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Banking Liquidity in Deficit Mode

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What's in News?

Liquidity in the banking system has swung into **deficit mode after remaining in surplus mode for almost 40 months.**

Banking system liquidity:

- Liquidity in the banking system refers **to readily available cash that banks need to meet short-term business and financial needs.**
- On a given day, if the **banking system is a net borrower from the RBI under Liquidity Adjustment Facility (LAF),** the system liquidity can be said to be in deficit and if the banking system is a net lender to the RBI, the system liquidity can be said to be in surplus.
- The LAF refers to the RBI's operations through which it injects or absorbs liquidity into or from the banking system.

Reasons for the Deficit:

1. Improvement in Demand for the Credit.
2. Incremental deposit growth not keeping pace with credit demand.
3. Intervention of the RBI into the forex market to stem the fall in the rupee against the US dollar.
4. Advance tax payments by corporates.
5. Government spending, which boosts liquidity in the market, has been slower than expected despite robust tax collections.

Impact on Consumers:

- A tight liquidity condition could lead to a **rise in the government securities yields** and subsequently lead to a rise in interest rates for consumers too.
- The **borrowing cost for short-term papers is increasing** at a faster pace compared to longer tenor securities and there is a possibility of RBI's rate hike.
- A **rise in the repo** rate will lead to a **higher cost of funds**.
- Banks will increase their repo-linked lending rates and **the marginal cost of funds-based lending rate (MCLR),** to which all loans are linked to.
- This rise will result in higher interest rates for consumers.
- This has also **nudged up call money rate** temporarily above the repo rate

RBI's intervention:

- If the current liquidity deficit situation is temporary and is largely on account of advance tax flow, the RBI may not have to act, as the funds should eventually come back into the system.
- However, if it is long-term in nature then the RBI may have to take measures to improve the liquidity situation in the system.

- To help the banking system tide over the liquidity deficit and also soften call money rates, the Reserve Bank of India will conduct a ?50,000-crore **Variable Rate Repo (VRR) auction of one-day tenor under Liquidity Adjustment Facility.**

Variable Rate Repo (VRR):

- Repo is the rate at which RBI lends short term loans to Banks. A part of it is done at a fixed rate and some of it is a variable rate.
- Under VRR operations, **banks bid for funds from the RBI at a rate higher than the repo rate, while the call money rate is an overnight rate at which banks lend to each other to meet cash requirements.**
- The overnight auction under LAF will be conducted on its core banking system (e-Kuber) platform.

(Edited on September 30th 2022, The RBI has merged the 28-day VRRR auction with the 14-day VRRR auction in order to tackle the moderation in liquidity in the system)