Impact of RBI measures to infuse liquidity

To address the deficit in banking system liquidity, RBI announced three major measures. They are,

1. Open Market bond purchases aggregating Rs 60000 Cr in 3 tranches of Rs 20000 Cr each on January 30, 2025, February 13, 2025, and February 20, 2025.

2. 56-day Variable Rate Repo (VRR) auction for a notified amount of ₹50,000 crore to be held on February 7, 2025.

3. USD/INR Buy/Sell Swap auction of USD 5 billion for a tenor of six months to be held on January 31, 2025.

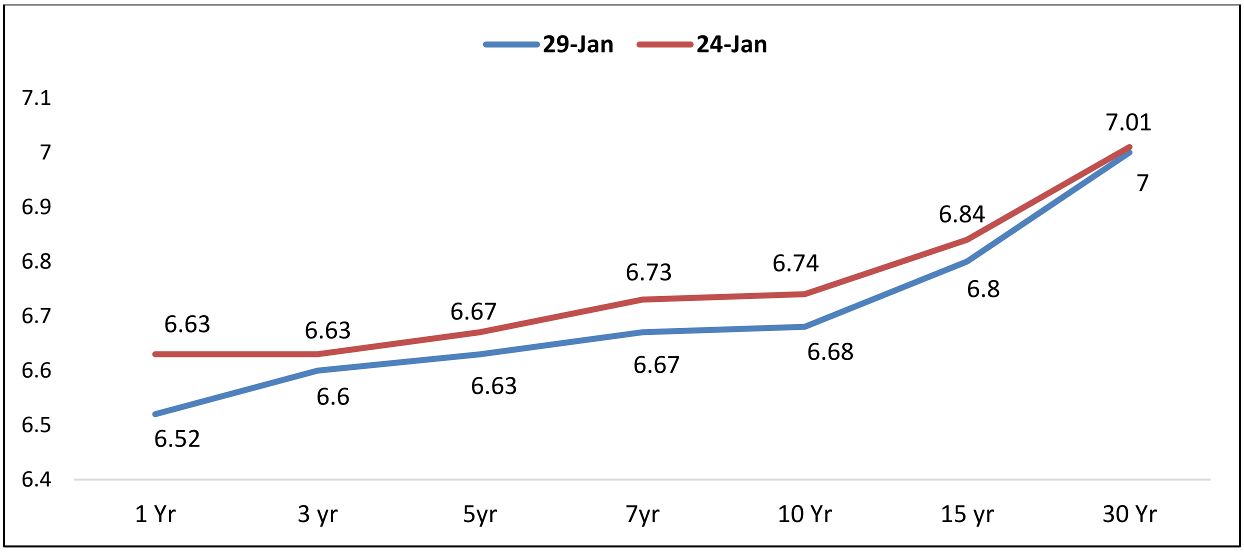
These measures are in addition to the daily variable rate repo (VRR) auctions from Monday to Friday announced on January 15, which saw average liquidity infusion of Rs 1.9 lakh crore over the past week.

Impact of the measures

The three measures announced above would infuse liquidity of over Rs 1.5 Lakh crore. This is long term liquidity and hence more durable in nature. However, in Q4FY25 there will be outflows on account of GST and advance taxes to the extent of Rs 2.5-3 lakh crore. Thus, the above measures along with daily VRR would provide comfort on the liquidity front until March 2025. There is also the additional factor of INR weakness necessitating incremental intervention which will add to outflows from the banking system.

An immediate impact is on bond yields. The benchmark 10 Yr softened to 6.63% but erased gains and reverted to 6.69% as markets digested the measures. As in chart G-Sec yields across maturities have softened between 11 bps for 1 yr tenor to 6 bps for 10 yr. If the upcoming Union Budget pegs FY26 fiscal deficit at 4.5% and borrowing programme is lower than expectations benchmark yield can soften further.

Fig 1: Tenor wise G-Sec yields as on 29th January 2025 and 24th January 2025

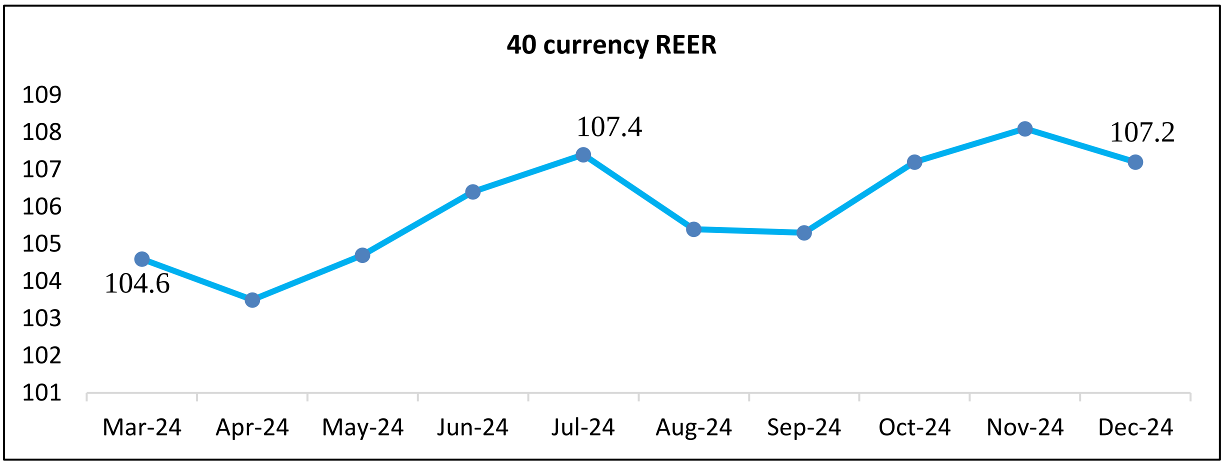


Source: Cogencis

There are expectations in some quarters that the liquidity injection is a prelude to a rate cut. A rate cut could have the following implications.

- Rupee could weaken further as FIIs will pull out due to more attractive yields abroad. The outflows can happen in two ways. While lower yield differentials will hasten the pull-out, a weak Rupee will reduce the returns for FIIs and slowdown investments. The 40 currency Real Effective Exchange Rate (REER) shows a Rupee overvaluation of 7.2% in December which implies its fair value at 91.55 (based on Dec average USD/INR spot). To prevent INR from depreciating to its fair value, intervention would be necessary.

Fig 2: REER of 40 Currencies from Mar-24 to Dec-24



Source: RBI Monthly Bulletin

- Liquidity deficits in banking system might worsen as deposit mobilisation will be harder due to lower rates though declining equity markets and falling SIPs could lend some comfort. Moreover, as almost two thirds of loans in the banking system are linked to EBLR, loss of interest income will be immediate and bank NIMs might shrink further.

- Lower rates and sinking equity markets will increase the attractiveness of commodities as an investment option. Gold prices have a high inverse correlation with interest rates and domestic gold prices might go up. Rupee depreciation will also push up domestic gold prices.

- Banks with overseas operations will see higher business growth due to Rupee weakness.

The liquidity injection measures will definitely have a soothing impact till March 2025 but the comfort in FY26 will depend on Government spending, private capex revival and RBI interventions to support INR. Given its focus on fiscal consolidation, if the government opts to underspent liquidity could be in deficit though FY26 could be different as election related curbs on spending would not be there. Windfall transfers from RBI (Rs 2 lakh Cr expected) would be a comfort for fiscal management which is a positive for public spending.

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