Monetary Transmission, Base Rates and ALM

After the repo rate was cut by 0.5% last week, many banks have reduced their base lending rates. Over the cycle of a series of repo rate cuts totalling 1.25%, the base rate reduction has been much lower, and the central bank has expressed concern that the transmission of monetary policy to the economy is not taking place very efficiently. One measure it has proposed is a formula for calculation of the base rate, on the basis of the marginal, not the average, cost of funding for the banking system. It is expected that final instructions on the subject would get formulated by next month.

In general, the transmission of monetary policy signals to the real economy has been poor in recent years even in the advanced industrial economies, despite the vaunted depth and sophistication of their financial markets. After years of quantitative easing and near zero policy rates, inflation is nowhere in sight – even in the US where growth and employment seem to be picking up. The standard jargon of central banking about "calibrated" monetary action; "anchoring" inflation expectations; etc. does not seem to be working: most central banks seem to be getting guided by data as it comes out in determining their monetary policy. One wonders whether the basic assumption of the standard Dynamic Stochastic General Equilibrium (DSGE) model of the macro economy -- that economic agents have rational expectations -- is at all realistic. Perhaps most of us form expectations on the basis of very limited data, and are less than rational most of the times. (I, for one, certainly plead guilty to this!) The pioneer in terms of inflation targeting was the central bank of New Zealand. A recent paper published by Brookings is titled "*Inflation targeting does not anchor inflation expectations: Evidence from firms in New Zealand*"; any comment is unnecessary, as the title says it all. In recent articles, commentators from Prem Shankar Jha (Indian Express, August 11) to Avinash Persaud (Mint, August 11) have raised question marks about the wisdom of inflation targeting: the former claims that "*inflation targeting has no theoretical foundation";* the latter quotes a study based on 46 developing countries which found that inflation targeting reduces growth.

Coming back to the base rate model, while the central bank is focused on inflation targeting, commercial banks do not have the luxury of having a single point agenda. On first principles, the *raison d'etre* of financial intermediation, particularly by the banking system, is maturity and liquidity transformation; they also have other objectives like earning a certain return on equity, priority sector lending, etc. etc., some of them in conflict with each other. And, most banks in India are hugely dependent on the net interest income for their profitability. Given the basic role of financial intermediation, namely maturity and liquidity transformation, the issue of asset: liability management is crucial to the bottom line. The reason why HDFC Bank seems to have responded quickly to policy rates is its efficient asset: liability management, which is also reflected in its traditionally high net interest margin.

For several years now, the central bank in its role as the banking regulator has been emphasising the need for banks to improve their ALM processes. A few years back banks were asked to use the duration based model for calculating the economic value of equity -- the present value of all the existing assets and liabilities, calculated at the ruling interest rates -- and the impact of interest rate changes on EVE. The regulator has also emphasised the need to monitor the impact of interest rate changes on earnings over the next one year. One wonders what impact the base rate model, if adopted, would have on the banking system's earnings and the economic value of equity. Base rate fixation should be an integral part of ALM.

This apart, even after the administered interest rate was cut by half a percent last week, one wonders whether the real interest rate is not still too high: the announced target is much lower, 1.5/2% by early 2016. High interest rates can have two opposite consequences for the banking system: on the one hand, they would help increase the net interest income while, on the other, they also tend to worsen the quality of assets, increasing the level of non-performing assets. No wonder, capital intensive industry and infrastructure projects seem to have a disproportionate share in NPAs.

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