January 14, 2021 I Economics

# RBI's Unconventional monetary Policy Tools: A Review


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With gradual restoration of economic conditions and persistent surplus liquidity in the banking system, the Reserve Bank of India (RBI) has announced to restore the normal liquidity management operations in a phased manner starting January 15, 2020.

The RBI had initially announced revised liquidity management framework in February 2020. However, even before the RBI could fully implement it, the pandemic posed serious challenge in front of the policy makers. The outbreak of the COVID-19 pandemic and subsequent nationwide lockdown announced towards end-March 2020 had disrupted the economic activities in the country. To mitigate the impact and to provide a monetary policy cushion, the revised liquidity management framework was suspended temporarily. The RBI had pulled out some unconventional monetary policy tools from its basket to mitigate any financial adversities arising from the pandemic. It also took a leaf out from the policies adopted by the central banks of the advanced economies to ensure ample liquidity and funds availability in the banking system to stem any adversities arising from the pandemic led disruptions.

In this report, we have taken a review of various unconventional monetary policy measures that the RBI had announced not only after the pandemic hit the country but also after the NBFC liquidity crisis.

## Conventional tools of liquidity management

The RBI manages liquidity in the banking system through the Liquidity Adjustment Facility (LAF). This entails repo operations - undertaken to infuse liquidity in the banking system if there is a liquidity deficit while the reverse repo operations are undertaken to absorb liquidity from the banking system owing to surplus liquidity with SCBs. Various instruments, which were available at the disposal of the RBI for this purpose include, fixed rate repo/reverse repo auctions, variable-rate repo/reverse repo auction, Marginal Standing Facility (MSF), Standing Deposit Facility (SDF), Open Market Operations (OMOs).

## What was the need for unconventional tools?

### *Pre-pandemic scenario*

- Despite substantial reduction in the repo rate by 135 basis points from 6.5% to 5.15% in October 2019 and other efforts, transmission of the rate cut remained muted on account of overhang of the NPA issue in the banking system, high term premium (i.e., difference between the overnight repo rate and yield on 10 year government security) over 100 basis points as well as credit spreads along with direct competition from the small saving schemes.

- In addition, mounting inflationary pressures and expectations of likely fiscal slippages by the central government owing to subdued tax collections kept the 10 year benchmark government security yields at elevated levels.
- Thus, to ensure lower borrowing cost by managing the bond yields and improve transmission of the past rate cuts, the RBI announced special OMOs, popularly termed as 'Operation Twist', in the month of December 2019.
- The central bank also introduced Long Term Repo Operations (LTROs) in February 2020 under its revised liquidity framework to kick start the cycle of lowering down borrowing cost by way of providing a durable liquidity to the banking system. The lower cost supports credit off take, boosts the investment and improves the aggregate demand in the economy.

***Post-pandemic scenario***

- Towards end-March 2020, the COVID-19 pandemic hit the economy and nationwide lockdown was announced to curb the spread of infection in the country. All businesses barring essential services were forced to shut for almost 3 months until the Unlock phase began since June 2020.
- Against this backdrop, on March 27, the RBI announced unscheduled monetary policy decision wherein it slashed the policy repo rate by 75 basis points to 4.4%. In addition, the RBI also announced a series of measures to address the stress in the financial conditions caused by the pandemic such as injecting sizeable liquidity in the financial system, ensuring credit flow, relaxation in repayment and debt servicing pressures and improving the functioning and stability of the financial markets such as Targeted Long Term Repo Operations (TLTROs) and Cash Reserve Ratio reduction.

## Unconventional tools explained

### 1. Simultaneous Purchase and Sale of OMOs 'Operation twist'

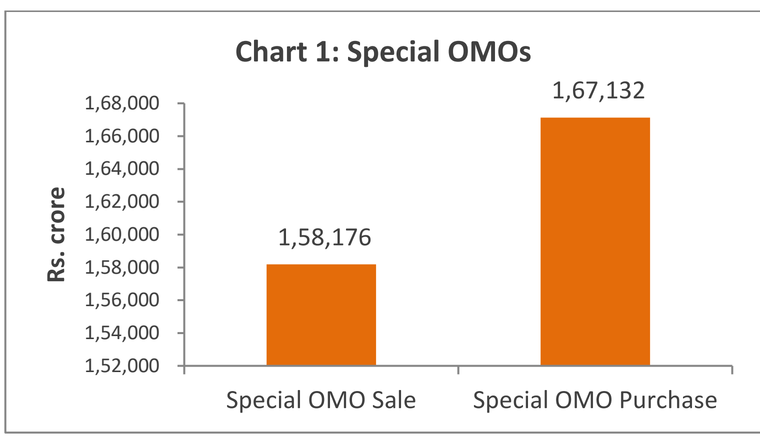
Operational twist is a term used for special OMOs i.e., simultaneous purchase and sale of OMOs of same quantum. The term 'operation twist' is coined because such operations tend to twist the yield curve by bringing down yields of the long duration papers and increasing yields of the shorter duration papers. The aim is to narrow the spread between the shorter and longer duration government securities. Herein, the central bank sells shorter duration papers and purchases longer duration papers using proceeds from sell of short term securities, leading to easing of interest rate on the long term papers. Because quantum purchased and sold through auctions is equal, such operations tend to be liquidity neutral.

The idea of operation twist was borrowed from the US Federal Reserve who applied this technique for the first time in 1961 and then in 2012. Operation Twist turned out to be so effective that the yield on the 10-year U.S. Treasury dropped to a 200-year low in 2012.

**Inverse relationship between price and yields of the securities**

**Sale (purchase) of securities → increase (decrease) in supply of papers → decrease (increase) in the price of security → yields go up (fall)**

The RBI has been undertaking Special OMOs since December 2019. Till January 8, 2021, 17 such auctions were conducted while another is scheduled on January 14, 2021. The special OMO purchases amounted to Rs. 1.67 lakh crore while sales aggregated to Rs. 1.58 lakh crore.




Note: Till January 8, 2021
Source: RBI

2. **LTROs**

As per the revised liquidity framework introduced in February 2020, a new instrument namely; LTROs with longer maturity (1 year and 3 year) was introduced. LTRO is a tool under which the central bank provides one-year to three-year money to banks at prevailing repo rate, accepting government securities with matching or higher tenure as the collateral. They provide durable liquidity to the banking system. These are intended to prevent short-term interest rates in the market from drifting away from the policy rate. By introducing the LTRO, the RBI emulated the action of European Central Bank (ECB) during the European financial crisis that began in 2008 and lasted for about three years. ECB had lent nearly € 1 trillion to various banks by way of LTROs to ease the liquidity situation particularly in the sovereign debt markets and to support credit starved households and non-financial firms. Through LTROs the RBI ensured durable liquidity supply to banks at reasonable cost relative to prevailing market conditions. This would further encourage banks to undertake maturity transformation smoothly and seamlessly so as to augment credit flows to productive sectors.

3. **Targeted Long term Repo Operations (TLTRO)**

In March 2020, the COVID-19 pandemic induced nation-wide lockdown was announced by the government force shutting various business operations. This ignited large sell-offs in the domestic equity, bond and forex market leading to spike in the liquidity premia on corporate bonds and commercial paper. In order to mitigate adverse effects on economic activity leading to pressures on cash flows, the RBI announced TLTROs to push the credit flow in the economy with certain inherent conditions. This helped banks get funds for a longer duration as compared to the short-term (up to 28 days) liquidity provided by the RBI through other tools such as liquidity adjustment facility (LAF) and marginal standing facility (MSF). The details of LTRO and TLTRO are listed in the following Table.

***Reversals***

Pursuant to the announcement made on August 31, 2020 on *Measures to Foster Orderly Market Conditions*, the RBI permitted banks to exercise an option of reversal of LTRO transactions before maturity. The objective was to allow banks to reduce their interest liability by returning funds taken at the repo rate of 5.15%. Further in the October 2020 monetary policy review, the banks were also given an option of reversing the funds availed under TLTRO 1.0 and TLTRO 2.0 before maturity.

Table 1: Snapshot of LTRO and TLTROs

| Particulars | LTRO | TLTRO 1.0 | TLTRO 2.0 | On Tap TLTRO |
|---|---|---|---|---|
| Announcement | Feb-20 | Mar-20 | Mar-20 | Oct-20 |
| Auction Date | Feb/March 2020 | March/April 2020 | April 23, 2020 | NA |
| Amount Auctioned (Rs. Cr.) | 1,25,000 | 1,00,000 | 25,000 | 1,00,000 |
| Amount Availed (Rs. Cr.) | 1,25,117 | 1,00,050 | 12,850 | NA |
| Tenure | 1 and 3 year | up to 3 years | up to 3 years | up to 3 years |
| Interest Rate | Repo rate (5.15%) | Floating rate linked to the policy repo rate | Floating rate linked to the policy repo rate | Floating rate linked to the policy repo rate |
| Deployment of funds | unconditional | - Fresh Investment grade corporate bonds, commercial paper and NCDs<br>- primary (50%) and secondary (50%) markets including from mutual funds and NBFCs | - Fresh Investment grade corporate bonds, commercial paper and NCDs<br>- 50% in issuances by small and mid-sized NBFCs and MFI. | - Fresh investment grade corporate bonds, commercial paper and NCDs<br>- Over and above outstanding debt as on September 30, 2020<br>- Sectors: Agriculture, agri-Infrastructure, secured retail, micro, small and medium enterprises (MSMEs), and drugs, pharmaceuticals, and healthcare sectors<br>- Extended to 26 stressed sectors identified by the KV Kamath committee |
| Reversals (Rs. Cr.) | -1,23,572 | -32,448 | -4,900 | NA |
| Outstanding (Rs. Cr.) | 1,545 | 67,602 | 7,950 | NA |

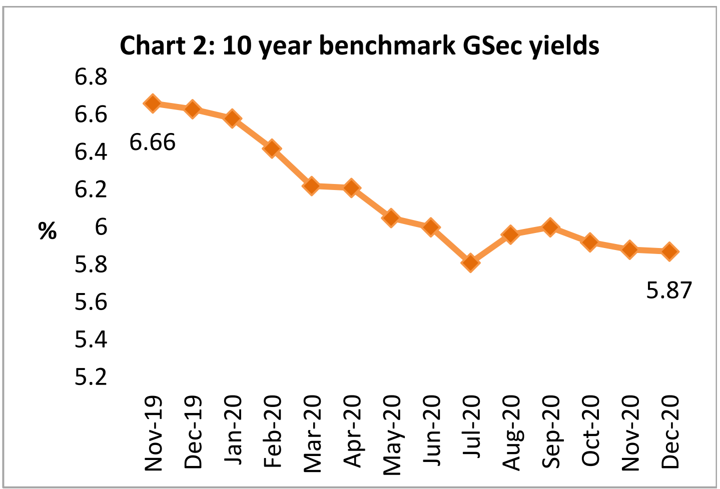
Source: RBI

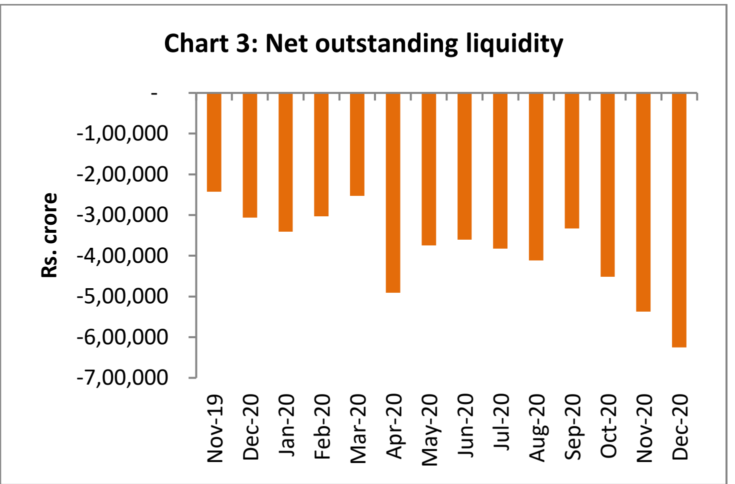
### 4. OMO purchase of state development loans (SDLs)

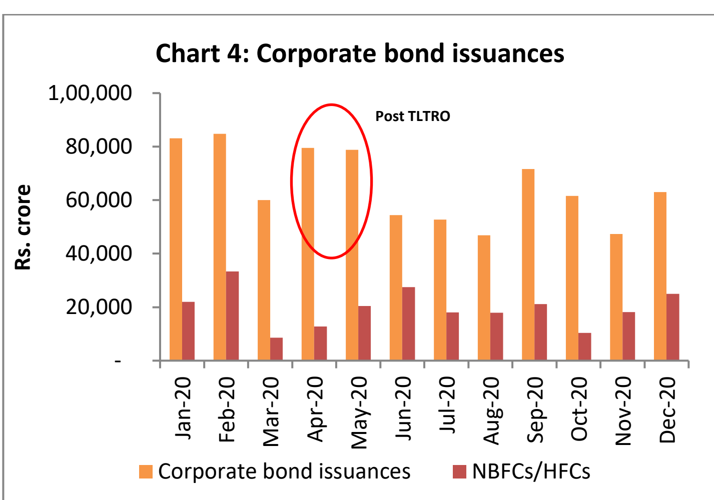
Fallout of COVID -19 pandemic, lockdowns announced by the central and the state government had bought economic activities to a near standstill. It has put extensive stress on the finances of the central and the state government. State governments ramped up their market borrowings to make up for the revenue shortfalls. The high quantum of market borrowings by the state government along with concerns over their fiscal deficit increased the cost of borrowing for the state government. The spreads of SDLs with 10 year maturity over benchmark 10 year government securities were above 60-70 bps since May 2020. With an aim to improve secondary market activity and rationalize spreads of SDLs over government securities of comparable maturities the RBI announced to conduct OMOs in SDLs as a special case during the current financial year. Since October 2020, the RBI has undertaken three auctions each amounting to Rs. 10,000 crore, aggregating Rs. 30,000 crore.

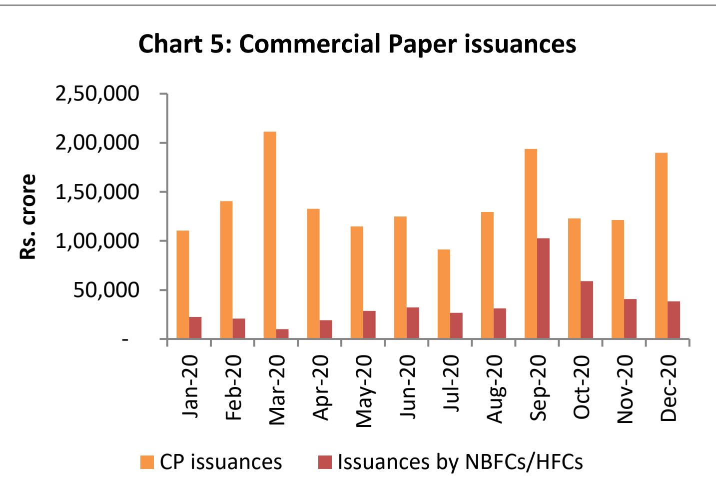
## What has been the impact of unconventional measures?

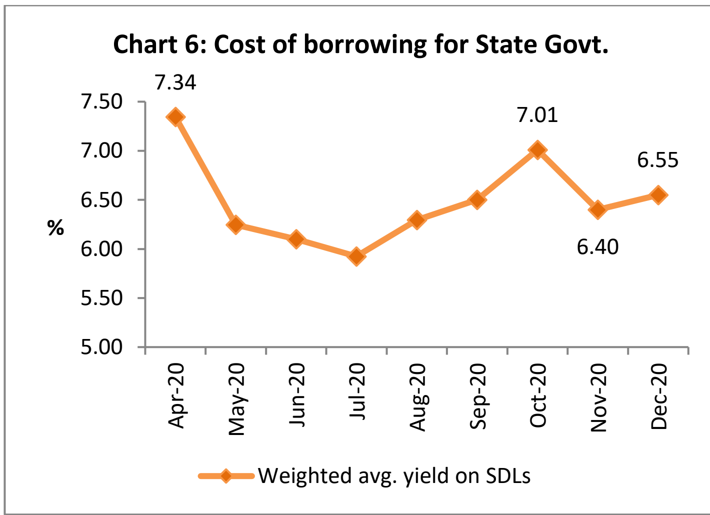
- Despite reduction in the policy repo rate, the 10 year benchmark GSec yields did not see commensurate decline on account of slow transmission, high inflation and concerns over fiscal slippages. Timely auctions of special OMOs since December 2019 coupled with reduction in the policy repo rate (from 5.15% in October 2019 to 4% in May 2020) have lowered the benchmark 10 year government securities yields by nearly 80 basis points and in turn lowered the cost of borrowing for the central government by nearly 120 basis points since December 2019.
- With injection of durable liquidity in the banking system by way of LTRO, TLTRO 1.0 and TLTRO 2.0 the system liquidity increased considerably with net outstanding liquidity ranging between Rs. 4-5 lakh crore during April-December 2020 from Rs. 2-3 lakh crore prior to March 2020.

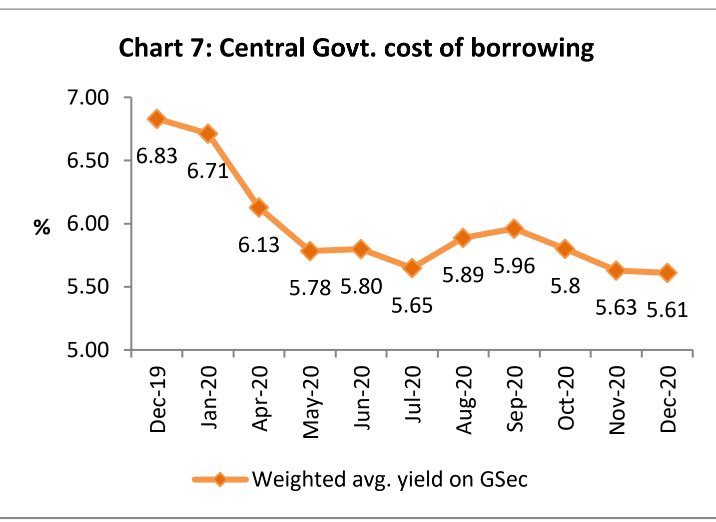



Source: RBI, Prime Database, FBIL, CARE Ratings estimates

- Corporate bond issuances increased in the month of April 2020 and May 2020 as a result of LTRO and TLTROs. The cumulative corporate bond issuances during 9M FY21 totalled Rs. 5.6 lakh crore, 23% higher than Rs. 4.51 lakh crore in 9M FY20. Corporate bond issuances by NBFCs/HFCs (~ 30% share in total) also increased from Rs. 1.4 lakh crore in 9M FY20 to Rs. 1.7 lakh crore in 9M FY21 – a growth by 24%.

- Commercial paper issuances, however, remained subdued during 9M FY21 at Rs. 12.2 lakh crore, 30% lower than Rs. 17.3 lakh crore in the corresponding period of last year. This can be ascribed to relatively high borrowing cost for these short term papers. Commercial paper issuances by NBFCs account for nearly 25% of total CP issuances on an average. During 9M FY21, the issuances by NBFCs increase by 12% to Rs. 3.8 lakh crore compared with Rs. 3.4 lakh crore in 9M FY20.
- The OMO purchase of SDLs announced in October 2020 helped lower the cost of borrowing for the state government (measured as weighted average yield on SDLs) by nearly 80 basis points to 6.55% in December 2020 from its April 2020 levels (7.34%).

**Concluding remarks**

Proactive and timely measures by the RBI have helped tide over the economic disruptions caused due to pandemic while ensuring gradual restoration of financial conditions. The RBI has reiterated its commitment to maintain adequate liquidity conditions in the system. Although the economic conditions are on recovery path, the pre-pandemic levels of economic activities are still some time away. The extension and introduction of such unconventional measures by the policymakers cannot be ruled out in the future if the situation demands it.

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