25, the WALR on outstanding loans has declined by only 66 bps.

This "transmission leak" is a structural by-product of two frictional factors: Credit-to-Deposit saturation and the new EBLR vs MCLR "rift." The banking system has hit a productive capacity limit, which means that the policy rate can no longer be the primary determinant of the price of credit.

THE BINDING FUNDING CONSTRAINT: THE 80% CHOKEHOLD

The first friction is the exhaustion of systemic liquidity. Data indicates the CD ratio climbed from 78.9% (Jun'25) to 82.2% (Jan'26).

- The Incremental Squeeze: The incremental CD ratio spiked sharply from 10% to 98% in the same period. This implies that the bulk of new deposits mobilized since June has been absorbed by incremental lending rather than adding to surplus liquidity.

- The Zero-Sum War: With a headline ratio above 80%, banks need to fight for deposits or wait for surplus banking system liquidity. In the near-term, to grow, a bank must cannibalise deposit from a competitor.

- The Floor: Banks do not want to get into a "deposit fight", yet hold their ground and not lose to competition. With loan growth targets, need to at least maintain market share and deliver shareholder returns, the deposit costs have been slow to decline. Consequently, the WADTDR on outstanding deposits declined by only 36 bps despite the 100 bps repo cut.

BENCHMARKING SCHIZOPHRENIA: EBLR VS. MCLR

Data from the below table highlights the rift between mechanical EBLR and cost-based MCLR transmission:

Benchmark	Repo Move	Actual Transmission	Pass-Through (%)
EBLR (External)	-100bps	-100bps	100%
Median MCLR (1yr)	-100bps	-50bps	50%
WALR (Outstanding)	-100bps	-66bps	66%
WADTDR (Deposits)	-100bps	-36bps	36%

Analysis: While 60% of the floating rate rupee loans are EBLR-linked and move mechanically, the "MCLR Drag" acts as an anchor. Because the stock of deposits has repriced by only 36 bps, as deposits are not priced via external benchmarks unlike loans, MCLR—that references the average cost of funds—cannot move in lock step with the Repo.

LIQUIDITY OPERATIONS: SHORT-END VS. DURABLE SUPPORT

The RBI's operational tools are currently treating the symptoms rather than the cause:

- VRR/VRRR (Fine-Tuning): Aligns the WACR with the Repo, helping the short-end of the curve.
- OMOs (Durable Liquidity): While OMOs inject cash, they cannot rewrite outstanding deposit contracts (down only 36 bps).

Until the structural CD ratio pressure is resolved, OMOs provide balance-sheet space but fail to lower the actual cost of credit.

EBLR-External Benchmark Linked Rate; MCLR-Marginal Cost of Funds Based Lending Rate; CD-Credit to Deposit; WADTDR-Weighted Average Domestic Term Deposit Rate; WALR-Weighted Average Lending Rate; OMO-Open Market Operations; WACR- Weighted Average Call Rate