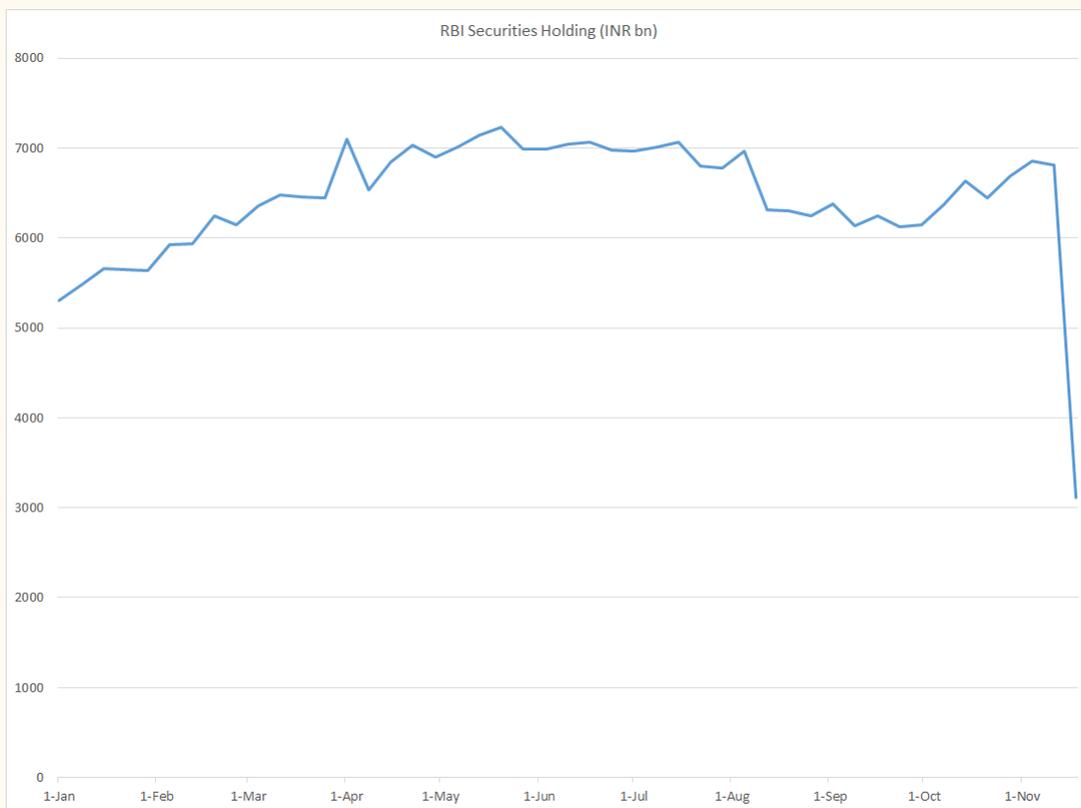


The Reserve Bank of India imposed an additional CRR requirement on banks asking banks to maintain CRR at 100% on incremental deposits between 16 September and 11 November. This means that banks would have to maintain about Rs. 3.2 trillion as additional reserves for the period 29 November to 9 December.

What has led to this move?

The banking system has been flooded with deposits following the demonetisation of ₹ 500 and 1000 notes on 8 November. These notes have been deposited with the RBI leading to a surge of liquidity for banks and a sharp fall in money market rates. To arrest the fall in rates, the RBI has been sterilising the inflow through reverse repo operations. In a reverse repo, the RBI sells government securities in the market and absorbs liquidity. The scale of deposits was threatening to overwhelm the RBI's capacity to sterilise. That is, while about Rs. 14 trillion of notes are to be demonetised, the RBI only held about half that amount in government bonds that could be used to mop up liquidity. The chart below shows the RBI holding in government bonds adjusted for claims on banks (i.e. adjusted for reverse repo operations).



Source: RBI

As may be seen from the chart, the RBI's holding of G-Secs fell by half till the 18th of November. What this also shows is that with another Rs. 3 trillion of flows, the RBI would have exhausted its holding of G-secs. By hiking the rate of CRR, the RBI is forcing the banking system to maintain the additional liquidity with the RBI on reserve rather than lending it at lower rates in the money markets.

What next?

The RBI has indicated that it will review this additional CRR measure at the end of the current reporting fortnight (9 December) or earlier. In addition the RBI and government will look to other tools such as Market Stabilisation Scheme (MSS) bonds to mop up liquidity for a longer period of time.

If the RBI chooses to continue with the hike in CRR, it may also choose to pay interest on these funds as it otherwise represents a substantial cost to the banking system.

Impact on markets

Before this CRR increase, the RBI had absorbed about Rs. 4.8 trillion through overnight and term reverse repos. Of this only about a third matures today (28 November). This creates a potential for significant reserve shortage that the Reserve Bank proposes to address through repos. This has resulted in the overnight rate rising above the policy repo rate but remaining reasonably anchored.

Money market rates have risen by about 20-30 basis points, while long rates have risen by about 5-10 bps. While some of the froth has been taken out, absolute yields still remain near lows indicating that the medium term weaker macro and rate cut expectations are driving the markets despite the liquidity tightening measure. As an example, 3-month treasury bills are still trading at 6% relative to the repo rate of 6.25% implying that the markets are expecting a rate cut in the coming policy review and are expecting easy liquidity conditions to prevail in the coming months.

What can we expect from interest rates?

Early indications are that there is going to be some impact on economic activity due to demonetisation. Thus it is reasonable to expect the RBI to cut rates in the near term. We expect the RBI to cut rates by 50-75 bps in the coming months. Thus bond yields are likely to fall in the medium term.

Banks have begun cutting deposit rates in view of the surge in liquidity and are likely to maintain lower deposit and lending rates going forward. If RBI holds this CRR hike for longer than this fortnight it is also possible that banks will review savings deposit rates. Money market and short term rates are likely to remain low as a result. On a more structural basis a reduction in the pace of currency in circulation should result in a systematic improvement in core banking liquidity.

What should investors do?

The improvement in bank liquidity is structural and is likely to benefit short and medium term rates. Investor should look to short to medium term funds as a core portfolio allocation. In the near term the possibility of rate cuts and macro weakness also provides opportunities in long duration assets. Investors who wish to participate in long bonds should also look at dynamic bond funds.

Statutory Details and Risk Factors

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