Indian Economy · GS - III

“The effectiveness of monetary policy depends not merely on changes in policy rates but also on their transmission through the banking system.” Examine the role of lending-rate benchmarks such as MCLR in monetary policy transmission in India.

EXAM YEAR	PAPER	SUBJECT
DAILY PRACTICE 11/11/2026	GS - III	Indian Economy

MARKS	WORD LIMIT
10	~150 words

Answer Hint

Monetary policy transmission, RBI repo rate, MCLR framework, marginal cost of funds, external benchmark lending rates, bank funding costs, loan reset periods, borrowers, transmission efficiency.

Model Answer

Introduction

Monetary policy transmission refers to the process through which changes in the RBI's policy rates influence lending rates, credit demand, investment and aggregate economic activity.

Role of MCLR

- **Cost-based pricing:** MCLR links lending rates to banks' marginal funding costs and other prescribed components.
- **Interest-rate transmission:** Changes in funding costs can influence banks' lending rates and affect borrowing decisions.
- **Transparency:** The framework seeks to improve consistency in loan pricing compared with less responsive benchmark systems.
- **Borrower impact:** Changes in MCLR affect existing borrowers according to contractual reset periods, influencing EMIs or loan tenures.

Limitations

Transmission may remain incomplete due to rigid deposit rates, liquidity conditions, risk premiums and differences in bank funding structures. External benchmark-linked lending rates provide a more direct connection with specified market or policy rates for eligible loans.

Way Forward

Greater transparency, efficient banking competition and timely benchmark adjustments can strengthen transmission while protecting borrowers.

Conclusion

An effective benchmark framework is essential for ensuring that monetary policy decisions influence credit conditions and economic activity in a predictable manner.

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