Banking System Liquidity

For Prelims: RBI, Liquidity Adjustment Facility, Call Money

For Mains: Banking System Liquidity surplus and deficit and its Impact

Why in News?

For the first time Liquidity in the banking system has moved into deficit mode after remaining in surplus mode for almost 40 months for the first time since May 2019.

What is 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.**

What has Triggered this Deficit?

- The change in the liquidity situation has come due to **advance tax outflows.** This also increases the **call money rate temporarily above** the repo rate.
    - **Call money rate** is the rate at which **short term funds are borrowed** and lent in the money market.
    - Banks resort to these types of loans to fill the asset liability mismatch, comply with the statutory **CRR (Cash Reserve Ratio)** and **SLR (Statutory Liquidity Ratio)** requirements and to meet the sudden demand of funds. RBI, banks, primary dealers etc are the participants of the call money market.
- Besides, there is the continuous intervention of the **RBI to stem the fall in the** rupee against the US dollar.
- The deficit in the liquidity situation has been caused by **an uptick in bank credit, intervention of the RBI into the forex market,** and also incremental deposit growth not keeping pace with credit demand.

How can a Tight Liquidity Condition Impact 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.
- RBI may increase Repo Rate, which can 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.**

    - The MCLR is the minimum interest rate that a bank can lend at.

Way Forward

- RBI's actions will depend upon the nature of the liquidity situation. 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.

UPSC Civil Services Examination, Previous Year Question (PYQ)

Q. If the RBI decides to adopt an expansionist monetary policy, which of the following would it not do? (2020)

1. Cut and optimize the Statutory Liquidity Ratio
2. Increase the Marginal Standing Facility Rate
3. Cut the Bank Rate and Repo Rate

Select the correct answer using the code given below:

(a) 1 and 2 only
(b) 2 only
(c) 1 and 3 only
(d) 1, 2 and 3

Ans: (b)

Exp:

- **Expansionary monetary policy,** or easy monetary policy, is when a central bank uses its tools to stimulate the economy. It increases the money supply, lowers interest rates, and increases demand. It boosts economic growth.
- **Statutory Liquidity Ratio (SLR)** is a monetary policy tool that the Reserve Bank of India (RBI) uses to assess the liquidity at the banks' disposal. It is the **minimum percentage of deposits that a commercial bank has to maintain in the form of cash, gold or other securities**. It is basically the reserve requirement that banks are expected to keep before offering credit to customers. Raising SLR makes banks park more money in government securities and reduce the level of cash in the economy. Doing the opposite helps maintain cash flow in the economy. Reducing SLR leaves more liquidity with banks, which in turn can fuel growth and demand in the economy. **Hence, statement 1 is not correct.**
- **Marginal standing facility (MSF)** is a window for scheduled banks to borrow overnight from the RBI in an emergency situation when interbank liquidity dries up completely. With the increase of MSF Rate, cost of borrowing increases for banks resulting in reduced available resources to lend. **Hence, statement 2 is correct.**
- **Repo Rate, or repurchase rate,** is the key monetary policy rate of interest at which the central bank or the Reserve Bank of India **(RBI) lends short term money to banks, against the collateral of government** and other approved securities under the liquidity adjustment facility (LAF). **Bank Rate** is the interest rate which the **RBI charges on its long-term lendings.** Under expansionary monetary policy, RBI reduces repo rate and bank rate to increase liquidity in the banking sector. **Hence, statement 3 is not correct.**
- **Therefore, option (b) is the correct answer.**

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