Experts see change of tack in RBI's liquidity handling

They say central bank is focused on durable relief rather than ad hoc support

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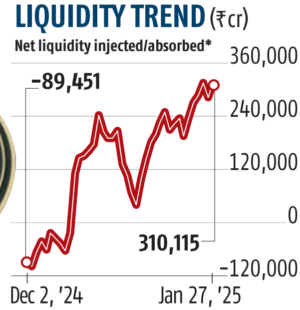
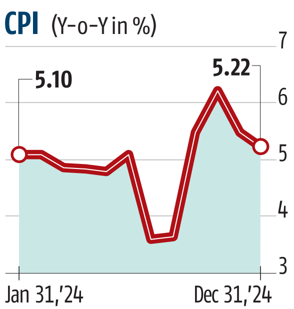
A wind of change is palpable in the Reserve Bank of India (RBI). On Monday, the central bank opened the liquidity floodgates, bringing relief to commercial banks and financial markets. The liquidity deficit, as measured by the RBI infusing funds through the liquidity adjustment facility (LAF), was over ₹3 trillion on several occasions in the past week.

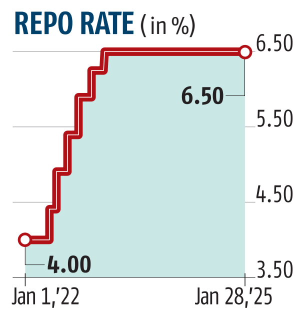
One of the key steps on Monday was the announcement of a calendar of open-market operations to purchase bonds — a first in five years.

Also, a 56-day variable rate repo auction was announced, which means banks do not have to return the money till the end of the financial year. Demand for funds is typically high at the quarter end because banks rush to meet business targets. The RBI also announced a $5 billion $-₹ buy-sell swap mainly to smooth the impact of the upcoming maturity of the massive short positions of the forward books.

"We believe the RBI's liquidity easing confirms that a regime shift is under way and a precursor to rate cuts," Nomura said in a report. "...(The) RBI's cumulative actions on liquidity are a clear signal of intent, and it is setting the stage for a repo rate cut on 7 February, a move that is long overdue, in our view, considering the deceleration in domestic demand," it said.







*- denotes surplus & + denotes deficit

Sources: Mospi, RBI, Bloomberg

Nomura expects a repo rate cut of 25 basis points in February and 100 basis points in 2025, taking the terminal policy rate to 5.50 per cent by the end of the year.

Radhika Rao, executive director and senior economist, DBS Bank, said: "There are signs of a shift in the central bank's approach to currency and liquidity management since late 2024. Addressing the liquidity deficit with a combination of tools suggests that the RBI is focused on providing durable relief rather than ad hoc support."

Monday's announcement was in addition to an assurance made on January 16 to conduct a daily variable rate repo auction until further notice.

In February 2020, the central bank announced a revised liquidity framework in which VRR auctions of up to 13 days were termed as fine-tuning operations while the 14-day VRR auction was a main operation. Bankers have been requesting the central bank to tweak the liquidity framework.

Market participants will wait for a clear communication from the central bank to confirm if there is change in the liquidity framework.

"Until the RBI announces a change in the liquidity-management framework, we continue to assume the 14-day repo is the main tool for liquidity management," said Vikas Jain, head of India FICC trading, Bank of America.

"...liquidity requirements of banks change over a fortnight as well and this needs to be modulated via a shorter-tenor VRR, which the RBI is now doing through daily VRR. Though there was suggestion from market participants to review the liquidity-management framework they have to wait till monetary policy in February for a final outcome," Jain said.

According to bankers, overnight rates hovering around the repo rate is no longer a comfort zone for the central bank.

Core liquidity (net LAF including the government's cash balance), which is in deficit mode for the first time since July 2019, may have prompted the OMO purchase decision.

Jain said the RBI had to inject about ₹3.0 trillion into the system and Monday's operations would release about ₹1.6 trillion. Hence ₹1.0-1.5 trillion more might have to be flushed in by the end of March.