



# Mopping up of Liquidity

## What is liquidity?

2010 brings with it lots of expectations from the Indian economy. The stock market is all set to party hard and therefore took a break on New Year's Day. The media is full of positive stories like the Tata Nano, Barack Obama, India growth story and so on. There is very little, if at all any, mention of the financial crisis that engulfed most of the world not too long ago. This is a clear indication of changing sentiments and optimism which is just the right fuel for the economy as it sets foot into 2010.

When the financial crisis reared its ugly head in 2008, a new term entered several homes—a term that was erstwhile confined to corporate boardrooms became the topic of discussion in drawing rooms. This new term was 'liquidity'. Suddenly everyone starting from the veteran professional to the seasoned housewife was worried that liquidity was drying up. It dawned on us that there is something called liquidity which affects our lives.

## So what is liquidity?

If one were to imagine the economy to be an engine, liquidity could be seen as the fuel. Just as a car would come to a grinding halt without fuel, so would an economy without liquidity. Literally speaking, liquidity is nothing but 'cash' or 'money' that is available to businesses for various economic activities.

Let's take the case of a manufacturer whose cash flow dries up because of increased risk averseness of banks triggered by macroeconomic factors like the global financial meltdown of 2008. With the money flow abruptly stopping, the manufacturer would not be in a position to meet his working capital requirements. And if his goods do not reach the markets he would not be able to recover the cost of his products let alone make any profits. Because of this, he would not be able to pay his employees their salaries and creditors their dues. This would snowball into a larger crisis with other banks and vendors

blocking their credit lines and thereby ensuring that his manufacturing activity comes to a grinding halt, just as a car would without fuel.

Fortunately things did not get out hand in this manner during the slow down due to the timely intervention of the governments who opened up lifelines by making credit available to failing industries so that they could revive their operations and complete their economic cycles. The central bank cut its policy lending rate by 425 basis points between October 2008 and April 2009, slashed CRR and pumped in liquidity in financial markets to revive the economy hit hard by the global slow down. This infusion of timely liquidity was one of the main reasons for the economy to gradually limp back.

Just as the meltdown paralysed economies globally, the recovery too has been nothing short of remarkable with the Indian economy now saddled in comfort zone.

#### What leads to 'excess' liquidity?

In this context, we need to understand that as long as the liquidity is absorbed by real economic activities such as meeting of working capital requirements and other genuine capital and infrastructure investments, the overall economic balance would be maintained. However, if there

is excess liquidity in the system over and above which can be absorbed in the economy, the surplus starts flowing into different asset classes like realty, gold, commodities like oil etc. giving rise to asset bubbles. And asset bubbles eventually cause widespread pain, when they eventually burst.

The reasons being attributed for excess liquidity in the Indian economy have emanated from the following:-

1. FII as well FDI money has been finding their way into the Indian economy.
2. Banks are flush with funds as credit demand continues to remain weak even as deposits are growing. According to RBI data, bank credit rose only 10 per cent on a year-on-year basis till November end 2009 as against 26 per cent in the corresponding period last year. In the same period, deposits rose 18.4 per cent against 20 per cent a year ago.
3. Maturing of government bonds and loans leading liquidity back into the system as the bond holders receive the proceeds. For instance, as per RBI data, the total bonds maturing in the coming six months are estimated to be around Rs. 80,336 crore including MSS bonds worth Rs. 18,773 crore.
4. Borrowing Holiday by the government between December and January
5. Advance tax paid by corporate India has been rather healthy this year. The advance tax collection from India Inc rose 20 per cent during the first nine months of the current fiscal compared to the same period last year. Advance tax payments by industries increased to Rs 1.13 lakh crore from Rs 0.94 lakh crore during the corresponding period last fiscal, according to the Finance Ministry.
6. Rupee strengthening against the USD too has had an effect in increasing the liquidity in the system. To prevent the Indian rupee from getting too strong for comfort, the Reserve Bank has to intervene by buying out the excess dollars and thereby releasing proportionate 'Rupees' into the system. The rupee has appreciated by almost 16% from the start of crises from Oct '07.

As a result of outflow and poor export earnings, the rupee had a hit lifetime low of 52.19 against the dollar last March.



**Rupee Movement – volatile note**

15 Oct '07	39.3
29 Oct '08	49.7
9 Mar '09	51.8
15 Oct '09	45.9
14 Jan '10	45.5

This has resulted in liquidity appreciation of Rs.1000 crore due to the appreciation of the rupee, which now needs to be mopped up so that it does not induce asset bubbles as well as inflationary pressures.

The Consumer price inflation is at a staggering 17% while the Wholesale price inflation too is inching upwards into 'concern' zone.

Balancing liquidity and growth is a fine balancing act that the RBI has to manage. In this context, one has to understand that the Reserve Bank looks at the overall growth prospect of the economy before vacuuming out the excess liquidity. Fortunately, the Indian economy seems to have picked up steam and appears reasonably stable with growth numbers appearing to be better than expected by the Reserve Bank.

There are several measures that the Reserve Bank can take in order to mop up excess liquidity from the system. Some of the tools used for this purpose are:-

**1. Hike in interest rates:** Since the economy is recovering on the back of strong fundamentals and the fiscal stimulus, the RBI would have to weigh the pros and cons of hiking interest rates so that the economy does not get derailed. Another reason for not warranting an immediate rate hike is because of the poor credit off take as such.

**2. Hike in Cash Reserve Ratio:** Therefore, tightening could be initially through CRR hikes. However, banks generally do not prefer a hike in CRR for they do not earn any interest on the cash that is parked with the RBI as CRR.

**3. Issuance of Market Stabilization Scheme (MSS) Bonds:** Banks, on the other hand, are keener that Reserve Bank of India (RBI) issues short-term bonds under the market stabilisation scheme (MSS) (see box) to drain surplus liquidity rather than increasing cash reserve requirements.

**4. Hike in Statutory Liquidity Ratio:** Banks are also not averse to a hike in the statutory liquidity ratio (SLR), which now stands at 25 per cent, as this would justify a demand for an increase in the percentage of bonds they can classify as 'held to maturity' (HTM). (See Box)

**5. Controls on 'External Borrowings':** The RBI has recently reintroduced controls on external borrowing, which were relaxed a year ago in the aftermath of the credit crisis.

**6. Withdrawal of Fiscal Stimulus:** As such, we all understand that abnormal measures to stimulate the economy that were taken across global economies cannot be sustained endlessly. Most governments will withdraw the support once their economies are on auto pilot. The Indian economy is expected to start cruising a lot before several of the other world economies and hence withdrawal of fiscal stimulus is on the cards and could get initiated at some point in 2010.

**MSS**

The MSS bonds are interest bearing securities created for the sole purpose of mopping surplus cash lying with banks. Banks are happy investing in MSS bonds as they yield market related returns. Unlike regular Central Government bonds, MSS bonds have an anti-inflationary impact as the proceeds of these bonds are retained by RBI in a separate account and not passed on to the government for spending.

"MSS bonds will not have any impact on fiscal deficit because it is not part of government borrowing. Their issue would also not impact g-sec yields if key rates are left alone. Investments in MSS bonds gives banks better returns while taking care of surplus liquidity.

**HTM**

Once bonds are moved into the HTM category, they need not make any provision for a fall in the value of these bonds if interest rates rise. Banks fear that a rise in yields on government securities could result in a fall in the bond prices. This does not happen for "Held To Maturity" papers as the investment is held to maturity and the paper is not traded in the market.

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