Abundant liquidity kept short-term rates soft: RBI bulletin

Why in news?

RBI recently released Monthly bulletin for the month of July 2020. The RBI has highlighted that on account of COVID-19 Pandemic, the Financial institutions in India faced liquidity stress, loss of access to funding, disruption of cash flows. Hence, in order to counter this, the RBI has taken recourse to several conventional and unconventional tools to improve the liquidity

Operation Twist

What is it?

- Operation Twist is a monetary policy tool employed to influence the yields (interest rates) which results in 'twist' in the yield curve and hence the name.
- Generally Open Market Operations involve buying or selling of government securities in order to manage the liquidity in the economy. (OMO-Medium term)

How does it work?

- Operation Twist involves simultaneous buying and selling of long-term and short-term government securities to influence the interest rate of the government securities.
- In the Operation Twist undertaken, RBI is buying long-term government securities (10-year bond) worth Rs.10000 Cr and selling 4 short-term securities (1-year bond) worth the same amount.
- The simultaneous buying and selling of long-term and short-term security respectively is done in order to moderate the interest rates of long-term securities and bring it closer to repo rate.

What is Repo rate?

- The Repo rate is the rate at which the banks borrow mainly short-term loans from the RBI. Under Repo mechanism, the banks sell their G-Secs to the RBI with an agreement to repurchase the G-Sec at a future date and at fixed price. The rate at which the banks repurchase the G-Secs from the RBI is known as the Repo rate.
- Depending upon the maturity period of the loans, there are different types of Repos in India. These are:
- Overnight Repos: (Maturity period of 1 day)
- Term Repos: There are different types of term repos depending upon the maturity period. Some of the term repos include 7-day, 14-day, 21 day, 28-day, 56-day.
- The overnight repos are available to the Banks from the RBI from Monday to Friday. However, the term repos are available to the Banks only when the RBI notifies about the Term Repos (Usually 2-3 days in a week). Further, the interest rate on the term repos is not same as the Repo rate. The Interest rate on the Term repos is determined through auction and hence is usually higher than the Repo rate.

What is Long Term Repo Operations (LTRO)?

- It is a new policy tool used by the RBI to inject more liquidity into the Economy. It is considered to be similar to the term repos, but with a longer maturity period of 1 year and 3 years.
- Through the LTRO, the RBI seeks to inject long term liquidity into the economy at a lower interest rate. This is so because the interest rate on the LTRO is fixed at the Repo rate

Some of the basic features of the LTRO include:

- Total Funds to be injected: Up to Rs 1 Lakh crores.
- Interest Rate: Repo Rate.
- Method of Operations: The LTROs would be carried out through e-Kuber (The e-Kuber is the Core Banking Solution of the RBI which enables each bank to connect their single current account across the country. The e-Kuber is also used by RBI to execute various transactions with banks such as carrying out overnight and term repos, reverse repos etc.)

Need for Carrying out the Long-Term Repo Operations (LTROs)

The RBI has consistently been reducing the Repo rates to inject liquidity into the economy. However, the Banks have not reduced the rate of interest on loans commensurately due to the poor monetary policy transmission.

Further, the rate of interest on the long-term loans has remained much higher and has hindered the investment rates within India. Hence, the RBI has carried out the LTROs for the following purposes:

- Reduce rate of Interest on the long-term loans.
- The reduction in the long-term rate of interest would force the banks to reduce the rate of interest on short term loans. (The rate of interest on long term loans is usually higher than that on short term loans)
- Incentivise the Banks to reduce their overall lending rates and improve the monetary policy transmission.

Targeted Long Term Repo Operations: In March 2020, the RBI injected around Rs 1 lakh crore into the economy through the targeted long term repo operations (LTROs) of 3 years tenor. The interest rate on the term repos was the floating interest rate, linked to policy Repo Rate. According to the RBI, the liquidity availed by banks had to be deployed only in investment grade corporate bonds, commercial paper and other financial instruments. Hence, it was referred to as Targeted LTROs.

Housing Price Index

Importance: House price is an essential indicator of the economy. Residential property is the largest single asset for most households around the world. Hence, the variations in residential property prices affect households' long-term investment strategy, influence their spending and borrowing patterns. The Changes in the property price influences the banking and financial sectors of the economy as well.

Indices to measure Housing Prices:

- House Price Index (HPI) - compiled by the Reserve Bank of India

RESIDEX - compiled by the National Housing Bank (NHB)