DAY-3

Repo, Reverse Repo,CRR and SLR

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Disclaimer

The course contains material for a total of 6 days. The materials are designed in such a way that it will give an overview to Macroeconomics. The materials designed as a part of bootcamp are self-explanatory. Video links has been added wherever needed. Team FEBS wishesyou a happy learning!

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All The Best!

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Society of Finance, Economics and Business

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Repo and Reverse Repo

Introduction:

Consider a scenario where you go to a bank and get a loan of ₹50,000 at a low-interest rate. Now, that you have this much cash in your pocket, bargaining for commodities won't come into your mind. You won't be asking how much a kilo of onion costs; you can see where this is going. Any sane seller in this case will quote a highly favorable price to him, and as a multitude of people like this come to him, he will be inclined to automatically raise the money for that commodity. We all know what this leads to – INFLATION. This is one of the reasons why just printing money doesn't eradicate economic hardship but rather leads to economic collapse. Now, Government has a duty to fulfil here, it must make sure that too much cash never goes into the economy. In our country, RBI (Reserve Bank Of India) regulates this and acts on the behalf of the government. It controls the money which goes into the economy using several of its monetary policies, and Today we will learn several of those.

Repo:

Repo or Repurchase agreement is a money market instrument, which enables collateralized short-term borrowing and lending through sale/purchase operations in debt instruments. In simpler terms, Repo facilitates the transfer of cash from the Central Bank of the country (RBI, in our case) to commercial banks, and as with any loan agreement against securities such as treasury bills or government bonds, the central bank charges an interest – this is what is called the repo rate.

Increasing or decreasing this rate at the right time is very essential for a country's economic growth.

It primarily controls the trade-off between liquidity and inflation in the economy as follows:

- **The rise in inflation:**
  During high levels of inflation, RBI makes strong attempts to reduce the flow of money in the economy, one such way is increasing the *repo rate*. This disincentivises borrowing for businesses and industries, which in turn slows down investment and money supply in the market, which has negative impacts on the economic growth of the country while controlling inflation.

  As with our earlier scenario, you can understand if the *repo rate* is hiked, then the commercial banks will charge you a higher interest rate, which will in turn disincentivise you from taking that loan and instead make do with the bare minimum. This will in turn cause the sellers to reduce their prices and not keep them at artificially high levels as they will have difficulty finding buyers at their original prices. This is also the reason why RBI hiked repo rates in recent times, i.e., to counter the growing inflation in the country.

- **Increasing the liquidity in the market:**
  Instead, when the RBI needs to pump cash into the system, it lowers the *repo rate*. As a result of which, businesses and industries find it economically feasible to borrow money for different investment purposes. It also increases the overall supply of cash in the economy. This ultimately boosts the growth rate of the economy.
  Due to this, RBI decreased the repo rate during the start of the pandemic and maintained a constant repo rate thought it to incentivise economic activities for recovery. But, as discussed earlier, this will also create an artificial increase in the price of the commodities in the market, thereby increasing inflation.

Reverse Repo:

A reverse repo is the mirror image of a repo. For, in a reverse repo, securities are acquired with a simultaneous commitment to resell. Hence whether a transaction is a repo or a reverse repo is determined only in terms of who initiated the first leg of the transaction. When the reverse repurchase transaction matures, the counterparty returns the security to the entity concerned and receives its cash along with a profit spread. What this means is that commercial banks purchase securities from the central banks (RBI in our case), and there is an agreement that they can sell the securities to RBI at a later date at a higher price; the profit that they earn is determined by an interest called – reverse repo rate. This rate is usually lower than the repo rate, similar to how bank loans have higher interest rates than bank deposits.

This facility is used by the banks to make use of their idle cash, which otherwise couldn’t be put to good use. This facility is useful for controlling the liquidity in the market, as you can clearly deduce higher reverse repo rate would mean that banks would be more incentivized to park more money in the central banks, which would mean that they have less money to lend to the public, which would, in turn, mean less cash flow into the market.

CRR

Cash reserve ratio (CRR) is the percentage of a bank’s total deposits that it needs to maintain as liquid cash. This is an RBI requirement, and the cash reserve is kept with the RBI. A bank does not earn interest on this liquid cash maintained with the RBI and neither can it use this for investing and lending purposes.

To understand the concept of CRR clearly, consider this example: if a bank has net demand and time deposits worth Rs. 10,00,000 and the CRR is 8%, it will have to keep Rs. 8,00,000 with the RBI in the form of liquid cash.

What are the objectives of Cash Reserve Ratio?

There are a handful of important reasons for CRR to exist.

- CRR ensures that banks always maintain a minimum level of liquidity. This way funds are easily available to customers, even if there is huge demand. Another way of saying it is that since the RBI holds part of the bank’s deposit, that portion, as defined by the CRR, remains secure
- CRR helps control inflation. If inflation is high, CRR can be increased to dissuade banks from lending more.
- CRR is also linked to the base rate of loans, which is the rate below which banks cannot lend. Base rate ensures transparency in lending and CRR serves as a reference rate for it.
- CRR helps control the supply of money in the economy. When CRR is reduced it has a positive effect on the economy.

How does CRR control inflation?

CRR affects the level of liquidity in the country’s economy and as such, has a direct bearing on inflation. You can think of CRR as one of the faucets the RBI has to control the supply of money in the economy.

If inflation is high and the supply of money is pushing it higher, the RBI can decide to turn up the CRR requirement and thereby reduce the capacity of banks to lend. With less loans there is less money flowing through the economy and less pressure on inflation.

SLR

The statutory liquidity ratio (SLR) is linked to the mandatory reserve of securities that financial institutions maintain as per the RBI's instructions. It is a percentage of the institution's Net Demand and Time Liabilities (NDTL) that must be set aside for investment in liquid assets such as state government or centrally approved securities. The SLR rate tells institutions how much this ratio must be.

What are the objectives of the SLR rate?

The primary objective of the SLR rate is to maintain liquidity in financial institutions operating in the country. Besides this, the SLR rate also helps:

- Control credit flow and inflation
- Promote investment in government securities
- Ensure solvency in financial institutions
- Prevent asset liquidation when the CRR is raised
- Aid the government's debt management program
- Fuel demand and growth, for instance, when the SLR decreases and liquidity increases
- Using repo in controlling inflation- Central bank of the country, RBI uses repo to control the internal inflation rate. It lends money to the institutions, supplying open market with liquid cash, increasing demand shoot price up, essentially resulting in inflation. When selling the securities, decreases the cash flow, resulting decreasing inflation.

2007 economic crisis

In the year of 2007, the big apples, the main banks of the US were utilising the repo market for fund keeping mortgages as securities. In the end of 2006, housing prices reaches the peak and started to fall. The declining housing prices meant the securities losing its value, made lenders, sell the repurchase agreement, virtually selling the mortgages, dragged the price even further down. This only made the situation worse, losing investment and affecting all over the world.

And *the repo agreement is salable, when mortgages aren't.*

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