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CAN OPEN MARKET OPERATIONS EASE TIGHT LIQUIDITY CONDITIONS?

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Banking, NPAs and RBI

The latest monetary policy statement highlighted the issue of liquidity crunch being faced by the banking system. The statement noted that the tight liquidity conditions had led to overnight call money rate breaching the policy corridor on several occasions. Consequently, the Reserve Bank of India (RBI) decided to scale up its open market operations (OMO) in December and January. It further added that liquidity conditions will continue to be monitored and depending on the assessment, RBI will consider similar quantum of OMO purchases until the end of March 2019.

The accompanying chart measures the tight monetary conditions in terms of quantities by plotting the RBI's provision of funds in the form of overnight and term repos under the liquidity adjustment facility (LAF) in response to banks' demand for liquidity. As can be seen, in the current fiscal, liquidity remained in a comfortable position and mostly in excess, in the first two quarters. On an average, there was an excess of nearly Rs. 1,000 crore between April 2018 and mid-September 2018.

Liquidity shortfall

However, there was a huge shortage of liquidity between September 15 and 26 averaging Rs. 1.18 lakh crore. The RBI, consequently, announced OMOs of Rs. 30,000 crore. This move did ease liquidity temporarily but it (the shortage) again shot up October 15 onwards. Since, then, liquidity deficit had averaged nearly Rs. 90,000 crore. In fact, as on December 26, liquidity deficit was in excess of Rs. 1.8 lakh crore.

Remember, the RBI had changed its liquidity management objective in June 2016. Prior to this period, the RBI used to maintain ex ante liquidity deficit in the system at around 1% of net time and demand liabilities (NDTL) of banks. However, since June 2016, the stated objective of the RBI is to keep the ex ante liquidity closer to neutral position. Interestingly, at present, the deficit in the system is in excess of 1% of the NDTL.

The tight liquidity has shown up in prices as well. The weighted average call rate (WACR) traded above the policy repo rate only four times out of 124 trading days since the start of the current fiscal to second week of September. On average, the WACR was 13 basis points (bps) below the repo rate. However, since mid-September the WACR has traded above the policy repo rate 20 times out of 74 trading days and the spread between WACR and policy repo rate narrowed to just 8 bps.

What explains the surge in the liquidity deficit since mid-September of this fiscal? There are three key factors which have led to this situation. First, the growth in bank credit take-off has improved in last few months, however growth in bank deposits remain tepid. Second, growth in currency in circulation has also accelerated during this period. Third, and the most significant, the RBI had to draw down its foreign exchangereserves in excess of $32 billion, since the start of the current financial year, to smoothen exchange rate volatility. Consequently, liquidity in excess of Rs. 2 lakh crore has been sucked out of the system.

The RBI has responded to solve this issue by infusing liquidity through OMOs. The frequency of OMOs have increased considerably since September. The RBI has conducted 19 OMOs so far in this fiscal, of which, only six happened prior to September. In terms of value, in 2018-19, the

RBI has injected liquidity worth Rs. 1.62 lakh crore of which Rs. 1.35 lakh crore has happened since September. However, the OMOs so far have failed to provide requisite liquidity in the system.

So, what should be done next to solve this issue? To answer this question, we need to understand what methods were deployed in the past when a similar situation had arisen. Remember that the banking system was facing severe liquidity crunch in the last two quarters of 2015-16. The RBI, just as now, had responded by infusing liquidity through OMOs. In addition, the statutory liquidity ratio (SLR) and the policy repo rate were also cut by 25bps each. In the current scenario as well, the RBI needs to resort to other methods of durable liquidity infusion given the ineffectiveness of OMO operations in solving the issue so far. A cumulative reduction in CRR and SLR by 1% would free up almost Rs. 1.2 lakh crore for the banks which will significantly improve liquidity issue that these banks are facing at the moment.

(The writer is from the Indian Economic Service. Views are personal)

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