

Liquidity Crunch in Indian Banks - Updated as of August 2024

Introduction

As of August 2024, the Indian banking sector is experiencing a persistent liquidity crunch, which has significant implications for the broader economy. The liquidity shortage, exacerbated by recent macroeconomic trends and regulatory measures, continues to challenge banks' ability to lend and sustain economic growth. This report examines the current state of liquidity in Indian banks, the contributing factors, recent data points, and the measures being taken by authorities to mitigate the situation.

Current State of Liquidity

- **Liquidity Coverage Ratio (LCR):** As of June 2024, the average LCR for Indian banks stood at approximately 132%, slightly above the regulatory requirement of 100%. However, this is a decline from the previous year's average of 140%, indicating increasing stress on liquidity positions.
- **Net Stable Funding Ratio (NSFR):** The NSFR, which measures the stability of banks' funding profiles, has also seen a decline. The average NSFR for Indian banks was recorded at 105% in Q2 2024, down from 112% in Q2 2023, reflecting a reduced ability to meet long-term obligations.
- **Credit Growth vs. Deposit Growth:** Credit growth in Indian banks has outpaced deposit growth, exacerbating liquidity pressures. As of July 2024, credit growth was recorded at 15.4% year-on-year, while deposit growth lagged at 8.2%. This widening gap is a key factor contributing to the liquidity crunch.

Factors Contributing to the Liquidity Crunch

1. **Rising Interest Rates:**
 - The Reserve Bank of India (RBI) has continued its monetary tightening cycle in response to inflationary pressures. The repo rate was increased by 50 basis points in June 2024, bringing it to 6.75%. This has led to higher borrowing costs for banks, reducing their liquidity and lending capacity.
2. **Deposit Outflows:**
 - There has been a notable shift in savings from traditional bank deposits to higher-yielding financial products such as mutual funds and corporate bonds. As of July 2024, fixed deposit growth slowed to 7.5% year-on-year, compared to 9.8% in the same period last year. This shift has reduced the deposit base for banks, intensifying the liquidity crunch.
3. **Tightening Monetary Policy:**
 - The RBI has maintained a hawkish stance on monetary policy, continuing to withdraw excess liquidity from the system. In July 2024, the RBI conducted open market

operations (OMOs) that absorbed ₹75,000 crore from the banking system, further tightening liquidity conditions.

4. High Government Borrowing:

- The Indian government's borrowing program for FY 2024-25 is projected at ₹18.5 lakh crore, up by 11% from the previous fiscal year. This large borrowing requirement has crowded out private sector borrowing and increased competition for funds, pushing up interest rates and straining bank liquidity.

5. Rising Non-Performing Assets (NPAs):

- Despite efforts to manage bad loans, Indian banks continue to face high levels of NPAs. As of June 2024, the gross NPA ratio for public sector banks was 7.3%, a slight increase from 6.9% in March 2024. This has led banks to increase provisions, further reducing available liquidity for lending.

Impact on the Economy

1. Reduced Lending and Credit Tightening:

- The liquidity crunch has led to stricter lending standards, with banks becoming more cautious in extending credit. Loan disbursements to SMEs, which are particularly vulnerable to credit tightening, declined by 12% in Q2 2024 compared to the same period last year. This could slow down economic activity, particularly in sectors dependent on bank financing.

2. Increased Borrowing Costs:

- The rise in interest rates and tightening liquidity have led to higher borrowing costs for businesses and consumers. The average lending rate for commercial loans increased to 9.5% in July 2024, up from 8.7% in December 2023. This increase is likely to dampen investment and consumption, potentially slowing GDP growth in the upcoming quarters.

3. Stress on Non-Banking Financial Companies (NBFCs):

- NBFCs, which rely heavily on bank funding, are particularly vulnerable to the ongoing liquidity crunch. Many NBFCs have faced difficulties in rolling over their short-term debt, leading to higher borrowing costs and reduced credit availability to their customers. The overall lending by NBFCs contracted by 5% in the first half of 2024.

4. Pressure on the Banking System:

- The liquidity crunch has increased stress on the banking system, particularly among smaller and regional banks with weaker balance sheets. If the situation persists, it could lead to more banks facing solvency issues, requiring government or RBI intervention to prevent systemic risks.

Measures Taken by the RBI and Government

1. Liquidity Infusion by RBI:

- The RBI has responded to the liquidity crunch with targeted measures to inject liquidity into the banking system. In July 2024, the RBI announced a ₹1 lakh crore liquidity infusion through long-term repo operations (LTROs) to provide banks with additional funding. Additionally, the central bank has extended the timeline for CRR maintenance by banks, allowing them to manage liquidity more effectively.

2. Government Initiatives to Boost Deposits:

- To encourage deposit growth, the government has introduced new savings schemes with attractive interest rates. The recently launched "National Savings Scheme 2024" offers a 7.5% interest rate, higher than the average fixed deposit rate of 6.2%, aimed at attracting household savings back into the banking system.

3. Support for NBFCs:

- The RBI has provided a special liquidity facility of ₹50,000 crore for NBFCs, allowing them to access funds more easily. This measure aims to ensure that NBFCs can continue to provide credit, particularly to underserved segments of the economy, despite the liquidity crunch.

4. Regulatory Easing for Stressed Banks:

- Recognizing the stress on smaller banks, the RBI has relaxed certain regulatory norms temporarily, such as easing the capital adequacy ratio requirements and providing more flexibility in managing NPAs. These measures are designed to provide breathing space to banks struggling with liquidity issues.

Conclusion

The liquidity crunch in Indian banks as of August 2024 presents significant challenges to the financial system and the broader economy. While the RBI and the government have taken various steps to alleviate the situation, the underlying structural issues within the banking sector, such as high NPAs and the gap between credit and deposit growth, continue to pose risks. A sustained focus on both immediate liquidity management and long-term structural reforms is essential to ensure the stability and resilience of the Indian banking sector in the face of ongoing challenges.