Surplus liquidity in Indian Banking system

***Prelims:** Current events of national and international importance | Economy*

Why in news?

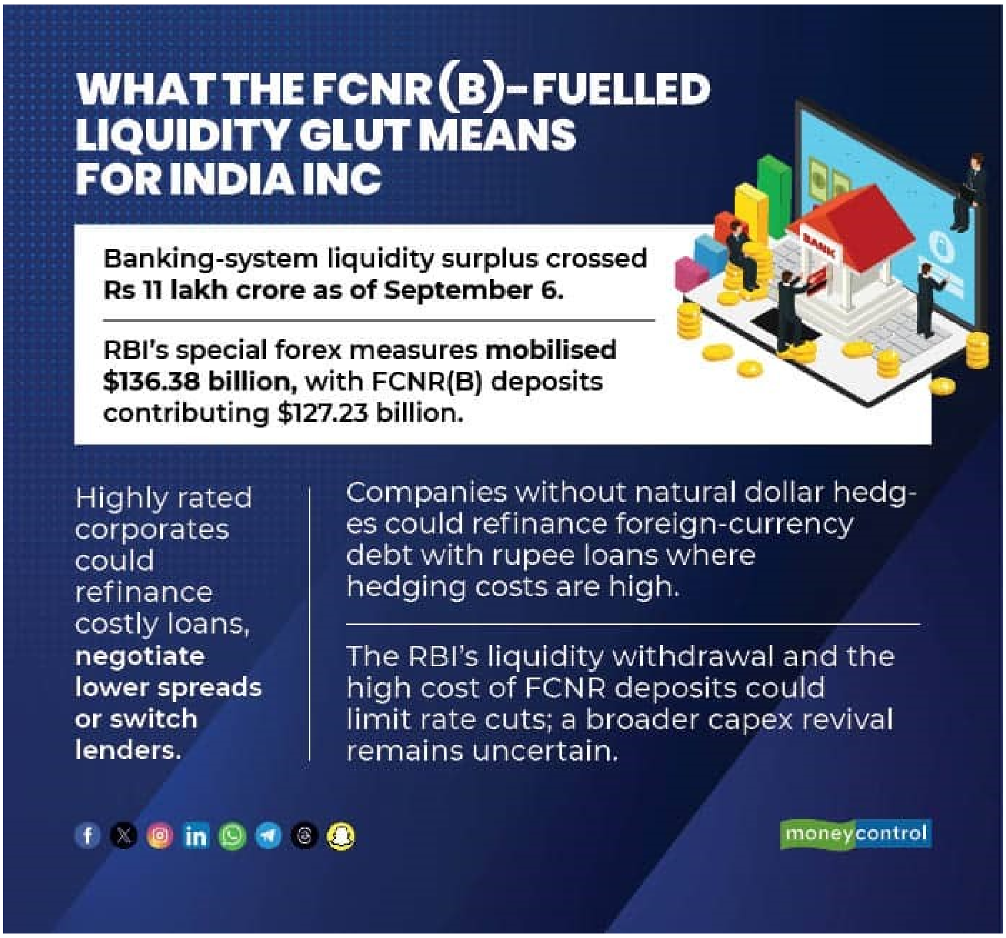
RBI liquidity surplus has crossed Rs 11 lakh crore, with abundant bank funds likely to affect loan rates, fixed deposits and short-term market yields.

- **Surplus liquidity** – Commercial banks have an excess of cash and liquid funds beyond what they need for
    - day-to-day operations,
    - customer withdrawals, and
    - minimum reserve requirements.
- **Reason for increase** – Sizeable *foreign-currency inflows* mobilised by Indian banks through the RBI's special FCNR(B) deposit window.
- **Foreign Inflows** – Banks raised about $136.4 billion from non-residents and foreign lenders, primarily via special FCNR(B) deposit and swap schemes.
- When foreign currency is converted/swapped into Indian rupees, it increases rupee liquidity in the domestic financial system.
- **Rupee Flooding** – Swapping these foreign funds with the RBI swelled India's forex reserves by $44.9 billion to $785.7 billion, but flooded the domestic money market with excess rupees.
- **Problem of Excess Liquidity** – Too much liquidity means banks have plenty of funds to lend, which can push short-term interest rates below the RBI's repo rate of 5.25%.
- The excess liquidity increased the challenge for the RBI in keeping overnight market rates aligned with its policy rate.
- **RBI's Response**
    - **Open Market Operations (OMO)** - RBI sells government bonds to absorb money from banks.
    - **Variable Rate Reverse Repo (VRRR)** - Banks park surplus funds with RBI for a specified period.
    - **Foreign-exchange swaps** - Used to manage both forex liquidity and

    ◦ rupee liquidity.
    ◦ Announced a Rs 1 lakh crore open-market bond sale in three tranches to drain record surplus liquidity.

Impacts

- **Market Impact** – The RBI's liquidity absorption measures can push bond yields upward.
- Following the announcement of a Rs.1 lakh crore bond sale, the 10-year government bond yield rose by six basis points to 7.04% & 5-year yield climbed nearly 10 basis points to 6.62%.
- **For borrowers** – Support softer lending rates, particularly if banks pass on easier funding conditions through changes in their lending rates.
- Lower funding pressure could encourage banks to compete more actively for creditworthy borrowers.
    - Loans could become cheaper if banks pass on the lower funding costs.
- **For fixed-deposit investors** – the impact could be less favourable.
- With banks holding surplus liquidity, their need to attract fresh deposits may decline, potentially limiting the scope for higher FD rates.
    - Surplus liquidity can reduce returns for FD investors.



Reference

[Business standard | RBI absorbs ₹1.10 lakh crore surplus liquidity]