

RBI's liquidity committee favours long-term lending operations

Existing liquidity framework good enough, says internal committee

Anup Roy | Mumbai September 26, 2019 Last Updated at 21:17 IST



Reserve Bank of India

An internal working group of the Reserve Bank of India (RBI) to review the current liquidity management framework has said that the existing framework can continue with some minor changes. The panel, however, said the central bank can minimise its secondary market bond purchases, and instead use longer term lending

operations as a new tool to infuse liquidity in the system. This, the panel said, would help offset build-up of a large deficit or surplus.

This is slightly contrary to what RBI Governor Shaktikanta Das had said on the June 6 monetary policy committee (MPC) that the existing framework, while serving well for years, needed a review considering the complexities that have arisen over the years.

The market was expecting the framework to be strictly rule-based, where the central bank would clearly state what would be the course of action — open market operations (OMO) in bonds, and even policy rate actions — if the systemic liquidity surplus or deficit crossed a certain level.

RBI does OMO to buy and sell bonds from the secondary market to infuse or remove liquidity from the system.

The report suggested that the 'corridor' system, or lending banks at repo rate (5.40 per cent now) and parking excess money at reverse repo rate (5.15 per cent), should continue. Such corridor system "affords the desired flexibility to manage situations of liquidity deficit as well as liquidity surplus and given that the repo rate is the policy rate set by the MPC," the report said.

According to a senior bond market participant, this would mean that the liquidity will continue to influence policy rate decision as before, but only by the collective judgment of the six MPC members, half of whom are from the RBI, including the governor.

"The bond yields will harden, as the report is clearly stating that long-term repo be used instead of OMO to minimise hardening yields disruption. The bond market has no reason to cheer without OMO support," said the bond trader.

The group recommended that as an alternative to OMO purchases, "longer-term variable rate repos, longer than 14 days and up to one-year tenor, be considered as a new tool for liquidity injection if system liquidity is in a large deficit. Similarly, longer-term variable-rate reverse-repos could be used to absorb excess liquidity. As these are possible substitutes for OMOs, these instruments should be operated at market determined rates."

The group was constituted with a view to simplifying the framework and suggesting measures to clearly communicate the objectives and the toolkit for liquidity management.

The main guiding principle of the working group was to ensure the call money rate remained close to the policy rate, should be consistent with the policy rate, and should not undermine the price discovery in the inter-bank money market.

The group said the call money rate, which is the interbank rate for borrowing and lending funds, should continue as the target rate of the liquidity management framework.

However, banks should have the incentive to trade among themselves rather than only with the central bank. This can be done by enabling banks to borrow in the inter-bank money market at rates not higher than the repo rate and should be able to lend in the inter-bank money market at rates not below the reverse repo rate.

While the framework generally requires the system liquidity to be in a small deficit of about 0.25 per cent - 0.5 per cent of the banking system deposit base, "if financial conditions warrant a situation of liquidity surplus, the framework could be used flexibly, with variable rate operations, to ensure that the call money rate remains close to the policy repo rate."

However, the current provision of assure liquidity of up to 1 per cent of deposit base would no longer be necessary since the proposed liquidity framework would entirely meet the system's liquidity needs.

"Thus, liquidity operations shall take into consideration prevailing conditions, based on which the required tools will be used to achieve the objective of the liquidity management framework," the group suggested.

"The RBI should stand ready to undertake intra-day fine-tuning operations, if necessary; however, such operations should be the exception to address unforeseeable intra-day shocks rather than the rule," the group said.

Therefore, the RBI should minimise the number of operations to improve the efficiency goal of the liquidity framework. Thus, there should be one single overnight variable rate operation in a day, supported by fine-tuning operations, if required.

Build-up of large deficit or surplus should be offset through durable liquidity operations. Apart from the OMOs, and forex swaps, longer term repo operations can be considered, it said.

Also, the daily dissemination through press release should be improved by including the 'flow' impact of liquidity operations. Besides, quantitative assessment of durable liquidity conditions of the banking system should also be published, the report stated.

The group said primary dealers can be allowed to take part in the daily liquidity operations.

RECOMMENDATIONS

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| <ul style="list-style-type: none">Existing rate corridor system should continueCall money should continue to be the target rate | <ul style="list-style-type: none">14 days to 1-year repo should be a new toolUse of instruments such as OMOs should be | <ul style="list-style-type: none">minimisedFramework should be flexible, RBI should be ready to infuse liquidity |
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