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Central Bank and the Unholy Trinity: A Practitioner's Perspective

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ABSTRACT

The monetary policy committee held from Dec 3- 5, 2025 gives a detailed assessment of the evolving macroeconomic and financial developments and accordingly responded with a 25-bps (basis point) cut in the policy repo rates along with announcement of a Buy -Sell swap. The weakening Rupee along with the rising Bond yields had caught attention of the market participants. However, the announcement of the swap measure tenor comes as a surprise. It seems the three market forces (Unholy trinity) of Bond Yield, Weakening Rupee & Worsening Liquidity are testing the Central Bank at the same time. The paper tries to understand the thought behind the various measures and also the implications of these measures across different asset classes.

Keywords: Monetary Policy, Liquidity, Currency

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I. Introduction

There is a saying "Only the one who wears the shoe knows where it pinches" which seems apt in the current market scenario for the Indian central bank. While the markets were focused towards the hardening yields & a weakness in the Rupee, liquidity infusion came in as a bit of a surprise to the market participants. The central bank now seems to be challenged by the three market forces together Rising Yields, Weakening Rupee & Worsening Liquidity situation. In the context of the present monetary policy, we analyze the difficult choices before the central bank in the current scenario.

II. The Context

Before the December monetary policy meeting from 03-05 Dec, 2025 the central bank had some tough choices to make. On one hand the Rupee was trading at all-time low of 90.00 (around 5% depreciation in the year 2025) and on the other hand the bond market yields starting to firm up. While the June substantial cuts (25 bps in Repo rate & 100 bps in CRR (Cash Reserve Ratio)) was expected to bring the yields lower, but the yields had moved up by 30 bps ever since (LSEG data, Reserve Bank of India, 2025). So, with both the asset classes drawing attention of the central bank, it was expected that it had to choose one of the two.

Long term technical charts for the 10 Year INR government bond seemed to be trading near the critical inflexion point of 6.60%, a break past 6.60% would have taken the yields up to 6.80%. There had also been cancellation of some auctions as the buyers bid the markets up indicating discomfort of the central bank towards higher yields.

(Source: investing.com)

Rupee outlook had been bearish on account of a number of factors like increasing CAD (Current Account Deficit), continued selling by the FIIs (Foreign Institutional Investors) in the stock market & the trade uncertainty (Investing, NSE data).

Looking at the Rupee movement before the policy it seems that Bonds was the chosen asset class over Rupee and we saw a new all-time low of 90.30 for the Rupee. Bonds seemed an obvious choice for the central bank, as the yield going higher would put spanner in the wheels of economic growth by making the cost of funds dearer. It would also have adverse impact on the treasury portfolio of all the banks as they would be forced to increase provisioning for the MTM (Mark to Market) losses. Additionally, Rupee weakening against the USD could help to counter the trade tariff inflicted impact and also by not intervening it may be giving a signal (of market data linked Rupee). Thus, would have been a positive signal to markets given the frequent criticism of intervention in the forex markets especially IMF as we are in the midst of a trade deal negotiation with the US.

III. Monetary Policy Decisions

The policy stance was kept at neutral and had the following operation in the month of December 2025:

a. OMO (Open Market Operations) purchase auctions of Government of India securities for an aggregate amount of ₹1,00,000 crore in two tranches of ₹50,000 crore each to be held on December 11, 2025, and December 18, 2025

b. USD/INR Buy/Sell Swap auction of USD 5 billion for a tenor of three years to be held on December 16, 2025

(Reserve Bank of India, 2025)[1]

IV. Analysis & Impact across asset classes

The policy stance being neutral and announcement of OMO of 100K crore in December was as per expectation of the market. A neutral stance opens up space for further rate cuts and also indicates its priority to keep the yields from moving higher by supporting the bonds. In a way the thought seems to be justified, with benign inflation, Central Bank may like to ease the policy thus reflate the economy, which in turn may pull up the nominal growth up which has been a cause of concern. If we look at the recent RBI relaxation in the ECB (External Commercial Borrowings) norms proposed in the October policy also, that seems to be towards easing the access to cheap foreign funds and put further downward pressure on the lending rates (Reserve Bank of India, 2025)[2]

Is there a relationship between the data and the policy action? Going by the latest available data on credit-deposit ratio as of 31Oct 25 at 80.21%. A high CD (Credit-Deposit) ratio shows pressure on the liability franchisee of the banks thus pressurizing

[1] Reserve Bank of India (2025), Monetary Policy Statement 2025-26 Resolution of the Monetary Policy Committee December 3 to 5, 2025

[2] Draft External Commercial Borrowing Framework under Foreign Exchange Management (Borrowing and Lending) Regulations, 2018.

the banks to raise the deposit rates. If we look at the YTD available data the Credit has increased by 11.30% in October 25 from 11% in March 2025 whereas the Deposit grew by 9.70% in October 25 vs 10.30% in March 2025 (Kumari A, Saha M, 2025). Clearly, the deposits have lagged credit growth and banks would need to mobilize more deposits offering higher rates would be a strategy to increase the deposits. The RBI's neutral stance and a 25-bps cut in repo rate puts pressure on the lending rates which in turn would keep the already squeezed NIMs of the banks under pressure.

The announcement of a Buy-Sell swap as a measure to pump liquidity by the RBI is to an extent a bit surprising. At a time when the Rupee was trading at an all-time Low the Buy-sell swap would put a floor on the Rupee level giving an indication that 90 would be the new normal going forward.

However, the tenor of the swap which was kept at 3 year is what gives a discomfort and reflects on the liquidity position going forward. We are at the end Q3 and liquidity would tighten towards the end of the quarter on account of advance tax outflows which is a quarterly phenomenon. The same liquidity comes back as the government spending starts at the start of the next quarter. In such a case the RBI should have resorted to VRR (Variable rate Repo) auction or Term Repos. Through a Buy-Sell swap the liquidity being injected would be for a longer tenor and permanent in nature which seem to indicate that liquidity situation may remain tight as we move further. The question to ask here is where has the liquidity from the CRR cuts gone? Additionally, we also had a huge dividend payout of Rupees 268590.07 crore (Reserve Bank of India , 2025)[3] to the government which would have also come back to the system as liquidity. It seems CRR cuts were not intended to increase liquidity but to maintain the expected liquidity outflow on account of the Swap maturing during second half of the year. The same liquidity is coming back through the Buy-sell swaps to the system but this time Rupee is on the receiving end.

V. What are the factors to watch

In the spirit of crystal ball gazing, the following three may be highlighted:

1) The FII have been net sellers in the Indian markets and continue to remain so currently, primarily due to valuation concerns. As we cross the financial year, we may see the time correction on valuation happening and the flows return, that may happen by Q1 27.

2) Trade deal has caused a lot of uncertainty and impacted lots of sectors across the economy. Anything concrete on the same may be positive and the FII's may come back releasing some pressure on the currency.

3) Japanese bond yields are an important thing to watch for further cues on Rupee, they seem to have a perfect correlation with the Rupee in the current times.

4) Dollar Index (98.50) also seems to be at a inflexion point as it has been testing a trendline on the long-term charts. In case it breaks the Dollar, Index may weaken from here which would be positive for the Rupee.

[3] Proceedings of the 616th Meeting of the Reserve Bank of India

VI. Conclusion

All in all, it seems to be a three-pronged test for the policy, worsening Liquidity, falling Rupee & higher Yields and it may be hard pressed to control all the three. Can we infer a hierarchy of the policy choices? Is liquidity the priority followed by yield and the Rupee?

Technical charts (Chart given above) indicate that the yields may trade with an upward bias. So, are we in the last phase of softer rates and they would move higher to 6.80% for 10-Year government bond by the end of FY 26?

Also, would the quantum of OMO be sufficient or be increased going forward?

The tenor of the swaps also leaves the question open as to "Would the Buy-Sell swaps continue or this was a onetime measure only"?

All these questions are going to be important in the days to come.

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