Invesco Mutual Fund

Liquidity and its implications on Fixed Income Market

Key Messages

- System liquidity (defined as banking liquidity + govt cash balances) has tightened significantly in FY25; it became deficit in mid-January against a surplus of ~Rs 4.5 lakh crores in September'2024
  - **RBI's Fx intervention to stabilize INR & Capital outflows primarily in the equity market led to a massive INR liquidity drag**
  - RBI had been taking active measures to provide temporary liquidity through VRRs
  - However, off-late RBI has also taken efforts to increase durable liquidity through CRR cut, OMOs and Fx swap
  - Even as the banking liquidity remains in deficit, RBI's various measures & especially the daily VRRs have helped the daily TREPs remain close to the policy repo rate

- **Historically, rate easing cycle typically has coincided with improvement in liquidity. Assuming a similar trend in this cycle, liquidity should improve from hereon**
  - In FY26, in absence of any substantial FPI/FDI inflow, we expect RBI to use significant quantum of OMO purchases as a key tool to inject durable liquidity

- RBI undertaking OMO purchases in FY26 shouldn't be seen as an exceptional measure as it has happened in 8 out of the last 12 years

- Other than liquidity requirement, other factors are also supportive of OMOs -
  - G-Secs as % of RBI's balance sheet is at 19% - towards the lower bound of historical levels (data as of February 21, 2025)
  - Due to no switch operations undertaken this year, ~Rs 1.1 lakh crores of government securities will mature in FY26 in RBI's books, thereby reducing the proportion of G-Secs in RBI's books further

Fx – Forex, VRR – Variable Repo Rate, CRR – Cash Reserve Ratio, OMO – Open Market Operations, TREPs – Triparty Repo, FPI – Foreign Portfolio Investments, FDI – Foreign Direct Investments

Source – RBI, Invesco Asset Management (India)

Building blocks of System liquidity

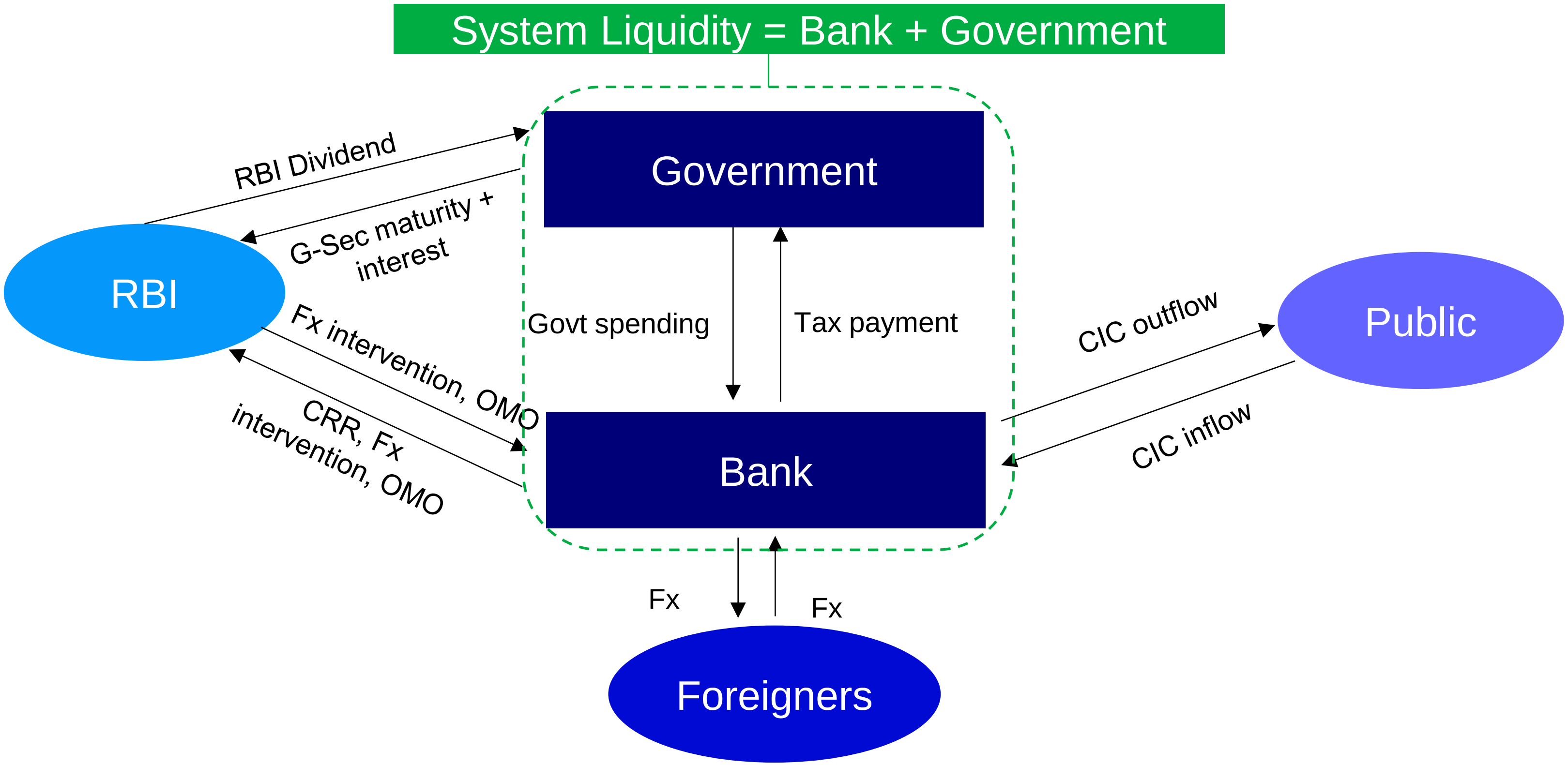
Sr. No.	Parameter	Brief	Impact on System liquidity
1	Change in Currency in Circulation (CIC)	Physical currency held in the hands of public	Negative as CIC increases with time
2	Incremental Cash Reserve Ratio (CRR) to be maintained by banks with RBI	Regulatory requirement	Negative as CRR increases with bank's balance sheet growth
3	RBI dividend	Dividend paid by RBI to GoI	Positive as Govt. receives this money
4	Maturity of Government Securities held in RBI books + Interest paid by GoI to RBI on bonds held by RBI		Negative as the G-Sec maturity proceeds go to RBI
5	Forex interventions carried out by RBI	Forex buy / sell by RBI	Negative in case of Fx sale Positive in case of Fx buy
6	Open Market Operations (OMO) carried out by RBI	G-sec buy / sell by RBI	Negative in case of OMO sale Positive in case of OMO purchase

- System Liquidity is defined as Banking Liquidity + Government Cash Balances
- **Banks and GoI cannot influence system level liquidity. Only RBI, and to a certain extent public (through withdrawal of cash), can influence the system liquidity through liquidity tools**

GoI – Government of India

Disclaimer - The information alone is not sufficient and shouldn't be used for the development or implementation of an investment strategy.

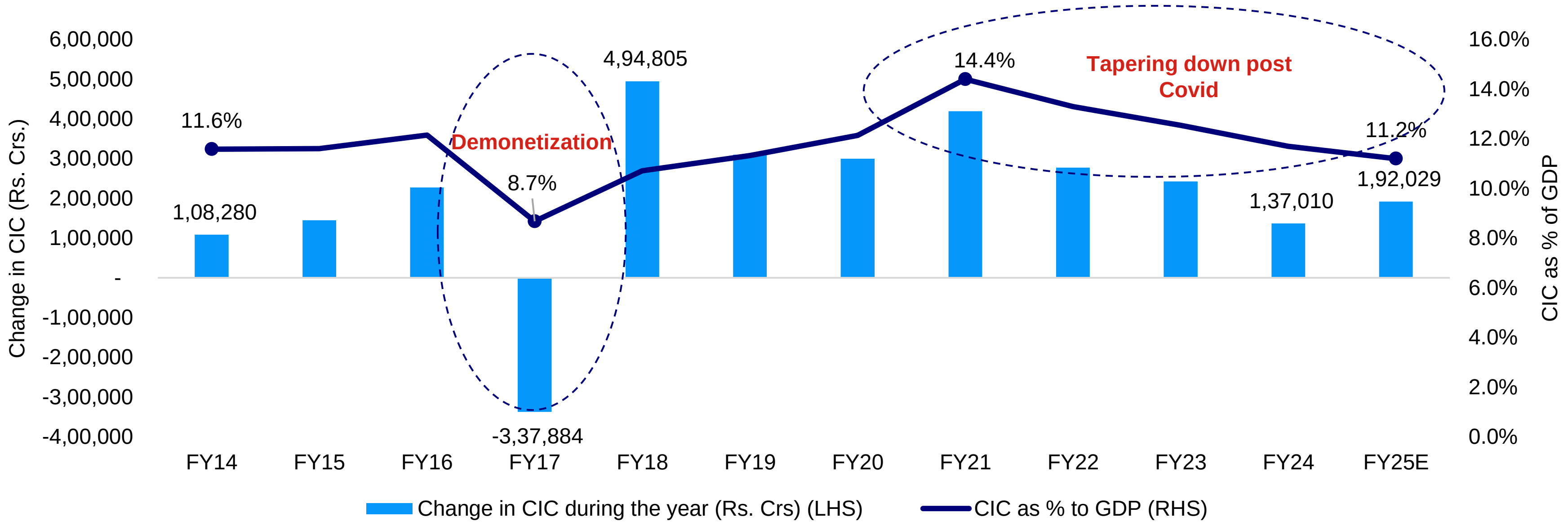
Interactions of different elements of System liquidity



Disclaimer: The above chart is for illustration purpose only to explain how different players (e.g. Government, Banks, Public, Foreigners etc.) and the various activities undertaken by these players impact system liquidity. The activities referred above are indicative in nature and does not include all the events that would have an impact on System liquidity and may change based on evolving conditions. The information alone is not sufficient and shouldn't be used for the development or implementation of an investment strategy.

1. Currency in Circulation (CIC)

Generally the biggest drag on system liquidity, has been declining as a % of GDP



Govt's digitization push has helped in lower CIC

E- Estimates. Positive figure denotes outflow of CIC and negative figure denotes inflow of CIC. Thus, a negative change in CIC indicates liquidity inflow in the system and positive change indicates liquidly outflow from the system.

Source - Bloomberg, RBI, Invesco Asset Management (India)

Disclaimer - The information provided herein may include statements/data of future expectations that are based on current views and assumptions and involves known and unknown risks and uncertainties that could cause actual results, performance or events to differ materially from those expressed or implied.

Currency in Circulation (Contd.)
Strong monthly seasonality in CIC

Change in Currency in Circulation (Rs. Crs.)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Annual CY
2013	(16,530)	(19,900)	(14,020)	(33,610)	(2,270)	10,770	11,360	2,560	1,100	(30,810)	(28,310)	(6,750)	(1,26,410)
2014	(3,140)	(16,710)	(12,470)	(41,320)	(23,570)	6,440	10,440	9,920	4,440	(32,690)	(2,300)	(20,410)	(1,21,370)
2015	(15,410)	(20,370)	(20,250)	(46,380)	(19,380)	14,250	22,180	(3,269)	(13,731)	(23,820)	(38,647)	(15,183)	(1,80,010)
2016	(14,270)	(36,810)	(52,170)	(46,960)	(13,350)	350	9,200	(8,580)	4,612	(49,652)	5,89,120	2,50,030	6,31,520
2017	(78,540)	(1,47,560)	(1,70,786)	(96,847)	(55,886)	(43,630)	(9,530)	(24,310)	(23,262)	(45,999)	(25,287)	(33,249)	(7,54,887)
2018	(45,316)	(43,716)	(47,772)	(73,577)	(27,108)	(12,374)	20,631	(5,134)	2,390	(36,019)	(34,637)	(29,139)	(3,31,772)
2019	(36,741)	(45,643)	(32,182)	(40,376)	(17,343)	7,839	13,948	(846)	(9,764)	(70,989)	260	(13,468)	(2,45,305)
2020	(40,630)	(37,264)	(91,069)	(83,661)	(93,571)	(43,939)	(12,081)	(7,988)	(2,409)	(32,308)	(55,508)	(7,365)	(5,07,794)
2021	(28,653)	(29,886)	(21,963)	(56,217)	(48,204)	(16,969)	33,380	2,703	18,838	(20,022)	(38,165)	(3,606)	(2,08,763)
2022	(45,466)	(48,135)	(55,148)	(74,831)	(8,948)	1,825	32,889	1,496	24,898	(52,627)	(6,901)	(14,804)	(2,45,751)
2023	(59,130)	(39,830)	(46,909)	(76,761)	13,085	81,779	35,855	14,498	20,901	(14,656)	(51,656)	(7,518)	(1,30,343)
2024	(56,212)	(36,945)	(59,378)	(50,791)	(4,824)	8,351	25,855	44,141	10,824	(52,459)	(12,296)	(14,208)	(1,97,943)

- CIC follows a specific seasonality pattern driven by different factors
  - As seen, CIC outflow is highest in February – April period
  - CIC witnesses an inflow in the months of June – September, which is linked to the harvest season
  - Outflows in October - November are linked to festive season and picks up before Diwali

Note -The colour coding indicates the intensity of outflows and inflows within a year. For example, higher outflow months are marked in red. As the intensity of outflows reduces, the colour changes to yellow, followed by green in case of inflows.

Source – Bloomberg, RBI

2. Cash Reserve Ratio (CRR)

Second biggest liquidity drag, quantum driven by banks business growth and prescribed CRR rate

Year	NDTL (Rs. Lakh Crs)	NDTL Growth (%)	CRR rate (%)	CRR to be maintained (Rs. Crs)	Incremental CRR (Rs. Crs)
FY25 E	234.29	11.0	4	937,156	-12,664
FY25 YTD	230.69	9.3	4	922,740	-27,080
FY24	211.07	15.5	4.5	949,820	127,717
FY23	182.69	10.8	4.5	822,103	162,701
FY22	164.85	8.6	4	659,402	128,155
FY21	151.79	10.6	3.5	531,247	119,466
FY20	137.26	8.3	3	411,781	-94,996
FY19	126.69	10.1	4	506,777	46,682
FY18	115.02	5.6	4	460,095	24,492
FY17	108.90	12.8	4	435,603	49,408
FY16	96.55	10.1	4	386,195	35,419
FY15	87.69	10.6	4	350,776	33,568
FY14	79.30	12.0	4	317,208	34,068

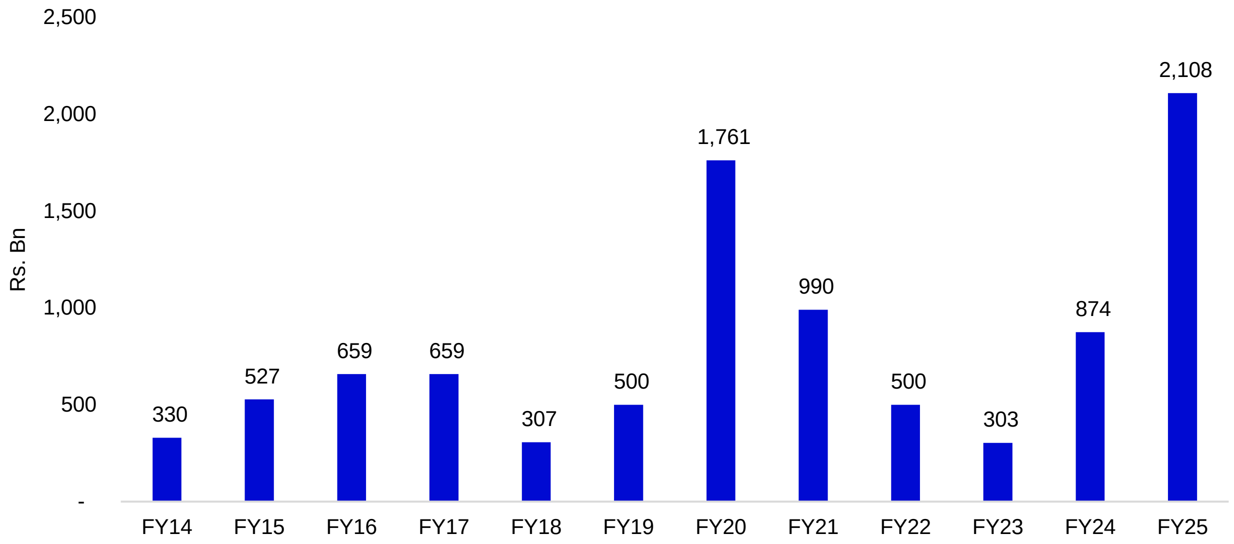
- Liquidity drag from CRR is relatively easy to model. Dependent on 2 key drivers: NDTL & RBI prescribed CRR rate
  - **NDTL**: Linked to deposit growth of banks
  - **CRR rate:** Generally maintained at 4%. Exceptional scenarios like Covid (FY20) and very high system liquidity & the need to withdraw it (~FY23) made RBI change CRR rates away from normal levels of 4%

YTD data is as on March 03, 2025, NDTL – Net Demand and Time Liabilities, E – Estimates
Source – Bloomberg, RBI, Invesco Asset Management (India)

3. RBI Dividend

A key liquidity infusion tool; quantum has increased recently

RBI Dividend (Rs. Bn)



- RBI pays annual dividend based on its profits for the year, the reserves maintained and cushion against required reserves
- The dividend is paid to RBI's sole shareholder i.e. Government of India (GoI)
- For FY25, RBI dividends had jumped sharply on the back of high global yields and RBI's Fx operations
- For FY26, GoI has budgeted another year of high RBI dividend

Source – RBI

Disclaimer - The above chart is for illustration purpose only to explain quantum of dividend declared by RBI to Government every financial year. The information alone is not sufficient and shouldn't be used for the development or implementation of an investment strategy.

4. RBI’s G-Sec holding

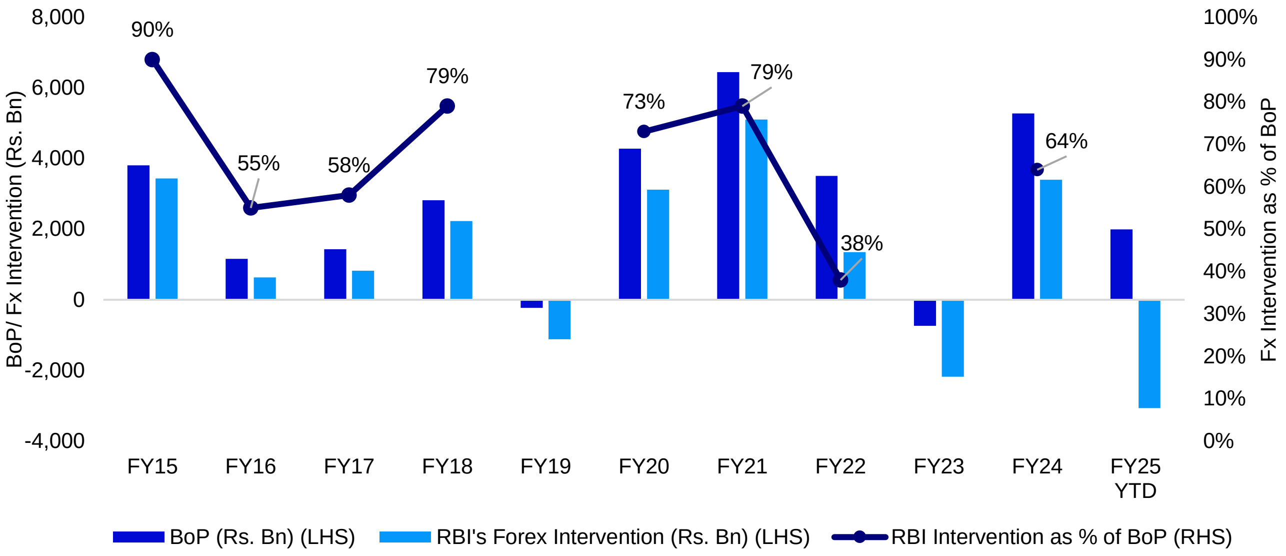
Acts as a liquidity drag at the time of maturity of these G-Secs

- RBI holds about Rs. 13.9 lakh crores of Govt. securities on its balance sheet
  - In case of maturity of these instruments at the hand of RBI, it reduces the system liquidity to that extent, as the maturity proceeds go to RBI
  - Similarly, interest payments on existing Govt. securities reduces liquidity as the proceeds go to RBI
- In the past, RBI has performed G-Sec switches with the GoI
  - Securities coming up for maturity in the upcoming fiscal used to be switched for longer term securities. Hence, no maturities and no liquidity drag
  - However, RBI has done no such switches in the last 2 fiscal years. Even for FY26, no such switch is budgeted
- As per market estimates, about Rs. 1.1 lakh crores of maturities and Rs. 75,000 crores of interest payment is lined up for FY26

Source – RBI, Data as on February 21, 2025

5. RBI’s Fx intervention

Most volatile element and is dependent on BoP, can impact liquidity either ways (addition / withdrawal)



BoP – Balance of Payment
Note - For YTD FY25, BOP is as on September 2024 and RBI’s Forex Intervention is as of December 2024. For FY19 and FY23, BoP and Forex intervention were negative hence the % of BoP is not captured in the above graph.
Source – Bloomberg, RBI

Disclaimer - The above chart is for illustration purpose only to explain how forex intervention by RBI is linked to BoP. The information alone is not sufficient and shouldn’t be used for the development or implementation of an investment strategy.

- Variability in BOP has historically come largely from variability in capital flows

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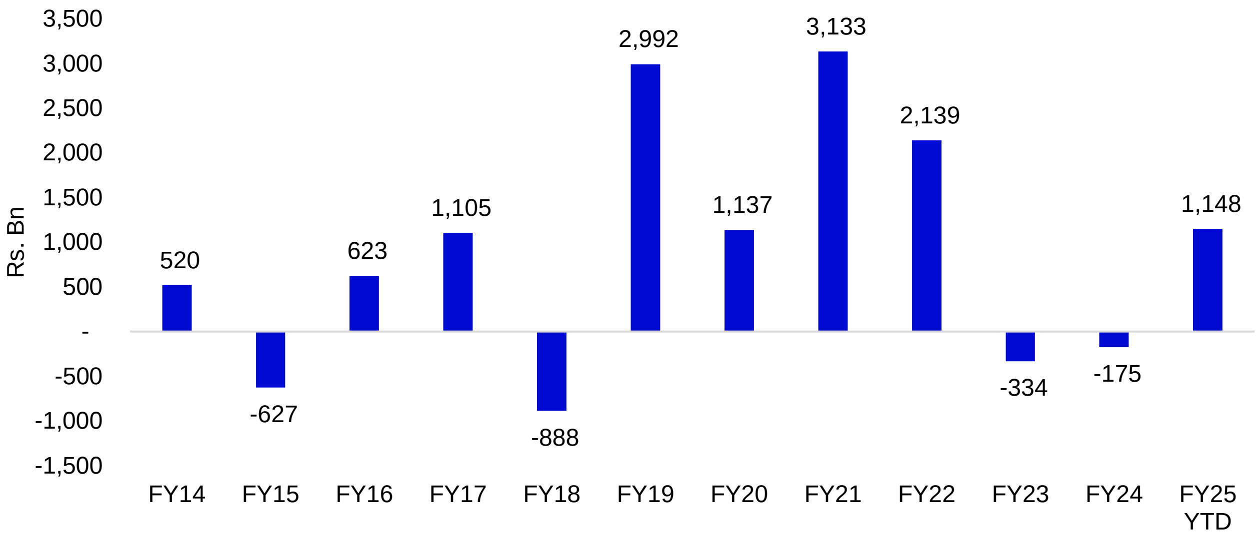
- **RBI’s Fx intervention policy acts as a counter to capital flows volatility** i.e. when BoP is high, RBI neutralizes ~80% of it by buying Fx, resulting in increase in INR liquidity. And vice-versa, when BoP is negative, RBI counters it by selling Fx (historically selling more than the BOP outflows)

- RBI’s forex intervention has been the key reason for the turn in liquidity since October 2024, sucking out ~Rs. 3 lakh crores of INR liquidity till December 2024 **– this is the highest Fx intervention (to absorb liquidity) in last 10 years**

6. RBI's Open Market Operations
A balancing figure

Open Market Operations (OMOs) – Rs. Bn

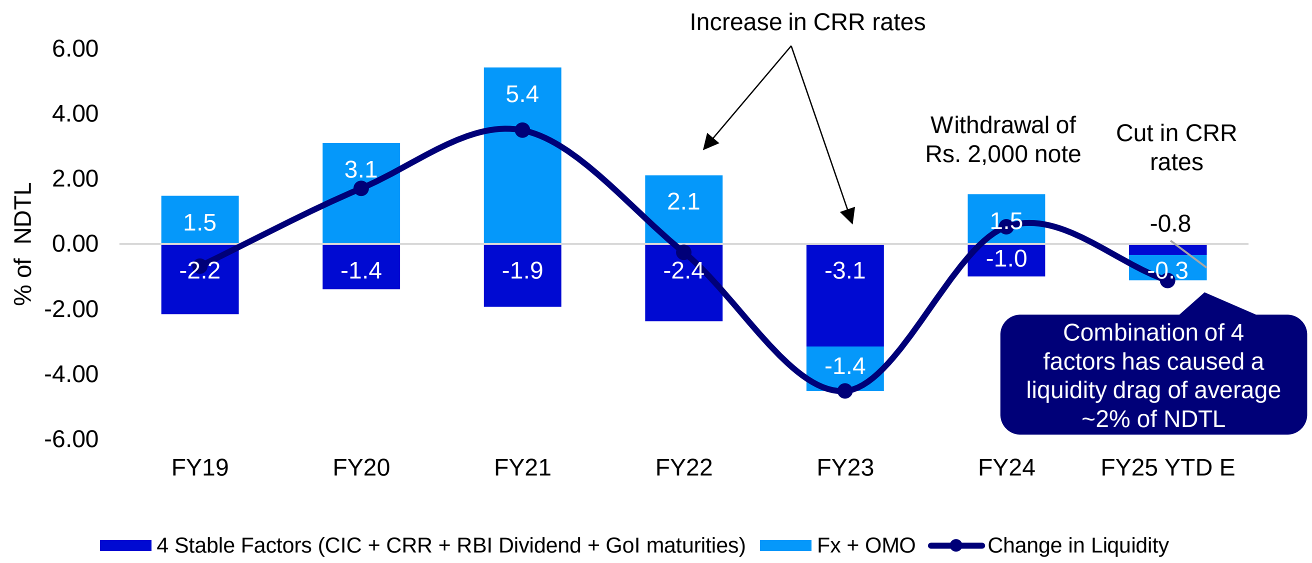


- RBI has used OMO purchases very frequently in the past (8 out of 12 years). The quantum has also been sizeable. Hence, using the tool again will not be an exception.
- G-Sec maturities of ~Rs 1.1 lakh crs in RBI's books means even a Rs. 2 lakh crs of OMO purchase will lead to just Rs. 90,000 crs on a net basis. This is well within the quantum conducted by RBI earlier.

Source – FY25 YTD– till February 20, 2025

Disclaimer - The above chart is for illustration purpose only to show OMO operations conducted by RBI. The information alone is not sufficient and shouldn't be used for the development or implementation of an investment strategy.

Summing up – Fx and OMO are the volatile elements, other four factors are relatively predictable



- 4 factors combined (CIC + CRR + RBI dividend + GoI maturities) is a relatively predictable element, contributes to average ~2% of liquidity drag of NDTL on an annual basis (From FY19 to FY24)
- The major volatility comes from Fx intervention + OMOs
- Despite the above factors being very stable, the overall liquidity change remains highly volatile over the years – this volatility is driven by RBI's Fx intervention and OMOs

E- Estimates, NDTL – Net Demand and Time Liabilities,
Source – Bloomberg, Invesco Asset Management (India). YTD data till February 21, 2025

Disclaimer –The above chart is for illustration purpose only to explain that 4 factors combined (i.e. CIC, CRR, RBI Dividend and GoI maturities) follow a relatively predictable pattern towards change in liquidity while forex intervention & OMO are the volatile elements. The information alone is not sufficient and shouldn't be used for the development or implementation of an investment strategy. The information provided herein may include statements/data of future expectations that are based on current views and assumptions and involves known and unknown risks and uncertainties that could cause actual results, performance or events to differ materially from those expressed or implied.

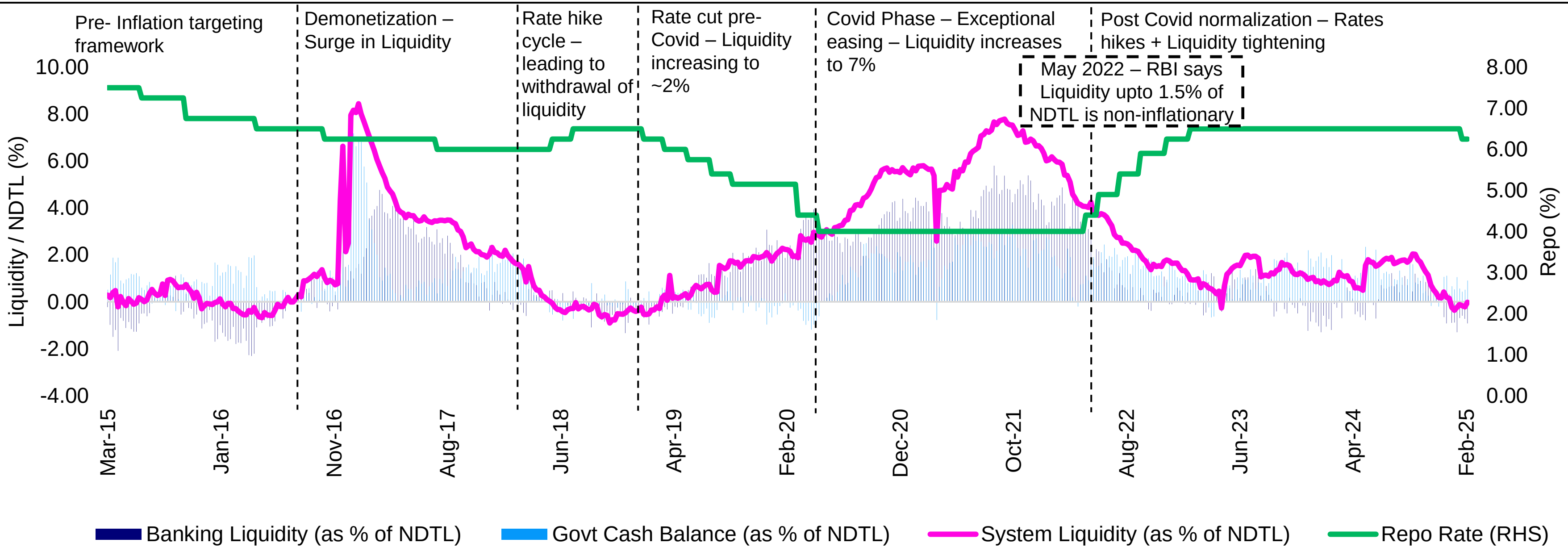
Quantifying these factors for FY25

Sr. no.	Parameter	FY25E in Rs. Bn
1	Opening Liquidity (as on April 01, 2024)	2,252
1.a	CIC (a)	-1,920
1.b	CRR (b)	127
1.c	RBI Dividend (c)	2,108
1.d	RBI’s G-Sec maturity (d)	-1,500
1.e	RBI’s Fx intervention (e)	-2,344
1.f	RBI’s OMO operations (f)	1,148
2.	Closing Liquidity (= Opening + a + b + c + d + e + f)	-129
3.	Closing Liquidity as a % of NDTL	-0.05%

- For FY26, system liquidity scenario should improve from current levels for effective transmission of rate cuts:
  - CIC, CRR and maturity of G-Secs on RBI books will be key drain on liquidity in FY26 (vs. CRR being a liquidity addition in FY25 due to cut in CRR rate).
  - Fx intervention and OMO will be the large moving parts in the liquidity analysis in FY26. Fx inflow may be limited due to the global volatility. Subsequently, to improve liquidity next fiscal, RBI is expected to use OMO purchases as a key tool. (OMOs estimated to be in the range of Rs 2-3 lakh crores next year).
  - In case the RBI decides for a higher system liquidity (as seen in the past during rate cut cycles), more liquidity addition steps will become important – OMOs again being a prime choice.

Source - Invesco Asset Management (India)

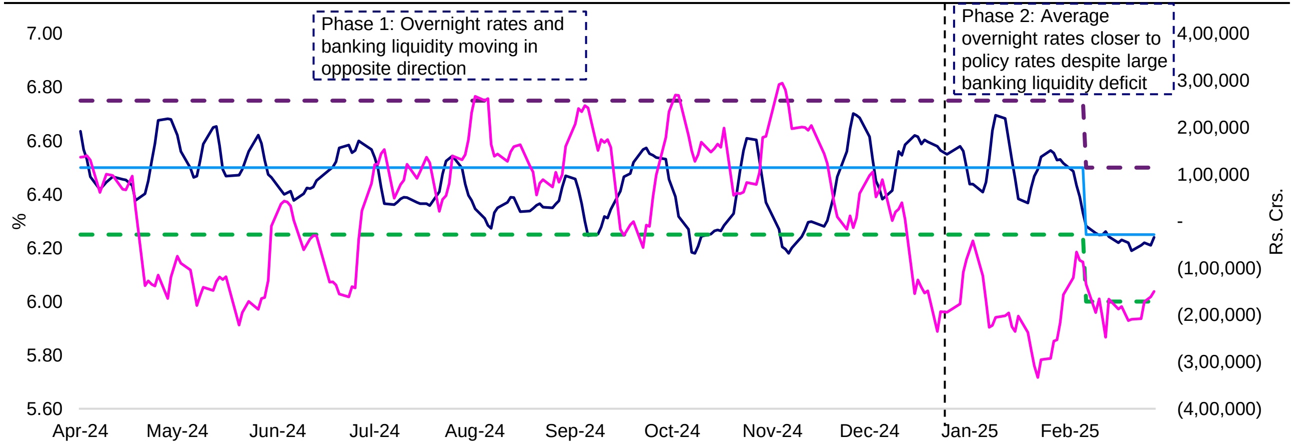
Rate easing cycle coincides with improvement in liquidity



Source – Bloomberg

Disclaimer - The above chart is for illustration purpose only to show movement of system liquidity during various phases of rate cycle. The information alone is not sufficient and shouldn't be used for the development or implementation of an investment strategy.

RBI is actively providing liquidity, but through transient VRRs – has helped keep overnight rates closer to policy rates



- 5-day TREPS moving average (LHS)
- Policy Repo Rate (LHS)
- Policy Repo Rate Lowe Limit (LHS)
- Policy Repo Rate Upper Limit (LHS)
- Banking Liquidity (Rs. Crs) (RHS)

Average	Apr 1, 2024 - Nov 30, 2024
Banking Liquidity (Rs. Crs)	59,279
TREPS rate	6.43%

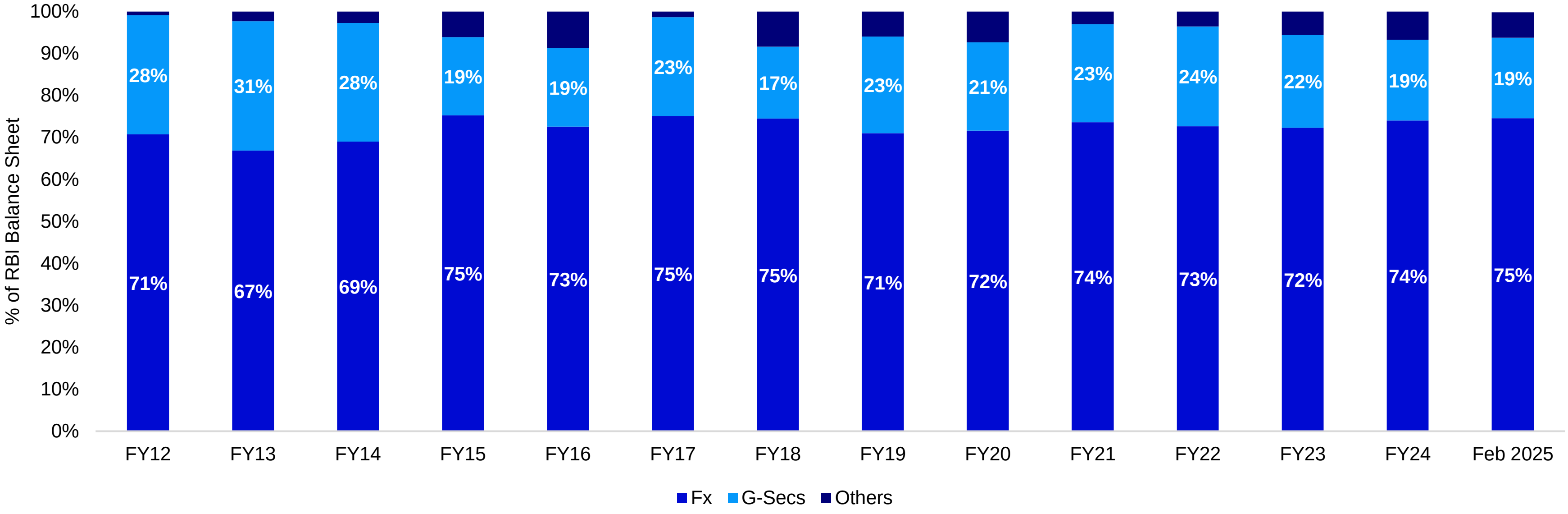
Average	Dec 1, 2024 - Feb 6, 2025
Banking Liquidity (Rs. Crs)	(133,947)
TREPS rate	6.49%

- As the banking liquidity moved into large deficits post December 2024 onwards, the average overnight rates continued to hover around the policy rate
- Average overnight rates during the 2 phases has also been closer to each other, despite large differences in banking liquidity. This is due to large-sized VRRs conducted by RBI at closer to policy rates

Data as on February 28, 2025. VRR – Variable Repo Rate, TREPS – Tripart Repo
Source – Bloomberg
Disclaimer - The above chart is for illustration purpose only to show movement of banking liquidity and corresponding change in overnight rate. The information alone is not sufficient and shouldn't be used for the development or implementation of an investment strategy.

OMO purchases are more durable measure

G-Secs as a % of RBI's balance sheet is towards lower bounds and is supportive of OMO purchases



Source: Bloomberg, RBI. FY25 data till February 21, 2025

Disclaimer - The above chart is for illustration purpose only to show the % allocation of RBI's Balance Sheet. Currently, G-sec as a % of RBI balance sheet is towards the lower bound compared to historical levels which indicates possibility of OMO purchases going forward. The information alone is not sufficient and shouldn't be used for the development or implementation of an investment strategy.

Conclusion

- **Liquidity management** and tools used by RBI to manage liquidity will be a **focus area in FY26**

- **Rate cut cycle has generally coincided with improvement in liquidity**

- Even with an assumption of neutral liquidity (system liquidity being zero), RBI will be required to undertake OMOs in the range of Rs. 2 – 3 lakh crores during FY26. OMO purchases will be higher in case RBI decided to keep system liquidity above neutral levels

- The FPI + FDI flows will be a key variable factor in liquidity analysis as we step into FY26

OMO – Open Market Operations, FPI – Foreign Portfolio Investments, FDI – Foreign Direct Investments

Disclaimer

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