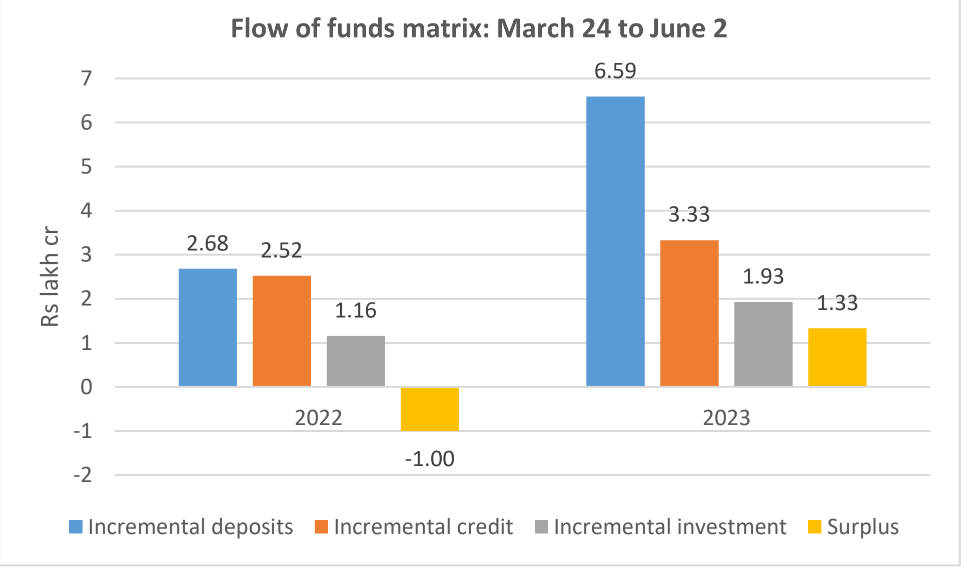
June 19, 2023

The question of liquidity

There have been some interesting developments that have taken place in the banking space in the last month or so which has changed the landscape of liquidity in the market. There was talk at one time of the central bank infusing liquidity in the system through the repo or V2R window; or at the extreme even OMO purchases to ensure stability in bond yields. However, things changed when the RBI announced the withdrawal of Rs 2000 notes from the system as this led to an increase in bank deposits as holders relinquished their holdings of these notes. The situation looks very comfortable today.

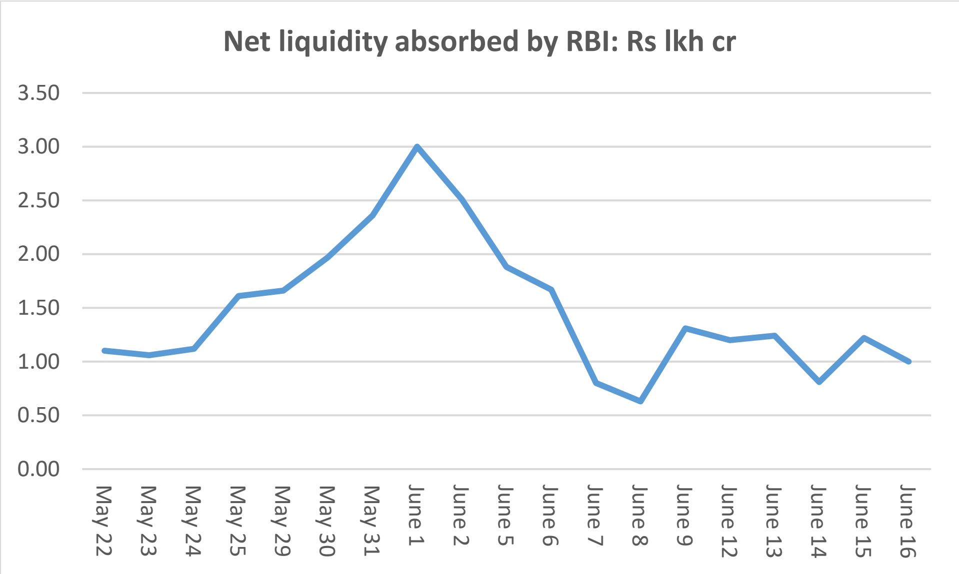
With 2 months of the financial year going by, the liquidity situation in banks can be assessed from the graph below. It looks at incremental credit and deposits for the first two months ending June 2nd. This is depicted for both 2022 and 2023.



As can be seen the increase in deposits this year has been of the order of Rs 6.59 lakh crore against Rs 2.68 lakh crore last year. Hence even though incremental credit has been higher at Rs 3.33 lakh crore as against Rs 2.52 lakh crore in 2022 the net surplus has increased even after adjusting for higher incremental investments. Against a deficit of Rs 1 lakh crore last year, it was in surplus of Rs 1.33 lakh crore.

The higher growth in deposits can be attributed to two factors. The dominant factor was the exchange of the Rs 2000 note as the last fortnight witnessed an increase of Rs 3.26 lakh crore (the exact amount cannot be known as deposits have also been rising smartly before this announcement). The second is the higher interest rates being offered by banks. Households are aware that the present rate cycle is over and that there would be no further rate hikes by the RBI. This being the case there has been urgency shown to lock into higher interest rates at this point of time.

The above phenomenon also led to excess liquidity in the system which was absorbed by the RBI through the SDF and reverse repo windows as shown in the graph below.



However after peaking at Rs 3 lakh crore on June 1st, there has been a decline in these surpluses as banks have held on to the surplus cash to address issue of decline in deposits as companies moved in to pay their advance tax. The GST payments would also be due towards the end of the month and hence the interest in banks in the V3R has also been very limited of late. We may expect this situation to prevail for the rest of the month too. Advance tax payments would have a temporary effect on liquidity until such time the government starts spending the money which would bring the funds back into the system.

How has currency in circulation moved post the announcement of withdrawal of Rs 2000 notes?

Movement in reserve money (o/s) Rs lakh crore				
Rs lakh cr	Reserve money	Currency	Bankers' deposits with RBI	Other deposits
March 24th	43.14	33.80	8.68	0.65
May 19th	44.60	34.78	9.13	0.68
May 26th	44.21	34.42	9.11	0.68
June 2nd	43.96	34.14	9.12	0.69
June 9th	43.85	34.08	9.08	0.68

The table above gives the outstanding reserve money as on March 24th followed by May 19th and subsequently all following weeks. The major component of reserve money is 'currency in circulation' which accounts for around 78% of the total. As can be seen, reserve money rose in the normal course from Rs 43.14 lakh crore as on March 24th to Rs 44.60 lakh crore on May 19th, which is the last date before the announcement of the withdrawal of the Rs 2000 note. The increase was of the order of Rs 1.46 lakh crore. However, subsequently there has been a fall of around Rs 75,000 crore in reserve money with currency in circulation coming down by Rs 70,000 crore. It may be pointed out that as of March 2023, there was Rs 3.62 lakh crore of currency in the Rs 2000 note denomination.

Concluding remarks.

Hence, we may expect liquidity to remain in surplus for the rest of the month. Bank deposits growth would tend to slow down with tax payments made by companies and hence the gap between incremental deposits and credit will moderate. The interesting data points would be the movement in reserve money which includes currency in circulation. Bond yields will remain steady with the 10-year maintaining the range of 6.95-7.05%.

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