



## **Monetary Policy and Role of Banks**

February 2015

The Federal Reserve has been pumping in huge amounts into the US economy by way of Open Market Operations (OMOs) for the last few years. It bought securities from market players and injected dollar liquidity into the system. As a result, the Fed's balance sheet had gone up from USD 900 billion to almost USD 4.3 trillion in a matter of just about 3-4 years, which means it has gone up to almost 5 times of its original size. This amount is almost 2.5 times the GDP of India, which is roughly USD 1.8 trillion. This is expected that this liquidity would eventually trigger growth impulses in the US economy through increased manufacturing activity and employment generation. This employment generation would automatically add to the income and spending capacity in the system, and that would propel consumer activity in the economy. The latest initial jobless claims number is pretty low. These are indicative of the fact that manufacturing activity and employment generation in the US is picking up.

When a major advanced economy like US pumps in so much liquidity into the system, it finds its way across the world as there is no capital account convertibility restriction on the dollar. The dollar moves seamlessly across the world and finds residence in attractive emerging market economies. The emerging market economies attract this capital due to a huge growth potential, and because they command a higher rate of interest. The interest rate differential between US and India today stands at 750 basis points (7.5%). Even junk bonds in US don't give a return of more than 4%, whereas risk-free government securities in India return 7.75%. This is an enormous differential, which attracts huge amounts of foreign flows into the country. As a result, India has been attracting a huge amount of forex flows (other than in July-Oct 2013, when the Federal Reserve announced the tapering of the quantitative easing program; that sent shock tremors across the world, and most of the emerging market economies were very severely affected by it). Last year India attracted USD 42 billion into equity and debt. This is a very important source of monetary policy dilemma for India, as it needs to evaluate its economic absorption capacity for these flows.

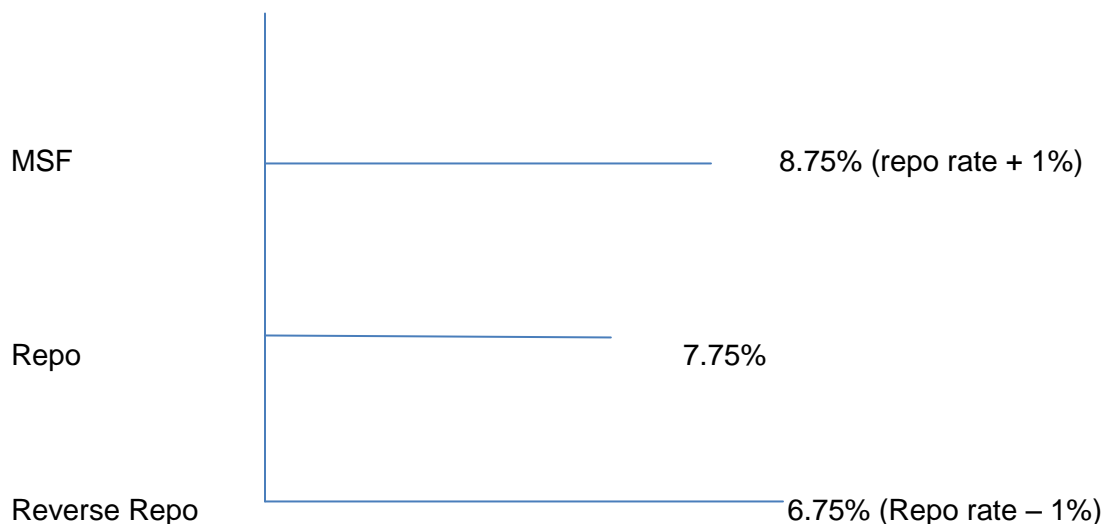
For the last few years, India has been grappling with high inflation, high Current Account Deficit (CAD) and low growth rate at the same time. A year back, CPI inflation was at almost 12%. The CAD had touched a record high of 6.7% in the fourth quarter of 2012-13. For the complete year, India ran a CAD of USD 88 billion. RBI had to hold the interest rates at very high levels in order to tame inflation, which made India a very attractive market for the FIIs. The resultant inflows were in turn pushing the inflation rate higher. These flows were however required to offset the high CAD, which can only be financed through foreign direct investments, foreign portfolio investment, non-resident deposits, external commercial borrowings (ECBs) and remittances. If RBI had lowered the interest rates as a policy response, the forex flows would have lessened, but the lower interest rates would have contributed to increased inflation. Even a lock-in period for the foreign investments would not have helped, as that would have stopped the flows and financing CAD would have become difficult.

Compared to a year back, the position is far better today. The WPI inflation is close to zero and the CPI inflation is in the 5-6% range. CAD has come down to almost 1.5%. In 2014-15, it is

expected to come down to USD 25 billion, and may even turn into a marginal surplus due to low oil prices.

Some of these conflicts are created due to the inherent structure of India's economy. In India, the latent demand is enormous. The purchasing power of the people is quite low. If there is a huge rupee liquidity inflow into the system, the purchasing power would go up, there would be a huge demand for consumer and durable goods, and inflation would immediately shoot up. It is completely different from the European or Japanese economies. Japan is trying its level best to increase the inflation rate and targeting it at 2%. They are trying to transmit the impulses of the monetary policy across the credit and money markets in a big way, but it's not happening. The reason is the demography of Japan. It is skewed in favour of older people, whose spending capacity is pretty low, as they are living mostly on pensions. The result is that demand cannot be spruced up in a big way. On the other hand, India has a huge young population and unmet demand due to poverty. Anytime liquidity flows in to the system and gets transformed into income for the population, demand will increase and hence will inflation. When Russia was faced with a currency speculative attack, it raised interest rates by 650 basis points (6.5%; 100 basis points = 1%) in one stroke from 10.5% to 17% to attract forex flows. That was a desperate measure. Thankfully, India is not placed in a similar situation. Today India can calibrate its monetary policy because of the comfort provided by the macroeconomic policy parameters.

Amongst the various monetary policy instruments, the major ones are the LAF (Liquidity Adjustment Facility), Term Repo, Open Market Operations (OMO) and Cash Reserve Ratio (CRR). LAF consists of the Reverse Repo (which is the lowest point), the Repo (which is the mid-point) and the MSF (Marginal Standing Facility, which is the topmost point). The corridor within which RBI is operating for the purpose of monetary policy can be represented by the following graph:



This band between the reverse repo rate (6.75%) and the MSF rate (8.75%) is called the Interest Rate Corridor. The RBI operates within this Interest Rate Corridor. The Repo rate is the

policy rates that RBI changes; the other two rates adjust automatically. The corridor moves up or down, but the width of the corridor stays the same (200 basis points).

Effective Date	Bank Rate	Fix Range LAF Rates		Cash Reserve Ratio	Marginal Standing Facility	Statutory Liquidity Ratio
		Repo	Reverse			
04-03-2015	8.50	7.50	6.50	-	8.50	-
07-02-2015	-	-	-	-	-	21.50
15-01-2015	8.75	7.75	6.75	-	8.75	-
09-08-2014	-	-	-	-	-	22.00
14-06-2014	-	-	-	-	-	22.50
28-01-2014	9.00	8.00	7.00	-	9.00	-
29-10-2013	8.75	7.75	6.75	-	8.75	-
07-10-2013	9.00	-	-	-	9.00	-
20-09-2013	9.50	7.50	6.50	-	9.50	-
15-07-2013	10.25	-	-	-	10.25	-
03-05-2013	8.25	7.25	6.25	-	8.25	-
19-03-2013	8.50	7.50	6.50	-	8.50	-
09-02-2013	-	-	-	4.00	-	-
29-01-2013	8.75	7.75	6.75	-	8.75	-

Source : RBI

Some of the most important policy drivers for interest rates are:

1. **Inflation-** Inflation is the most important policy driver. With the softening of inflation, RBI lowered the interest rates, and thereby gave a trigger to demand. If RBI gives this trigger when inflation is high, inflation will increase further on the back of increased spending. Hence inflation has to be low for RBI to reduce rates.
2. **Output gap** -The country is still operating with a sufficient amount of output gap. That means the country is operating at a level lower than its full potential. So when RBI lowers the interest rates, people start operating the unused capacity and produce more goods that would be consumed without creating any excess capacity. This would ensure that inflation does not go up as a result of the rate cut. Further, in future, as the excess capacity is utilised and interest rates remain low, even more capital expenditure takes place through bank loans and the overall investment increases. The result is creation of even more capacity that creates a buffer of output gap for the future.

3. **Growth** – Presently, growth is floundering in India. The manufacturing activity has calmed down considerably, so unless interest rates are brought down, there is no incentive to borrow from banks. RBI tried to give a pep to the manufacturing activity by bringing down interest rates.
4. **Operating target** – In order to analyse if the policy is getting transmitted to the system, RBI's first point of reference is the call money market. It also looks at the CBLO (Collateralized Borrowing and Lending Obligation) market, market repos, Commercial Papers (CPs) and CDs. These are the major instruments in the money market. The average daily turnover in these instruments are - Call money Rs.15,000 crores, CBLO- Rs. 75,000 crores, Repo- Rs.30,000 crores, CPs – Rs.3000 crores, CDs – 7,000 crores. The weighted average call money rate is the policy operating target.

### **Role banks can play in this mechanism**

Most banks are holding excess SLR securities (instead of the mandated 21.5%, the current holding is 28.5%). Each percentage represents Rs.80,000 crores today, which translates into Rs.5,60,000 crores of excess SLR securities. A good part of this is in the hands of PSBs. These excess securities can be used by banks in a way that is profitable to banks and helps in a faster transmission of the monetary policy. Normally, if a bank is running a liquidity shortfall on a particular day, it borrows from RBI's LAF window on a collateralized basis (only excess SLR held in the form of Gov securities and State Government securities is eligible). If a bank has excess SLR at the time of a rate cut, it can borrow upto 0.25% of its Demand & Time Liabilities (DTL) at the LAF rate from RBI, and on-lend it to other banks in the call money market at the higher prevalent rate, thus realising a profit. This would help the monetary policy to be transmitted to the call money market gradually.

Second part of the transmission is CPs. Banks can and do invest in CPs as an alternate to working capital loans. When corporates are able to float CPs at new rates in line with the monetary policy, transmission is seen to have taken place. This transmission can be brought about by borrowing in LAF against excess SLR securities and investing in CPs. However, an additional factor to be taken care of in these deals is the ALM mismatch. Whether banks borrow in LAF overnight or in term repo for 14 days, it would need to create an equivalent maturity asset. Otherwise the investment will have to be made in accordance with the gap available in the various maturity buckets. These can be actively explored, and will help the transmission of the monetary policy.

No. 29: Average Daily Turnover in Select Financial Markets								
( Billion)								
Item	2013-14	2014		2015				
		Jan. 31	Dec. 26	Jan. 2	Jan. 9	Jan. 16	Jan. 23	Jan. 30
	1	2	3	4	5	6	7	8
1 Call Money	230.7	218.8	210.7	258.6	176.1	167.6	209.7	224.8
2 Notice Money	71.6	64.9	92.1	59.5	83.5	64.9	79.1	111.8
3 Term Money	5.4	4.7	5.3	2.5	3.3	2.2	4.7	7.3
4 CBLO	1,196.3	1,117.9	1,125.2	1,272.9	1,236.7	1,270.5	1,134.6	1,242.7
5 Market Repo	986.8	745.8	949.4	944.7	1,200.7	1,178.5	1,372.7	1,109.5
6 Repo in Corporate Bond	0.3	–	–	–	–	–	–	–
7 Forex (US \$ million)	50,568	56,252	44,460	44,805	56,452	59,616	55,311	68,155
8 Govt. of India Dated Securities	662.5	526.9	738.1	776.5	1,005.4	1,109.0	1,013.4	764.1
9 State Govt. Securities	12.8	12.6	24.0	18.7	13.0	20.3	23.0	21.4
10 Treasury Bills								
10.1 91-Day	26.7	35.5	31.0	47.0	32.2	36.9	18.7	25.6
10.2 182-Day	12.9	18.8	7.7	10.5	5.8	10.2	2.8	13.5
10.3 364-Day	25.4	17.3	9.5	15.2	30.2	26.3	32.4	53.5
10.4 Cash Management Bills	7.3	–	–	–	–	–	–	–
11 Total Govt. Securities (8+9+10)	747.6	611.1	810.2	867.9	1,086.6	1,202.7	1,090.3	878.2
11.1 RBI	4.0	–	3.3	5.2	3.5	9.6	0.8	2.9

Source : RBI

Banks should manage this through a very active treasury. There is no shortage of talent pool in the PSBs. However, the control systems and a reluctant attitude prevent banks from being active in this area. The mark-to-market (MTM) risk of excess SLR securities can also be managed by an active bank treasury through hedging instruments like Interest Rate Futures (IRFs) and Overnight Index Swaps (OIS). The OIS market is dominated by 8-9 foreign banks, despite the fact that all banks are allowed to deal in it. Even the private sector banks play a subdued role. This is a culture that needs to be inculcated in PSBs. Banks should not plunge recklessly into these markets, but with proper checks and controls, with defined open positions for your dealers and for the treasury as a whole, banks should be able to take advantage of these markets. This would augment the balance sheet without resulting in an NPA problem, and the transmission mechanism in the system would improve considerably. Currently in India, the transmission time is around 3-4 quarters for impacting inflation. Banks follow suit as per circumstances over a period of time.

From a bank's point of view, transmission is important, as monetary policy changes get reflected in the balance sheet through the cost of funds that they borrow from RBI. It should hence get reflected in cost of deposits and lending as well. If banks don't borrow from RBI at all, the transmission is not going to seep through, except by way of moral suasion. Ultimately, the

transmission has to seep through the entire market instruments, especially as the market is very active. If banks' treasuries take an active part in these markets, they have enough opportunities to take advantage of.

One of these areas is retail housing loans. These rates are highly interest rate sensitive, and the passing on of a rate cut can help banks augment their balance sheet. While an excessively large portfolio of retail mortgages is not recommended, the banking sector has not yet realised the full potential of this segment. This sector plays a large role in kick starting the economy through demand for steel, cement etc., and thus helps in realising the objective of a rate cut.

The other instruments of liquidity are Open Market Operations, Cash Reserve Ratio, and forex market intervention.

### **Factors Affecting Liquidity**

Banking today has become very complicated. Unless banks keep in touch with the day to day developments, it becomes very difficult to take advantage of the emerging environment. Some of the factors affecting liquidity that banks need to keep in touch with are:

- ❖ Currency drain – Withdrawal or deposit of cash from/with banks changes the liquidity available in the banking system
- ❖ Government of India (GoI) balances with RBI – if GoI holds huge balances with RBI, liquidity in the system dries up, if the balances are small, liquidity in the system goes up
- ❖ Advance tax collections – When corporates make advance tax payments, liquidity dries up. When GoI pays coupons on G-Secs, liquidity goes up
- ❖ Auction of Govt balances – if RBI reduces rates on one hand and GoI is holding huge balances with RBI on the other hand, the whole effect nullifies and the transmission gets affected. As a part of the fixed rate and variable rate overnight repo, government balances with RBI are auctioned to banks. Any auction increases the liquidity in the system. If these balances can be disclosed to the market, the banks' research desks' liquidity predictions can be more accurate.