4. Variable Rate Repo (VRR) - Economy

The Reserve Bank of India (RBI) injected ₹25,101 crore transient liquidity in the banking system through a three-day variable rate repo (VRR) auction.The RBI injected the funds at cut-off and weighted average rates of 5.26 per cent as per the central bank release.Currently, liquidity in the banking system is estimated to be in a surplus of around ₹75,483.63 crore as of March 16, which is sharply down from ₹2.08 lakh crore as of March 15, before the advance tax payouts.

1.Introduction

1. Variable Rate Repo (VRR) is a key liquidity management instrument used by the Reserve Bank of India to regulate short-term liquidity in the banking system.
2. It represents a shift from administered interest rates to market-driven mechanisms, enhancing efficiency and responsiveness in monetary operations.
3. VRR plays a crucial role in aligning short-term interest rates with the policy repo rate and ensuring smooth functioning of financial markets.

2.Concept and Nature of Variable Rate Repo

Definition and Core Mechanism

1. Variable Rate Repo is an auction-based liquidity injection tool through which banks borrow funds from the RBI.
2. Unlike fixed repo operations, where the interest rate is predetermined, VRR allows banks to bid for funds at rates they are willing to pay.
3. The final cut-off rate is determined through market demand and supply conditions, making it a market-oriented instrument.

Comparison with Fixed Rate Repo

1. In fixed repo operations, the RBI pre-determines the interest rate, offering limited flexibility.
2. In VRR, the interest rate is discovered through competitive bidding, ensuring greater alignment with market conditions.
3. VRR is primarily used for active liquidity management, whereas fixed repo is used for routine liquidity support.

3.Types of Variable Rate Repo

Overnight VRR

1. This is used for very short-term liquidity adjustments to address daily mismatches in the banking system.
2. It helps stabilise overnight money market rates.

Term VRR

1. This includes longer tenors such as 3-day, 6-day, 7-day, or 14-day operations.
2. It is used to manage temporary liquidity imbalances over short to medium durations.

Fine-Tuning VRR

1. This is conducted to address sudden and unexpected liquidity fluctuations.
2. It is particularly useful during events such as tax outflows, government spending, or volatile capital flows.

Operational Mechanism of VRR

1. The RBI announces a VRR auction specifying the liquidity amount and tenure.

2. Banks submit bids indicating the amount they wish to borrow and the interest rate they are willing to pay.
3. The RBI accepts bids starting from the lowest interest rates until the notified amount is reached.
4. The highest accepted rate becomes the cut-off rate, which serves as the effective borrowing rate.
5. This process ensures efficient allocation of liquidity based on market conditions.

4.Advantages of Variable Rate Repo

Market-Based Interest Rate Discovery

1. VRR ensures that interest rates are determined through competitive bidding, reflecting real-time liquidity conditions.
2. This enhances transparency and efficiency in the money market.

Flexibility in Liquidity Management

1. The RBI can adjust the amount and tenor of liquidity injection based on evolving market conditions.
2. This provides operational flexibility in managing both surplus and deficit liquidity situations.

Improved Monetary Policy Transmission

1. By aligning short-term rates with the policy repo rate, VRR strengthens the transmission of monetary policy signals.
2. It ensures that changes in policy rates are reflected across financial markets.

Efficient Response to Liquidity Shocks

1. VRR allows quick intervention during sudden liquidity fluctuations caused by fiscal operations or external shocks.
2. Fine-tuning operations help maintain stability in the money market.

Cost-Effective Allocation of Funds

1. Funds are allocated based on competitive bidding, ensuring efficient utilisation of resources.
2. This reduces distortions associated with fixed-rate liquidity provision.

5.Limitations of Variable Rate Repo

Uncertainty in Borrowing Costs

1. Since interest rates are determined through auctions, banks face uncertainty in predicting borrowing costs.
2. This complicates asset-liability management and financial planning.

Reduced Effectiveness in Surplus Liquidity Conditions

1. When the banking system has excess liquidity, banks may not participate actively in VRR auctions.
2. This limits the effectiveness of the instrument during such periods.

Volatility in Short-Term Interest Rates

1. Auction-based rate discovery can lead to fluctuations in short-term money market rates.
2. This may create instability in overnight and call money markets.

Competitive Imbalance Among Banks

1. Larger banks with stronger liquidity positions may dominate auctions.
2. Smaller banks may face disadvantages in accessing funds at competitive rates.

Limited Role in Structural Liquidity Management

1. VRR is primarily a short-term tool and cannot address long-term liquidity mismatches.
2. Structural issues require other instruments such as open market operations or policy rate changes.

6.Significance in Monetary Policy Framework

Strengthening Liquidity Management Framework

1. VRR enhances the RBI's ability to manage liquidity dynamically and efficiently.
2. It complements other tools such as reverse repo and open market operations.

Promoting Market Development

1. The auction-based mechanism deepens financial markets by encouraging participation and competition.
2. It improves price discovery in the money market.

Ensuring Financial Stability

1. By stabilising short-term interest rates, VRR contributes to overall financial system stability.
2. It helps prevent excessive volatility in liquidity conditions.

Conclusion

1. Variable Rate Repo represents a significant evolution in India's monetary policy toolkit, emphasising market-based mechanisms.
2. While it offers flexibility and efficiency in liquidity management, its effectiveness depends on prevailing liquidity conditions and market participation.
3. A balanced use of VRR along with other instruments is essential for maintaining monetary stability and effective policy transmission.

Source- https-//www.thehindubusinessline.com/money-and-banking/rbi-injects-25101-crore-in-banking-system-via-3-day-vrr-auction/article70765382.ece