ICRA

Liquidity and Monetary Policy

Phased discontinuation of I-CRR to augment liquidity ahead of advance tax payments, festive season; status quo likely in Oct 2023 policy meeting

SEPTEMBER 2023

Highlights

Click to Provide Feedback

Liquidity augmentation on account of phased reversal of I-CRR would partly offset the drain related to advance tax outflows in the second half of Sep 2023

Despite the expected liquidity tightening in H2 FY2024, a shift to VRR as primary tool may only arise in the event of sustained capital outflows

Expect the MPC to maintain status quo in its Oct 2023 meeting, despite the likely overshooting in its Q2 FY2024 CPI inflation forecasts

- The RBI had introduced an incremental cash reserve ratio (I-CRR) of 10% on the increase in net demand and time liabilities (NDTL) of scheduled banks that was seen during May 19-July 28, 2023, to address liquidity overhang in the banking system after the withdrawal of Rs. 2,000 bank notes.
- Consequently, the surplus liquidity moderated sharply to Rs. 0.7 trillion on Aug 14 (first business day post I-CRR) from Rs. 2.1 trillion on Aug 11. Thereafter, there were transient episodes of liquidity deficits during Aug 21-23, averaging at Rs. 0.2 trillion, before liquidity reverted to surplus of Rs. 1.0 trillion by the end of the month and averaged at Rs. 1.2 trillion in Sep 2023 (till Sep 8).
- The impounding of liquidity led to a surge in borrowings under the Marginal Standing Facility (MSF; average of Rs. 493 billion during Aug 13-31 vs. Rs. 31 billion during Aug 1-11), as well as a surge in short term rates, with the weighted average call rate (WACR) and T-bill yields exceeding the repo rate by 13 bps and 29 bps, respectively, in the second half of Aug 2023.
- Systemic liquidity typically tightens in the second half of September vis-à-vis the first half owing to advance tax outflows during the second half of the month. However, the expected liquidity augmentation on account of the phased reversal of the I-CRR (by Rs. 0.32 trillion each on Sep 9 and Sep 23) should partly offset the drain on account of advance tax outflows in the second half of Sep 2023. Consequently, ICRA does not expect the RBI to conduct VRRs in the near term.
- Overall, the RBI's decision to discontinue the I-CRR will augment liquidity by ~Rs. 1.3 trillion by October 7, 2023, ahead of the busy season. The Central bank is likely to continue with VRRRs over the next few months, although the frequency may reduce. While ICRA expects the RBI to conduct VRRs intermittently in H2 FY2024 in the event of sharp systemic liquidity deficits, a situation to shift to VRRs as the primary tool may only arise if there are sustained capital outflows.
- Notwithstanding the likely overshooting in the CPI inflation in Q2 FY2024 vis-à-vis the Monetary Policy Committee's (MPC's) forecast, ICRA expects the MPC to maintain status quo in its policy meeting on Oct 6, 2023. We foresee the policy rate remaining unchanged through FY2024, with the earliest rate cut in Q2 FY2025, amid a shallow rate cut cycle of 50-75 bps.

RBI discontinued I-CRR measure in a phased manner

ICRA

Key developments on the liquidity front

May 19, 2023 - Rs. 2,000 banknote withdrawal

- The RBI announced the withdrawal of Rs. 2,000 bank notes from circulation
- Consequently, there was a sharp increase in systemic liquidity amid the fall in currency in circulation and a surge in bank deposits

August 10, 2023 - Introduction of I-CRR

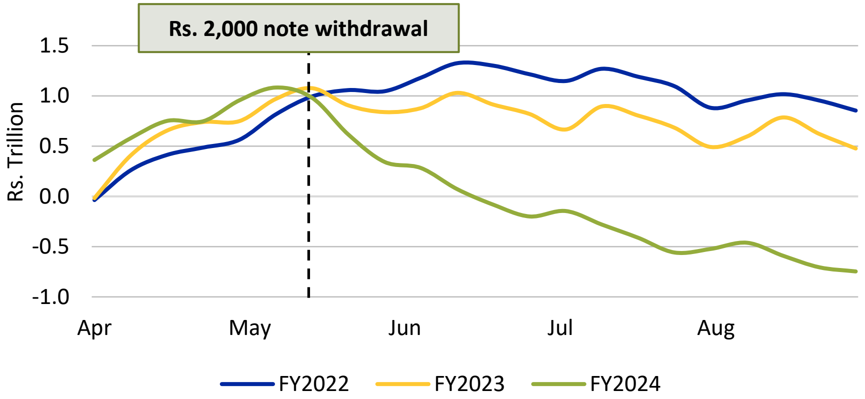
- To address liquidity overhang in the banking system, the RBI directed the scheduled banks to maintain an I-CRR of 10% on the increase in their NDTL between May 19 and July 28, 2023 with effect from Aug 12, 2023

Sep 8, 2023 – Phased discontinuation of I-CRR

- The RBI decided to discontinue the I-CRR in a phased manner by releasing the impounded amounts under the I-CRR as follows:
  a) Sep 9: 25% of the I-CRR maintained
  b) Sep 23: 25%
  c) Oct 7: 50%

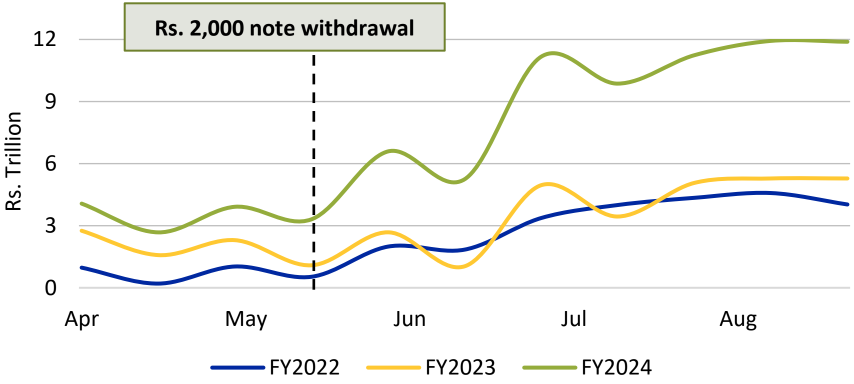
Rs. 2,000 banknote withdrawal led to sharper-than-usual increase in deposit base, contraction in currency in circulation

EXHIBIT: Incremental change in currency in circulation (CIC) in FYTD



**The corresponding periods have been taken for FY2022 and FY2023; FY2024 YTD for CIC and deposits include data up to Sep 1 and Aug 25, 2023 respectively; Source: RBI; ICRA Research*

EXHIBIT: Incremental change in aggregate deposits in FYTD

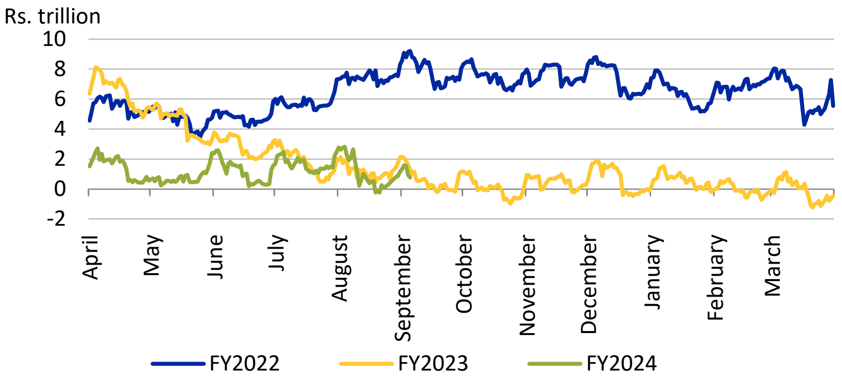


*Reporting Friday coincided with the quarter-end, partly leading to the surge in deposits during end-Jun 2023; *The corresponding periods have been taken for FY2022 and FY2023; Source: RBI; ICRA Research*

- The RBI decided to withdraw Rs. 2,000 notes from circulation w.e.f. May 22, 2023, as a part of its 'Clean Note Policy'. As much as Rs. 3.33 trillion, equivalent to 93% of the outstanding value of Rs. 2,000 notes as on May 19, 2023 (Rs. 3.56 trillion) has been returned up to Aug 31, 2023. Of this ~87% was in the form of deposits and ~13% was exchanged into other denomination banknotes.
- CIC contracted by Rs. 1.7 trillion between May 19, 2023 and Sep 1, 2023, as against the Rs. 0.4 trillion decline in the year-ago period (FY2022: - Rs. 0.3 trillion). Overall, CIC has fallen by Rs. 0.7 trillion in FY2024 YTD (till Sep 1, 2023), as against the Rs. 0.5 trillion increase in the year-ago period (FY2022: + Rs. 0.8 trillion).
- Additionally, aggregate bank deposits surged by Rs. 8.6 trillion between May 19, 2023 and Aug 25, 2023, more-than-double the increase in the year-ago period (Rs. 4.2 trillion; FY2022: Rs. 3.5 trillion). On a FYTD basis, deposits rose by Rs. 11.9 trillion (till Aug 25, 2023), relative to the Rs. 5.3 trillion rise seen in the corresponding period of FY2023 (Rs. 4.0 trillion in FY2022).

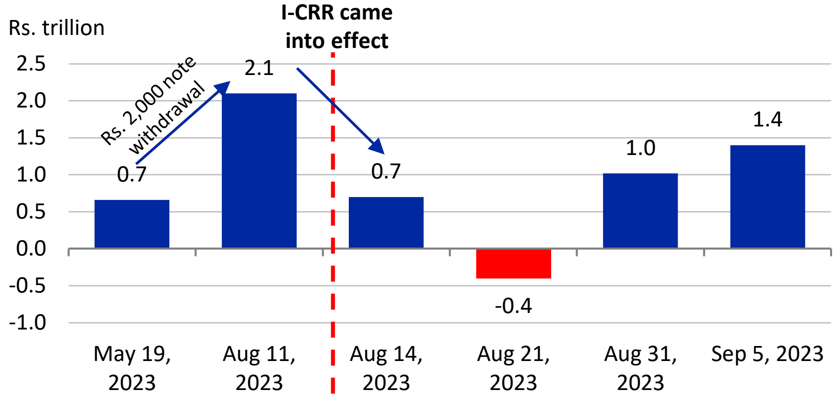
Introduction of I-CRR triggered sharp albeit expected moderation in systemic liquidity in mid-Aug 2023, which improved gradually thereafter

EXHIBIT: Liquidity Infusion (-)/ absorption (+) (Net Overnight & Term Repos/Reverse Repos; MSF; SLF; SDF; MSS)



Source: RBI; CEIC; ICRA Research

EXHIBIT: Movement in Systemic Liquidity (as on date)



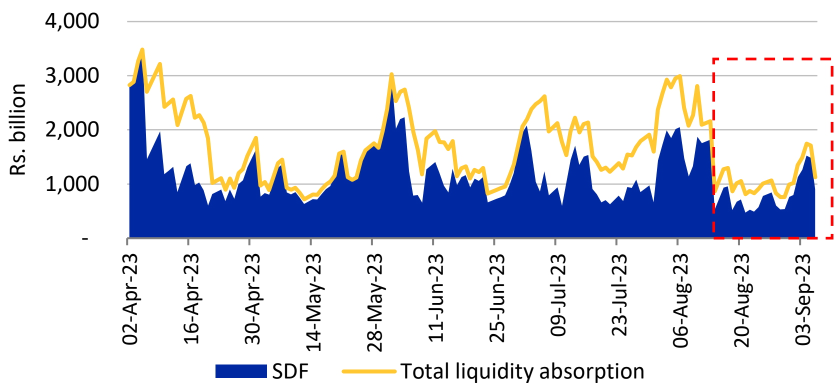
Source: RBI; CEIC; ICRA Research

- The average systemic liquidity rose from Rs. 1.1 trillion in Apr-May 2023 to Rs. 1.2 trillion in June 2023, and further to Rs. 1.6 trillion in July 2023, following the decline in CIC on account of withdrawal of the Rs. 2,000 bank notes, as well as healthy FPI inflows seen in this period.
- With the introduction of I-CRR effective from Aug 12, 2023, the surplus liquidity moderated sharply to Rs. 0.7 trillion on Aug 14 (first business day post I-CRR) from Rs. 2.1 trillion on Aug 11 resulting in an immediate absorption of ~Rs. 1.3 trillion, modestly higher than expectations. Thereafter, the liquidity slipped into a transient deficit during Aug 21-23, 2023, averaging at ~Rs. 0.2 trillion during this period, before reverting to surplus of Rs. 1.0 trillion by the end of the month.
- Thereafter, the liquidity surplus improved in September 2023, averaging at Rs. 1.3 trillion up to Sep 7, 2023, even before the RBI announced the calibrated withdrawal of the I-CRR.

Amount parked under SDF reduced considerably, while funds raised via MSF route shot up amid moderation in liquidity in August 2023

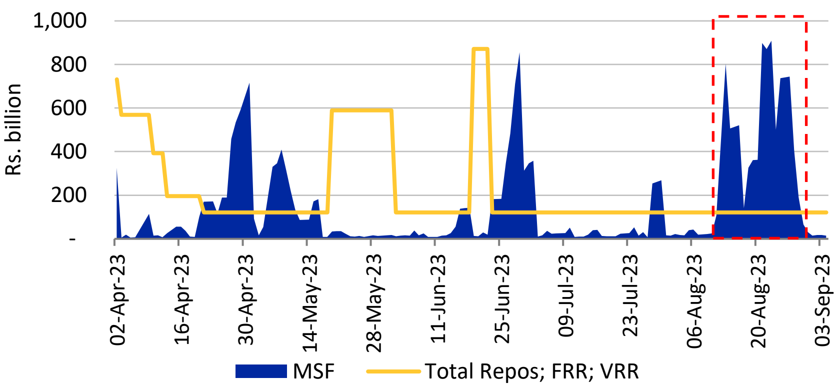
ICRA

EXHIBIT: Aggregate liquidity absorption and amount parked under SDF



Total liquidity absorption = SDF + reverse repos; Source: RBI; ICRA Research

EXHIBIT: Amount outstanding in repo operations and raised under MSF



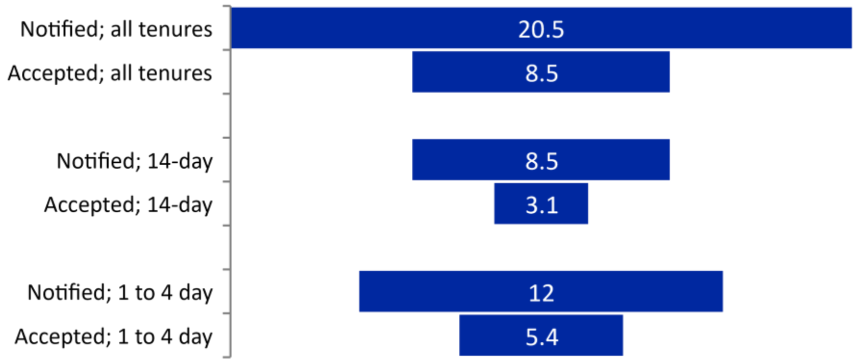
Source: RBI; ICRA Research

- Following the introduction of I-CRR, the aggregate liquidity absorption (via FRRR, VRRR and SDF), on an average, witnessed a sharp reduction to Rs. 1.0 trillion during Aug 13-31, 2023 from Rs. 2.0 trillion during July 1-Aug 11, 2023. Banks parked a larger proportion of funds under the Standing Deposit Facility (SDF), with the share in total absorption rising to 69% from 61%, respectively, between these periods. In Sep 2023 (up to Sep 8), the share has risen further to 82%.
- At the time of stressed liquidity conditions, banks used the MSF route to raise additional funds in absence of any fine tuning or regular VRR auctions. The average amount raised under the MSF surged to Rs. 493 billion during Aug 13-31, 2023 from just Rs. 31 billion in the initial part of the month. Notably, during the episodes of liquidity deficit (Aug 21-23, 2023), the funds availed via MSF touched as high as Rs. 909 billion (as on Aug 23, 2023), the highest since March 31, 2019 (Rs. 943 billion). Thereafter, in Sep 2023, the average amount raised via the MSF route has fallen to just Rs. 33 billion (up to Sep 8, 2023).

Response under VRRR auctions lukewarm since Jun 2023; no VRR auctions conducted in Aug 2023

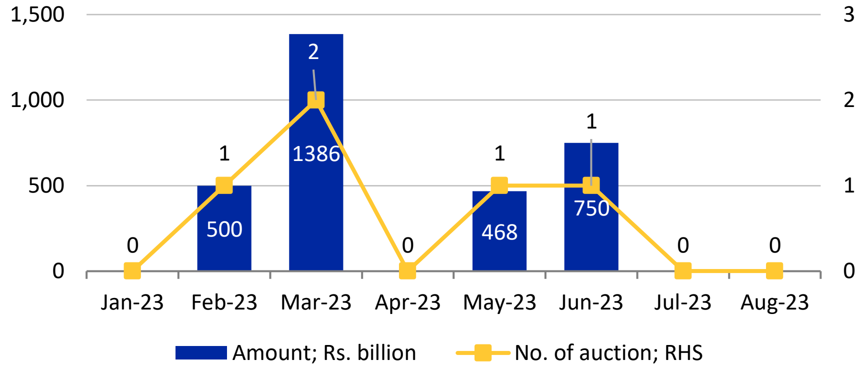
ICRA

EXHIBIT: VRRR auctions across tenures (Rs. trillion) in June-Sep 2023*



**Up to Sep 8, 2023; Source: RBI; ICRA Research*

EXHIBIT: Liquidity infusion via VRR auctions (14-day and fine tuning) in H1 CY2023 so far



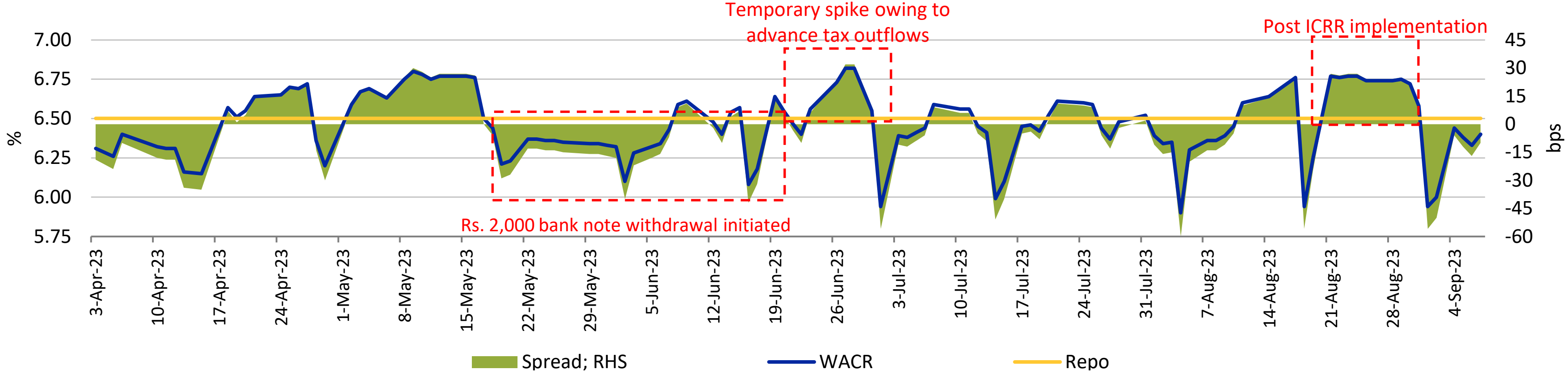
Source: RBI; ICRA Research

- The RBI conducted 19 variable rate reverse repo (VRRR) auctions so far during June-Sep 2023 (up to Sep 8). However, the response was lukewarm in these auctions, with a total liquidity absorption of Rs. 8.5 trillion, only 41.4% of the total notified amount of Rs. 20.5 trillion. Notably, 64% or Rs. 5.4 trillion of the Rs. 8.3 trillion was absorbed under the fine tuning VRRRs of 1-4 days maturity and the remaining under the main 14-day operations, revealing banks' caution towards park funds for a relatively longer tenure period.
- Surprisingly, the RBI conducted VRRR auction on Aug 25, 2023 worth Rs. 1.0 trillion (following the maturity of the previous 14-day VRRR that was conducted on Aug 11) despite the episode of liquidity deficit in the system during Aug 21-23, 2023.
- In the ongoing fiscal, the RBI has conducted just two VRR auctions (one each in May 2023 and Jun 2023) given the sustained liquidity surplus that was seen until July 2023. It avoided VRR auctions in August 2023, as it drained liquidity via the implementation of the I-CRR, nudging banks to access the MSF route to raise additional funds in the month.

WACR exceeded repo rate through most of Aug 2023, post I-CRR implementation; wedge in negative territory in Sep 2023 amid improved liquidity conditions

ICRA

EXHIBIT: Trends in WACR, Repo rate and Spread

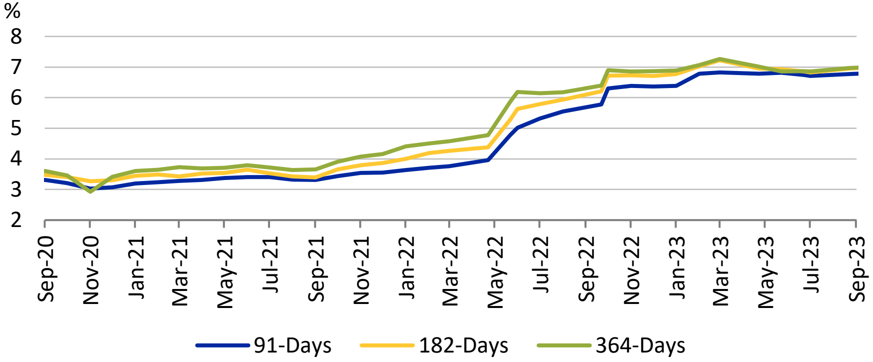


Source: RBI; ICRA Research

- The daily weighted average call money rate (WACR) eased from an average of 6.53% in May 2023 to 6.47% in June 2023 and further to a six-month low of 6.42% in July 2023, with a surge in systemic liquidity following the Rs. 2,000 note withdrawal on May 19, 2023. The spread between the two was negative territory from May 18 to June 6, 2023, before the WACR surpassed the repo rate in the second half of June 2023 amid tighter liquidity conditions owing to advance tax outflows.
- With a surge in liquidity surplus, the WACR fell to 6.29% during August 1-10, 2023, thereby trailing the repo rate, after having exceeded it in a few instances in July 2023. Thereafter, the impounding of liquidity following the introduction of I-CRR resulted in the WACR overshooting the repo rate in the remainder of August 2023 (average of 6.63% during Aug 14-31), with wedge between the two being as high as 27 bps on some days during this period. Overall, the WACR averaged at 6.51% in August 2023. Thereafter, it has eased significantly in Sep 2023, averaging at 6.31% up to Sep 8, 2023, reverting below the repo rate, amid the improvement in liquidity conditions.

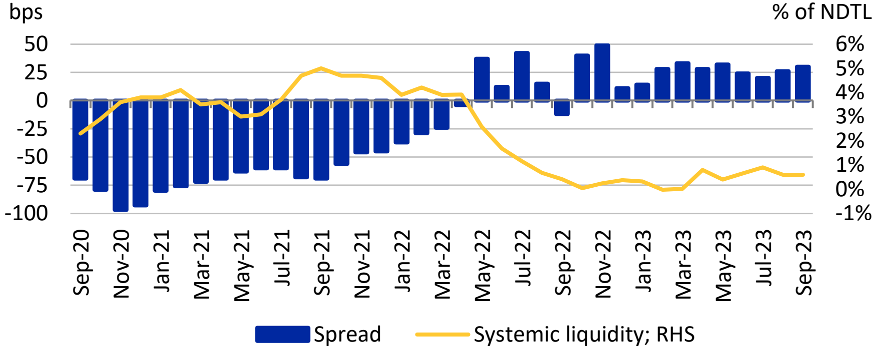
T-bill yields rose in Aug 2023 following I-CRR implementation

EXHIBIT: Trends in T-bills yields in secondary market



Source: RBI; CMIE; ICRA Research

EXHIBIT: Spread between 3-month T-bill yield and the repo rate, and systemic liquidity under the LAF corridor



Data for Sep 2023 is till Sep 8, 2023; Source: RBI; CMIE; ICRA Research

- After declining consistently through Apr-Jul FY2024, T-bill yields rose slightly in Aug 2023, with the average 91/182/365-day yield inching up by 2/11/8 bps between June 2023 and Aug 2023, to average at 6.77%/6.95%/6.97% in the latter month (in line with the trends seen in the WACR). Thereafter, such yields have risen marginally in the ongoing month (up to Sep 8, 2023), in contrast with the dip seen in the WACR.
- The average spread between 3-month T-bill yield and the repo rate fell from 32 bps in May 2023 to 24 bps in June 2023, and further to a six-month low of 20 bps in July 2023. Subsequently, it rose to an average of 25 bps up to Aug 11, 2023, and further to 29 bps during Aug 14-31, 2023, owing to the implementation of the I-CRR. Thereafter, it has remained at 30 bps in Sep 2023 so far (up to Sep 8, 2023). The spread has largely mirrored the movements in systemic liquidity.

Gradual phasing out of I-CRR to augment liquidity conditions ahead of seasonal tightening owing to advance tax outflows and onset of busy season

After reviewing the current liquidity situation, the RBI has decided to discontinue the I-CRR, in a gradual manner releasing the amount impounded under this measure in three stages – 25% as on Sep 9, 2023; 25% as on Sep 23, 2023; 50% as on Oct 7, 2023.

The initial introduction of the I-CRR of 10% on the increase in NDTL between May 19, 2023 and July 28, 2023 (~Rs. 12.7 trillion) is estimated to have absorbed liquidity to the tune of nearly Rs. 1.27 trillion (10% of Rs. 12.7 trillion).

As per RBI's latest announcement, nearly ~Rs. 0.32 trillion (25% of Rs. 1.27 trillion) is estimated to have returned to the banking system on Sep 9, 2023, ahead of the tax outflows starting mid-Sep 2023.

Thereafter, an additional ~Rs. 0.32 trillion (25% of Rs. 1.27 trillion) would be returned on Sep 23, 2023, followed by ~Rs. 0.64 trillion (50% of Rs. 1.27 trillion) on Oct 7, 2023. This would augment liquidity ahead of the onset of the busy season.

EXHIBIT: Introduction and phasing out of I-CRR as per RBI

Introduction of I-CRR			
Date	**Increase in NDTL during May 19 to Jul 28, 2023 (A)**	**I-CRR (%) to be maintained (B)**	**Liquidity absorbed (A*B)**
Aug 12, 2023	12.7	10%	~1.27

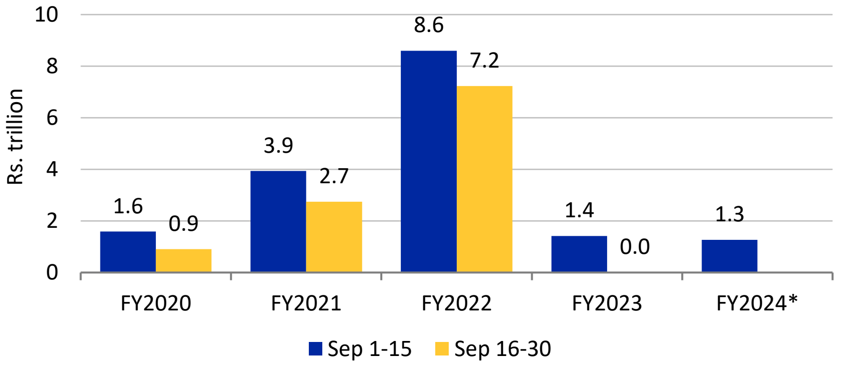
Phasing out of I-CRR			
Date	**Increase in NDTL during May 19 to Jul 28, 2023 (A)**	**% of I-CRR to be released (B)**	**Amount to be released (A*B)**
Sep 9, 2023	12.7	25%	~0.32
Sep 23, 2023		25%	~0.32
Oct 7, 2023		50%	~0.64

Source: RBI; ICRA Research

Liquidity tightening on account of tax outflows in second half of Sep 2023 to be partly offset by return of I-CRR funds; VRRs unlikely in near term

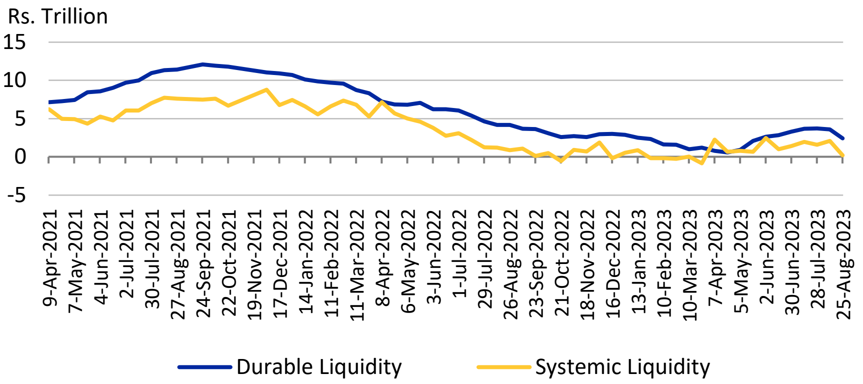
ICRA

EXHIBIT: Average systemic liquidity during Sep 1-15 and Sep 16-30 during FY2020-24



**up to Sep 7, 2023; Source: RBI; ICRA Research*

EXHIBIT: Durable and systemic liquidity



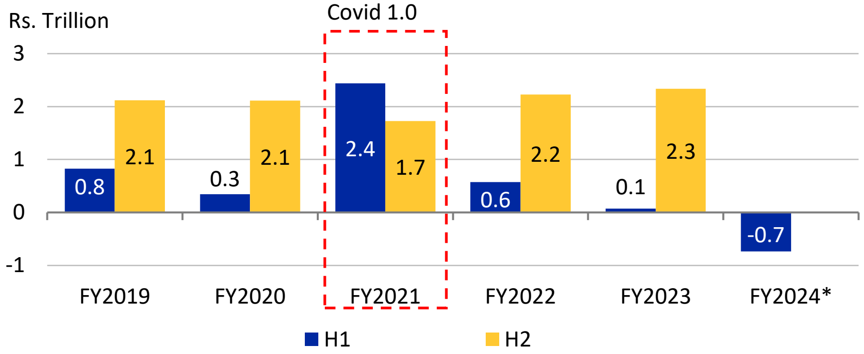
Durable liquidity = Systemic liquidity + GoI cash balances; Source: RBI; ICRA Research

- Systemic liquidity typically tightens in the second half of September vis-à-vis the first half owing to advance tax outflows during the second half of the month. **However, the expected liquidity augmentation on account of the phased reversal of the I-CRR (by Rs. 0.32 trillion each on Sep 9 and Sep 23) should partly offset the drain on account of advance tax outflows in the second half of Sep 2023. Consequently, ICRA does not expect the RBI to conduct VRRs in the near term.**
- Advance tax outflows do not impact durable liquidity, which includes the GoI's cash balances. Durable liquidity has risen consistently through the ongoing fiscal to touch Rs. 3.7 trillion on July 28, 2023, the highest level recorded since Aug 2022 (from a multi-year low of Rs. 0.6 trillion at end-Apr 2023). This largely reflects the seasonal uptick in GoI cash balances, the fall in the CIC owing to the Rs. 2,000 banknote withdrawal and large dollar purchases by the RBI in Q1 FY2024 (amid healthy capital inflows). Thereafter, durable liquidity has moderated to Rs. 2.4 trillion on Aug 25, 2023 from Rs. 3.6 trillion on Aug 11, 2023, while remaining healthy.

Liquidity conditions to tighten in H2 FY2024, led by seasonal uptick in CWP and expected moderation in capital inflows

ICRA

EXHIBIT: Trends in incremental currency with public (CWP) in H1 and H2 since FY2019



Data for H1 FY2024 available till Aug 25, 2023; Source: RBI; ICRA Research

EXHIBIT: Trends in capital flows and ICRA's expectations for FY2024

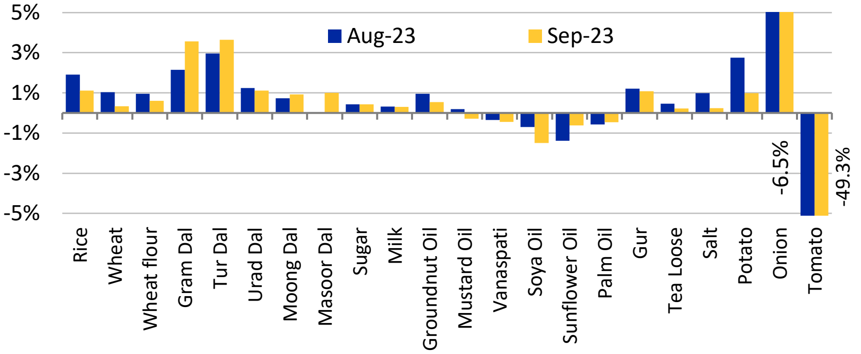
($ billion)	Q4 FY2023	Q1 FY2024	FY2023	ICRA's expectations for FY2024
Net FIIs (equity, debt, hybrid)	-3.0	14.4	**-5.5**	**25 to 30**
Gross FDI	9.5	11.3	**47.3**	**44 to 46**
Gross ECB	6.2	20.7	**26.6**	**45 to 50**
NRI Deposits	3.6	2.1	**9.0**	**8 to 10**

Source: RBI; NSDL; CEIC; ICRA Research

- The systemic liquidity surplus is likely to decline in H2 FY2024, amid the onset of the busy season, driven by an increase in CWP as well as a moderation in the pace of capital inflows in H2 FY2024, vis-à-vis H1 FY2024.
- Based on historical data, the CWP typically witnesses a seasonal uptick in H2 of the fiscal year vis-à-vis H1, owing to increased currency demand during the festive season. For instance, incremental CWP rose quite sharply from Rs. 0.1 trillion in H1 FY2023 to Rs. 2.3 trillion in H2 FY2023. In H1 FY2024 so far (up to Aug 25, 2023), CWP has recorded a decline of Rs. 0.7 trillion, due to Rs, 2,000 banknote withdrawal. However, this trend is likely to reverse in H2 FY2024.
- Moreover, while the pace of capital inflows on account of net FIIs (Q1 FY2024: $14.4 billion) and gross ECBs ($20.7 billion) was quite robust in Q1 FY2024; this trend is unlikely to sustain in the remainder of FY2024, based on ICRA's projections.
- **The RBI's decision to discontinue the I-CRR will augment liquidity by ~Rs. 1.3 trillion by October 7, 2023, ahead of the busy season, which would provide some comfort, given the expected tightening in H2 FY2024 vis-à-vis H1. The Central bank is likely to continue with VRRRs over the next few months, although the frequency of the same is likely to reduce as the liquidity surplus narrows. Although the RBI is expected to conduct VRRs intermittently in H2 FY2024 in the event of sharp systemic liquidity deficits, ICRA believes that a shift to VRRs as the primary tool may only arise if there are sustained capital outflows.**

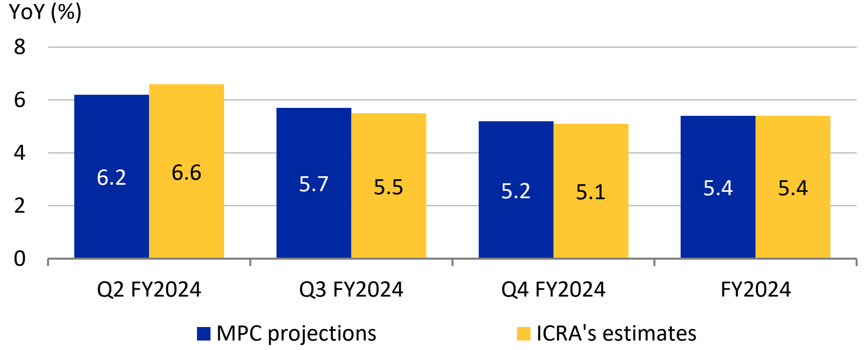
ICRA expects headline CPI inflation to remain elevated at 7.0% in August 2023, average at 6.6% in Q2 FY2024, breaching the MPC's forecast for that quarter

EXHIBIT: Month-on-month (MoM) trends in retail prices in Aug-Sep* 2023



**till Sep 7, 2023; Source: Department of Consumer Affairs (DCA); CEIC; ICRA Research*

EXHIBIT: YoY CPI inflation projections by MPC and ICRA

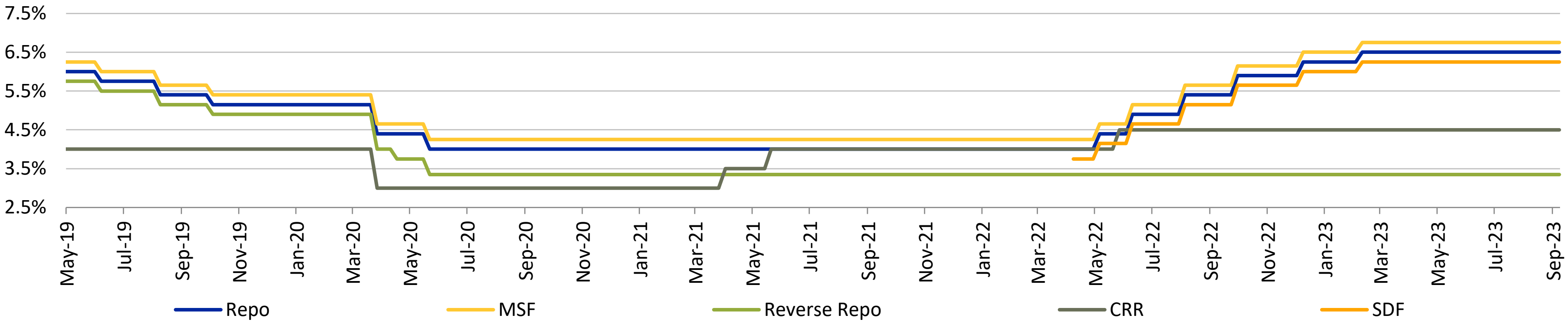


Source: RBI; ICRA Research

- As per the data released by the Department of Consumer Affairs (DCA), while tomato prices declined through Aug 2023 (-6.5% MoM), the full impact of this fall would be witnessed in the ongoing month (49.3% MoM up to Sep 7, 2023). Moreover, the average retail prices of most essential commodities, such as rice, wheat, milk, some pulses (urad and moong), most edible oils, vegetables (onions, potatoes), etc. have seen a lower MoM uptick in Sep 2023, vis-à-vis Aug 2023. However, the retail prices of onions have risen by double digits in Aug 2023 (+12.7%) and during Sep 1-7, 2023 (+10.7%), owing to tight supply conditions.
- **Overall, given the CPI inflation print for July 2023 (+7.4%) and ICRA's expectations of ~7.0% for August 2023, the MPC's inflation forecast for Q2 FY2024 (+6.2%) appears to be at risk of being overshot (ICRA's exp.: +6.6%). However, ICRA expects the CPI inflation readings to mildly undershoot the MPC's projections for Q3 and Q4 FY2024, at the current juncture, notwithstanding upside risks to prices of several food items on account of sub-par monsoons.**

MPC to maintain status quo in Oct 2023 policy meeting; earliest rate cut foreseen in Q2 FY2025, amidst shallow rate cut cycle of 50-75 bps

EXHIBIT: Movement in key rates



Source: RBI; ICRA Research

- As per the minutes of the Aug 2023 monetary policy meeting, the MPC members expect the vegetable price shock seen during Jul-Aug 2023 to be transient. However, they expect the current liquidity overhang in the banking system to pose a direct threat to the RBI's goal of aligning India's inflation with the target, thereby necessitating primary focus on withdrawal of excess liquidity.
- While the MPC emphasised the need to be vigilant and to be ready to act appropriately to ensure that the effects of shocks do not persist, the bar for a rate hike would be quite high. **In ICRA's view, inflation would need to persist above 6.0% for at least two quarters, amid transmission of pressures to core inflation, to set the stage for a rate hike. We expect the MPC to maintain status quo on rates and the policy stance in its upcoming meeting on Oct 6, 2023.**
- **The MPC's latest forecasts suggest that inflation will remain above 5% through Q1 FY2025, based on which ICRA expects the earliest rate cut in Q2 FY2025. Moreover, ICRA continues to anticipate the rate cut cycle to be shallow, limited to 50-75 bps.**

ICRA

Click to Provide Feedback

ICRA

Analytical Contact Details

Name	Designation	Email	Contact Number
Aditi Nayar	Chief Economist, Head-Research and Outreach	aditin@icraindia.com	0124- 4545 385
Rahul Agrawal	Senior Economist	rahul.agrawal@icraindia.com	022 – 6114 3425
Aarzoo Pahwa	Senior Associate Economist	aarzoo.pahwa@icraindia.com	0124 – 4545 835
Tiasha Chakraborty	Senior Associate Economist	tiasha.chakraborty@icraindia.com	0124- 4545 848
Diksha Bansal	Associate Economist	diksha.bansal@icraindia.com	0124 – 4545 399

ICRA Business Development/Media Contact Details

Name	Designation	Email	Contact Number
L Shivakumar	Chief Business Officer	shivakumar@icraindia.com	022-61693304
Neha Agarwal	Head – Research Sales	neha.agarwal@icraindia.com	022-61693377
Rohit Gupta	Head Business Development - Infrastructure Sector	rohitg@icraindia.com	0124-4545340
Vivek Bhalla	Head Business Development - Financial Sector	vivek.bhalla@icraindia.com	022-61693372
Vipin Saboo	Head Business Development – Corporate Sector - West & East	vipin.saboo@icraindia.com	022-61693348
Shivam Bhatia	Head Business Development – Corporate Sector - North & South	shivam.bhatia@icraindia.com	0124-4545803
Naznin Prodhani	Head – Media & Communications	communications@icraindia.com	0124-4545860

ICRA

ICRA

Thank You!