Liquidity Management Dilemma

This editorial is based on **RBI’s liquidity management dilemma** which was published in The Hindu Businessline on 28/06/2023. It talks about challenges of maintaining growth and inflation.

For Prelims: Monetary Policy**,** Reserve Bank of India**,** Repo Rate, Reverse Repo Rate**,** marginal standing facility**,** Covid-19 pandemic**,** cash reserve ratio and the statutory liquidity ratio**,** Fiscal Deficit**,** Union Budget**,** Open Market Operations**,** Standing Deposit Facility**,** Ways and mMeans Advances

For Mains: Challenges of RBI in Liquidity Management

The **Reserve Bank of India (RBI)** faces a **twin challenge of managing inflation and supporting growth** in the context of the **Covid-19 pandemic** and its aftermath. RBI’s job involves **balancing short-term as well as long-term growth**, ensuring **economic growth while meeting the inflation targets.** However, issues pertaining to the incomplete transmission of monetary policy and inherent weakness of inflation targeting approach, are some of the challenges faced by RBI.

The RBI’s monetary policy stance and liquidity management framework are the key instruments to address this challenge. **Managing liquidity** and **financing the fiscal deficit** are crucial in balancing the inflation-growth dynamic.

The **liquidity management dilemma adds complexity to the RBI's task,** requiring careful navigation of liquidity conditions to support growth while managing inflation.

What is the RBI’s Liquidity Management Dilemma?

The **RBI’s (Reserve Bank of India)** liquidity management dilemma is the challenge of balancing its objectives of price stability, growth and financial stability while dealing with the surplus liquidity situation and the government’s borrowing requirements. Some of the aspects of this dilemma are:

- **The Trade-off Between Inflation and Growth:**
    - The RBI **has to maintain an appropriate level of liquidity** in the banking system **to support the economic recovery and credit growth**, while also **keeping inflation within its target range.**
    - The RBI has to use its policy tools, such as the **repo rate, the reverse repo rate, the marginal standing facility, the** cash reserve ratio and the statutory liquidity ratio, to influence the cost and availability of money in the economy.
    - However, these **tools may have different effects** on inflation and growth, **depending on the prevailing economic conditions** and expectations.
- **The Coordination with Fiscal Policy:**
    - The RBI **has to support the financing of the** fiscal deficit in the context of **higher**

capital expenditure (3.32% of GDP) provisioned in the **Union Budget**, which aims to boost public investment and support economic recovery.
  - The RBI **has to manage the government's debt and cash balances**, conduct open market operations**, and participate in the primary and secondary markets for government securities.**
  - However, these activities **may have implications for liquidity management,** monetary policy transmission, market stability and central bank independence.
  - The RBI and the government need to coordinate and cooperate on their respective policies and operations to ensure consistency and effectiveness.
- **The Development of Financial Markets:**
  - The RBI has to use market-oriented instruments, such as **variable rate reverse repo auctions, open market sales and central bank debt securities,** to absorb surplus liquidity from the banking system.
  - These instruments **require a well-developed and liquid financial market to function effectively.**
  - However, the financial **markets may be underdeveloped, fragmented or volatile, which may limit the scope and effectiveness** of market-oriented instruments.

How can RBI Overcome the Liquidity Management Dilemma?

- **Active Use of** Standing Deposit Facility **(SDF):**
  - The RBI can **actively use the standing deposit facility to absorb surplus liquidity** from the banking system.
  - By doing so, the RBI can prevent excess money supply, which could lead to inflationary pressures in the economy.
- **Use of Instruments:**
  - The RBI can **utilize various instruments to manage** liquidity effectively which includes **variable rate reverse repo (VRRR)** auctions, open market sales, and adjustments to the standing deposit facility.
  - These tools can be **employed to absorb excess liquidity** from the system and maintain a balance between inflation and growth objectives.
- **Monitoring Cash Balances:**
  - The RBI should **closely monitor the cash balances** of the government with the central bank.
  - This involves analyzing the **patterns of government cash flows,** deposits, investments, and the use of **ways and means advances** (WMA).
  - By monitoring these factors, the RBI can identify any imbalances and take appropriate measures to manage liquidity effectively.
- **Strengthening Cash Management:**
  - The government needs to improve its cash management practices to avoid prolonged surplus or deficit cash positions with the RBI.
  - This includes ensuring that WMA is used for temporary cash flow mismatches rather than as a resource for financing the fiscal deficit.
  - By strengthening cash management, the government can reduce the impact on RBI's liquidity management and overall monetary management.

What are the Challenges of Using Market-Oriented Instruments for Liquidity Management?

- **Depend on the Availability and Depth of the Financial Markets:**
  - Market-oriented instruments, such as variable rate repo/reverse repo auctions, open market sales and central bank debt securities, require a well-developed and liquid financial market to function effectively.
- **Expose the Central Bank and the Financial Institutions to Market Risks:**
  - Market-oriented instruments, involve transactions in financial assets that are subject to price fluctuations due to changes in market conditions, such as interest rates, exchange rates, credit ratings and market sentiments.
  - These fluctuations may affect the value and returns of the assets and create losses or gains

for the central bank and the financial institutions.

- **Require a Robust Regulatory and Supervisory Framework:**
  - Market-oriented instruments, require a clear and consistent regulatory and supervisory framework to ensure transparency, accountability, compliance and risk management.
  - The central bank and the financial institutions need to have adequate policies, procedures, systems and controls to monitor and manage their liquidity positions and risks.
  - The regulators and supervisors need to have adequate powers, tools and resources to oversee and enforce the rules and standards.

What is Liquidity Management by RBI?

- **About:**
  - Liquidity management is one of the key functions of the Reserve Bank of India (RBI) to ensure smooth functioning of the financial system and effective transmission of monetary policy.
  - Liquidity management involves three aspects: the **operating framework, the drivers of liquidity, and the management of liquidity.**
- **The Operating Framework:**
  - The operating framework of liquidity management by RBI is guided by the Liquidity Adjustment Facility (LAF) corridor, which is a set of policy instruments that influence the overnight interest rates in the money market.
  - The LAF corridor consists of three rates:
    - The policy repo rate (PRR), which is the key policy rate at which RBI lends to banks;
    - The marginal standing facility (MSF) rate, which is the ceiling rate at which banks can borrow from RBI against government securities; and
    - The standing deposit facility (SDF) rate, which is the floor rate at which banks can deposit their excess funds with RBI without any collateral.
- **Objective:**
  - The objective of the LAF corridor is to keep the weighted average call rate (WACR), which is the operating target of RBI's monetary policy, in sync with the PRR.
  - The WACR is the average interest rate at which banks lend and borrow from each other in the overnight interbank market.
  - The PRR signals the stance of monetary policy and influences the cost and availability of money in the economy.
- **The Drivers of Liquidity:**
  - **Currency in circulation:**
    - This refers to the amount of cash held by the public outside banks. When people withdraw cash from banks or spend less cash, currency in circulation increases and reduces bank deposits and reserves.
    - This creates a liquidity deficit in the banking system.
    - When people deposit cash into banks or spend more cash, currency in circulation decreases and increases bank deposits and reserves.
    - This creates a liquidity surplus in the banking system.
  - **Net foreign exchange purchases/sales by RBI:**
    - This refers to the net amount of foreign currency that RBI buys or sells from/to the market.
    - When RBI buys foreign currency from exporters or other sources, it pays them in rupees and increases bank reserves and liquidity.
    - When RBI sells foreign currency to importers or other sources, it receives rupees and reduces bank reserves and liquidity.
  - **Government cash balances with RBI:**
    - This refers to the amount of money that the government has deposited with RBI for its expenditure and revenue purposes.
    - When the government spends more than it collects in taxes or other receipts, it draws down its cash balances with RBI and injects liquidity into the banking system.
    - When the government collects more than it spends, it accumulates its cash balances with RBI and drains liquidity from the banking system.
  - **Excess reserves maintained with RBI:**
    - This refers to the amount of money that banks voluntarily keep with RBI over and

above the statutory requirement of cash reserve ratio (CRR). CRR is the percentage of deposits that banks have to mandatorily maintain with RBI as a prudential measure.
- When banks keep more excess reserves with RBI, they reduce the availability of funds for lending and create a liquidity deficit in the banking system.
- When banks keep fewer excess reserves with RBI, they increase the availability of funds for lending and create a liquidity surplus in the banking system.

What Should be the Way Forward?

- **Monitoring Liquidity Position and Fiscal Deficit Financing:**
    - The RBI needs to remain agile and flexible in managing liquidity through two-way operations.
    - A closer watch on liquidity management and fiscal deficit financing will help strike a balance between inflation and growth objectives.
- **Strengthening the Monetary-Fiscal Interface:**
    - Strict monitoring of the liquidity position by the RBI and financing pattern of the fiscal deficit by the government is essential.
    - Addressing the issues of over-borrowing and improper cash management will improve the monetary-fiscal interface.
- **Evaluating Liquidity Management Instruments:**
    - The RBI should continuously evaluate the effectiveness of liquidity management instruments like VRRR and SDF to ensure stability.
- **Coordination Between Fiscal Policy and Monetary Policy:**
    - If the government truly wants to reduce lending rates in India in a meaningful and sustained manner, it would be far better served to focus on bringing down its own fiscal deficit.
    - Separating debt management from monetary management in order to make the central bank more independent would be a good move.

Drishti Mains Question:

The RBI’s liquidity management dilemma is the challenge of balancing its objectives of price stability, growth and financial stability while dealing with the surplus liquidity situation. Comment.

UPSC Civil Services Examination Previous Year’s Question (PYQs)

Prelims:

Q. If the RBI decides to adopt an expansionist monetary policy, which of the following would it not do? (2020)

1. Cut and optimise the Statutory Liquidity Ratio
2. Increase the Marginal Standing Facility Rate
3. Cut the Bank Rate and Repo Rate

Select the correct answer using the code given below:

(a) 1 and 2 only
(b) 2 only
(c) 1 and 3 only
(d) 1, 2 and 3

Ans: (b)

Mains:

Q. Do you agree with the view that steady GDP growth and low inflation have left the Indian economy in good shape? Give reasons in support of your arguments. **(2019)**