21 Feb 2023

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Liquidity: Can it be a devil in disguise?

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.

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.

Demand for funds in FY23:

- The current financial year has seen quite a bit of pace in terms of demand for funds in the economy. Pent up demand and pickup in economic activity post Covid-19 induced slowdown contributed towards the same. We expect credit to grow almost at the same pace as nominal GDP. *Our calculation based on past 10 years data show that credit-GDP multiplier is around 0.98.* So taking into account, the multiplier and base case of ~15% growth in credit in FY23, the incremental change in credit comes to Rs 17.8 lakh crore.
- Another important component of liabilities side of SCBs balance sheet is the investments. Based on the assumption of holdings of Banks in Central and State government securities,

which translate to around 38% and 34% respectively currently, in total holdings of Government securities, investment accretion is expected to be around Rs 5.9 lakh crore in FY23.

- Thus the total incremental demand for funds taking into account credit and investment in FY23, translates to around Rs 23.8 lakh crore.

Supply of funds in FY23:

- The rising rate cycle has helped in garnering funds for the banking sector. The deposit to GDP multiplier stands at ~0.92. Thus, on the assumption of 12% growth in deposits in the base case, which is slightly higher than the current growth rate of 10.5%, on account of month end adjustments in deposits, we expect deposit accretion in FY23 to be at around Rs 19.8 lakh crore. Adjusting for CRR balances, the accretion amount stands to Rs 18.9 lakh crore.

- *Thus based on the asset and liabilities side of SCBs' balance sheet there is expected to be a gap of Rs 4 lakh crore in the banking system in FY23.*

Table 1. Higher demand for funds to put pressure on banking system liquidity

Rs lakh crore	Demand for funds	Supply of funds	Deficit-/Surplus+
2012-13	9.2	8.4	-0.8
2013-14	9.4	9.6	0.1
2014-15	8.2	8.3	0.1
2015-16	8.5	7.9	-0.5
2016-17	10.0	14.3	4.3
2017-18	10.7	6.7	-4.0
2018-19	12.1	11.5	-0.6
2019-20	9.7	9.9	0.3
2020-21	12.9	15.5	2.5
2021-22	12.1	13.5	1.4
2022-23E	23.8	19.8	-4.0
2023-24E	21.8	19.4	-2.3

Source: CEIC, RBI, Bank of Baroda Research

What will be the situation in FY24?

- **Demand side:** FY24 will be a crucial year, as some slowdown on growth front is expected, due to spill over effect of muted global growth. Based on the assumption of 11.5% growth in nominal GDP and incorporating our credit-GDP multiplier, the incremental change in credit comes to around Rs 15.3 lakh crore in FY24.

- For investments, we have assumed the same percentage of holding of securities by Banks (38%-Centre, 34%-State). We expect accretion of around Rs 6.5 lakh crore, which is higher than what is expected to observe in FY23. Also, since a lot of frontloading of rates to secondary market is way past us, so some faster pace of accretion towards this segment cannot be ruled out, on account of discounting factor. Thus the total demand side translates to around Rs 21.8 lakh crore.

- On the **supply side**, accounting for the deposit-GDP multiplier, there is expected to be accretion of around Rs 19.4 lakh crore in FY24. This is also based on the assumption that higher deposit rates is likely to continue in the competitive space for some since the rate cycle of deposits took at a laggard pace compared to the lending rate cycle. So to protect margins, the inching up of deposit rates would persist in FY24 as well. Adjusting for CRR, deposit accretion in FY24, turns around Rs 18.6 lakh crore.

- Thus in FY24, the deficit or the gap between demand and supply of funds is expected to come around Rs 2.3 lakh crore. The moderation is on account of slight slowdown in pace of credit growth in line with GDP growth.

What can we infer from Balance sheet of SCBs in the past?

We analysed the consolidated balance sheet of SCBs for the period FY21-22 and note that deposits have the largest share on the liabilities side of the balance sheet, followed by borrowings and reserves and surplus.

- In FY22, RBI's data showed that share of deposits had come down only marginally to 79.3% from 79.6% in FY21. On the other hand, share of borrowings (7.7% versus 7.5%) and reserves and surplus (7.8% versus 7.6%) have increased. While the bump in reserves and surplus can be explained by higher profitability of banks, increase in borrowings was to help maintain the pace of credit growth (8.6% in FY22 versus 5.6% in FY21). Borrowings in this case also include borrowings from RBI, including repos and TLTROs. Capital also increased in the previous fiscal year from Rs 1.9 lakh crore to Rs 2.1 lakh crore, which helped banks maintain a healthy credit growth.

- On the asset side, loans and advances and investments hold majority (~83%) of the share in SCB's balance sheet. In FY22, it was noted that share of loans and advances in banks' sheet rose to 56.3% from 55.2% in FY21. Share of investments however came down to 26.7% from 27.7%. In case of investments, a major share is attributed to purchase of government securities by banks. RBI data shows that share of SCBs in total demand of central government securities remained stable at 38% in FY22, unchanged from FY21, while in case of states it was up at 34.4% from 33.7% in FY21. In absolute terms, gross demand of government (state + centre) securities by banks in FY22 was at Rs 5.45 lakh crore versus Rs 4.69 lakh crore in FY21. Another important category is cash and balances with RBI, which includes maintaining of the CRR. Notably, CRR as of FY22 was 4%, compared with 3% in FY21.

Table 2: Consolidated Balance Sheet of SCBs

Rs lakh crore	FY21	FY22	Incremental Change FY22
Capital	1.9	2.1	0.3
Reserves and Surplus	15.0	16.9	1.9
Deposits	**155.8**	**171.8**	**16.0**
Borrowings	14.7	16.6	1.9
Other liabilities and provisions	8.4	9.2	0.8
Total liabilities/assets	**195.8**	**216.7**	**20.9**
Cash and balances with RBI	9.5	11.7	2.2
Balances with banks and money at call and short-notice	9.8	11.1	1.3
Investments	**54.2**	**57.8**	**3.6**
Loans and advances	**108.1**	**122.1**	**14.0**
Fixed assets	1.5	1.6	0.1
Other assets	12.7	12.4	-0.3

Source: RBI, Ace Equity, Bank of Baroda Research

Mapping in terms of current balance sheet data:

- We analysed balance sheet data of major public and private sector banks (count: 20) for the 9-month ending period Dec'22, to gauge the trend of overall balance sheet of SCBs.

- An interesting finding here is that while incremental change in credit (Dec'22/Dec'21) has far surpassed FY22 level (at Rs 17.8 lakh crore for only 9month period compared to Rs 14 lakh crore in entire FY22), incremental change in deposit growth is slightly lagging (at Rs 15 lakh crore for the 9-month period against Rs 16 lakh crore in FY22). *Thereby, the faster pace of credit accretion, is widening the liquidity deficit.*

- This data should be used only for representational purpose as it is only a subset of SCBs. *Although, looking at the current trend it can be said that change in both deposit and credit growth is set to surpass previous year's level significantly in the current fiscal year*. Investments too are running higher (Rs 4.2 lakh crore for the 9month period compared to Rs 3.6 lakh crore in entire FY22). So far (H1FY23), share of SCBs in central government securities is marginally up at 38.3% (37.8% in H1FY22), while share in state government securities is down to 34.4% versus 35.9% in H1FY22.

- Borrowings have increased by Rs 1.8 lakh crore in the 9month ending Dec'22, versus Rs 1.9 lakh crore in FY22.

Table 3: Consolidated Balance Sheet of SCBs*-FYTD23

Rs lakh crore	Dec'21	Dec'22	Incremental Change (Dec'22 over Dec'21)
Capital	0.87	0.91	0.04
Reserves and Surplus	12.5	14.4	1.9
Deposits	**135.5**	**150.5**	**15.0**
Borrowings	14.0	15.8	1.8
Other liabilities and provisions	6.1	7.0	0.9
Total liabilities/assets	**169.0**	**188.6**	**19.6**
Cash and balances with RBI	11.8	8.4	-3.3
Balances with banks and money at call and short-notice	5.0	4.5	-0.5
Investments	**45.7**	**49.9**	**4.2**
Loans and advances	**95.4**	**113.2**	**17.9**
Fixed assets	1.3	1.4	0.1
Other assets	9.9	11.1	1.2

Source: Ace Equity, Bank of Baroda Research| Note: *Data pertains to large PSBs and PVBs only, is used for representational purpose only

- Thus the demand for funds (9-month basis) taking into account credit and investment accretion turn around to be Rs 22 lakh crore. On the supply side (9-month basis), deposit accretion is around Rs 14.9 lakh crore, which creates a gap of Rs 7.1 lakh crore liquidity deficit when compared to the same 9 month period of previous year, where deficit is only Rs 1.6 lakh crore. There was a fall in balances with RBI which is the reverse repo/SDF which has come down over the months with the RBI in the mode of withdrawal of liquidity from the system.

- Taking into account our assumptions of credit, deposit and investment growth and seeing the current trend (Credit accretion till 27 Jan 2023: Rs 14.5 lakh crore, deposit accretion: Rs 12.5 lakh crore, investment accretion: Rs 4.7 lakh crore), we expect deficit to slightly moderate to Rs 4 lakh crore. *The slight reduction in deficit has happened on account of recent pickup in deposit inflows post series of increase in deposit rates (WATDR of SCBs +80bps increase, post RBI's rate hike policy).*

- *With this Rs 4 lakh crore deficit, financing is likely to come from higher borrowing especially the dig in may be through borrowing from RBI component which includes repo operations*. *So in the coming days, more variable rate repo of longer tenors may be visible.*

Liquidity deficit to widen:

Factors which are going to put stress on liquidity are:

- **Maturity of TLTROs:** The stimulus given in the form of LTROs and TLROs during Covid times is due for maturity in the coming months. For FY23, the amount is Rs 13,018 crore crore compared to Rs 66,131 crore in FY24. However, Bank had prepayment options. So the quantum of strain in liquidity is opaque. *But definitely some pressure cannot be ruled out, which might be balanced by RBI through conduct of more variable rate repos*.

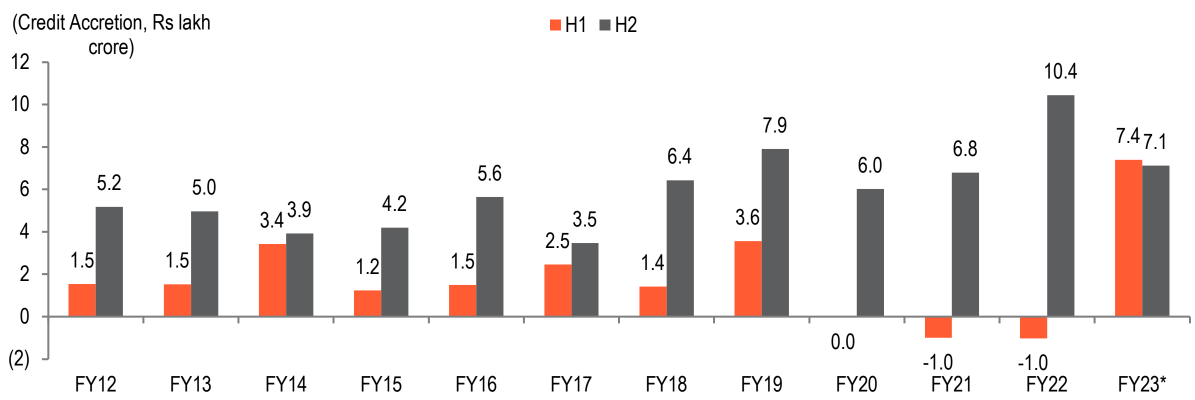
Table 4: TLTRO, LTRO schedule

Instrument, Rs crore	Auction Date	Maturity Date	Amount
Long-Term Repo Operations	02-03-2020	01-03-2023	253
	09-03-2020	07-03-2023	484
	18-03-2020	17-03-2023	294
Targeted Long Term Repo Operations	27-03-2020	24-03-2023	11987
Total-FY23			**1,3018**
	03-04-2020	03-04-2023	16,423
	09-04-2020	07-04-2023	17,512
	17-04-2020	13-04-2023	19,746
Targeted Long Term Repo Operations 2.0	23-04-2020	21-04-2023	7,450
On Tap Targeted Long Term Repo Operations	22-03-2021	21-03-2024	5,000
Total-FY24			**66,131**

Source: RBI, Bank of Baroda Research

- **Seasonal trend of pickup in credit growth:** As historical data shows, *credit growth generally picks in the second half of financial year.* This is on account of demand post sowing, festival demand etc. which is more seasonal in nature. In FY24 as well, owing to the election year, this number is likely to be elevated. *Even credit growth outpacing nominal GDP growth in FY24, cannot also be ruled out. In that case, strain on liquidity would be much severe.*

Fig 1. Generally credit accretion happens at a faster pace in H2



Source: CEIC, Bank of Baroda Research, * till 27 Jan 2023 for H2

What is the way out?

- Banks are currently posting healthy jump in net profit (for the 9-month period net profit of major SCBs rose by 46% to Rs 1.7 lakh crore against Rs 1.1 lakh crore in the same period of previous year). Also, in terms of capital, Banks are comfortably placed. *Thus going forward, to maintain a healthy pace of credit growth and to bridge the liquidity gap, some digging into the capital and reserves and surplus component may be a feasible option.*

- Other than that, borrowing from RBI if the frequency of variable rate repo increases might also be another resort. In that case, *long tenor variable rate repos will be helpful for maintaining durability.*

- Though based on the underlying growth inflation dynamics, we are not foreseeing any rate cut from RBI. However, *some stimulus from RBI in the form of OMO calendar if liquidity dips well below the neutral level, may prove to be helpful*.

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