Government to oppose RBI's proposal of new cash tool

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The Indian central bank's proposal to introduce a new liquidity tool to help manage a banking system flooded with surplus cash is facing opposition from the government, according to people with knowledge of the matter.

The government is concerned that the so-called Standing Deposit Facility, or SDF, will give the Reserve Bank of India the discretion to set an interest rate outside the purview of the monetary policy panel, two of the people said, asking not to be identified as the matter isn't public. Allowing the facility could also lead to the possibility of the SDF rate becoming the main operative measure in times of excess liquidity, the people said.

On its part, the RBI has recommended SDF as the tool will allow it to mop up extra funds without having to provide lenders any collateral in exchange. It is largely seen replacing the Market Stabilization Scheme, or MSS, which uses bonds issued outside the government's regular borrowings to suck out liquidity.

Cash at Indian banks swelled after Prime Minister Narendra Modi invalidated 86 per cent of the nation's currency in circulation late last year and mandated the worthless notes be deposited with lenders. Banks rushed to park these funds with the RBI, forcing the central bank to raise the MSS limit. The surplus, however, still persists, and has restricted the RBI's ability to intervene in currency markets while the rupee surges.

The new facility could also prompt banks to park their excess cash with the RBI for easy interest income, instead of using it for lending, the people said. A spokeswoman for the RBI wasn't immediately available for comment. Finance Ministry spokesman D.S. Malik also couldn't be immediately reached.

The government and the central bank are still engaged in talks and no decision has been taken so far, the people said.

The SDF will help the central bank define a floor rate in the inter-bank market and give it a window to intervene in both directions, when needed, to achieve the operating target rate, according to a 2014 report prepared by a panel led by RBI Governor Urjit Patel -- who was at that time a deputy governor at the authority.

Patel took over as governor in September, just around the time that India created a monetary-policy panel to collectively set borrowing costs, migrating from a system where the RBI chief had the discretion to decide on rates.

The SDF may be introduced with the discretion to set the rate without reference to the policy rate, the 2014 RBI panel report had stated, adding that it would also require an amendment to the RBI Act.

Central banks globally that use the SDF tend to link the rate to policy rates, although the corridor is not ‘cast in stone’ and can be changed frequently, ICICI Securities Primary Dealership Ltd. wrote in a note in March. Any change in the discretionary SDF rate will be read as a policy change as it would impacting overnight borrowing rates, according to the report.

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