

“MONETARY POLICY IS A SCIENCE, BUT THIS RBI IS MAKING IT AN ART”

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In 1996, Alan Blinder one of the most profound exponents of monetary policy making had famously commented “By making itself more predictable to the markets, the central bank makes market reactions to monetary policy more predictable to itself”. This was reiterated by Michael Woodford in his famous Jackson Hole address in 2001 “successful monetary policy is not so much a matter of effective control of overnight interest rate as of affecting the evolution of market expectations”. Incidentally, Professor Woodford is a speaker in 2020 Jackson Hole also, speaking on effective lower bound. **Following the sagacious advice of Blinder and Woodford, this RBI seems to have managed the art of managing expectations as auction outcomes are turning out to be in line with market expectations.**

G-sec yield has risen significantly in the recent month more so after the RBI August monetary policy committee and the release of Policy Minutes. The yield has increased across all tenures and the most in 5 year. It seems that the entire purpose of monetary transmission was being defeated. Against this background, the operation twist/OT was a much-needed relief for the markets after yields had moved up by as much as 56 points in the aftermath of August 6. Before the auction there was some concern among market participants that OT may not work in this scenario as majority of the holders of these securities would be out of the money. By accepting offers at prices much higher than market, RBI has indicated its willingness to support the market at a time when supply outstrips demand. The OT coupled with the Governor’s address in the morning has soothed frayed market sentiments. It is perhaps perfectly legitimate that the RBI has chosen to use OTs instead of direct OMO purchases to avoid adding more liquidity to the banking system which is already flush with liquidity after the LTROs and TLTROs done earlier this year. **RBI may have to continue to manage auction expectations more aggressively in coming days through OT so as to pull down the yields even further.**

RBI has been largely successful in managing the yield movements in the current year. For example, when we look at the G-sec spread, it reached a peak of 350 basis points in FY09. The spread has reached 284 basis points in the current year. With a Rs 22 trillion consolidated borrowing, yield should have been at much higher level now if RBI had not acted with alacrity.

Finally, when fear runs high amid a hawkish MPC minutes and higher CPI prints, market players across all markets may take short positions to stop out the long, as like any asset class behaviour. **We thus expect RBI to continue to make policy announcements in tune with changing times like LTRO in the 3-5 year G-sec, exercising green shoe options and other announcements as it may deem fit.**

We must appreciate that for any central bank specifying an explicit policy rule, from which the central bank would never deviate under any circumstances, is naïve. In this context, **it will thus not be a surprise and it will be better to keep the markets in a wait and watch mode as monetary policy is all about managing expectations and as long as this RBI is doing it successfully, market players should not have too many complaints!**

SIGNIFICANT INCREASE IN YIELD

- ◆ There has been a significant increase in yield recently, more so after the August RBI Monetary Policy Committee and the release of RBI policy minutes. It seems that the entire purpose of monetary transmission was getting defeated in the post MPC period of 21 days. This yield increase has been witnessed across all tenures with maturity at the middle end getting impacted more. **In fact, the impact on maturity at the middle end is remarkably similar to Fed and ECB where also the impact is mostly seen at the middle end as per empirical studies.**
- ◆ The reason for the sustained rise could be increasing institutional short-selling happening in the G-Sec market. The data reveals that institutional entities have been selling excessively in the last two months.
- ◆ Interestingly, with an objective to deepen further the G-Sec and repo market, RBI had changed its norms in July 2018 and liberalised the eligible short sale participants’ base as well as relaxed the entity-wise and security category-wise limits for short selling in G-Sec. Short sale in central government securities (G-Secs) was introduced in February 2006 to provide participants with a tool to express two-way view on interest rates and thereby enhance price discovery. Prior to this revision, scheduled commercial banks, primary dealers and certain well-managed urban cooperative banks were permitted to undertake short sale transactions.
- ◆ Against all this background, the key empirical question is how communication and policy actions under the current RBI dispensation has significantly contributed to the effectiveness of monetary policy by creating genuine news (e.g., by moving short-term interest rates in a desired way) or by reducing noise (e.g., by lowering market uncertainty, that earlier RBI may not have been able to achieve within such a short span time, like fastest transmission within 3 months, when we know that monetary policy works with long and variable lags. Notably, if communications steer expectations successfully, asset prices should react and policy decisions should become more predictable. Both appear to have happened under the current RBI.

Change in Yield									
Tenure	Security	Yield as on 27-08-2020	Yield as on 26-08-2020	Yield as on 20-08-2020	Yield as on 05-08-2020	Change from 05 Aug to 26 Aug	Change from 20 Aug to 26	Impact of Governor's speech today	
14 yr	6.19% GS 2034	6.50	6.54	6.30	6.16	0.38	0.24	-0.04	
10 yr	5.77% GS 2030	6.15	6.19	5.95	5.77	0.42	0.24	-0.04	
10 yr	5.79% GS 2030	6.18	6.20	6.00	5.83	0.38	0.20	-0.03	
9 yr	6.45% GS 2029	6.28	6.30	6.06	5.95	0.35	0.24	-0.03	
9 yr	7.26% GS 2029	6.32	6.33	6.09	5.99	0.34	0.23	0.00	
8 yr	7.17% GS 2028	6.18	6.18	5.99	5.86	0.31	0.18	0.00	
6 yr	7.27% GS 2026	5.88	5.90	5.59	5.40	0.50	0.31	-0.02	
5 yr	5.22% GS 2025	5.52	5.55	5.22	4.99	0.56	0.33	-0.03	
4 yr	6.18% GS 2024	5.35	5.37	5.08	4.90	0.48	0.29	-0.02	
3.5 yr	7.32% GS 2024	5.08	5.08	4.81	4.73	0.35	0.27	0.00	
3.5 yr	7.68% GS 2023	4.97	4.97	4.80	4.74	0.23	0.17	0.00	
3 yr	7.37% GS 2023	4.68	4.66	4.47	4.41	0.25	0.19	0.02	
2 yr	5.09% GS 2022	4.16	4.18	4.04	4.03	0.15	0.14	-0.02	
1 yr	6.17% GS 2021		3.77	3.63	3.62	0.15	0.14		
3 months	Treasury Bill		3.25	3.15	3.27	-0.02	0.10		

Memo:

Effects of interviews and speeches by central bank committee members on interest rates (movement in bps)		
	FED	ECB
2 yr	1.01	2.4
5 yr	1.14	1.96
10 yr	0.76	0.61

Source: Source: Ehrmann and Fratzscher (2007b), SBI Research

Net Market Activity in the Trading of Gsec in Rs Cr						
	Public sector Banks	Foreign Banks	Private Banks	MF	Others	P Dealers
Dec-19	15444	-9962	-8579	2147	16449	-15499
Jan-20	15361	-15062	-12376	6074	18052	-12050
Feb-20	-36564	26756	1637	9856	-86	-1599
Mar-20	7992	-36452	28508	208	5738	-5994
Apr-20	-18668	-4517	24704	-724	5341	-6136
May-20	-28972	-8993	9313	20392	10009	-1748
Jun-20	-17996	-5509	1541	17157	25839	-21033
Jul-20	2011	-20484	-1592	27057	19753	-26745
Aug-20	16214	-18460	-1442	9146	17754	-23212

OPERATION TWIST:MANAGING AUCTION EXPECTATIONS

- ◆ In the Operation Twist today RBI accepted the benchmark 5.79% 2030 paper at an aggressive cut-off of 6.0782%, as against the day's high of 6.19% earlier in the day, managing to pull down the yields to 6.15% levels. This was a much-needed relief for the markets after yields had moved up by more than 30 basis points in less than a month. Before the auction there was some concern among market participants that OT may not work in this scenario as majority of the holders of these securities would be out of the money. Banks are usually reluctant to sell securities at yields higher than their purchase levels as it forces them to book losses.
- ◆ By accepting offers at prices much higher than market, RBI has clearly indicated its willingness to support the market at a time when supply outstrips demand. While today's auction is a positive step, to fully convince the market, RBI may have to show the same aggression in next few rounds of OTs as well, ideally till the benchmark yield is pulled back below 6% levels. RBI has chosen to use OTs instead of direct OMO purchases to avoid adding more liquidity to the banking system which is already flush with liquidity after the LTROs and TLTROs done earlier this year. Central Banks around the world have pumped in liquidity to support recovery from the damage caused to economic activity by Covid-19, as well as to support the additional borrowings by the Governments.

G-SEC AND REPO SPREAD

- ◆ When we look at the G-sec spread, it reached a peak of 350 basis points in FY09 however it continued to decline thereafter. The spread has been on a rising trend in the last couple of years reaching 284 basis points in the current year. In fact, the RBI has seemed to have managed the yield expectations extremely well as with a Rs 22 trillion consolidated borrowing, yield should have been at much higher level now if RBI had not acted with alacrity.
- ◆ Meanwhile, RBI has injected liquidity in the system through OMO purchases in FY19 and FY20. Moreover, the current fiscal has abundant liquidity as is revealed by average net absorption of Rs 4167 billion by RBI so far, and hence an OMO at this point is futile and meaningless. In fact, the evolution of OMO over the last decade shows OMO has been the primarily the norm, when liquidity has been in a short supply.

GOVERNMENT BORROWING

- ◆ When we look at the Government borrowing, there has been a huge jump in Centre's as well as States borrowing. The average auction size for Centre has also increased from Rs 14,000 crore in Jan'20 to Rs 20,000 crore in May and further to Rs 30,000 crore in Aug'20. In case of states, the average auction size has reduced from Rs 18000 crore in Jan'20 and May'20 and has become Rs 11,550 crore in Aug'20. We expect the states to tap the markets aggressively in second half of the current fiscal.

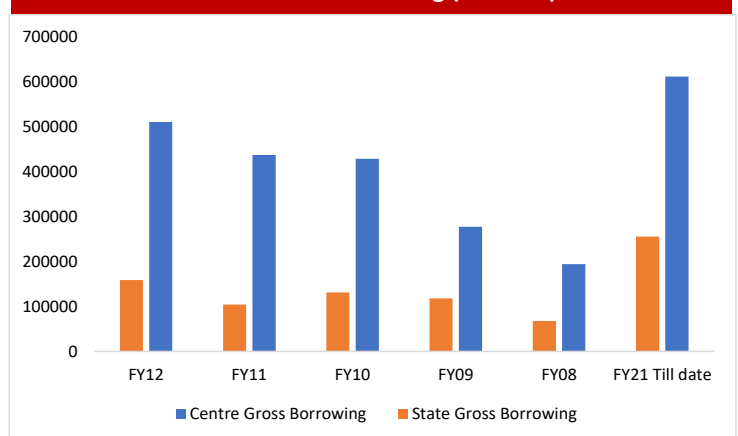
YIELD ON COMMERCIAL PAPERS RAISED BY NBFCs

- ◆ Yield on Commercial Papers raised by NBFCs has also increased marginally in August compared to previous months. The weighted average yield on the same was 4.11% upto 5 Aug which increased to 4.29% between 6 Aug-26Aug'20.

10 Year Gsec spread and market liquidity

	10-yr G-sec (yr-end)	Repo rate	Reverse Repo Rate	Spread	Average Daily Liquidity operations of RBI (-injection, Rs Bn)*	OMO Rs Bn
FY08	7.959	7.75	6	0.209	13	59
FY09	7.011	5	3.5	3.511	55	945
FY10	7.832	5	3.75	2.832	1000	755
FY11	7.989	6.75	5.75	1.239	-810	672
FY12	8.542	8.5	7.5	0.042	-1570	1341
FY13	7.963	7.5	6.5	0.463	-1084	1545
FY14	8.803	8	7	0.803	-648	520
FY15	7.737	7.5	6.5	0.237	-157	-297
FY16	7.465	6.75	5.75	0.715	-87	636
FY17	6.680	6.25	5.75	0.430	331	1100
FY18	7.399	6	5.75	1.399	336	-900
FY19	7.351	6.25	6	1.101	206	2905
FY20	6.138	4.4	4	1.738	1278	1042
FY21	6.192	4	3.35	2.842	4610	0

Source: SBI Research, FY09 and FY21 spread taken from Reverse Repo which is the operating target. * FY08-FY12 Liquidity is taken as net repo operations of RBI from Annual report, for FY11 it is average of March

Government Borrowing (Rs crore)

Source: SBI Research

Yield on Commercial Papers raised by NBFCs FY21

Month	WAY
April	5.44
May	5.44
June	4.92
July	4.71
Aug	4.28
up to Aug 5th	4.11
from 6th to 26th Aug	4.29

Source: CCIL; SBI Research; WAY - Weighted Average Yield

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