Managing Surplus Liquidity

What is the issue?

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With a mixed scenario of inflows, liquidity and inflation risk, RBI is in a policy dilemma to take the right course of action.

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What are the recent developments?

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- **Domestic liquidity** has been in surplus since the recent demonetisation drive.
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- Simultaneously, India is experiencing the strongest **portfolio inflows** in two years and FDI rose to a record high last year and is likely to climb further this year.
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- Dollar flows have thus strengthened.
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- A narrower current account deficit and easing external debt condition persists.
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- The economy's **absorptive capacity** has thus fallen, further by the increased liquidity.
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What lies ahead for RBI?

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- The Reserve Bank of India is thus in a policy dilemma to handle this.
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- Any decision or measure by the RBI should take into its mandate the following:
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1. managing liquidity.
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2. keeping the currency stable.
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3. sticking with its inflation-targets
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What are the possible options and challenges?

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- **Inflows** - The central bank is expected to lower the interest rates in an effort to control inflows.
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- However a small reduction in real rates is unlikely to dissuade foreign investors given the pull factor with economy’s macroeconomic fundamentals.
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- RBI is now considering open market operations through bond sales to deal with dollar inflows through FPIs.
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- **Liquidity** - RBI briefly raised the incremental cash reserve ratio to deal with deposits in the wake of demonetisation.
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- However, to deal with the present liquidity condition which has a balance in surplus, RBI has returned to the market-based tools.
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- These include the reverse repo auctions and market stabilisation bills.
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- Besides, RBI should also take into account the following:
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- The liquidity levels and its future course are not likely to result in the anticipated liquidity fuelled inflation.
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- Despite the conditions for future hike in inflation, the present number being still below the 4 per cent target reduces serious inflationary pressures.
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- Given all these, instead of a macro policy shift, RBI can move ahead with a combination of forex market intervention, liquidity-absorption measures and modest rupee gains.
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- A mix of regular tools, regulatory caps on foreign portfolio investments, bond

sales and market stabilisation bills can help deal with the situation.
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Source: Business Line

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