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Role of Liquidity Management in India's Monetary Policy

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Critical role of Liquidity Management in Monetary Policy

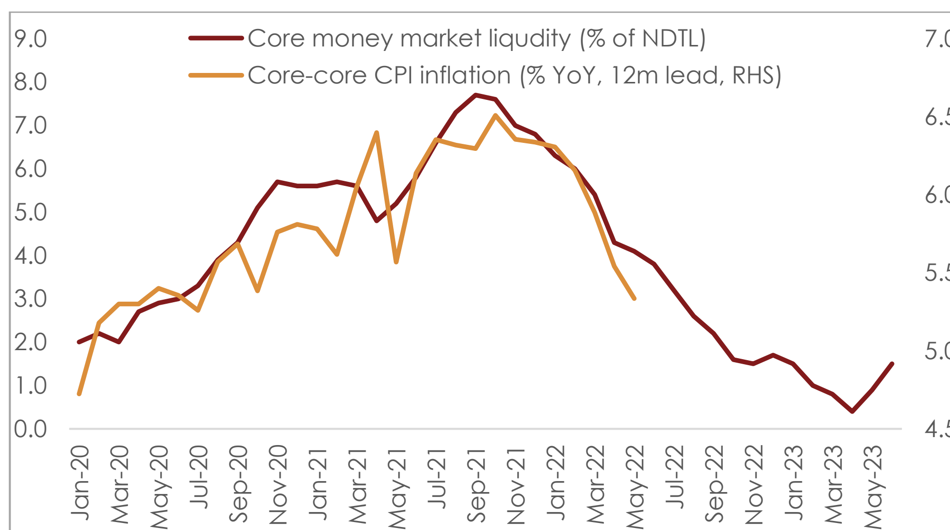
Money market plays a crucial role in transmitting monetary policy signals. Most central banks in the world target some form of short-term interest rate (usually of one day tenor) that impacts price of money, and thereby determines overall price stability in the economy via inflation and exchange rate. At the same time, central banks can also influence the quantity of money (which can be understood as money market liquidity) through their balance sheet operations to send out a concerted policy signal.

Liquidity and inflation: The Indian economy context

In case of India, the Monetary Policy Committee (an integral part of RBI) has been using the repo rate to maintain price stability. In addition, the RBI has been using money market operations to modulate liquidity conditions in accordance with the overall monetary policy objectives. As per RBI's Report on Currency and Finance 2021-22, liquidity surplus of more than 1.5% of NDTL could be inflationary:

- One percentage point exogenous increase in liquidity surplus above this threshold value could push up inflation by 60 bps on an average in a year.
- The inflation impact is statistically significant after 6-months and persists for long – potentially having a cumulative impact of as much as 200 bps on inflation over a period of 18-months.

Chart 1: Core liquidity tends to impact core-core inflation with a lag of 1-year



*Core-core CPI index excludes indices of Food, Fuel & light, and petrol, diesel, gold jewellery from Miscellaneous index. The data on inflation pushed back by a year to show the matching pattern.

The journey of liquidity in the post Covid world

During heightened uncertainty around the Covid period, most central banks employed huge liquidity stimulus as a form of policy accommodation (between Mar-20 and Sep-21, G4 central banks cumulatively infused a little over USD 10 trillion via asset purchases). In case of India, core money market liquidity surplus increased from

its pre pandemic levels of 2.2% of NDTL in Feb-20 to its peak of 7.7% in Sep-21. With economy showing signs of stabilization, the RBI commenced a gradual monetary policy normalization with core liquidity surplus moderating below the inflationary threshold of 1.5% of NDTL by Feb-23. However, recent autonomous actions like higher than budgeted dividend transfer to the central government (Rs 87,416 Cr) and withdrawal of Rs 2000 banknote from circulation has once again pushed core liquidity surplus towards the inflationary threshold of 1.5% of NDTL in Jun-23. Headline liquidity appears lower though, in comparison on account of bunching up of transient outflows due to quarterly advance tax payment and monthly GST payment.

Why liquidity management needs to aid monetary policy

From a monetary policy perspective, the Indian economy currently appears to be in a Goldilocks scenario[1]*. Nevertheless, policy challenges continue to prevail:

- Notwithstanding the recent moderation, core inflation remains elevated, while showing downward rigidity.
- Strong likelihood of El Nino related disruption to south-west monsoon performance provides an upside risk to inflation estimates.
- Widening of divergence between domestic and foreign monetary policy could potentially have implications for exchange rate stability.

This requires monetary policy to remain nimble footed and cautious. While it is ideal for the RBI to maintain status quo on policy rate in the near term (rather than go for an insurance hike to address inflation risks) and help nurture the post pandemic growth momentum, it is equally important to emphasize caution via maintenance of non-inflationary liquidity conditions to dissuade market expectations of a premature monetary policy pivot while ensuring complete transmission of monetary policy signal.

Near term liquidity trajectory and creation of 'Liquidity Dam'

Core, or durable liquidity has been flirting with the inflationary threshold of 1.5% of NDTL since the third week of May-23 with support from autonomous drivers. Out of this:

- One has a known deterministic impact, i.e., the transfer of dividend by the RBI,
- While the other two carry a potential impact (build-up of FX Reserves by the RBI and withdrawal of Rs 2000 banknote from circulation) that needs to be estimated.

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[1] Goldilocks refers to a state where an economy is neither too hot nor too cold. This usually refers to a moderate level of economic growth accompanied by stable inflation.

- CPI inflation is widely expected to remain within the target band (RBI's projection of 5.1% inflation in FY24 would result in a tolerable deviation of 110 bps vs. the 4% target – the deviation stands much lower in comparison to what most major countries are likely to face).
- Among all major countries (with 2022 GDP size of at least USD 500 mn), the IMF projects India's GDP growth to consistently clock the highest position over 2023-2028. Nevertheless, on trend basis, India's GDP growth is projected to moderate to 6.1% between 2023-2028 compared to its own pre pandemic trend of 7.0% (observed between 2010-2019).

We project India's FY24 balance of payments at a surplus position of USD 24 bn compared to a deficit of USD 9 bn in FY23. At current exchange rate, this would potentially translate into a core liquidity infusion of Rs 2 trillion during FY24 (out of which, Rs 633 bn has already happened via net FX purchases by the RBI in Apr-23).

Moving on to assess the durable liquidity impact of withdrawal of Rs 2000 banknote, we estimate currency in circulation to have cumulatively declined by approximately Rs 1 trillion on seasonally adjusted basis (between week ending Jun 23rd and week ending May 26th). Having said so, we note that after the initial pace of decline in currency in circulation on account of Rs 2000 banknote returning to the banking system, the sequential momentum now seems to be moderating. Basis initial trend, we estimate approximately 78% of the stock of Rs 2000 banknote to be withdrawn by end Jun-23, 87% by end Jul-23, and the remainder by end Sep-23. Out of this, we expect 70-75% to return as bank deposits, while the remaining would get exchanged for lower denomination banknotes. The cumulative net liquidity impact of this would be in the range of Rs 1.0-1.3 trillion that will be realised between Jun-Sep 2023 in a front-loaded manner.

How does the central bank manage this surfeit of liquidity on account of autonomous factors without choking credit disbursal while also upholding of its anti-inflation stance? The best solution in this case would be to erect a dam. Like manmade dams, which impound and store water for flood control, water supply, energy generation, etc., the RBI can create a dam to temporarily impound money market liquidity and release it in a calibrated manner to ensure short term money market rates remain hugged to the policy repo rate. This can be achieved by deploying a host of instruments, viz., regular use of VRRR (variable rate reverse repo) auctions, announcement of graded sell-buy FX swaps, issuance of cash management bills, OMO sale, and a temporary CRR hike. Out of these, VRRR auctions and sell-buy FX swaps appear to be most suitable in the current macroeconomic environment.

Implication for bond market

While the market participants keep their focus on the benchmark rates, it is more important to understand and assess the liquidity management plan of RBI for better treasury decisions. From bond investors, the initial euphoria with respect to increase in liquidity on account of higher than budgeted RBI dividend and withdrawal of Rs 2000 banknote from circulation has waned. The creation of the Liquidity Dam to suitably mop up headline money market liquidity will ensure yield curve slopes upward as long-term rates reflect fiscal pressures and a cautious monetary policy stance amidst inflation risks. The steady albeit moderate uptrend in 10 yr g-sec yields in the last 2 weeks is an indication in that direction.

Annexure – Additional Charts

Chart 2: Dividend payout by the RBI in FY24 has been 1.9x of the budgeted target

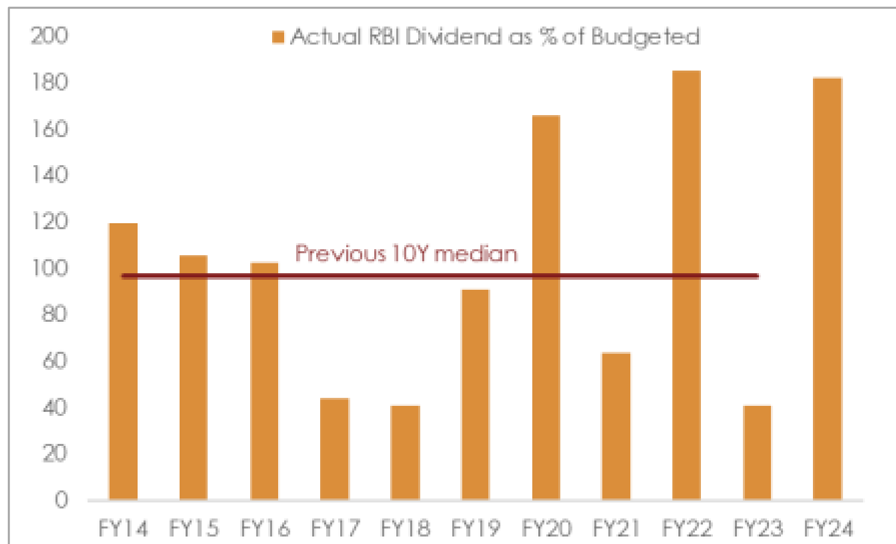


Chart 3: As of Mar-23, Rs 2000 banknote constituted 10.7% of currency in circulation

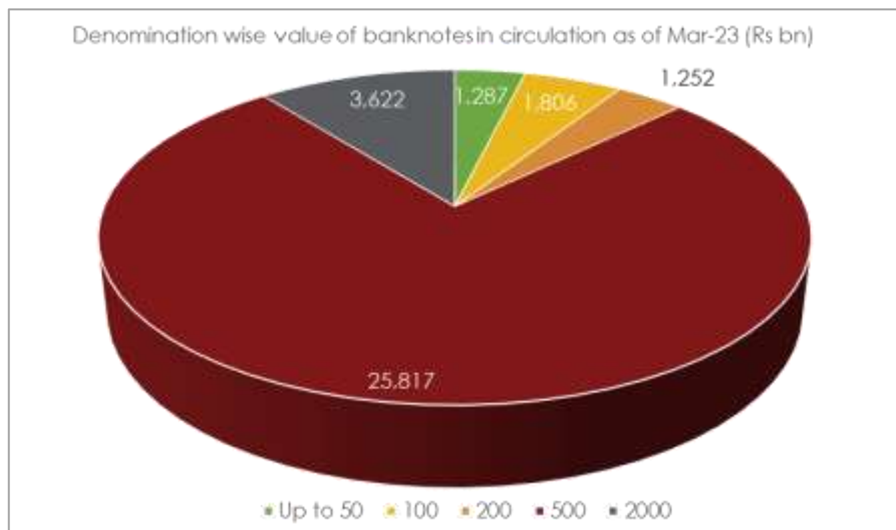


Chart 4: Withdrawal of Rs 2000 note resulted in a sharp fall in currency in circulation

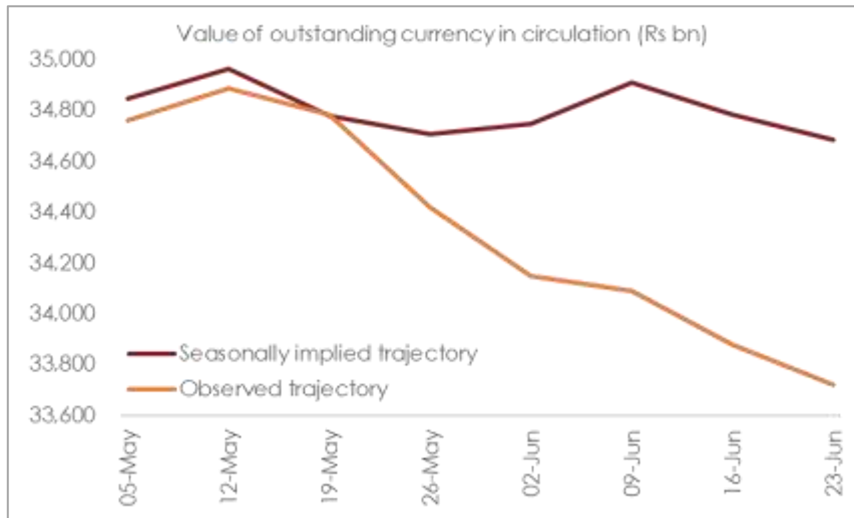
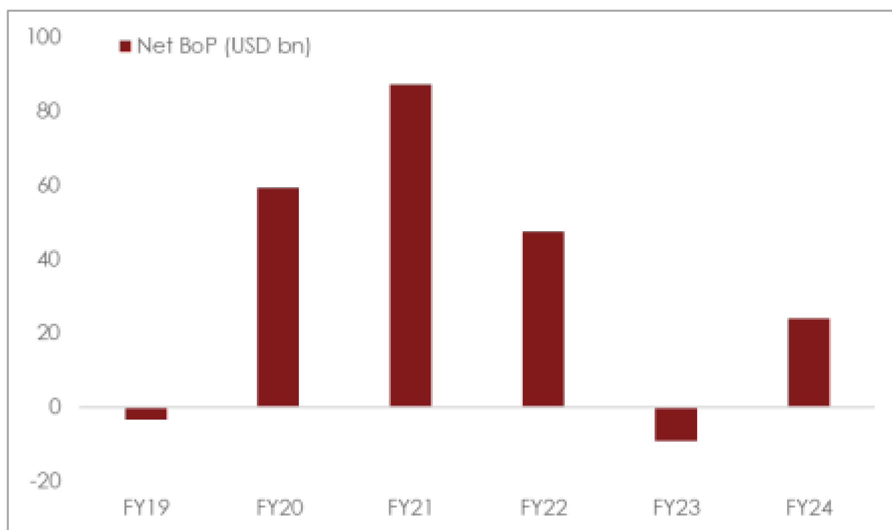
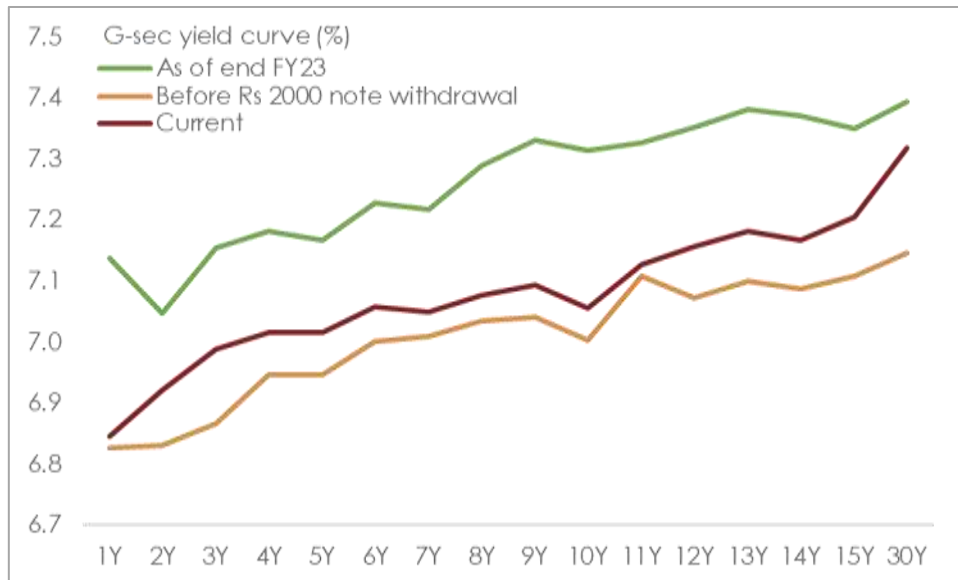


Chart 5: Projection of BoP surplus will support money market liquidity in FY24



Note: Number for FY24 denotes Acuite forecasts

Chart 6: A mildly upward sloping yield curve depicts macroeconomic stability



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