Invesco Mutual Fund

Event Update - RBI Dividend and its implications on Fixed Income Market

RBI has recently declared a record dividend of Rs. 2.1 lakh crores (approx. 0.6% of GDP and 0.89% of NDTL) to the Government which was higher than our expectation of Rs. 85,000 crores (approx. 0.25% of GDP and 0.4% of NDTL). The fixed income markets are abuzz with this development.

The increase in RBI dividend to the Government has raised questions. Firstly, will the Government use this opportunity to reduce its fiscal deficit or increase its spending. Secondly, how would RBI react on the high system liquidity due to government spending post elections, forex inflows and JP Morgan Index led bond flows.

Higher spending or reduction in fiscal deficit – which path will the Government choose?

It is too early to say whether the Government will cut its fiscal deficit or spend higher than budgeted. Market participants would keenly watch out for the actual Budget announcement in early July to get a sense of how the Government plans on utilizing the windfall dividend. At this point of time, our first thoughts are that the Government will use it to partly cut its fiscal deficit. However, we would like to see the initial statements from the upcoming Government to further comment.

System liquidity expected to be in comfortable range going forward

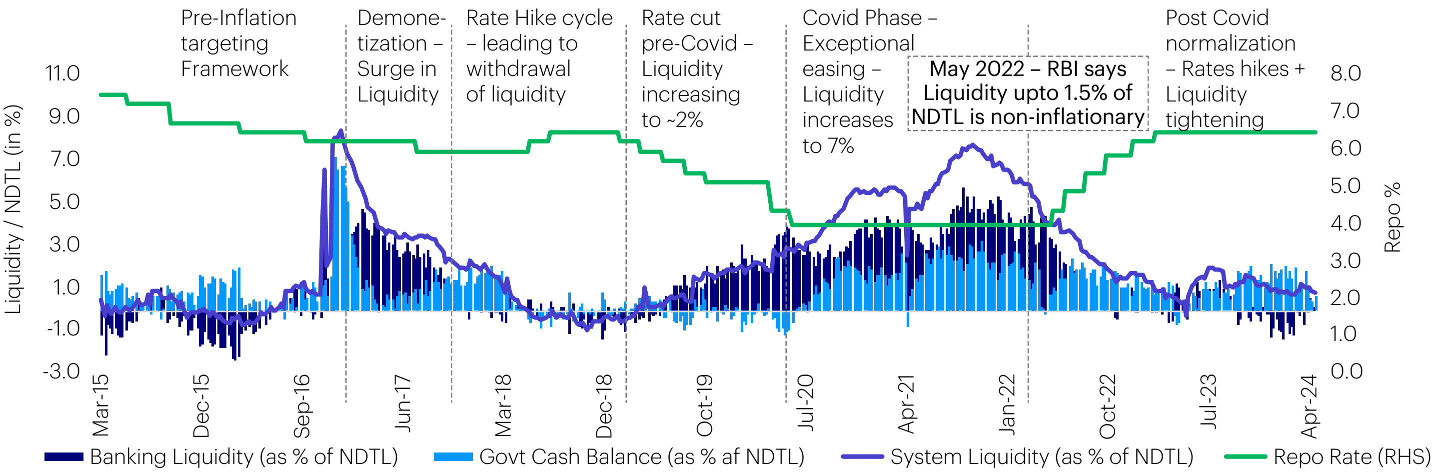
The higher-than-expected RBI dividend will negate a large part of the liquidity outflows expected due to increase in CIC (currency in circulation) and due to CRR (Cash reserve Ratio) balances maintained with RBI (due to increase in NDTL). At the same time, index inclusion flows are expected in FY25. RBI is expected to absorb a large part of the forex inflows, thereby adding to the liquidity.

After accounting for all these flows, system liquidity is expected to be around Rs. 3.5 lakh crores by the end of FY25

	FY25 - Starting Liquidity (as on April 01, 2024)	CIC outflows	RBI dividend (inflow) (as on May 22, 2024)	CRR (outflows)	Forex intervention	**FY25 - Ending Liquidity**
in Rs Bn	2,275	(3,013)	2,108	(1,140)	3,320	**3,550**
as % of NDTL	1.12	-1.27	0.89	-0.48	1.4	**1.5**

Source – Internal. Please note total CIC is assumed at 11.7% of GDP for FY25, for CRR - NDTL growth expected at 12% in FY25. For forex intervention, Balance of Payment (BOP) is assumed at USD 50bn, out of which RBI is assumed to absorb 80% of the flows.

System liquidity at 1.5% of NDTL by end of FY25 is within comfort levels of RBI. Similar (and much higher levels) of liquidity have been seen in the past:



Source- Bloomberg, Internal. Data as on April 30, 2024.
NDTL - Net Demand & Time Liabilities, FY - Financial Year

Large cash balances of Government will lead to much lower liquidity surplus for the banking system

While system liquidity is expected to end at 1.5% of NDTL for FY25, high government cash balances mean much lower liquidity surplus for the banking system. Government has been maintaining high cash balances in the recent past, as shown below:

as % of NDTL	System Liquidity	Government Cash Balances	Banking System Liquidity
FY22	5.49	2.16	3.33
FY23	2.34	1.32	1.02
FY24	1.09	1.14	-0.05
FY25 Estimate	1.50	1.10 (at the lower end of avg cash balance of 1.1 to 2%)	0.4 (difference of system liquidity & Govt. cash balance)

The above is the balance at the end of the year. Source - Internal

As seen above, government cash balances have remained high in the recent years (1.1%-2% in the past 3 years). Even if the Government maintains cash balance at relatively lower levels of around 1.1% of the above range, the banking system will maintain a small surplus of around ~0.4% only – given the system liquidity of 1.5% of NDTL.

High interim liquidity to be managed through VRRR, Fx swaps rather than OMO sales

Having taken a medium projection on system liquidity, let's look at the near term outlook for system liquidity.

As on date, banking system liquidity is in deficit of ~Rs. 2 lakh crores. In turn, G overnment surplus cash balances can be estimated to be over Rs. 5 lakh crores (after the RBI dividend & tax collections). This leads to high system liquidity in the interim (estimated at ~2% of NDTL).

Government spending has been muted due to the ongoing general elections and the model code of conduct. This has led to deficit banking system liquidity. For the banking system deficit to reduce, the Government has to cancel / reduce T bill auction sizes and / or start spending – which will happen only post election result. Even after the Government formation, the utilization of cash could at least take a month or so – due to sheer high balances.

Additionally, the overall system liquidity should start normalizing during festive season around mid of the fiscal i.e. September (due to the high CIC outflows). This leads to a small window of around 2-3 months when the liquidity will be high – **RBI is likely to manage this window through options like longer dated Variable Reverse Repo Rate (VRRR) auctions, Forex (Fx) swaps rather more permanent options like Open Market Operations (OMO) sales.**

Key Takeaways

- We don't see any OMO sales announcement by RBI despite improving liquidity conditions given that the high liquidity is transitory in nature and will normalize after September. This reduces the pressure on short term as well long term yields.
- Improving liquidity in interim is expected to drive the yields at the shorter end lower. Investors can take the benefit of current elevated yields to park their short term surpluses.
- We need to watch out the implication of windfall dividend by RBI on borrowing calendar and fiscal deficit. Any reduction in fiscal deficit by the Government will be positive for long term yields.