Summary of the Report of the Working Group on Instruments of Sterilisation

Forex flows have implications for the conduct of domestic monetary policy and exchange rate management. How such flows impact domestic monetary policy depends largely on the kind of exchange rate regime that the authorities follow. In a fixed exchange rate regime, excess forex inflows, resulting from current and capital account surpluses or net surpluses, would perforce need to be taken to forex reserves to maintain the desired exchange rate parity. In a fully floating exchange rate regime, the exchange rate would itself adjust according to demand and supply conditions in the foreign exchange market, and there would be no need to take such inflows into the forex reserves. In such a scenario, in the presence of heavy forex inflows, however, it is possible that the exchange rate may appreciate significantly though an appreciation may not automatically restore equilibrium in the balance of payments. While in practice in all countries, the central banks do intervene in the forex markets there are some features in emerging markets where a more intensive approach to intervention may be warranted in the context of large inflows. In emerging markets, capital flows are often relatively more volatile and sentiment driven, not necessarily being related to the fundamentals in these markets. Such volatility imposes substantial risks on market agents, which they may not be able to sustain or manage. Where the exchange rate is essentially market determined, but the authorities intervene in order to contain volatility and reduce risks to market participants and for the economy as a whole, some difficult choices need to be made. First, a choice has to be made whether to intervene or not to intervene in the forex market; and second, if the choice is made to intervene, the extent of intervention.

2. What choices are made depend on a number of considerations. The key issue under consideration of the monetary authority is to determine whether the capital inflows are of a permanent and sustainable nature or whether such inflows are temporary and subject to reversal. In practice, this determination is difficult to achieve. Since external capital flows cannot be easily predicted and can also reverse even in the presence of sound fundamentals, monetary authorities have to make choices for day-to-day exchange rate and monetary management. When the monetary authority intervenes in the foreign exchange market through purchases of foreign exchange it injects liquidity into the system through the corresponding sales of domestic currency. Conversely, when it sells foreign exchange domestic liquidity is absorbed from the system. Such operations in the foreign exchange market cause unanticipated expansion or contraction of base money and money supply, which may not necessarily be consistent with the prevailing monetary policy stance. The appropriate management of monetary policy may require the monetary authorities to consider offseting the impact of such foreign exchange market intervention, partly or wholly, so as to retain the intent of monetary policy through such intervention. Most techniques to offset the impact of forex inflows can be classified as either market based or non-market based approaches. The market based approach involves financial transactions between the central bank and the market, which leads to withdrawal or injection of liquidity, as the case may be. The non-market based approach involves the use of quantitative barriers, rules or restrictions in market activity, which attempt to keep the potential injection of liquidity outside the domestic financial system. The market based approach aimed at neutralising part or whole of the monetary impact of foreign inflows is termed as sterilisation.

3. Conceptually distinct, but operationally overlapping steps in the sterilisation process are: (a) decision of the monetary authority to intervene by substituting foreign currency with domestic currency in case of excess capital inflows, and (b) decision to intervene further in the bond or money market to substitute domestic currency so released out of the intervention in forex market with bonds or other eligible paper. While open market operations (OMO) involving sale of securities constitute the commonly used instrument of sterilisation, there are several other instruments available to offset the impact of capital inflows on domestic money supply. However, there are occasions when it is difficult to distinguish the normal liquidity management operations of a central bank from its sterilisation operations.

4. Apart from exchange rate flexibility and forex market intervention there are several other policy responses that can be used to manage large capital inflows. (a) Trade liberalisation: Trade liberalisation could have the effect of increasing imports leading to a higher trade and current account deficit and this would enable the economy to absorb the capital inflows. However, trade liberalisation is generally irreversible and hence may not be suitable for dealing with temporary or reversible capital inflows. Furthermore, rapid trade liberalisation can also lead to additional capital inflows which may have the effect of actually making the current account deficit unsustainable in the future when such capital inflows slow down or reverse. Thus, decisions on trade liberalisation have to be based on the overall view of the economy and not just on issues related to forex inflows, although inflows may provide some comfort in terms of timing the transition to a more liberal trade regime. (b) Investment Promotion: Absorption of capital flows for growth promoting purposes can be considered through measures designed to facilitate greater investment in the economy. Implementation of such measures would be desirable to reduce the current account surplus or expand the relatively low level of current account deficit, leading to productive absorption of capital flows. However, such measures would become progressively effective over a period of time. (c) Liberalisation of the Capital Account: Liberalisation of outflows under the capital account can be considered while taking advantage of the excess forex inflows, particularly, with regard to the timing for such action. However, the liberalisation of outflows can also have the effect of increasing inflows further if it reinforces the positive sentiment relating to the host country. (d) Management of External Debt: Pre-payment of external debt can be used to reduce the accretion of forex inflows. Such pre-payment is attractive provided the cost differential between the domestic and external debt is adequate after taking into account the associated costs of pre-payment like penalties and other charges. Measures can also be taken to moderate the access of corporates and intermediaries to additional external debt. However, such measures would generally be of the non-market variety involving reinforcement of the capital control regime. (e) Management of Non-Debt Flows: Non-debt flows consist of foreign direct investment (FDI) and portfolio investments. Usually, FDI decisions are taken in a medium term perspective, and are accorded higher priority in the hierarchy of capital flows; thus, there is very little reason to restrict FDI flows. Once portfolio investment flows are permitted there are few quantitative or price instruments that are available to impede them, without seriously undermining market sentiment. (f) Taxation of Inflows: Price based measures to restrict forex inflows could include the imposition of a "Tobin" type tax. However, such a tax has rarely been practised and is too blunt an instrument to be used for discouraging forex inflows. It does not distinguish between the different types of flows or transactions, whether permanent or temporary, debt or non-debt, long-term or short-term, or between export receipts or import payments. Furthermore, to be effective "Tobin" type taxes have to be implemented across

countries; otherwise, there may be opportunities for circumvention. Moreover, a 'Tobin" type tax is of limited use where forex transactions are largely related to underlying transactions as is the case in India. (g) Use of Foreign Exchange Reserves: As foreign exchange reserves rise, it is often suggested that such reserves can be used for "productive" domestic activities through on-lending in foreign currencies to residents. If the reserves are used in such fashion domestically they are not then available as forex reserves. Further, if the use of such reserves is through domestic credit provision for rupee expenditure, the forex resources so used would again end up in the forex reserves. Such an action would be equivalent to not on lending the foreign exchange resources in the first place. If the reserves are on-lent for overseas operations, this could lead to encumbrance on the reserves and once again they would not be characterised as reserves since they would not then be available for usage. Considerations of safety and liquidity that are essential for forex reserves would also be compromised if forex reserves are used in such fashion.

5. In the context of large forex inflows as India is experiencing at present, an ongoing view has to be taken by the authorities for operational purposes on: (a) the extent of forex market intervention and consequent build up of reserves; and (b) whether to sterilise or not and if so, to what extent. It is evident that operations involving sterilisation are undertaken in the context of a policy response which has to be viewed as a package encompassing exchange rate policy, level of reserves, interest rate policy, along with considerations related to domestic liquidity, financial market conditions as a whole, and degree of openness of the economy.

6. The policy response depends on several considerations involving trade-offs between the short term and the long term; judgement on whether capital flows are temporary or enduring; as well as on the operation of self-correcting mechanisms in the market and market responses in terms of sentiments. Whereas the distinction between short term and long term flows is conceptually clear, in practice, it is not always easy to distinguish between the two for operational purposes. Moreover, at any given time, some flows could be of an enduring nature whereas others could be short term and hence reversible. More important, what appears to be short term, could tend to last longer and *vice versa,* imparting a dynamic dimension to judgments about their relative composition. Arguments in favour of unsterilised intervention in forex markets are that it could lead to an alignment of domestic interest rates with international interest rates and this could have beneficial effects on investment and growth. In the short run, however, it could lead to asset price volatility, imprudent lending and adverse selection. In such a scenario, there could be adverse effects on the real economy with possibilities of capital reversals. There is greater agreement on the policy response of sterilisation as a temporary measure since it addresses temporary inflows effectively, and it can be implemented quickly. If the inflows are more enduring it provides time to formulate a longer term response. Even in the case of mixed flows, some enduring and some short term, some degree of sterilisation would need to be considered. The arguments in favour of sterilisation are that it keeps base money and money supply unchanged, thereby avoiding the undesirable expansionary effects of capital inflows. Furthermore, forex market intervention accompanied by sterilisation allows the monetary authority to build international reserves that will help to withstand future shocks, and provide comfort and confidence to market participants. On the other hand, prolonged sterilisation may not be possible without upward pressure on interest rates, which could itself attract further forex inflows neutralising the impact of sterilisation. Sterilisation also has its financial costs. If it is

conducted through OMO, the net cost of sterilisation to the central bank is the difference between the interest rate on domestic securities and the rate of return on foreign exchange reserves adjusted for any exchange rate change. The larger the extent of sterilisation and greater the yield differentials, the higher is the cost. In the literature, these are referred to as "quasi-fiscal" costs since central bank costs are passed on to the sovereign through a lower transfer of profits. Similarly, when sterilisation is effected through an increase in reserve requirements, this could adversely affect the profitability of the financial system as it is a tax specifically on banks and could give rise to dis-intermediation. Sterilisation as a process, therefore, involves a range of costs and benefits. On balance, there must be adequate preparedness to undertake sterilisation operations, which includes availability of instruments though the need for and size of such operations will be governed by several larger policy considerations.

7. In India, the reserves have increased from US $ 54 billion as at the end of March 2002 to US $ 95 billion by November 21, 2003. The liquidity impact of such large inflows was managed mainly through the day-to-day Liquidity Adjustment Facility (LAF). Liquidity absorption through LAF repos on a daily average basis, amounted to Rs.11,212 crore during 2002-03 and Rs.29,310 crore during 2003-04 (up to end-October). The LAF operations were supplemented by open market operations (OMO) of outright sales of government securities, amounting to Rs.52,716 crore during 2002-03 and Rs.35,733 crore during 2003-04 (up to end-October). Both these operations, however, require an adequate stock of government securities. Consequent upon the conversion of the entire stock of special securities issued by the Government to the Reserve Bank in lieu of outstanding *ad hoc* Treasury Bills, the stock of government securities with the Reserve Bank amounted to Rs.93,281 crore as at end-October 2003. As per the current operations, the usage of the entire stock of securities for outright open market sales is constrained by the allocation of a part of the securities for day-to-day LAF operations as well as for investments of surplus balances of the Government. In addition to LAF and OMO, measures taken to deal with capital inflows have included building up of government balances with the Reserve Bank particularly through increase in the notified amounts of 91-day Treasury Bills, forex swaps, pre-payment of external debt, liberalisation of current and capital outflows and measures to restrict debt inflows.

8. The Group reviewed the experiences of countries that have had to contend with capital inflows in recent years in order to identify new instruments suitable in the Indian context. These measures can broadly be classified into (i) use of market-based instruments (i.e. instruments of sterilisation) and (ii) non-market based measures involving, *inter alia*, control on inflows and liberalisation of outflows. Besides making use of well known instruments of sterilisation such as open market operations (including repos) with the help of government securities and foreign exchange swaps, the survey also found a wide variety of other instruments of sterilisaton, ranging from provision for remunerated/ uncollateralised deposit facilities for financial intermediaries with central banks (*viz*., China, Taiwan and Malaysia), issuance by the central bank of money stabilization bonds/central bank bills (*viz*., Korea, China, Malaysia, Indonesia, Thailand, Sri Lanka, Poland and Peru), and Government/ public sector deposits with the central bank (*viz*., Indonesia, Malaysia, Singapore, Thailand and Peru). Countries have also used Cash Reserve Ratio (CRR) on domestic/foreign deposits (on remunerated/non-remunerated basis) to absorb liquidity. While China and Taiwan raised CRR on domestic liabilities of banks to impound liquidity from the financial system, countries such as Thailand imposed CRR on non-

resident deposits of banks. There are several countries that have liberalised capital outflows. For example, countries like Taiwan and China with restrictive capital accounts liberalised capital outflows/surrender requirements by allowing resident firms to retain forex earnings abroad. Among the countries that have imposed capital control on short term capital inflows, mention may be made of Thailand, China, Taiwan and Malaysia. Latin American countries, such as, Chile and Colombia adopted the policy of unremunerated reserve requirements. Countries have also used variants of "Tobin" taxes on capital inflows (*viz.*, Brazil and Chile). Taiwan has also resorted to moral suasion. These apart, international financial institutions were allowed to raise local currency bonds from Taiwan and permitted to remit foreign exchange through the swap route. In countries like Japan and Korea, Governments have held forex on their account and met the cost of sterilised intervention. It is thus observed that in the face of rapid capital inflows, countries have resorted to a variety of instruments/measures keeping in view the prevailing monetary policy objectives, the fiscal situation, and institutional developments.

9. Without prejudice to a view on the extent of intervention and extent of sterilisation, which has to be based on several considerations, the Group reviewed the various instruments used in India and in other countries and noted the various trade-offs involved in the choice and the extent of use of such instruments to deal with the emerging situation. In light of the above, the Group deliberated on the suitability of various instruments to the current conditions in India. Notwithstanding the need or otherwise for deployment of such instruments, an assessment of suitability of each instrument would enable the Reserve Bank to be equipped well in advance should a need arise in the future for their use in the interest of monetary and financial stability. In the choice of instruments for sterilisation, it is important to recognise the benefits from and the costs of sterilisation in general and relative costs/benefits in the usage of a particular instrument. The various instruments have differential impact on the balance sheets of the central bank, government and the financial sector. For example, the differential between the yield on government securities and return on foreign exchange assets is the cost to the Reserve Bank. Sales of government securities under OMO also involves a transfer of market risks to the financial intermediaries, mostly banks. The repo operations under LAF have a direct cost to the Reserve Bank. In the context of an increase in CRR, the cost is borne by the banking sector if CRR balances are not remunerated. However, if the CRR balances are remunerated, the cost could be shared between the banking sector and the Reserve Bank. The extent of capital flows to be sterilised and the choice of instruments, thus, also depend upon the impact on the balance sheets of these entities.

10. In analysing the implications of costs of sterilisation, it is essential to recognise the consolidated nature of the balance sheet of the central bank and the Government. Any cost on the central bank's balance sheet is largely reflected in the Government's accounts by way of transfer of surplus. Where instruments of sterilisation involve the cost being borne by the central bank's balance sheet, the resultant transfer of surplus to the Government is reduced, thereby impacting the fisc indirectly. Where the sterilisation cost is borne directly by the Government, the impact on the fisc is direct. In the Indian context, the Group recognised that the extent to which instruments that result in the cost of sterilisation being borne by the Reserve Bank/Government of India would depend on the capital inflows that would need to be sterilised and the headroom available in the fisc.

11. When measures that directly impact the financial system/non-government sector are resorted to, it would represent a "tax”. This could, however, be justified in view of the benefits that accrue to this sector from sterilisation. In the absence of sterilisation, there could be excessive volatility in the financial markets, interest and exchange rates, leading to erosion of competitiveness of the economy; this would have an adverse impact on the economy at large and the non-government sector in particular. Against the above background, the Group is of the view that while the Reserve Bank may continue to resort to the existing instruments of sterilisation, looking ahead, consideration needs to be given to the addition of new instruments to enhance its ability to sterilise the impact of increase in its foreign currency assets. While some of the existing instruments can be modified and strengthened within the ambit of the RBI Act, introduction of some new instruments for sterilisation would require amendment to the RBI Act.

12. Against the background of international experience with various instruments of sterilisation and application of available instruments with the Reserve Bank within the existing financial and legal structure, the Group felt that there is a need for a two-pronged approach: (i) strengthening and refining the existing instruments; and (ii) exploring new instruments appropriate in the Indian context. The appropriate mix of instruments would depend on the prevailing circumstances, the associated costs and benefits, and the opportunity cost of not using sterilisation as a policy option.

13. The options for sterilisation of inflows by using/refining the existing instrument without changing the legal framework would include the following:

(i) Liquidity Adjustment Facility (LAF)

The Liquidity Adjustment Facility (LAF) over the past two years has served as the primary means for day-to-day liquidity management through the absorption or injection of liquidity by way of sale or purchase of securities followed by their repurchase or resale under the repo/reverse repo operations. These operations have the added advantage that sale of securities does not require the financial system to take the market risk involved in such purchase of securities. Further, the access to this facility is at the discretion of market participants enabling them to undertake their own liquidity management. Thus, this facility has all the advantages of reserve maintenance without being an across-the-board mandatory requirement. The Group observed that in this fiscal year (April - October 2003), the average absorption on daily basis has been Rs.29,310 crore as against Rs.13,836 crore in the corresponding period of the previous year. Hence, it must be recognised that, in effect, the LAF has also effectively acted as an instrument of sterilisation. Furthermore, in addition to the normal operation of the overnight/14-day repos, in the month of October 2003 repos for longer tenure of 28-days were also conducted for five consecutive days. Operations under LAF, however, require the availability of adequate stock of government securities with the Reserve Bank. Moreover, these operations involve costs, which impact on the balance sheet of the Reserve Bank. Most importantly, if the LAF is used as an instrument of sterilisation, it loses its character as a day-to-day liquidity adjustment tool operating at the margin. On balance, the Group is of the view that it is not desirable to use the LAF as an instrument of sterilisation on an enduring basis; however, for limited periods, it can be used in a flexible manner along with other instruments.

(ii) Open Market Operations (OMO)

The main instrument of sterilisation used by the Reserve Bank is Open Market Operations (OMO). The Reserve Bank has conducted OMO for absorbing excess liquidity in the system through outright sale of securities. During 2003-04 (up to end-October 2003), Rs.35,733 crore was absorbed through OMO sales as against Rs. 52,716 crore in the full fiscal year 2002-03. Although the Reserve Bank would make use of this instrument as and when necessary, in view of the finite stock of government securities with the Reserve Bank, such operations for sterilisation can obviously not continue indefinitely. There are also additional concerns on the mismatches arising from using long term securities for sterilising short term flows. In a bank-based system, as in India, OMO sales ultimately involve a transfer of risks associated with government securities to the banking system. As the OMO sales entail the permanent absorption of the liquidity, in the event of the liquidity not being of an enduring nature, the alternative of using the existing stock of securities for longer term repos (up to 3 to 6 months) as an option can also be considered. There could, however, be an issue of possible lack of attractiveness of longer term repos with market participants as they could be taking liquidity risk for a long period since these are non-tradable.

(iii) Balances of the Government of India with the Reserve Bank

The surplus balances of the Government with the Reserve Bank effectively act as an instrument of sterilisation. As the RBI Act does not permit payments of interest on Government balances, these balances are invested in government securities held in the portfolio of the Reserve Bank, thus enabling Government to obtain a return on such balances as per the agreement entered into with the Government in 1997. As a consequence, the stock of government securities to that extent becomes unavailable for monetary management operations, such as, LAF and OMO. In the light of reduction in stock of government securities with the Reserve Bank, consideration can be given to the review of the 1997 agreement. Such a review may consider the placement of government balances with the Reserve Bank without remuneration. This would release government securities for further sterilisation operations. In the context of the consolidated balance sheet, the cost of sterilisation in any case has to be borne by the fisc directly or indirectly irrespective of remuneration of such balances. As the RBI Act does not require it to pay interest to Government on its surplus balances with the Reserve Bank, the Group suggests that the existing agreement of 1997 may be revisited so that Government surpluses with the Reserve Bank are not automatically invested and can remain as interest-free balances with the Reserve Bank, if required.

(iv) Forex Swaps

Some central banks use foreign exchange swaps for sterilisation as it helps postponement of creation of liquidity generated by capital inflows and the consequent accretion to reserves. Accordingly, central banks resort to sell/buy swaps in the forex market for sterilisation purposes and also to correct distortions, if any, in the forward premia, which is usually the case when these are not aligned to the interest rate differential. The cost of such swaps gets reflected in the premium paid by the central bank and the earnings on the foreign exchange reserves foregone. The extent to which such swaps can be undertaken depends on the depth of the forex market. The

recent experience of building up of forward purchase obligations to meet repayment of Resurgent India Bonds (RIB) showed that such operations could result in pressure on the market to meet deliveries. It was also observed that forex sold by the Reserve Bank through swaps has been used by the market for extending forex loans to customers for meeting rupee expenditure. To the extent that such loans are not hedged, the forex finds its way back into the reserves of the Reserve Bank attenuating the efficacy of swaps as a sterilisation instrument. Moreover, sell/buy swaps, even when undertaken on a large scale, do not have any lasting impact in correcting distortions in forward premia. Also, the cost of swaps, as captured in the accounts of the Reserve Bank, has increased with the appreciation of the rupee. Hence, while limited use of this instrument for very short periods may be useful, any decision to use this instrument extensively has to be taken with due care and circumspection.

(v) Cash Reserve Requirements

The use of Cash Reserve Ratio (CRR) as a direct method of monetary policy intervention has the ability of sterilising liquidity by raising the proportion of net demand and time liabilities (NDTL) of banks to be kept impounded with the central bank. However, it is an inflexible instrument of monetary policy that drains liquidity across the board for all banks without distinguishing between banks having idle cash balances from those that are deficient. In case, CRR is not remunerated, it has the distortionary impact of a "tax" on the banking system. CRR is also discriminatory in that it has an in-built bias in favour of financial intermediaries that are not required to maintain balances with the Reserve Bank. As against repos/OMO that can be used flexibly to withdraw liquidity from surplus entitles while injecting liquidity to the deficient ones, CRR is not a preferred option. It is also to be noted that the medium term objective of monetary policy is to bring down the CRR to its statutory minimum level of 3.0 per cent of NDTL. Further, the proposed legislative changes would make CRR more flexible, which can then be brought down to below 3.0 per cent. Nevertheless, use of CRR as an instrument of sterilisation, under extreme conditions of excess liquidity and when other options are exhausted, should not be ruled out altogether by a prudent monetary authority ready to meet all eventualities.

14. The Group also considered the introduction of certain new instruments which would involve amendments to the RBI Act as indicated below:

(i) ***Interest Bearing Deposits by Commercial Banks***

An option for impounding excess liquidity in the banking system is to pay interest on deposits parked by banks on a voluntary basis with the central bank. Cross-country experience suggests that a few countries, such as, Malaysia and Taiwan, have exercised this option. As far as the Reserve Bank is concerned, this option is presently not available. As per section 42 of the Reserve Bank of India Act, the Reserve Bank cannot pay interest on balances kept with it except under CRR, whereby the Reserve Bank pays interest to scheduled banks on the balances which are held in excess of the statutory minimum of 3 per cent and up to the level stipulated to be maintained as CRR on a mandatory basis (currently at 4.50 per cent of NDTL). The Group noted that the Reserve Bank of India (Amendment) Bill, 2001 [hereafter "Bill"] proposing amendments to RBI Act to accord greater operational flexibility to the Reserve Bank is under active consideration of the Government. Clause 8 of the Bill proposes important changes to section 42

of RBI Act whereby the Reserve Bank would have flexibility in determination and remuneration of CRR balances. The Reserve Bank would have the discretion to fix the rate of CRR without any minimum or maximum limit and the deposits held in the Reserve Bank above or below the CRR level can be remunerated. If this amendment is carried out, it would be possible for the Reserve Bank to determine from time to time, interest at any rate that it may deem fit to be paid on the balances actually maintained with it by scheduled banks. The Group feels that these amendments, which are already under consideration of the Central Government, need to be pursued. However, the extent to which such an option can be exercised has to be carefully evaluated in the context of its impact on the Reserve Bank's balance sheet.

(ii) Issuance of Central Bank Securities

In the context of a declining stock of government securities with the Reserve Bank to conduct sterilisation operations, the Group deliberated in detail whether issuances of securities by the Reserve Bank could be enabled to facilitate OMO. In this context, it may be mentioned that a number of central banks in emerging market economies have resorted to issuance of central bank paper to facilitate sterilisation. Such central bank paper, however, has generally been issued by countries which have experienced fiscal surpluses or mild deficits. Moreover, central banks that issued their own paper for the conduct of monetary policy operations often have had to incur losses, more so when the interest rates on such paper are bid up by repeated issuances. Central banks in countries with fiscal surplus have credible assurance of recapitalisation from the government. Maintenance of a healthy central bank balance sheet is also essential for the smooth conduct of central banking functions. Apart from the impact on the Reserve Bank's balance sheet as indicated above, issuance of central bank securities can fragment the debt market due to availability of two competing sovereign issues, one of the Government of India and the other of the Reserve Bank. Normally central banks issue securities at the short end of the maturity spectrum, on the premise that the capital inflows are transient and may reverse over a short period; in the event of reversal, liquidity could be matched by the maturing central bank paper. However, the Group felt that in the Indian context, issuance of government securities at the short end, particularly for the cash management needs, would also be quite significant and, therefore, market fragmentation remains a key issue. On balance and keeping in view the current fiscal situation, the Group is of the view that it may not be desirable to pursue the option of issuance of central bank paper.

Issuance of Market Stabilisation Bills / Bonds by Government

15. The Group considered the following new instrument not requiring amendment to the RBI Act if the existing instruments are found to be inadequate to meet the size of operations in future.

16. In view of the finite stock of government securities available with the Reserve Bank for sterilisation, particularly, as the option of issuing central bank securities is neither permissible under the Act nor desirable as indicated above, the Group considered whether the Government could issue a special variety of bills/bonds for sterilisation purposes. Unlike in the case of central bank securities where the cost of sterilisation is borne indirectly by the fisc given the consolidated balance sheet approach as discussed earlier, the cost of issuance of such instruments by the Government would be directly and transparently borne by the fisc. To operationalise such

a new instrument of sterilisation and ensure fiscal transparency, the Group recommends that the Government may consider setting up a Market Stabilisation Fund (MSF) to be created in the Public Account. This Fund could issue new instruments called Market Stabilisation Bills/Bonds (MSBs) for mopping up enduring surplus liquidity from the system over and above the amount that could be absorbed under the day to day repo operations of LAF. Issuance of such bills/bonds by the Government will obviate any confusion that may arise if the Reserve Bank also issues its own securities. To impart liquidity to these bills/bonds, they may be raised through auctions and permitted to be actively traded in the secondary market. The amounts raised would be credited to the Market Stabilisation Fund (MSF). The Fund account would be maintained with and operated by the Reserve Bank. The maturity, amount, and timing of issue of MSBs may be decided by the Reserve Bank in consultation with the Government depending, *inter alia*, on the expected duration and quantum of capital inflows, and the extent of sterilisation of such inflows. As the funds raised through MSBs would remain immobilised in the books of the Reserve Bank it would not entail any redemption pressure on the Central Government at the time of maturity. As inflows raised through such bills/bonds will not enter the Consolidated Fund of the Central Government, the impact on the fisc would be limited to the extent of interest payments on the outstanding bills.

17. The major recommendations of the Group for use of various instruments are as follows:

(a) Use of existing instruments not requiring amendment to the RBI Act

- It is not desirable to use the LAF as an instrument of sterilisation on an enduring basis; however, for limited periods, it can be used in a flexible manner along with other instruments.

- Open market operations of outright sales of government securities should continue to be an instrument of sterilisation to the extent that securities with the Reserve Bank can be utilised for the purpose. However, as the OMO sales entail the permanent absorption of the liquidity and transfer market risk to participants, the alternative of using the existing stock of securities for longer-term repos (up to 3 to 6 months) as an option can also be considered.

- Surplus balances of the government may be maintained with the Reserve Bank without any payment of interest so as to release securities for OMO. This would entail a review of the 1997 agreement between the Government of India and the Reserve Bank.

- Use of CRR as an instrument of sterilisation, under extreme conditions of excess liquidity and when other options are exhausted, should not be ruled out altogether by a prudent monetary authority ready to meet all eventualities.

(b) *Use of new instruments requiring amendment to the RBI Act*

- The RBI Act may be amended to provide for flexibility in determination/remuneration of CRR balances so that interest can be paid on deposit balances actually maintained by scheduled banks with the Reserve Bank.

- In the context of current fiscal situation and considerations of market fragmentation, it is not desirable to pursue the option of issuance of central bank paper.

(c) *Use of a new instrument not requiring amendment to the RBI Act*

The Government may issue Market Stabilisation Bills/Bonds (MSBs) for mopping up liquidity from the system. The amounts so raised should be credited to a fund created in the Public Account and the Fund should be maintained and operated by the Reserve Bank in consultation with the Government.