

RESEARCH

BOB ECONOMICS RESEARCH | BANK LIQUIDITY

Can it be a devil in disguise?

SUMMARY

INDIA ECONOMICS: BANK LIQUIDITY

Liquidity has been quite a pertinent issue of late when financial conditions remained stringent on account of tightening policy response to higher inflation. In this context, we look at how banking system liquidity is going to evolve in the coming year. In India's context, relatively well placed macro fundamentals and pent up demand contributed to faster pace of credit growth, which outpaced deposit growth where transmission to rates have been relatively slower as the new rates apply to fresh or renewed deposits while the existing ones remain unaffected. This has widened deficit significantly in context of liquidity in the current fiscal.

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Daily macro indicators

Indicator	17-Feb	20-Feb	Chg (%)
US 10Y yield (%)	3.86	3.81	(5bps)
India 10Y yield (%)	7.37	7.35	(2bps)
USD/INR	82.83	82.73	0.1
Brent Crude (US\$/bbl)	83.0	84.1	1.3
Dow	33,697	33,827	0.4
Hang Seng	20,720	20,887	0.8
Sensex	61,003	60,692	(0.5)
India FII (US\$ mn)	16-Feb	17-Feb	Chg (\$ mn)
FII-D	9.1	55.8	46.7
FII-E	245.6	(89.9)	(335.5)

Source: Bank of Baroda Economics Research

BOBCAPS Research

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BANK LIQUIDITY

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Dipanwita Mazumdar | Sonal Badhan
Economists

Even in the coming year, with anticipation of moderation in pace of nominal growth, we expect a considerable gap between demand and supply of funds to the banking system. Further, significant quantum of LTROs/TLTROs are maturing in FY23 and FY24, which will put additional strain on liquidity. This can be corrected through conduct of RBI's long term variable rate repo operations, with the frequency being increased. Or there could be OMOs to induce liquidity in the system on a permanent basis if required.

Also, since Banks' net profit have improved significantly they are well placed in terms of capital. Thus, to continue with the higher pace of lending, they could consider digging into their own capital or reserves and surplus going forward.

How do we define liquidity?

Often when we talk about liquidity, we look at RBI's daily money market operations which consist of RBI's LAF operation, government cash balances and adjusting for all the figures, we arrive at the net system level liquidity. This is one way of looking at it as flows are examined.

The other way is to look at stocks which are basically components of the balance sheets of banks. This encompasses the gap between the flow of funds to the banking system which comes broadly from the deposits and demand for funds in terms of credit and investments. Our exercise is based on the same. Further we have juxtaposed our assumptions on credit, deposit and investment growth in FY23 and FY24 and tried to arrive at the gap between demand and supply of funds, which gives us an idea about the quantum of deficit or surplus of liquidity in the system.



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Recommendation scale: Recommendations and Absolute returns (%) over 12 months

BUY – Expected return >+15%

HOLD – Expected return from -6% to +15%

SELL – Expected return <-6%

Note: Recommendation structure changed with effect from 21 June 2021

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