THE HINDU BusinessLine

Why the temporary hike in CRR

Our Bureau

Surplus liquidity in the banking system was inching closer to RBI's absorption capacity, say Citi India economists

Mumbai, November 28:

The CRR requirement for banks have temporarily risen by ₹ 3.2 lakh crore following the RBI announcing a temporary hike in cash reserve ratio (CRR) on Saturday. The current CRR is 4 per cent or about ₹ 4.1 lakh crore.

The RBI has asked banks to set aside 100 per cent of the deposits accrued between September 16 and November 11 as incremental CRR. This will be reviewed in a fortnight. It has done this to address the surplus liquidity in the banking system emerging from the government's demonetisation scheme.

Three factors

Samiran Chakraborty, Chief Economist, and Anurag Jha, Economist, at Citi India, said in a report that there could be three motivations for the move.

First, the surplus in the banking system, at about ₹ 5 lakh crore, was inching closer to the maximum absorption capacity of the central bank. The RBI had ₹ 7.5 lakh crore of government securities (G-Secs) prior to the demonetisation drive, which act as collateral to absorb banking system surplus through the reverse repo window.

The RBI's estimate of deposit accretion going forward might have prompted them to announce a large CRR hike which would obviate any discussion around RBI running short of G-Secs.

Second, the process of putting in place other liquidity-absorption measures such as issuance of Market Stabilisation Scheme (MSS) bonds was taking time.

The issuance limit of MSS bonds for this year was set at ₹ 30,000 crore earlier, which was too small given the liquidity-absorption requirement.

And, third, the strong action could also be aimed at signalling RBI's reluctance on market interest rates falling too sharply, too soon in the present global context.

The surplus rupee liquidity and sharply falling rates were also creating distortions in the forward premia and indirectly impacting the spot dollar-rupee rate. This liquidity-absorption measure could reverse some of these distortions.

Surplus to remain

Citi India's economists predicted a temporary shift to repo mode. Given the excess liquidity in the banking system, of ₹ 5 lakh crore plus incremental CRR requirement of around ₹ 3.2 lakh crore, the liquidity would remain in surplus even after this measure.

However, for a brief period, the banking system will need to borrow from the repo/term repo window, since large part of the surplus liquidity of the banking system (₹ 3.5 lakh crore on November 28) is trapped in longer term reverse repos.

Bond yields could see knee-jerk reaction of 15 basis points and the reduction in lending and deposit rates might halt for now (as banks lose 750 crore of interest income on the incremental CRR).

The other triggers

- ***Putting in place other liquidity-absorption measures such as issuance of Market Stabilisation Scheme bonds was taking time***
- ***RBI's reluctance to see market interest rates falling too sharply, too soon in the present global context***

(This article was published in the Business Line print edition dated November 29, 2016)