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Return of the Market Stabilisation Scheme?

Balachandran R

Balachandran R is an alumnus of IIM Calcutta (1987-89) with extensive experience in corporate banking, investment banking and product management.

The Indian economy saw a surge in capital inflows in 2020, despite the Covid-19 pandemic, through foreign direct investment (for example, in Jio Telecom) and foreign portfolio investment (in the secondary markets). Despite this, the Rupee was reportedly the worst-performing Asian currency in 2020. Blame it on the RBI!

Why would the Reserve Bank of India keep the exchange rate low, risking the United States' wrath by potentially being labeled a currency manipulator? A Dollar deluge puts upward pressure on the Rupee. Imports become cheaper while exports can become uncompetitive. India, with the rare exception of the current financial year 2020-21 (till date i.e. February 2021), has been running a perennial current account deficit; in other words, our exports of goods and services and NRI remittances are not sufficient to meet our import bill. Exports are critical to managing the current account. RBI, therefore, needs to step in to curb excessive Rupee appreciation (which can make exports uncompetitive) in the face of capital inflows.

RBI's intervention in the FX markets

RBI's exchange rate policy is termed *managed float*. Unlike the developed market currencies (the US Dollar, Euro, Japanese Yen, Pound Sterling, Swiss Franc, etc.), which float freely with market conditions, RBI intervenes in the Foreign Exchange (FX) markets to curb volatility and speculative activity. In the scenario of excessive capital inflows, RBI purchases Dollars and sells Rupees.

Unintended Consequences on Domestic Liquidity

RBI's intervention in the FX markets leads to unintended consequences. In buying foreign currency assets (US Dollars), RBI unleashes an equivalent amount of Rupee liquidity into the system; when purchasing Dollars, RBI credits banks with Rupees, increasing the money supply. Where does RBI get the Rupees? It's from thin air!

Central banks not only print fiat currency, but they also create electronic currency when paying for the purchase of foreign currency assets and domestic assets (e.g., open market purchase operations of government securities). The former Chairman of the US Federal Reserve Ben Bernanke acquired the nickname of "Helicopter Ben" for his allusion to the central bank dropping money from a Helicopter!

Sterilization Operations

The Rupees infused into the system through RBI's FX market intervention can be potentially inflationary and cause short-term rates to fall below the policy repo rate. RBI has monetary policy tools for neutralizing or "sterilizing" the excess domestic liquidity. It can conduct open market sale operations of government securities. Such securities are purchased by banks and paid out of their "excess reserves." Here the purchase consideration is debited to their current account maintained with RBI, and the Rupees in the accounts of banks vanishes into thin air. It moves out of the system, thereby negating the rupee liquidity injected through RBI's intervention in the FX market.

Such sterilization can impact the central bank's surplus (profits). For example, RBI replaces higher yield domestic government securities (about 6.20% now for 10-year Indian government security) with a lower yield foreign currency asset (about 1.6% now for a 10-year US government Treasury bill).

Table 1 depicts the effect of RBI's FX market intervention, both for purchase and sale of FX.

Table 1: The effect of RBI's FX market intervention

Nature of Intervention	Effect on Foreign Currency Assets (FX Reserves)	Effect on Domestic Assets (Government Securities)	Effect on Liquidity in the Banking System/Money Supply
Non-Sterilized FX Intervention (Purchase)	Increases	No Impact	Increases
Sterilized FX Intervention (Purchase)	Increases	Decreases	No Impact
Non-Sterilized FX Intervention (Sale)	Decreases	No Impact	Decreases
Sterilized FX Intervention (Sale)	Decreases	Increases	No Impact

(Adapted from RBI's "Report on Currency and Finance")

MSS scheme

RBI has built up a war chest of about USD 600 billion of foreign currency assets through such interventions in the FX market. Continuous open market sale operations of domestic government securities to sterilize the consequent impact on Rupee liquidity can deplete RBI's stock of such securities. Therefore, the Market Stabilisation Scheme (MSS) was envisaged by which the Central Government would provide RBI with adequate stock of government securities to undertake sterilization activity. In paying for its subscription to the securities, RBI credits a separate cash account of the Government held with RBI. The original idea was that the funds would be sequestered and not form part of the Consolidated Fund of India. In other words, the money is not for the Government's use but for subsequent redemption of the securities issued under the MSS scheme. RBI can use the securities under MSS (on its balance sheet) to mop up the excessive domestic liquidity (arising from its FX market intervention) from banks. It is noteworthy that RBI does not appear to have conducted sterilization operations in the Covid-19 era, perhaps to keep domestic liquidity in surplus and mitigate the pandemic's impact on the economy.

Demonetization

RBI was not using MSS as a tool for a while, until demonetization. When Rs 500 and Rs 1000 currency notes were demonetized in November 2016, customers deposited the old notes into their savings accounts with banks. Next, banks deposited the demonetized currency with RBI, reducing the currency in circulation by a whopping amount of nearly Rs 9 lakh crores. When retail customers deposit currency notes into their savings account, their bank balance goes up accordingly. Subsequently, if banks deposit these currency notes with RBI their balances in their current accounts with RBI go up (in this case the balances went up by nearly Rs 9 lakh crores).

Demonetization led to a strange situation: the economy was starved of physical cash, while the banking system was awash with an unprecedented amount of liquidity. The excess liquidity in the system could potentially cause the rates in the interbank call money market to fall to the lower end of the interest rate corridor (the reverse repo rate). This sharp decline would negate the objective of RBI's day-to-day liquidity management operations to keep the weighted average call money rate around the repo rate.

RBI initially used its monetary policy tool, reverse repo, to absorb the excess liquidity. In this operation, RBI sells government securities to banks, with an agreement to repurchase them within a short tenor (usually overnight). In the first leg of the transaction, banks pay for their purchase from their current account with RBI. Thus, funds will move out from the banking system, thereby meeting RBI's objective of absorbing the excess liquidity created through demonetization. Open market sale operations are not the appropriate tool here since they

result in long-term draining of banking system liquidity; the need was to absorb temporary surplus liquidity conditions until "remonetization" happens.

100% Incremental CRR

Reverse repo operations too are constrained on account of the finite availability of stock of government securities on RBI's balance sheet. RBI could absorb only about Rs 5 lakh crores through reverse repo auctions out of the Rs 9 lakh crores excess liquidity in the system due to demonetization. Therefore, RBI used the ultimate weapon in its armory: an incremental cash reserve ratio (ICRR) of 100 percent on the increase in net demand and time liabilities (NDTL) of banks between September 16 and November 11, 2016, was applied. This drained the balance excess liquidity of Rs 4 lakh crores. Along with the reverse repo operation, the 100% incremental CRR thus led to the absorption of the entire excess liquidity of Rs 9 lakh crores created in the banking system on account of demonetization.

However, the use of 100% incremental CRR led to fresh issues. CRR balances maintained by banks with RBI are not remunerated. On the one hand, banks were paying interest on the savings account balances that had surged due to demonetization. On the other hand, banks were not to allowed to lend or invest this amount, to the extent of the incremental CRR. As a result, banks' income was being hit for no fault of theirs. RBI was forced to roll back its 100% incremental CRR mandate, leading back to excess banking system liquidity, to the extent not absorbed by reverse repo operations.

Subsequently, in an unprecedented move, RBI deployed the MSS tool, which was originally conceived for a different purpose: sterilizing banking system liquidity on account of intervention in the FX market. The Government provided about Rs 6 lakh crores of securities under MSS to RBI. Armed with this, RBI sold the securities to banks and absorbed the surplus liquidity. As "remonetization" in the economy happened over the next few months, the securities issued under MSS were redeemed, and normalcy returned to RBI's balance sheet.

In today's context of surging liquidity on account of RBI's intervention in the FX markets, talk of MSS is again doing the rounds, with a notable mention in the latest "Report on Currency and Finance" published on RBI's website.[1] However, neither RBI has endorsed the report as its official point of view, nor the Government has made any statement on an agreement with RBI to provide securities under the MSS scheme.

[1] https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=51187

Standing Deposit Facility

Except for CRR, the other monetary policy tools of RBI for absorbing the excess liquidity in the banking system depend on the availability of government securities, as RBI cannot "borrow" unsecured from banks. Therefore, the Standing Deposit Facility (SDF) was announced in the Union Budget 2018-29, through which RBI can absorb liquidity from banks without selling an equivalent amount of government securities.

Conclusion

With a sharp upswing in the yields on government securities post the February 2021 budget and an inadequate market appetite to finance the massive government borrowing plans, open market operation purchases of government securities may be the only option for RBI. The resultant surplus liquidity can be absorbed by the Standing Deposit Facility. However, RBI is yet to activate this monetary policy tool, though the Governor alluded to its use in a recent speech.

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