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Banking liquidity shrinks on RBI's defence of rupee

GST outflows have also pushed up interbank cost of funds

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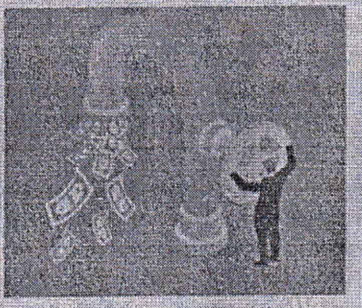
CALL RATES SPIKE

- Interbank call money rate has risen sharply over last two days, currently near MSF rate
- Rise in call money rate due to sharp fall in liquidity surplus in banking system
- Aggressive RBI intervention in FX market, GST outflows key reasons for reduced liquidity
- RBI estimated to have sucked out around ₹1 trillion through dollar sales in last three weeks
- Banks parking significantly lower quantum of funds with RBI now
- Interbank call rate represents overnight cost of funds for banks



Over the last couple of days, the interbank call money rate has hardened towards the upper band of the Reserve Bank of India's (RBI's) interest rate corridor as the liquidity surplus in the banking system has shrunk significantly due to the central bank's interventions in the currency market, treasury officials said.

Outflows on account of goods and services tax (GST) also played a role in reducing the surplus liquidity and sending the call rate sharply higher.

The net outflows on account of GST are estimated around ₹1.2 trillion to ₹1.4 trillion in July, treasury officials said. However, given that this quantum is similar to the amount of outflows observed over the last few months, the more sizeable impact has been felt from the RBI's aggressive interventions in the currency market. The RBI has been aggressively selling dollars from its reserves to shield the rupee from excessive volatility in the face of higher US interest rates and a stronger greenback globally. The rupee touched a record low of 80.06 per US dollar on July 19.

When the RBI sells US dollars in the spot market, it sucks out rupee liquidity from the banking system.

"The RBI has been taking out ₹35,000 to ₹37,000 crore per week for the last three weeks through its FX interventions," a senior treasury official with a foreign bank said.

"The reserves have also fallen sharply. Earlier, the RBI was letting its forwards (position) mature, which is why the headline reserves were not falling too sharply, but now the data is showing that the reserves have dropped significantly," he said.

From $590.6 billion worth of foreign exchange reserves as on June 17, the RBI's reserves have fallen to $572.7 billion as on July 15.

Given that the RBI intervenes in the currency market through transactions with individual banks, the overall impact on liquidity in the banking system is hard to gauge at the time of the central bank's interventions.

This could have led to some banks miscalculating the amount of funds to park with the RBI at variable rate reverse repos and therefore facing liquidity stress when outflows occurred. The banking system liquidity surplus which fell to around ₹1.5 trillion on Monday is current estimated around ₹2 trillion, dealers said.

Market impact

The weighted average interbank call rate closed at 5.07 per cent on Wednesday, not far from the marginal standing facility (MSF) rate of 5.15 per cent. The weighted average call rate had settled at 5.09 per cent on Tuesday.

The interbank call money rate represents the bank's overnight cost of funds. The weighted average call money rate is the operating target of the RBI's monetary policy.

The MSF is the upper band of the RBI's liquidity adjustment facility, or interest rate corridor. The repo rate represents the middle of the corridor while the standing deposit facility marks the lower band.

During the course of trade on Wednesday, the interbank call money rate even outstripped the MSF rate, rising to a high of 5.35 per cent, Clearing Corporation of India data showed.

From ₹2.8 trillion of net liquidity absorbed by the RBI on July 1, the central bank received funds from lenders worth ₹49,876 crore on July 26.

"The quantum being placed by banks in overnight SDF with central bank has been steadily declining. Banks had borrowed ₹59,000 crore from the RBI through MSF on Monday. The RBI intervened by conducting a 3-day ₹50, 000 crore variable rate repo auction to ease the liquidity tightness," IFA Global's CEO Abhishek Goenka said.

With ₹1.8-trillion funds set to return to the system through the maturity of a variable rate reverse repo on Friday, the liquidity stress is set to ease. The government's month-end spending on salaries and pensions —estimated around ₹80,000-90,000 crore a month — is set to further reduce the strain.

However, given the RBI's firm commitment to smoothen out volatility in the exchange rate, banks may park a lower amount of funds with the RBI in anticipation of periodic stress on liquidity.