

Demonetisation may hurt RBI's balance sheet temporarily

Govt bonds are used as securities against the central bank's overnight liquidity operations

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Banks on Tuesday deposited a record Rs 1.8 lakh crore of their surplus liquidity with the Reserve Bank of India (RBI), and this will likely increase in the coming days as the

demonetisation exercise will continue till December for the lenders.

But, does the Reserve Bank of India (RBI) have enough bonds in its balance sheet that can be mortgaged against the surplus deposits? Experts are divided on this.

Government bonds are used as securities against the central bank's overnight liquidity operations. While lending to banks, RBI takes these bonds, while keeping surplus funds of banks, the central bank uses bonds on its books as a collateral.

At any time, the central bank maintains a certain portion of its assets in government bonds. RBI comes to the secondary market anonymously to buy bonds when the asset class shrinks beyond a particular point. At the end of June 2016, the total bond holding of RBI was Rs 7 lakh crore.

However, if the demonetisation exercise turns out to be a grand success, banks' deposits with RBI will likely outstrip, or test the limits of the central bank's total bond holding, say experts.

“Due to restriction on withdrawal by the government and operational glitches, there are more deposits than

withdrawal. This may lead to excessive liquidity in the banking system – necessitating its sterilisation. Estimated G-Sec (government security) holding of RBI stands at Rs 6.5-7 trillion (lakh crore), suggesting the RBI will have to explore alternative and innovative ways for sterilisation of this liquidity glut,” said Soumyajit Niyogi, associate director, credit and market research group at India Ratings and Research.

This might hamper the central bank’s ability to act normally for months to come. While an official RBI response could not be obtained for this story, an official at the central bank said the rise in reverse repo amount is a technical strain. However, the official maintained that Rs 7 lakh crore of bonds are more than enough for any situation and the present situation will normalise within a month or so.

The total bank deposits, apart from the usual Rs 60,000-80,000 crore of mobilisation every month, are going to zoom because of this demonetisation exercise. After setting aside a portion of the money for mandatory bond investment (24.75 per cent in bonds and four per cent in cash), banks will park the excess money with the central bank as there is no other avenue to invest those funds in the absence of credit growth. There are even not enough bonds to buy to accommodate this money.

Therefore, according to experts, the more the government is successful in the scheme, the more painful it will be for the central bank to manage its balance sheet. RBI cannot go to the market to buy bonds to replenish its reserves as that will put further cash in the system.

While nobody knows how much money can be recovered from the demonetisation scheme, assuming the entire money worth Rs 14-15 lakh crore comes back as deposits and the restrictions on withdrawal continue till December, it would be a massive amount of liquidity for the banks and RBI to manage.

Therefore, RBI will have to use innovative and unconventional ways to conduct its liquidity operations. In fact, the central bank has already started doing it. On Wednesday, for the first time, it conducted reverse repo with a 91-day treasury bills.

Experts say it is just the starting.

“If demonetisation leads to collection of less than Rs 9-10 lakh crore, nothing will likely change, but if it is more than Rs 12 lakh crore, RBI for sure will increase the cash reserve ratio or will ask the government to issue special bonds under market stabilisation scheme, or will issue massive amount of cash management bills,” said the head of treasury at a foreign bank, asking not to be identified.

“The government will not use the money but it will remain with RBI as government cash balance,” said the banker. RBI cannot let go all its bond securities for the sake of its own liquidity. In any case, the situation will only compound for the banking system and RBI with every passing day of chaos. RBI, in this scenario, can only hope to print new notes fast enough and restore liquidity in the hands of the public as soon as possible.