Festival demand pushes liquidity into deficit again

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A sharp uptick in credit demand, higher consumption during the festival season, and dollar sales by the Reserve Bank of India (RBI) in the foreign exchange market have led to liquidity in the banking system tightening sharply.

The weighted average call rate (WACR), which is the operating target of the RBI's monetary policy, is currently at its highest since April 30, 2019, reflecting the shrinking liquidity in the system. The spread between the WACR and the repo rate, too, is at its highest since February 7, 2019 — the day when the RBI started a monetary easing cycle, which saw the repo rate being reduced by a total of 250 bps to a historic low of 4 per cent during the Covid-19 crises. Since May 4, 2022, the RBI has hiked the repo rate by a total of 190 bps.

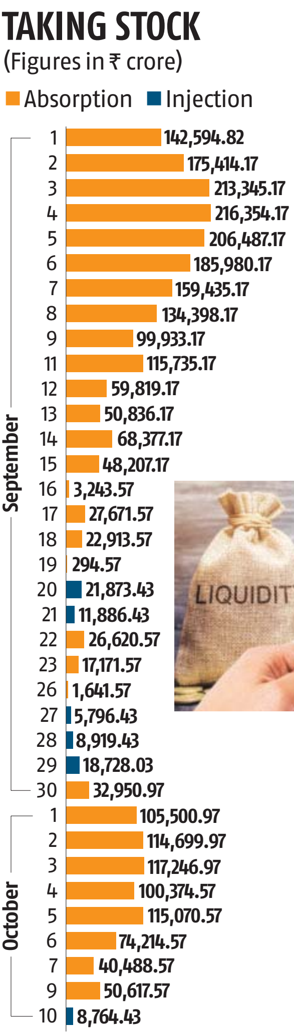
On Tuesday, the WACR closed at 6.11 per cent — 21 bps higher than the repo rate and not far from the marginal standing facility (MSF) of 6.15 per cent. The MSF is the higher band of the RBI's interest rate corridor. When banks borrow from the MSF window, they shell out the highest rate to the central bank for funds.

"Meanwhile, banks with liquidity deficits have been tapping the MSF route. On Monday, banks borrowed ₹21,000 crore overnight from the RBI via the MSF window. This indicates the stress on banking system liquidity. The RBI's FX sales, festival season cash demand, and high government cash balances have contributed to the current tightness in liquidity," said IFA Global CEO Abhishek Goenka.

According to RBI data, the central bank infused ₹8,764.43 crore in the banking system on Monday. An infusion of funds implies that liquidity is at a deficit. In September, the RBI absorbed liquidity worth around ₹91,000 crore.

It was in September that liquidity in the system slipped into deficit for the first time in three years, leading to an infusion of funds by the RBI for five days.

In October, the system slipped into a liquidity deficit for the first time on Monday. Before that, the RBI absorbed ₹90,000 crore, on average, daily in the month, so far.



Source: RBI

"We have seen the interbank liquidity going down sharply and at a faster pace than was initially estimated. But, it's largely on account of government balances. If you take into account the government's balances with the RBI, the overall systemic liquidity surplus is still meaningful," said Neeraj Gambhir, head of treasury at Axis Bank.

"There can be a bit of volatility here because, depending on government spending and the RBI's FX interventions, liquidity in the system can swing between a deficit and a surplus," he said.

For banks, liquidity tightness translates into further pressure to raise deposit rates to fund high credit growth. The latest RBI data showed that as on September 23, bank credit grew at a nine-year high of 16.4 per cent YoY. Deposit growth lagged at 9.2 per cent.

"If you look at total amount of credit that has been given and compare it with growth in deposits, it's far higher. This means that intrinsically, all transactions put together, including the foreign exchange that comes in and goes out, get reflected in the bank balance sheets," said Bank of Baroda's Chief Economist Madan Sabnavis.

"Banks would definitely face pressure to raise deposits further. They are already in the process of doing so because finally, credit has to be supported by deposits. One of the reasons deposits have not grown at the same level is that consumption has grown very well, partly because of inflation — you can see this in GST collections. There have been some compromises that people have done in their savings," he said.

According to CareEdge, banks' credit-to-deposit ratio has been increasing since October 2021 and touched 74.2 per cent, expanding by 460 bps YoY over a similar fortnight last year and by 57 bps as compared to the immediate fortnight, due to faster growth in credit as against deposits.

Since the RBI commenced its rate hike cycle on May 4, banks have been quicker to pass on the higher rates to loans, than deposits. From April to September, banks' marginal cost of funds-based lending rate (MCLR) for tenures ranging from overnight to one-year increased by 55-105 bps, while weighted average lending rates rose 41-68 bps, Bank of Baroda wrote.

Over the same period, however, the weighted average domestic term deposit rates climbed 40-87 bps for term deposits of more than one year, on average.

If government spending falls short of estimates and liquidity in the banking system consistently remains in deficit, the pressure on banks to garner deposits goes up further. "Given the strong demand for credit, it can become challenging to access credit, especially for weaker entities, and potentially it can slow down credit growth," said India Ratings Director Soumyajit Niyogi.