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G-SAP and Quantitative Easing

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The RBI governor Dr. Shaktikanta Das in his statement accompanying the First Bi-monthly policy for FY2021-22 of the Monetary Policy Committee (MPC), announced an asset purchase programme to be implemented by the Central Bank. This asset purchase programme termed as the Government Securities Acquisition Programme (G-SAP), is being hailed as India's very own Quantitative Easing (QE). In the words of the RBI Governor, this programme has a distinct character, and should ideally be not mixed with the usual asset purchases of the RBI known as Open Market Operations (OMOs). This has given rise to several questions and doubts like what are the distinguishing features of this programme that make it distinct from the usual OMOs, which the bond market is accustomed to; is this an Indian version of the Quantitative Easing (QE); how will the asset purchase be operationalized in the market as the first tranche of GSAP 1.0 will amount to the RBI buying a significant Rs.1 Lakh Crore in Q1FY22? In this note, we attempt to answer some of these questions based on the comments and clarifications provided by the RBI Governor in his interaction with the press.

The Central Bank used many unconventional policy tools in the previous year as a response to the economic challenges that arose due to the COVID-19 pandemic. FY21 witnessed record borrowings of Rs.22 Lakh Crore for the Centre and the States combined. For most of the year, RBI was able to manage an orderly evolution of the yield curve, keeping the average borrowing costs near a level of 5.79% - an average borrowing cost last seen in the year 2004-05. FY21 also saw OMO purchases to the tune of Rs.3.13 Lakh Crore. Based on this experience, the RBI has now embarked on the G-SAP. The distinguishing feature of this programme according to the RBI Deputy Governor Dr.Michael Patra comes down to three points:

1. The RBI has for the first time in its history committed its balance sheet in the conduct of monetary policy;
2. GSAP is different from OMO as the RBI has given away the discretion that it enjoys with the usual OMOs so that the market participants are assured of the RBI's assistance in the conduct of the borrowing programme;
3. The quantum of the asset purchases is known to the market beforehand which would help the market participants to plan their engagement with the borrowing programme.

This has been done primarily to ensure the orderly evolution of the yield curve. The RBI Governor has repeatedly said that the Central Bank could conduct the huge borrowing programme and ensure that yields did not blow-out in FY2020-21 by judiciously conducting OMOs of Rs.3.13 Lakh Crore and reiterated his commitment to ensuring the same for FY2021-22. As regards operationalizing of the same, the RBI has chosen to go via the auction route to buy stocks from the market with the first tranche of the GSAP scheduled on 15th April 2021, for a quantum of Rs.25,000 Crore.

Why is G-SAP not QE? Equating the present asset purchases with the Quantitative Easing (QE) programmes implemented in the Advanced Economies (AEs) does not fit the bill entirely as typically QE programmes are implemented in a situation where the general price level is dangerously close to deflation - quite opposite to the situation in India with inflation expected to run close to 5% in FY22. QE also is implemented to raise asset prices via the large value asset purchases and mostly risky asset yields, which again would not be the case in India as RBI has stuck with the sovereign/sub-sovereign asset purchases (G-Sec/SDLs). Rather the transmission mechanism has been in the limelight since the corporate borrowers would eventually reap the benefits of lower sovereign yields and will be able to themselves borrow at lower yields from the bond market. This phenomenon was widely seen in the Indian bond market over the past year with the implementation of targeted financing of the corporate bond market through various channels like the LTRO/TLTRO wherein the corporate bond yields have responded not only to a fall in the underlying G-sec yields but also to the liquidity flow afforded by these schemes.

The Indian economy is far from facing the most pertinent reason for implementing an asset purchase of the kind that can be termed as a QE since the domestic economy is nowhere near facing a “liquidity trap”. There has been much debate on the hit that the savers have taken in recent times as real interest rates remain negative with high inflation and low yields. However, interest rates in India are structurally rigid on account of a variety of factors including the small savings rates and are not likely to come anywhere near the dreaded Zero Lower Bound at least in the foreseeable future. QE is typically used, at least in theory, when the interest rates are close to zero and the Central Bank loses the power to influence interest rates by lowering policy rates further and thus has to resort to expanding the monetary base in the economy.

Hence, as the RBI states: “*The positive externalities of G-SAP 1.0 operations need to be seen in the context of those segments of the financial markets that rely on the G-sec yield curve as a pricing benchmark*”, which in our view hints at the sub-national (state borrowings) and the corporate bond market (private sector borrowings) benefitting from the lower yields on sovereign benchmarks across the yield curve. With the first tranche of GSAP standing at Rs.1 Lakh Crore and assuming that the RBI continues to purchase at least Rs.50,000 crore per quarter under subsequent GSAP tranches in addition to the discretionary outright OMO purchases, the overall asset purchase by RBI could be about Rs.3-4 trillion, significantly bridging the gap between the demand and supply in the bond market and keeping bond yields strongly supported for FY22.

Liquidity & USDINR: The announcement of the Variable Rate Reverse Repo auctions to manage short term liquidity surpluses will possibly lead to a gradual and phased normalisation of the low overnight rates by managing surplus liquidity through Longer Term Reverse Repos (LTRR) as opposed to the 14 day Reverse Repo auctions which began in January 2021. The RBI deputy Governor Dr. Patra and the RBI Governor have mentioned in the RBI's press interaction that this was not to be read as a step towards a tightening of the liquidity stance, although an eventual normalisation at the shorter end of the curve is surely in the offing in our view towards the end of Q2FY22. The Deputy Governor also elucidated the fact that as long as the Reverse Repo rate is the operative rate for monetary policy, the stance of the RBI is "accommodative".

In our view, the RBI's liquidity management strategy would hinge on developments in the US economy and a possible extension of the on-going strength in the US dollar, which looks imminent given the fiscal push that the Biden administration has given to the economy. This massive stimulus would surely increase depreciation pressures on Emerging Market (EM) currencies like INR, and hence to an extent might be a blessing in disguise for the RBI, who would gain the extra firepower to buy additional domestic assets as compared to being forced to intervene in the forex markets to manage the currency. This would also accord more flexibility to the RBI in terms of managing the impossible trinity enabling it to focus more closely on the domestic interest rates.

Outlook: The RBI has given a clear assurance to the market about the Central Bank's focus on economic recovery and its stated objective of eschewing disruptive volatility in the bond markets, much similar to its smoothening of volatility in the exchange rate market. The bond market participants have responded with a surge of optimism by pushing 10 year yield close to the 6.00% mark after the announcement. The current financial year will be guided by these asset purchases and yields should be fairly range bound and we expect a trading range between 5.90%-6.30% for the 10 year yield for H1FY22.

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