RBI and the liquidity question

The central bank has done well to make a distinction between short-term and durable liquidity, but that's not enough

C RANGARAJAN

The most important takeaway from the April bi-monthly monetary policy statement was the recognition and emphasis by the Reserve Bank of India of the need to supply 'durable liquidity' in the economy. The liquidity requirements, as the policy statement elaborates, are of two types — temporary and durable.

Short-term or temporary liquidity arises out of temporary mismatches between assets and liabilities. The first recourse to meet such a situation is for banks to approach the money market and, in India, the call money market. The call money market can, however, be the answer only in situations where some banks have excess liquidity and some others are in deficit. But there can be situations where the temporary need may be felt by the entire banking system. In that situation, the only recourse is to go to the central bank.

In India, the various types of repo facilities are meant to meet this requirement. The repo rate is also a policy rate giving a signal to the banking system. In performing this function, the RBI is fulfilling its role as a lender of last resort.

The fine-tuning of repo facilities is a welcome development. However, meeting the temporary liquidity does not exhaust the functions of a central bank. There is a need to augment durable liquidity to "facilitate growth and to meet the transaction needs of the economy". The bi-monthly report states clearly that the RBI will meet the need for durable liquidity "by modulating the net foreign assets and net domestic assets growth over the course of the year".

Determining durable liquidity

The key question is: How does one determine the quantum of durable liquidity that is required? In fact, in the earlier days, the term that was used for durable liquidity was simply 'money supply'. The regulation of money supply was sought to be linked to the expected increase in real output and the income elasticity of demand for money.

Also, assuming a fixed relationship between money supply and reserve money, the RBI tried to regulate the extent of the creation of reserve money. So long as the interest rate structure was 'administered' by the RBI, regulation of money supply was the only option open to it. However, our own history prior to the launch of reforms in 1991 clearly shows that because of the automatic monetisation of fiscal deficit, the RBI was fighting a losing battle in controlling money supply. That is why one of the early actions in the reform process was to get away from the issue of ad hoc treasury bills.

However, there were other problems with regulating money supply. The estimation of the required growth of money rested on the assumption of a reasonably stable demand function of money. There have been doubts about this. Targeting money supply also required a stable relationship between money supply and reserve money which is under the control of the RBI.

Solid state Of monetary affairs MOREMARI/SHUTTERSTOCK.COM

Having said this, there has to be some way of assessing the required level of liquidity. In the April bi-monthly report, there is no mention of the change in money supply or any other liquidity metric.

Transmission mechanism

There has been considerable discussion in recent months about the transmission mechanism. The repo rate changes have not so far been fully reflected in the lending rates of banks. For this, there could be several reasons.

The repo rate is a short-term rate and for that to get reflected in the long-term rate which is the relevant rate for influencing investment, there has to be an increase in durable liquidity. In fact earlier, the RBI used to warn commercial banks not to use the borrowing from the call money market as a basis for lending. As the bi-monthly report itself says, the provision of short-term liquidity does not substitute fully the need for durable liquidity.

In the earlier days a major source of the expansion of reserve money was RBI credit to government. This is no longer so. Changes in net foreign assets have become a major source of the creation of reserve money. This is what happens when the RBI buys foreign exchange from the market and builds reserves. The discretionary open market operations can be used to supplement and sometimes modulate the accretion of net foreign exchange assets. Of course, there have been occasions as in 2013 when there could be a sudden decline in the foreign exchange assets.

Quantity vs price

'Quantitative easing', a term that has become popular since the 2008 crisis, is a recognition of the fact that there are occasions when the focus of the central banks has to be on 'quantity' rather than 'price'. Even in normal circumstances, in equilibrium, quantity and price are simultaneously determined. Central banks cannot act like King Canute. They cannot order interest rates to behave. They must create conditions under which the desired changes in interest rate come about. The recent changes in policy repo rate might have had a more immediate effect if they had been coupled with a change in cash revenue ratio or with an explicit statement on injection of liquidity through open market operations.

Thus the assertion of the RBI in its April policy statement that it has decided to "smooth the supply of durable liquidity over the year using asset purchases and sales as needed" is welcome and is an important policy announcement.

However, there must be a methodology to assess the need for durable liquidity. If the old method is not tenable, what is the new one? The policy statements should share with the public the central bank's perception on the extent of liquidity in the system and whether it is sufficient. This will help banks take the appropriate decisions.

The writer was formerly governor of the RBI