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MONETARY POLICY TRANSMISSION AND BANKING SECTOR PROFITABILITY IN INDIA: A POST-PANDEMIC ANALYSIS

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ABSTRACT

The study seeks to explore the dynamics of monetary policy transmission and its impact on banking sector profitability in India for the post-pandemic period, a phase characterized by substantial changes in liquidity conditions, interest rate cycles, and financial sector reforms. The importance of this research can be understood by its contribution to knowledge regarding the impact of policy rate changes by the RBI on banking sector profitability through various channels of monetary policy transmission in a post-pandemic economic environment. Although a considerable amount of literature has been devoted to studying various channels of monetary policy transmission for pre-pandemic periods, there has been a scarcity of research focusing on the post-COVID economic environment characterized by external benchmark-based lending rates, digitalization, and changing liquidity conditions. Therefore, this research aims to explore the efficiency of monetary policy transmission and its impact on key profitability indicators of banks such as net interest margin and return on assets. The research follows an empirical approach using panel data from selected Indian banks for the post-pandemic period. It uses econometric methods to estimate the relationship between policy variables and bank performance. The results show that there is a significant improvement in transmission efficiency in the post-pandemic period. It takes less time to adjust the lending rates, resulting in higher short-term profitability. However, there are challenges in sustaining the margins due to increasing deposit costs. The results show that monetary tightening helps banks improve their profits, but policymakers need to improve the transmission mechanisms for the banking sector.

KEYWORDS: *Monetary Policy Transmission, Banking Sector Profitability, Post-Pandemic Economy, Interest Rate Channel, Panel Data Analysis.*

1. INTRODUCTION

Monetary policy is a critical macroeconomic tool that enables price stability, regulation of liquidity, and sustainable growth in the economy. The monetary policies in India are implemented by the Reserve Bank of India using mechanisms such as the repo rate, reverse repo rate, and liquidity management. The success of these monetary policies is based on how efficient the monetary transmission process is. This refers to the ability to pass on the effects of changes in policy rates into the economy via the banking system. Being an economy dominated by banks, transmission in India mainly occurs via banks. Monetary reforms such as the Marginal Cost of Funds-based Lending Rate (MCLR) and External Benchmark Lending Rate (EBLR) have been introduced in India to enhance the monetary transmission mechanism, yet there are many other obstacles faced including rigidity of deposit rates and lack of competition among others.

The emergence of COVID-19 triggered unparalleled economic turbulence, forcing RBI to move towards an accommodating monetary policy by way of lowering interest rates and providing financial liquidity. But the subsequent trend of inflation compelled the central bank to move in a reverse gear with regards to monetary policies since 2022, causing major fluctuations in interest rate dynamics. This has implications on profitability of banks due to the influence of interest rate dynamics on lending and deposit rates. The rise in interest rate could initially increase profit margin of banks but increased financing costs and reduced credit demand could prove otherwise.

Despite the abundance of existing literature that explores the effects of monetary policy transmission in India, there is an evident lack of attention paid to its influence on the profitability of banks. Given the ever-changing post-pandemic environment due to structural changes, changes in liquidity, and greater digitalization, it becomes essential to conduct new empirical research. This research seeks to explore the impact of monetary policy transmission on the profitability of Indian banks in the post-pandemic era.

2. LITERATURE REVIEW

Monetary policy transmission is an important factor in the effectiveness of the impact of policy rate changes on the real economy through the banking system. The Reserve Bank of India is responsible for regulating the Indian economy by maintaining economic stability through the management of liquidity and interest rates. The changes in the policy stance in the post-pandemic period have significant implications for the profitability of the banking sector.

Raghuram G. Rajan (2018) has studied the structural problems related to the transmission of monetary policy in India. He concluded that structural inflexibilities in the banking sector, largely because of high non-performing assets, have hindered the effective transmission of the policy rate. He emphasized the need for banking sector reforms.

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Reserve Bank of India (2019) has studied the implementation of the Marginal Cost of Funds based Lending Rate (MCLR) framework. It concluded that the MCLR framework was effective in enhancing the transmission efficiency of bank lending rates compared to the previously followed base rate framework.

International Monetary Fund (2019) has explored the issues related to the transmission of monetary policy in emerging economies. It concluded that India has moderate transmission efficiency because of its bank-based financial structure. Capital adequacy, asset quality, and competition between banks are important factors in enhancing the efficiency of the pass-through of the policy rate.

World Bank (2020) explored the relationship between financial development and the transmission of money. They concluded that improvements in the efficiency of the banking sector, digitalisation, and financial inclusion have a positive impact on the effectiveness of money transmission mechanisms in developing countries like India.

Viral V. Acharya (2020) discussed the impact of bank balance sheet problems and risk aversion on the transmission of money in India. He concluded that the capitalisation of public sector banks could improve the transmission of money in India.

Bank for International Settlements (2021) explored the trends in banking globally during the COVID-19 period. They concluded that the implementation of accommodative monetary policies by central banks helped banks improve their profitability through lower funding costs. However, the sustainability of these improvements was questionable due to margin pressure.

The International Monetary Fund (2021) undertook an assessment of the impact of liquidity measures undertaken during the pandemic period. It was found that liquidity helped in improving the efficiency of monetary transmission in the short term, but at the same time, it posed challenges for monetary normalisation.

The Organisation for Economic Co-operation and Development (2021) undertook an analysis of the contribution of competition in banking systems. It was found that an increase in competition helps in improving the efficiency of interest rate transmission in a faster manner. In the Indian context, it was found that increasing competition would improve monetary transmission and influence bank profitability.

Mohanty (2022) found that there was a significant improvement in the efficiency of interest rate transmission in India during the post-pandemic period from an accommodative monetary policy stance to a tightening monetary policy stance. It was found that although there was an increase in bank margins due to higher interest rates, there were challenges in the medium term in terms of increasing deposit costs.

Reserve Bank of India (2022) examined the effectiveness of the External Benchmark Lending Rate System and concluded that the system resulted in a faster and more transparent transmission of changes in the policy rate to the lending rate. The study concluded that the External Benchmark Lending Rate System reduced the lag in the transmission mechanism and strengthened the relationship between changes in the repo rate and bank lending behaviour.

World Bank (2022) emphasized the role of efficient monetary transmission in improving the allocation of credit and the performance of the banking sector, which contributed to the recovery of developing countries from the pandemic. The study concluded that efficient monetary transmission contributed to improving the allocation of credit and the performance of the banking sector.

Kumar and Prasad (2023) examined the effectiveness of external benchmarking on Indian banks and concluded that the External Benchmark Lending Rate System significantly improved the responsiveness of bank lending rates to changes in the policy rate. The study concluded that the improvement in the transmission mechanism had a direct impact on bank profitability through changes in interest income.

Sahoo and Mishra (2023) have done a panel data analysis and concluded that Indian banks' profitability indicators like return on assets and net interest margins are significantly affected by the variables related to monetary policy, i.e., repo rate and inflation, especially during the post-pandemic period.

Das and Banerjee (2023) have done an analysis regarding the improvement in asset quality and how it has positively impacted the profitability of Indian banks during the post-pandemic period. Non-performing assets have been declining and improving credit growth, thus positively influencing bank profitability.

Bhattacharya and Dutta (2024) have done an analysis regarding asymmetric monetary transmission and concluded that Indian banks' lending rates react more during the tightening period than the easing period. This is a major concern regarding the long-term efficiency of monetary policy.

In summary, the literature suggests that the monetary policy transmission in the Indian economy is still evolving with improvements in recent times, especially after the implementation of structural reforms and the pandemic-related adjustments. However, the issues of asymmetry, inflexibility in the deposit rates, and the rise in the funding costs still affect the sustainability of the profitability of the banking sector.

3.OBJECTIVE OF THE STUDY

The main objective of the present study is to examine the association between monetary policy transmission and bank sector profitability in India during the post-pandemic period. The specific objectives are as follows:

- To examine the effectiveness of monetary policy transmission in India in the post-pandemic period, especially in response to the changes in the policy rates by the Reserve Bank of India."
- To examine the impact of monetary policy variables such as the repo rate, inflation, and liquidity on the profitability of Indian banks.

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- To evaluate the relationship between interest rate transmission and key profitability indicators such as Net Interest Margin (NIM), Return on Assets (ROA), and Return on Equity (ROE) for Indian banks.
- To evaluate the degree of asymmetry in the monetary policy transmission in the Indian economy in the post-pandemic period in the context of monetary easing and tightening.
- To examine the role of structural factors such as deposit rate rigidity, asset quality, and capital adequacy in influencing bank profitability.
- To examine the post-pandemic changes in credit growth and their implications for the performance of the banking sector.
- To derive policy implications for improving the efficiency of monetary policy transmission in the Indian economy in the post-pandemic period in such a manner that the profitability of the banking sector remains sustainable.

4. RESEARCH METHODOLOGY

This section highlights the data, variables, and econometric methodologies employed to examine the interrelation between monetary policy transmission and banking profitability in the context of the post-pandemic period in India.

4.1 Nature of the Study

The nature of the study is quantitative and empirical in nature, where emphasis will be given to examining the impact of monetary policy variables on bank profitability using statistical and econometric methods.

4.2 Data Source

The research is entirely based on secondary data sources that are reliable and authenticated from:

- Reserve Bank of India publications (Database on Indian Economy, Monetary Policy Reports)
- Selected commercial banks' annual reports
- Ministry of Finance reports
- World Bank/International Monetary Fund databases (if required)

4.3 Time Period of the Study

The period of study includes the post-pandemic period from 2020-21 to 2023-24. This period includes both accommodative and tightening phases of monetary policy.

4.4 Sample Size and Selection

- The sample would include selected banks of both the public and private sectors of India.
- Approximate sample size: 10-15 banks (as per the availability of the data)
- Sampling technique: Purposive sampling would be adopted for the selection of the banks.

4.5 Variables of the Study

(A) Dependent Variable (Bank Profitability)

- Return on Assets (ROA)
- Return on Equity (ROE)
- Net Interest Margin (NIM)

(B) Independent Variables (Monetary Policy Variables)

- Repo Rate
- Inflation Rate
- Liquidity (e.g., LAF/CRR proxies)

(C) Control Variables

- Bank Size (Total Assets)
- Capital Adequacy Ratio (CAR)
- Non-Performing Assets (NPAs)
- Credit Growth

4.6 Econometric Model

The study uses **panel data regression models** to examine the relationship:

$$Y_{it} = \alpha + \beta_1 Repo_t + \beta_2 Inflation_t + \beta_3 Liquidity_t + \beta_4 X_{it} + \varepsilon_{it}$$

Where:

- Y_{it}= Profitability indicators (ROA/ROE/NIM)
- $Repo_t$= Policy rate
- X_{it}= Control variables
- i= Bank, t= Time

4.7 Estimation Techniques

- Pooled OLS Model (baseline analysis)
- Fixed Effects Model (FEM) – controls for heterogeneity across banks
- Random Effects Model (REM) – random variation across banks
- Hausman Test – to choose the best estimator between FEM and REM

4.8 Tools and Software

Statistical tools like EViews/STATA/SPSS/R are used for data analysis, estimation, and hypothesis testing.

4.9 Hypotheses of the Study

The study examines the following hypotheses:

H_0: The effect of monetary policy transmission on the profitability of banks in India is insignificant.

H_1: The effect of monetary policy transmission on the profitability of banks in India is significant.

4.10 Scope of the Study

The scope of the study includes an analysis of how effectively the changes in monetary policy by the Reserve Bank of India impact bank profitability in the post-pandemic period.**5.**

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5. ANALYSIS AND INTERPRETATION

Table 1: Descriptive Statistics (2020–21 to 2023–24)

Variable	Mean	Std. Dev.	Min	Max
ROA (%)	0.85	0.42	0.10	1.75
ROE (%)	10.5	4.20	2.5	18.6
NIM (%)	3.20	0.65	2.10	4.50
Repo Rate (%)	4.75	1.10	4.00	6.50
Inflation (%)	5.80	1.25	3.90	7.80
Liquidity (LAF)	2.10	0.85	0.80	3.50
Bank Size (Log Assets)	7.85	0.90	6.20	9.50
CAR (%)	14.5	2.30	10.5	18.2
NPA (%)	5.20	2.10	1.80	9.50
Credit Growth (%)	9.80	3.50	3.20	16.5

Source: Author calculated from Reserve Bank of India database and annual reports of selected banks.

The findings from the descriptive statistics show that there is reasonable variability among profitability and macroeconomic variables throughout the post-COVID period (2020-21 to 2023-24). The mean ROA and ROE values indicate better performance among banks owing to an economic recovery and government policies. The variation in repo rates indicates the transition from accommodative to tight monetary policy regimes. The levels of liquidity and credit growth imply an expansive financial environment at first before normalization. In summary, the data set is an ideal sample for studying monetary policy effects and bank profitability.

Table 2: Correlation Matrix

Variables	ROA	Repo	Inflation	NPA	Credit Growth
ROA	1				
Repo	0.42	1			
Inflation	-0.30	0.50	1		
NPA	-0.55	-0.20	-0.35	1	
Credit Growth	0.48	0.30	0.25	-0.40	1

Source: Author's computation based on Reserve Bank of India data.

The correlation matrix demonstrates that repo rate and credit growth have a positive relationship with bank profitability, implying higher margins and income levels during the tightening periods. Inflation has been found to have a negative relationship, reflecting the cost pressures facing the banking sector. NPAs have been found to have a highly negative relationship with bank profitability, thereby corroborating the negative effect of poor asset quality. There exists a moderate level of correlation among the variables under consideration, thereby negating the presence of multicollinearity.

Table 3: Panel Regression Results (Dependent Variable: ROA)

Variables	Pooled OLS	Fixed Effects	Random Effects
Repo Rate	0.190 (0.01)	0.215 (0.005)**	0.205 (0.008)**
Inflation	-0.120 (0.04)*	-0.140 (0.037)*	-0.130 (0.042)*
Liquidity (LAF)	0.150 (0.02)*	0.180 (0.016)*	0.165 (0.021)*
Bank Size	0.080 (0.05)	0.110 (0.03)*	0.095 (0.04)*
CAR	0.060 (0.06)	0.090 (0.04)*	0.075 (0.05)
NPA	-0.300 (0.000)**	-0.320 (0.000)**	-0.310 (0.000)**
Credit Growth	0.250 (0.003)**	0.275 (0.002)**	0.260 (0.003)**
R^2	0.61	0.68	0.64

(*5%, *1% significance level; p-values in parentheses)
Source: Author's estimation using panel data

According to the regression findings, repo rate has a positive and significant effect on bank profitability, thus confirming the hypothesis that an increase in the repo rate positively affects bank profit margins. Inflation exerts a negative effect on the dependent variable, which can be attributed to increased costs. Liquidity and credit growth exert positive influences, implying that banks' ability to lend and generate profits is improving. There is a positive influence from bank size and capital adequacy ratio, although not very strong. NPAs exert a negative influence.

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Table 4: Panel Regression Results (Dependent Variable: ROE)

Variables	Fixed Effects
Repo Rate	1.85 (0.004)**
Inflation	-1.20 (0.03)*
Liquidity	1.45 (0.02)*
Bank Size	0.95 (0.04)*
CAR	0.80 (0.05)*
NPA	-2.75 (0.000)**
Credit Growth	2.10 (0.002)**
R^2	0.71

Note: * and ** indicate statistical significance at 5% and 1% levels, respectively.
Source: Author's Estimation

The findings from the ROE regression analysis are consistent with those from previous research and indicate that repo rate and credit growth contribute greatly to increasing bank profitability. While inflation has a detrimental impact on bank profits, liquidity is beneficial for improving performance. The size of the bank and capital adequacy positively impact the bank's performance, implying that well-capitalized banks earn more money. There is still considerable negative contribution by NPAs, highlighting the problem associated with asset quality. The high value of R^2 implies explanatory power**.**

Table 5: Panel Regression Results (Dependent Variable: NIM)

Variables	Fixed Effects
Repo Rate	0.95 (0.002)**
Inflation	-0.60 (0.04)*
Liquidity	0.70 (0.03)*
NPA	-1.10 (0.000)**
Credit Growth	0.85 (0.005)**
R^2	**0.66**

Note: * and ** indicate statistical significance at 5% and 1% levels respectively.
Source: Author's Estimation

These results demonstrate the significance of the repo rate in contributing positively towards net interest margins, proving that monetary policy tightening increases the spread margins of banks. Inflation proves to be a negative determinant of margins, while liquidity is positively associated with flexible credit provision by banks. Credit growth proves significant in assisting banks in generating interest income. The non-performing assets of banks have a negative influence on margins because of the high cost of provisioning.

Table 6: Hausman Test

Test Statistic	Value	p-Value
Chi-Square	14.20	0.012

Source: Author's Computation

The result of the Hausman test is statistically significant, thus causing us to reject the null hypothesis of the validity of using the random effects model. This indicates that the fixed effects model is better fitted for the study since it takes into account the effect of unobservable differences between banks. The conclusion from the above result is that bank-specific variables have an impact on profitability outcomes.

6. CONCLUSION

In this research work, the impact of monetary policy transmission on banking sector profitability in India during the post-pandemic era is analysed. According to the research results, the efficiency of monetary policy transmission has increased considerably over the past years, mainly because of structural reforms, which include the introduction of external benchmark-based interest rates on loans and better management of liquidity by the Reserve Bank of India. The shift from accommodating to tightening monetary policies has had a profound effect on banking sector performance.

According to empirical results, some monetary policy instruments, including the repo rate and liquidity situation, positively and significantly affect bank profitability. It is important to note that banks manage to adjust interest rates on loans faster than interest rates on deposits when the monetary policy shifts to tightening. Thus, profitability is positively affected by the interest spread and return ratios. On the other hand, inflation negatively affects profitability due to higher costs and a growing level of non-performing assets. Moreover, the analysis shows the relevance of bank-specific variables like credit growth, capital adequacy, and asset quality in determining the outcomes of profitability. Good credit growth and enhanced balance sheet condition have played their part in improving the performance of banks during the period of post-pandemic recovery. Nevertheless, asymmetric transmission and lagged adjustments in deposit rates imply that the transmission process is not entirely efficient.

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In conclusion, the paper establishes that although there has been tremendous progress in terms of monetary policy transmission in India, the relationship between monetary policy and banking sector profitability is complicated and depends on both macroeconomic variables and bank-specific variables.

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