RBI is holding a Tiger by the Tail

Having earned well deserved global accolades for its deft handling of the 2008-09 financial crisis, the Reserve Bank of India embarked upon a new journey in January 2010 when it started the current cycle of interest rate tightening. By that time, the country had recovered completely from the trauma that a worldwide recession had induced. In fact, with the GDP growth rate having crossed 8% again and the stock exchanges starting to boom, we all felt that the country was about to cross into the realms of a fairy tale.

Alas, inflation which had gone into negative territory in mid-2009, was again rearing its ugly head in late 2009 and the Reserve Bank felt it imperative to make its presence felt by initiating the first classic step to reduce the pressure on prices. Cash Reserve Ratio (CRR) was increased by 75 basis points (50+25) in February 2010. However, repo and reverse repo rates were left unchanged. This appeared to be somewhat strange as the excess system liquidity being absorbed by RBI every day through Repo auctions at time was just around Rs 700 billion, a figure that can hardly be described as a liquidity glut for a fast growing economy. Many observers were also surprised that RBI did not chose to increase the reverse repo rates instead which than stood at a historical low of 3.25%.

Baby steps with Repo and Reverse Repo rates….

Come March and the central bank increased the repo and reverse repo rates wef 19 March 2010 by a mere 25 bps each. Given that the inflation rates had nearly crossed into double digits (9.90%) by then, this appeared to be a baby step. Once again, on 20 April 2010, RBI increased both repo and reverse repo by another 25 bps (to 5.25% and 3.75% respectively) even though these were very low rates by Indian standards. In a system having free floating liquidity exceeding Rs 500 billion, a low return of 3.75% was hardly enough to make banks to go slow on asset purchases and increase loan rates. And yes, another CRR hike of 25 bps was also announced. By this time , the CRR hikes totaling 100 bps had effectively removed roughly Rs 450 billion from the banking system.

Giant Steps with CRR….

The RBI has continued to increase repo and reverse repo rates every second month in its battle against inflation which has actually started tapering off. However, it is the CRR hikes that have been the source of a lot of misgivings in financial circles. When RBI increased the rates in the earlier part of the year, it did not factor in a slower growth rate of deposits which stands at 15% Yoy as against 18.4% in the previous year. It also did not account for the auction of 3G spectrum which took away over Rs 1100 billion of liquidity from banking system into government coffers. Further, it did not consider a higher than budgeted growth in tax revenues and lastly it looked on helplessly as a rich Government preferred to keep overflowing coffers and did not increase its spending significantly or else even reduce the scheduled borrowing. All these factors combined to suck out precious money and the system became negative in early June 2010. This then was the cue for RBI to release banks's own money that had earlier been impounded in the CRR hikes. But it did not happen.

The banks began to borrow from RBI small amounts of about Rs 50 to 60 billion in June which increased to Rs 500 billion in September to Rs 800 billion in October and finally peaked to Rs 1720 billion in December 2010.

Negative Liquidity as a Policy…..

In the meantime, RBI steadfastly refused to even consider decreasing CRR and even stated in its October policy that the negative system liquidity was consistent with RBI's monetary stance (http://www.rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=23351). As the liquidity situation deteriorated, the Bank introduced twice a day repo auctions and allowed commercial banks to maintain lower SLR(government securities holding) at 24% instead of 25%. At the end of November '10 a squeezed out system led RBI to allow banks higher access to repo funds and further allowed them to temporarily maintain SLR at 23% instead of the stipulated 25%. Still no cut in CRR was offered. As the situation did not improve, RBI entered the market through open market operations to buy GOI securities. But the seemingly straightforward CRR cut was not announced. And then came the mid –mid policy review of December 16, 2010.

Quantitative easing India style….

In a strange series of steps, RBI decided to introduce liquidity by reducing SLR permanently by 1% to 24%. This would reduce banks' investments in GOI securities by roughly Rs 480 billion. But who would buy the securities ? After all, almost all banks would turn into net sellers as a result of this step. Therefore, in a first step of its kind, RBI also simultaneously offered to buy Rs 480 billion worth of securities from banks through a number of weekly OMOs.

Thus, we are now witnessing the very odd situations as under. Every Wednesday, the central bank announces and buys GOI from banks for Rs.120 billion; every other Friday the same Central Bank also helps the Government to place fresh securities with the same banks despite the overflowing coffers; every day the same central bank lends Rs 1500 billion in repos to beleaguered banks to help tide over liquidity shortage; and the same central bank also continues to hold over Rs 2800 billion of Cash Reserves impounded from these very banks including 450 billion taken over during 2010 itself. Thus, the government is selling securities to banks which is selling these securities to RBI whose stock must be reaching historical proportions.

Letting go of the tiger's tail - gradually ….

It is becoming increasingly difficult for observers to understand the very unusual equilibrium which the central bank has imposed upon itself and upon the Indian banking system. The reasons for avoiding a cut in CRR while giving an unworkable cut in SLR are also difficult to fathom. It would appear that the RBI (by initially reducing liquidity sharply) appears to have caught the proverbial tiger by the tail and is now finding it difficult to let go and is , hence, now being pulled around by the ferocious tiger. One may advocate the RBI to opt for a safer landing by reducing CRR and give immediate relief to the banking system and also prod the government to spend more and allow the banking deposits grow at a healthier pace.

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