SBI RESEARCH

Systemic Liquidity needs Flexible Targeting of Permanent Nature…. RBI doing a commendable job yet ~Rs 1 trillion Liquidity Support may be needed further by March end…Delicate mix of temporary and permanent liquidity injection / withdrawal remains a work-in-progress calling for development of liquid term money markets even as exchange rate volatility and capital outflows are 'clear and present' dangers

Issue # 31, FY25 Date: 04-March-2025

Executive Summary….. 1/2

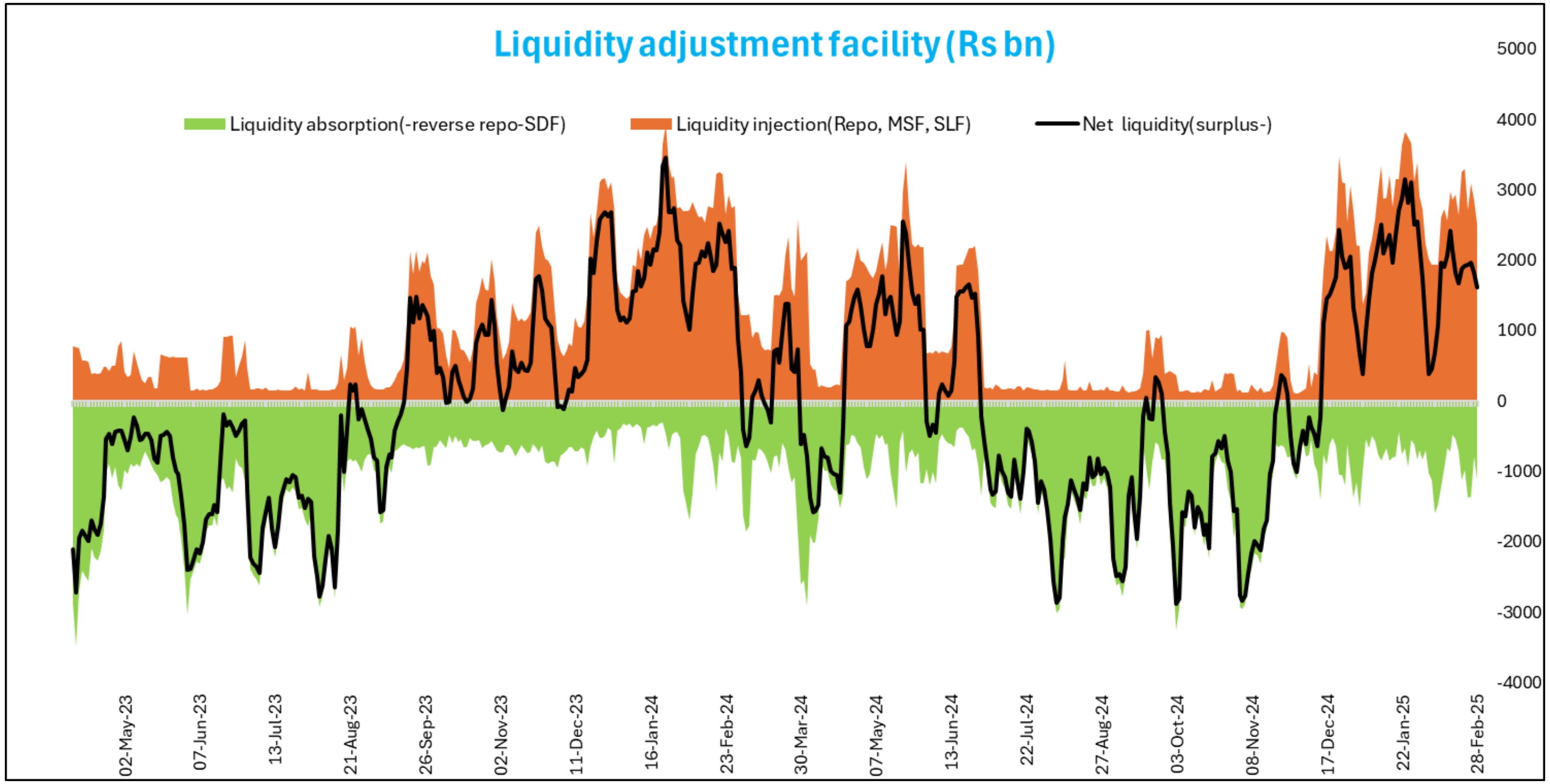
- Series of Forex market intervention to counter volatility in capital flows and Tax outflows, along with a nudge to JIT SPARSH transition and movement in GoI cash balances simultaneously have impacted the systemic liquidity
- RBI has resorted to several measures to inject liquidity into the system, several variable rate repo (VRR) auctions of varying tenors and a series of daily VRR auctions since January 16, jumbo dollar-rupee swaps, unrestricted OMOs apart from a 25 bps repo cut
- While the liquidity situation has eased somewhat, with daily liquidity deficit reducing in March, we believe system liquidity will remain tight due to year end tax outflows / credit off-take….Going by repo auction figures, it is evident that RBI is also using more than what GoI cash balances is available for VRR auctions balances and thus the residual amount has been out of RBI's liquidity from other (own) sources…
- Given that such daily VRR transactions is akin to frictional / transient liquidity injections but is somehow also substituting for permanent / durable liquidity shortfall (shortfalls arising out of currency leakage and liquidity impact of RBI forex intervention) To negate such, RBI is selling in NDF forwards and then carrying over short term buy sell swaps to replace the maturing forward sale position and also to counter the durable liquidity drain from spot intervention
- **This long swap deal of RBI should have a cascading impact on money market. Corporate bond yields and CD were elevated. The spread between a repo rate and a Corporate Bond yield was as much as 125 basis point northwards over the repo rate, while buying activity in secondary market had also been under pressure….the present swap will ensure transition to money market yields**
- While the market players (through banks) are provided with liquidity injection and the Central Bank replenishes its reserves, **corporate ALM mismatches** are also taken care of through hedging due to liquidity rich feature of such Fx swaps
- As the effective INR cost (~7% with a downward bias inclusive of swap cost via forward premia and USD funding costs) is a tad lower than the cost of issuance of CDs (keeping in mind the elevated demand due to March end credit push), which has seen a lot of heat as banks do not look forward to roll over high-cost wholesale funding from non-retail sources received till last year, **the ripple effect could be yield accretive for CD markets in the short term**

Executive Summary….. 2/2

- FIIs have favored India more than other emerging markets in the last decade, the number of net positive inflows years far outweighing net negative years…**However, the spell and intensity of present sell-off wherein FIIs have pulled out Rs 34,574 crore from the Indian equity markets in Feb'25 pushing total outflows to Rs 1.12 lakh crore in the first two months of 2025 and Rs 2.12 lakh crore in five months period (Oct'24 to Feb'25)** despite ~Rs 3.3 lakh crore DIIs push
- To infuse liquidity, OMOs worth Rs 1.39 lakh crore have also been conducted so far with Rs 1.00 lakh crore in primary markets and Rs 0.38 lakh crore in secondary markets… however, the structural friction in money / capital markets has ensured the divergences have accentuated
- On a (not so!) surprising note, despite rate cut, SGS and corporate bonds spreads over G-Secs have widened from 30-35 bps (over G-Secs) to 45-50 bps…. This has spilled over to Corporate bond markets as well, hampering effective transmission of rate cut. **We are of the opinion that there is a need to address this 'spread widening' and believe that open market operations may be considered in SGSs as well to smoothen/harmonize the spreads**…**also, states need to spread their issuances more evenly throughout the year (against bunching more in last quarter) to avoid paying higher cost in the last quarter**
- **With an unchanged ownership in G-sec in FY26, OMO gap in FY26 could hover around Rs 1.7 trillion. Thus, more liquidity measures could be required on a sustained basis…. RBI could look into using CRR more as a regulatory intervention tool / countercyclical liquidity buffer rather than as a liquidity tool in future,**
- The banks were holding ~Rs 1.5 trillion excess SLR because of LCR requirements and a large part stands offloaded to RBI through OMOs. However, this did not have any material impact on sovereign yields (or on spreads between T-bills/G-Sec and Corp. Bonds for that matter)… CD rates have climbed northwards since last year while Spread between repo and CP (weighted average rate) which was negative during FY21 has now increased to around 110 bps in FY25 and 145 bps in Feb 2025…. Similarly, spread between repo and 3 months CD which was negative during FY21 now increased to around 80 bps in FY25 and 119 bps in Feb 2025
- **Separately, there is now inadvertent cash leakage since In Mahakumbh, the withdrawal has been largely by retail depositors whereas the accretion of fresh deposits has been with non-retail participants and hence a significant part of the currency may not come back to systemic deposits, at least by March end**
- **System liquidity is still at a deficit of ~Rs 1.6 trillion (end-Feb) while average deficit is higher at ~Rs 1.95 trillion. We believe around Rs 1 trillion more will be needed by March still to keep the systemic liquidity just in equilibrium mode**

System Liquidity Position

- The system liquidity situation remained tight and turned to injection mode since 16 Dec'2024, due to many reasons like tax outflows, forex market intervention and volatility in capital flows. Further with the implementation of Just in Time (JIT), the system liquidity has been impacted through movements in Government cash balances
- The Indian banking system liquidity encountered its worst liquidity crunch in more than a decade. The system liquidity moved from a surplus of Rs 1.35 lakh crore in November to a deficit of Rs 0.65 lakh crore in December, further to Rs 2.07 lakh crore deficit in January and Rs 1.59 lakh crore in February



Steps taken by RBI to Manage Liquidity

- To ease the liquidity pressure, RBI has resorted to several measures to inject liquidity into the system, including several variable rate repo (VRR) auctions of varying tenors and a series of daily VRR auctions since January 16, dollar-rupee swap, OMOs and 25 bps repo rate cut
- If we look at RBI's daily VRR data, which indicate allotted amount % to Bids Received is 83% (average since 17 Dec'2024) and the daily liquidity deficit has been reduced in March, but we expect system liquidity will remained tight due to year end tax outflows and credit off-take

RBI liquidity Injections from 17 Jan 25 to till now(Cumulative)	
Instruments	Rs Lakh cr
Daily VRR including overnight VRR	32.3
Total 14 days VRR	5.6
Total long term VRR	1.8
Total OMO purchase(primary and Secondary)	1.39
USD INR swap*	1.3
Total	**42.4**
Source: RBI, Till Feb 28,~as per average exchange rate	

GOI cash balance and VRR auctions

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- Repo auction amount allotted is lower than GOI cash balance for most of the days from 16th Dec, but days are given in the table shows that auction amount is higher than GOI balance with RBI…indicating that RBI has fully used up the GoI balances and the residual amount was out of RBI liquidity from other sources…RBI is thus neutralising the Government cash balances through a carefully crafted dynamic liquidity management policy…an example of injection of temporary liquidity replacing not only shortfall of temporary liquidity, but also perhaps shortfall in permanent liquidity
- In principle, the unspent cash balance of the Government is now being auctioned by the RBI through repos, has its limitation in terms of amount and tenor. While RBI's steps do provide some comfort in terms of liquidity, the cash balances of Government cannot become a part of permanent liquidity as they cannot be transferred to Banking system under the current JIT mechanism and can at best be used to manage only short term mismatches

Gov cash balance Vs VRR auctions

Start Date	Auction Amount allotted (Lakh cr)	Gov cash balance (Lakh Cr)	Difference
10-01-2025	2.75	1.65	**1.10**
24-01-2025	3.62	2.55	**1.07**
07-02-2025	1.83	1.01	**0.82**
10-02-2025	2.01	1.61	**0.40**
11-02-2025	2.00	1.31	**0.69**
12-02-2025	1.94	1.71	**0.23**
13-02-2025	2.36	2.13	**0.23**
14-02-2025	2.25	1.32	**0.93**
17-02-2025	1.57	1.53	**0.04**
Average	**2.26**	**1.65**	**0.61**

Source: RBI, GoI cash balnce estimated from System and Core liquidity from RBI Money market operations

Liquidity Estimation; CRR cut is necessary to ease the pressure

- With an unchanged ownership in G-sec in FY26, OMO gap in FY26 could still be around Rs 1.7 trillion. Thus, more liquidity measures could be required on a sustained basis

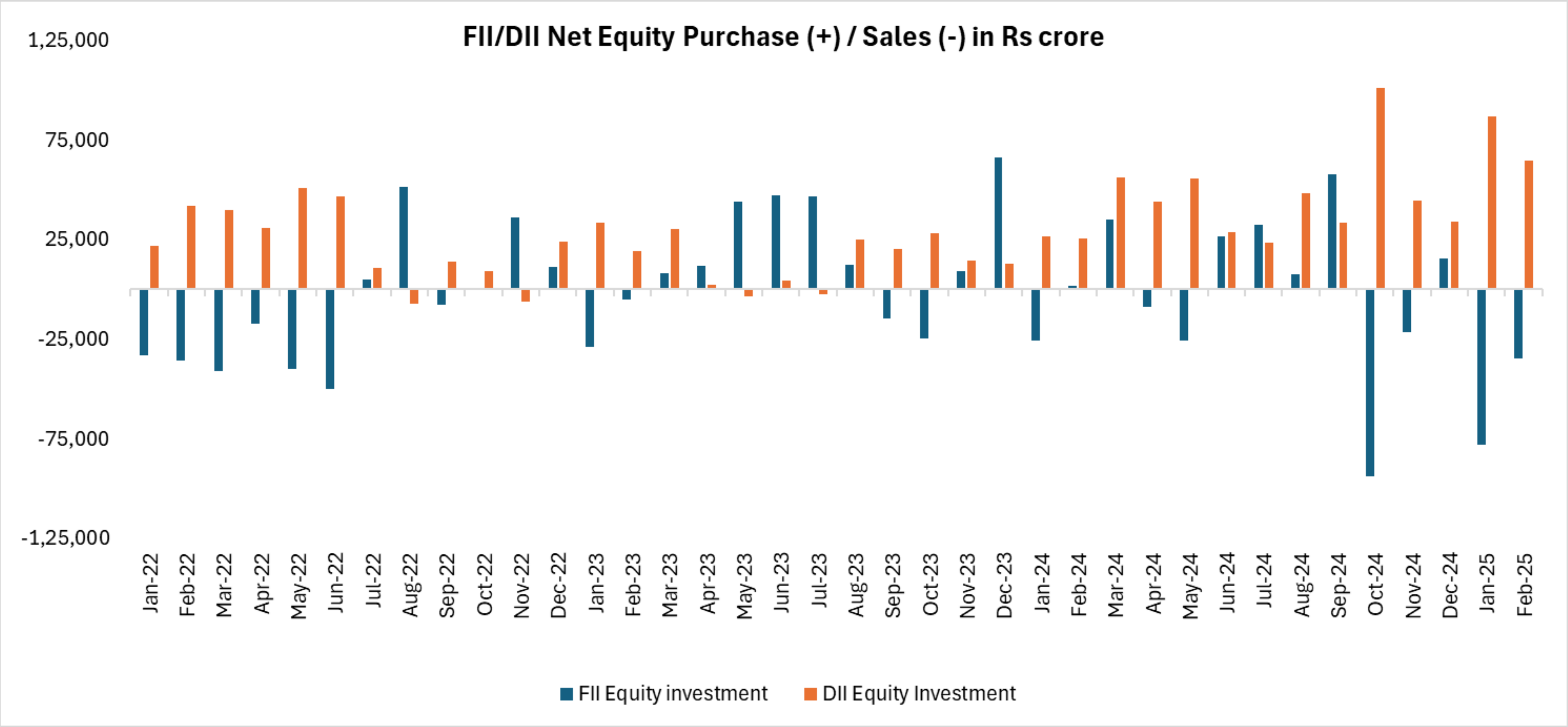
- RBI could look into using CRR more as a regulatory intervention tool / countercyclical liquidity buffer rather than as a liquidity tool in future

- There is an urgent need to revisit the existing liquidity management framework by RBI by replacing the WACR as a policy rate as it does not serve the intended purpose

Liquidity Estimate by Mar'25 (Rs billion)	
Autonomous factors	Rs bn
1. Currency in circulation withdrawal	-1600
2. GoI Cash Balances drawdown	520
3. Forex intervention by RBI	-2000
Policy driven (Discretionary) factors	
4. VRR auction 56 +49+45 days	1830
5. Open Market Operations by RBI(Net)	1150
6. USD/INR buy sell swap	1,290
7. Required CRR at 4% (drawdown)	50
8. Core liquidity change(1+3+4+5+6+7)	**720**
Memo items:	
System liquidity [Net Absorption (+) / Injection (-)] as at end-period	~1500
Net durable liquidity [surplus (+)/deficit (-)] as at end-period	~1000
Source: SBI Research, *OMO purchase is Rs 1.39 Lakh cr	

FII outflows exacerbated Liquidity situation further…..

- FIIs have pulled out Rs 34,574 crore from the Indian equity markets in Feb’25 pushing total outflows to Rs 1.12 lakh crore in the first two months of 2025 and Rs 2.12 lakh crore in five months period (Oct’24 to Feb’25)
- Despite Rs 3.3 lakh crore injected by DIIs, the BSE Sensex has dropped by more than 11,000 points in the last five months



Multiple factors dictating equity outflows….

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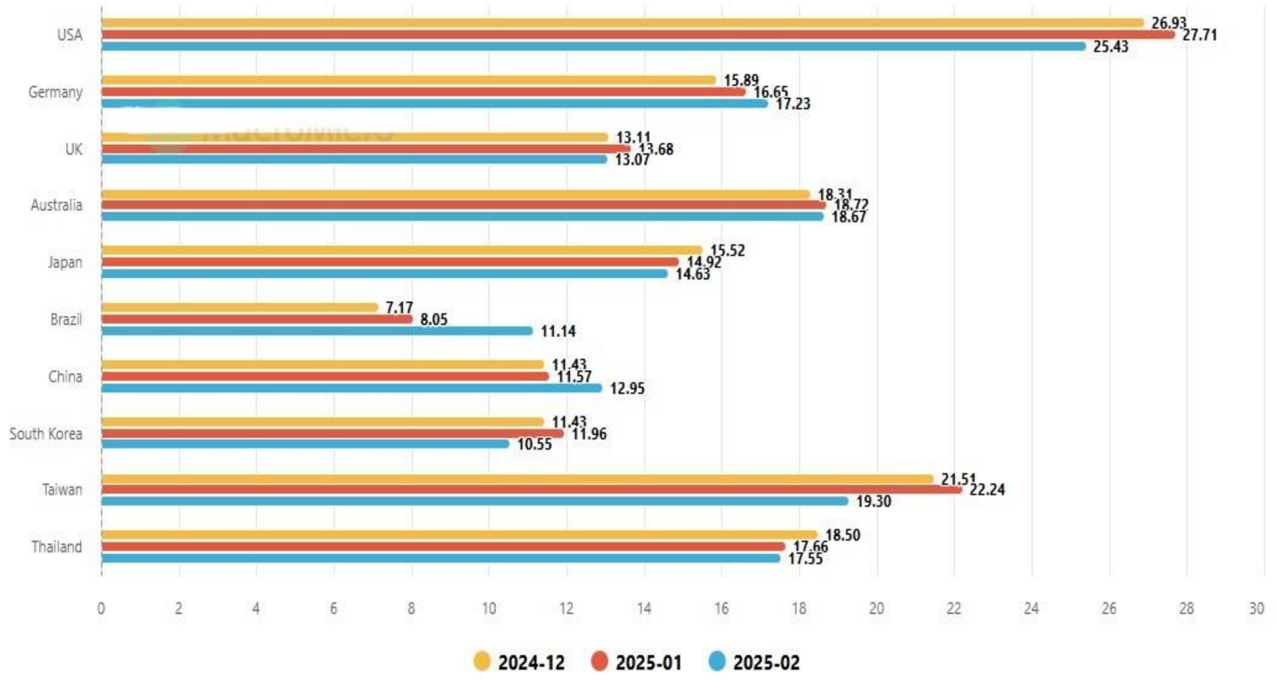
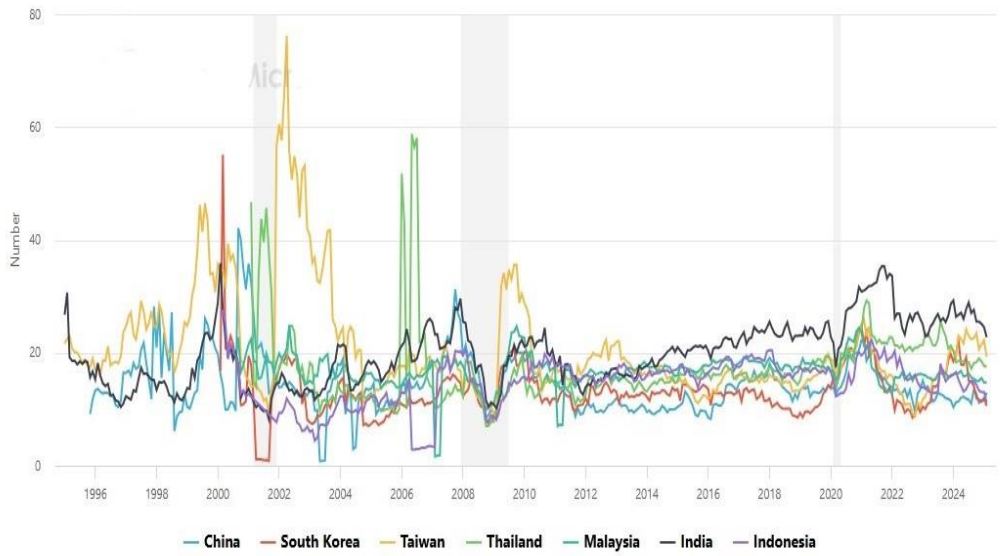
WORLD- MSCI PE RATIO BY COUNTRY



MSCI PE RATIO: EMERGING ASIA-PACIFIC



- Post stupendous performance through 2023/24 from equities, certain major indexes have embraced ‘rich’ valuations warranting mean reversion…. Post Pandemic, the divergence of Indian equities with its Asian counterparts has been on a high In terms of valuations multiples
- Reshuffling of portfolios by Global wealth managers ensured money flows to relatively cheaper jurisdictions though the democratic demographics and renewed growth/earnings prospects should ensure long term money to return and chase value stocks sooner that have well protected economic moats… **Strong DIIs purchase has ensured no spike in volatility despite a general downward trend**

Source: MSCI P-E ratio, SBI Research

RBI has been on a charm offensive… using its toolkit innovatively and intuitively

	USD/INR Sell Buy Swap auction									
	Aggregate amount notified by RBI (USD Billion)	Total amount bid by participants (USD Billion)	Total amount accepted by RBI (USD Billion)	Cut-off premium (in paisa)	Bid to cover ratio	No. of bids received	No. of bids accepted	Weighted Average Premium of accepted bids (in paisa)	First leg settlement date	Second leg settlement date
28-02-2025	10	16.23	10.06	655.1	1.62	244	161	673.29	March 04, 2025	March 06, 2028
31-01-2025	5	25.59	5.1	96.81	5.12	253	28	97.72	February 04, 2025	August 04, 2025
28-04-2022	5	14.31	5	468.89	2.86	237	73	462.52	April 28, 2022	October 23, 2023
08-03-2022	5	13.565	5.135	656	2.71	246	86	649.71	March 10, 2022	March 11, 2024
23-03-2020	2	1.53	0.65	196	0.77	42	14	188.5	March 26, 2020	September 25, 2020
16-03-2020	2	4.67	2.06	156	2.34	78	19	154.38	March 18, 2020	September 18, 2020

- RBI's recent swap of US$ 10 billion (largest so far) has calmed the market participants' frayed nerves, indicating the Central Bank is willing to walk the extra mile to restore sanity, infusing long term liquidity, while keeping the cost dynamics in mind….It should also help Corporates in better ALM management even as more B/S swaps of longer duration could be considered to shore up reserves and release liquidity to counter the stress

Swaps have served multiple purposes beyond liquidity….

- RBI has responded proactively by announcing 3yr Buy/Sell Fx swap of US$ 10 bn meeting head-on demands raised by banks for more longer-term liquidity measures

- RBI has been walking the talk with great prudence, fine-tuning the twin dilemma of managing currency depreciation with liquidity infusion in the system…. The massive Buy/Sell swaps, involving simultaneous purchase and sale of USD with varied maturities, apart from being risk neutral to banks, is remunerative too from a cost perspective

- As the effective INR cost (~7% with a downward bias inclusive of swap cost via forward premia and USD funding costs) is a tad lower than the cost of issuance of CDs (keeping in mind the elevated demand due to March end), which has seen a lot of heat as banks do not look forward to roll over high-cost wholesale funding from non-retail sources received till last year, the ripple effect could be accretive for CD markets in the short term

- While the market players (through banks) are provided with liquidity injection and the Central Bank replenishes its reserves, corporate ALM mismatches are also taken care of through hedging due to liquidity rich feature of Fx swaps that comes handy for corporates that have availed of longer tenor ECBs… Corporates may prefer a shorter tenor (say 1 year) forward premium swap, willing to take a calculated risk on gap years movement

- Market players would be familiar with RBI’s strategy during the heady days of taper tantrum when RBI had facilitated banks to use the swap window against gush of FCNR deposits that had a twin positive effect on filling the Fx reserves and INR strengthening…. While FCNR deposits are in positive territory since last year, the narrowed interest rate differential has kept the flows in check

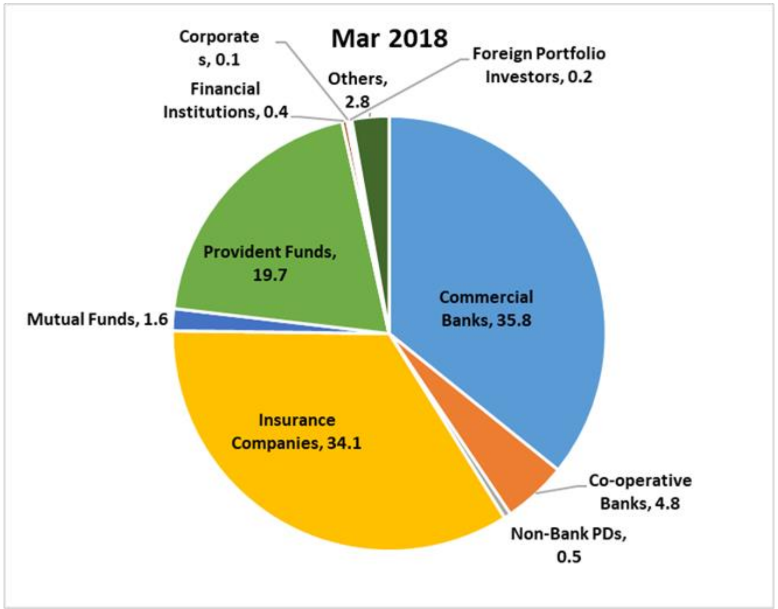
OMOs have been a lifeline for now but would need tweaks for a profound impact…..

- To infuse liquidity, the Central Bank has been conducting OMOs (also demanded by bankers in their recent meets with RBI) but the pace and nature needs some fine tuning to ensure the March end does not bring a 'high & dry' spell for market liquidity, as tax outflows with FIIs induced currency movements may strike a material impact on optimal threshold desired….OMOs worth Rs 1.39 lakh crore have been conducted so far with Rs 1.00 lakh crore in primary markets and Rs 0.38 lakh crore in secondary markets

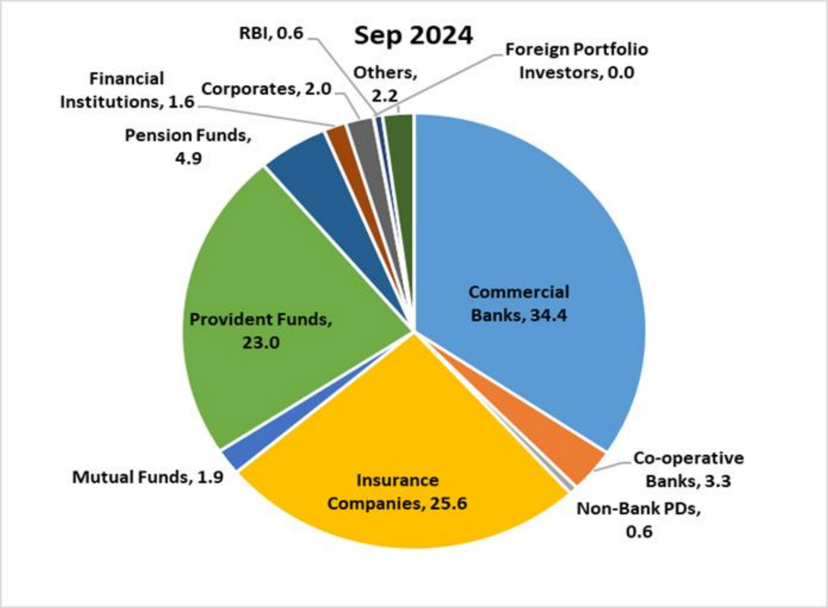
OMO Purchase in Rs cr			
	Purchase	Purchase	Purchase
auction held on	Jan 30, 2025	Feb 13,2025	Feb 20,2025
Settlement on	Jan 31, 2025	Feb 14,2025	Feb 21, 2025
7.17% GS 2030		7315	9918
7.18% GS 2033	4375	8840	4585
7.10% GS 2034	4125	4105	4340
6.79% GS 2034	5000		4091
7.41% GS 2036			10005
7.54% GS 2036		10000	
7.18% GS 2037	6520	9740	7061
sum	**20020**	**40000**	**40000**
Total amount notified	**20000**	**40000**	**40000**

#Primary market OMOs

OMOs need to skew towards SGS now to harmonize transmission of rate cut(s)…..



SGS ownership pattern



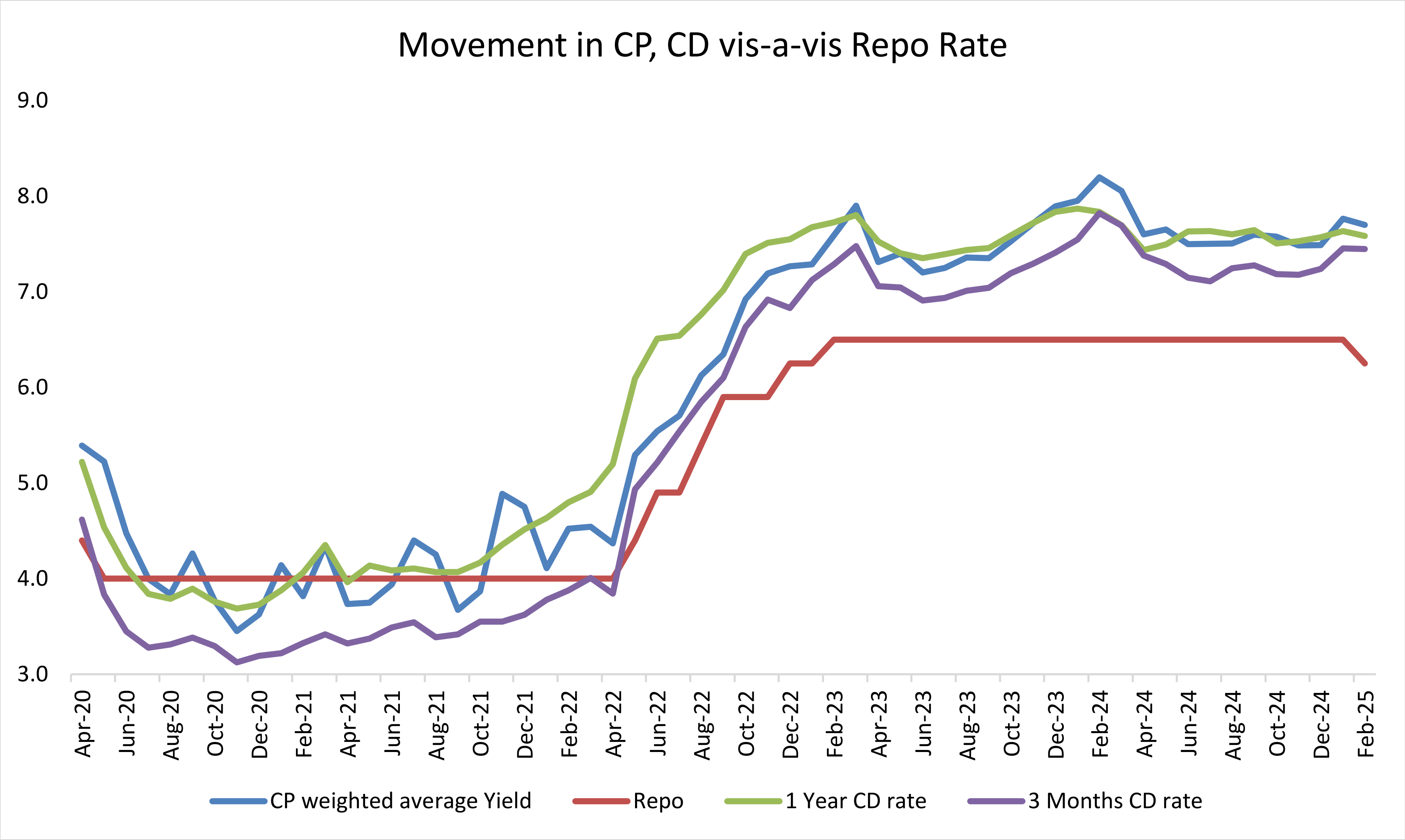
- On a (not so!) surprising note, despite rate cut, SGS and corporate bonds spreads over G-Secs have widened from 30-35 bps (over G-Secs) to 45-50 bps…. This has spilled over to Corporate bond markets as well, hampering effective transmission of rate cut. We are of the opinion that there is a need to address this ‘spread widening’ and believe that open market operations may be considered in SGSs as well to smoothen/harmonize the spreads.
- It has also been observed that bunching up of SGS issuances in the last quarter often leads to widening of spreads. It is worth a shot if states could be sensitized to spread their issuances more evenly throughout the year to avoid paying higher cost in the last quarter. Permitting States to avail money-market borrowings within the overall borrowing can help them manage funds flow and SGS issuances better.

Balancing the Known-Unknowns of Liquidity Trap….

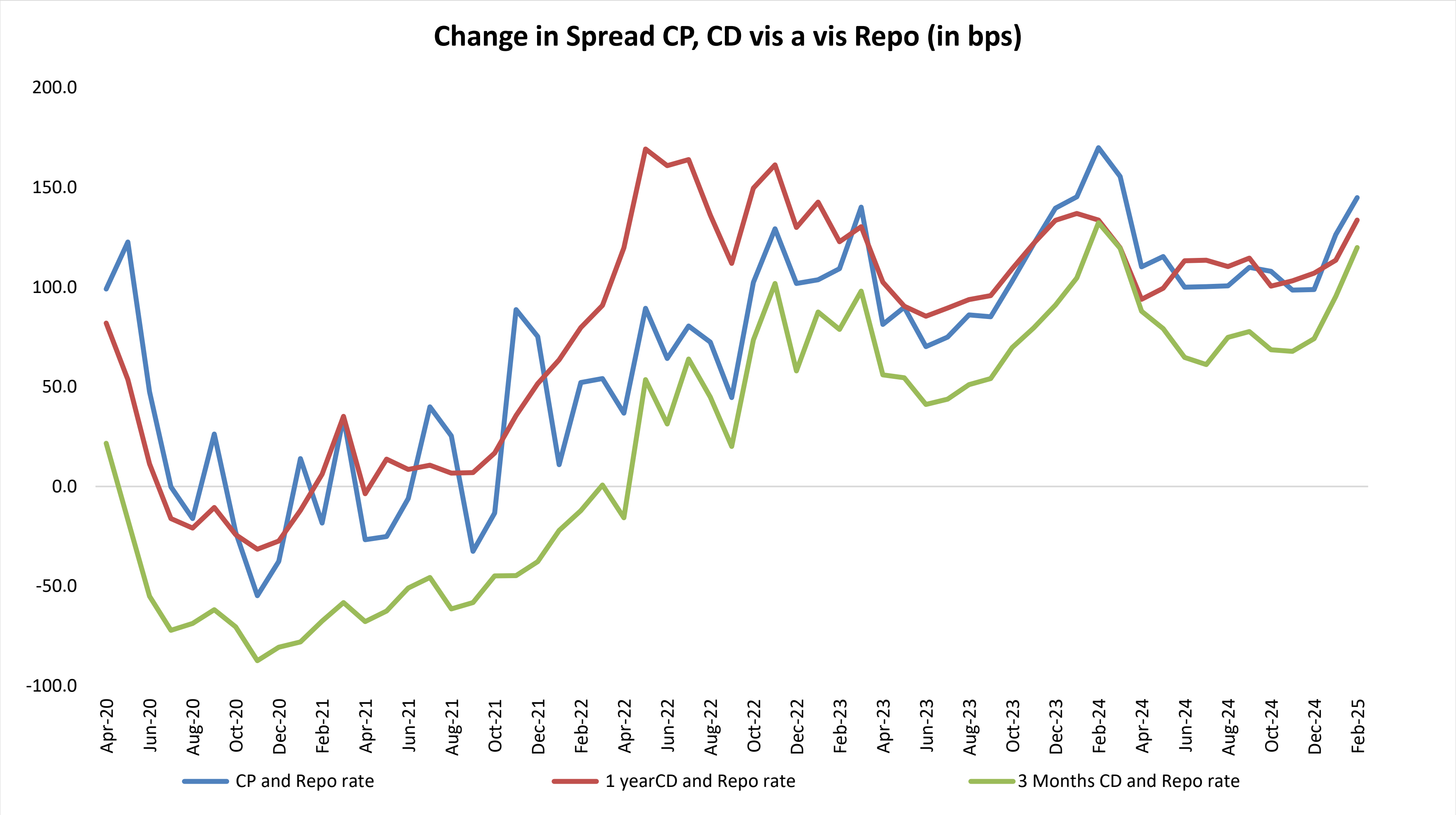
- The banks were holding ~Rs 1.5 trillion excess SLR because of LCR requirements.
- They have now offloaded a large part to RBI through OMOs. However, this did not have any material impact on sovereign yields (or on spreads between T-bills/G-Sec and Corp. Bonds for that matter)
- This long swap deal of RBI will have a cascading impact on money market. Corporate bond yields and CD were elevated. The spread between a repo rate and a Corporate Bond yield was as much as 125 basis point northwards over the repo rate, while buying activity in secondary market had also evaporated.
- Hence, the present swap will ensure transition to money market yields which will have an impact on real economy
- **Separately, there is now inadvertent cash leakage because of Mahakumbh (In Mahakumbh, the withdrawal has been largely by retail depositors whereas the accretion of fresh deposits has been with non retail participants and hence a significant part of the money may not come back to systemic deposits**
- Daily FPI outflows of significant amount and the maturing of forward transactions within 1/2/3 month and hence the RBI will need to infuse further liquidity. System liquidity is still at a deficit of ~Rs 1.6 trillion (end-Feb). OMO done till date is Rs 1.38 trillion and quarter crossing VRR in April is at ~Rs 1.8 trillion (56/49/45 days). **We believe around Rs 1 trillion more will be needed by March still to keep the systemic liquidity just in equilibrium**

Movement of rate - CP, CD vis-a-vis Repo Rate

Change in CP, CD and Repo Rates				
Period	**Repo Rate**	**CP (WAY)**	**3M CD (WAR)**	**1Y CD (WAR)**
Apr-21	4	3.7	3.7	4
Feb-25	6.25	7.7	7.45	7.59
Change	**2.25**	**4**	**3.75**	**3.59**



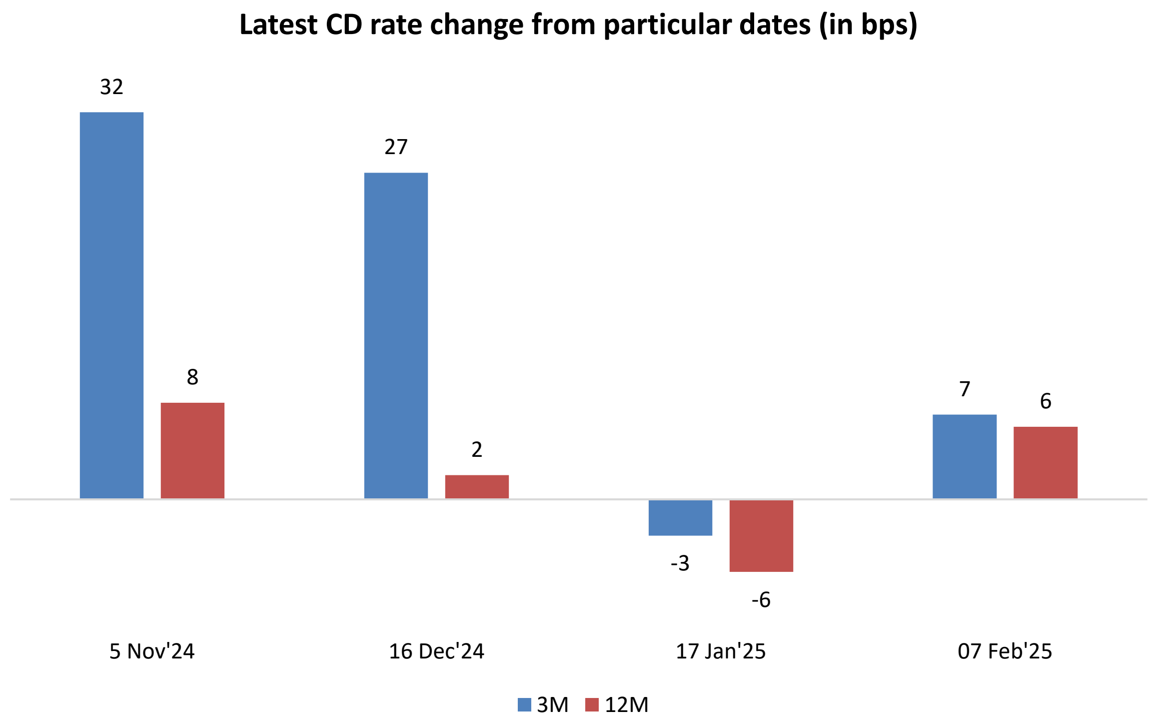
Spread between CP, CD and Repo



- Spread between repo and CP (weighted average rate) which was negative during FY21 now increased to around 110 bps in FY25 and 145 in Feb 2025

- Similarly, spread between repo and 3 months CD which was negative during FY21 now increased to around 80 bps in FY25 and 119 bps in Feb 2025

Hardening CD rates are agnostic to deposits repricing….



movement as on 20 Feb'25 against the previous date (FBIL)

- Despite rate cut by MPC, CD rates have climbed upwards driven by liquidity fears and envisaged trajectory of repricing of bulk deposits
- Banks have raised Rs 9.87 lakh Crore through CDs in the FY'25 (YTD) against Rs 7.28 lakh Crore In the similar period last year…. With deposits clocking growth of 10.6% but tilted towards high-cost time buckets, banks could increasingly resort to short tenor market borrowings (also the increasing issuance of infrastructure bonds warrants reckoning) to fund their operations

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