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What are banks doing with the cash pile-up?

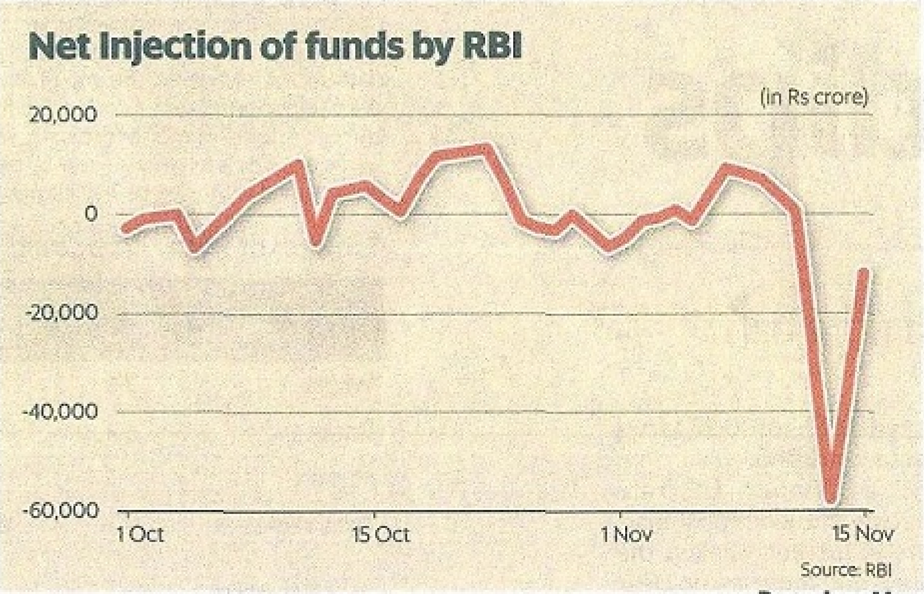
Imposition of withdrawal limits means a lion's share of deposits is still within the banking system

BY KARTHIK SHASHIDHAR
feedback@livemint.com

Since the Union government withdrew Rs500 and Rs1,000 notes from midnight on 8 November, banks have been flush with cash, primarily on account of people depositing now-invalid notes in their bank accounts.

With the country's largest lender, State Bank of India, itself having collected Rs1.27 trillion in cash deposits in the first nine days after the prime minister's announcement (*see http://bit.ly/2fM2Upf*), the total amount of cash deposited in the banking system is likely to be over Rs4 trillion. In fact, it has been estimated by the Indian Banks' Association that this amount was collected by Tuesday itself (see *http://bit.ly/2gqkVOI*).

While a part of this money has been subsequently withdrawn, the imposition of withdrawal limits means that a lion's share of deposits is still within the banking system. With banks strapped for employee bandwidth on account of heavy public demand to deposit, withdraw and exchange currency, it will be interesting to analyse what banks are doing with the money.



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While data on what exactly banks are *doing with the money they have accumulated* is not out yet, daily data put out by the Reserve Bank of India (RBI) suggests an interesting insight. RBI takes in overnight deposits from banks in the reverse repurchase (repo) market, and also lends to banks that are short on liquidity. The difference between the amount of money lent by RBI to banks and the amount of overnight deposits by banks is called "net injection".

We have looked at net injection in these pages earlier, when we analysed it *in the context of RBI cutting policy rates* (*see http://bit.ly/2gqImFG*. While it is too early to say what the Monetary Policy Committee will do about interest rates in the next review of the monetary policy, net injection can give us a quick indication of what banks are doing with their money.

As can be seen from the graphic, net injection hovered at around 0 throughout October and the first part of November, indicating demand and supply of overnight liquidity were more or less balanced. The prime minister announced the withdrawal of high denomination currency on 8 November, and banks were closed on the following day. Despite banks reopening for business on 10 November, when they started accepting deposits and exchanging currency, net injection until 11 November was more or less in tune with what we had seen earlier this year.

Finance minister Arun Jaitley was quoted by *The Indian Express* as saying that banks had collected nearly Rs2 trillion in deposits until midday of 12 November (*see http://bit.ly/2g3EXdy*). Considering that most of this amount would have been deposited by 11 November, it is intriguing that there was no big change in net injection numbers by that date.

Over the weekend, though (when banks were kept open to aid people looking to exchange currency), net injection dropped sharply as banks proceeded to park their excess funds with RBI. On 13 November (Sunday), net injection by RBI dropped to a whopping negative Rs57,000 crore, indicating banks chose to park a large part of their newly acquired deposits in the form of overnight deposits with RBI.

In order to effectively absorb this additional liquidity, the RBI has been conducting long-duration variable rate reverse repo auctions this week, in addition to the daily repo and reverse repo auctions conducted as part of the Liquidity Adjustment Facility (LAF).

While RBI periodically conducts variable rate reverse repo auctions, what is special about this week's auctions is the duration of the repurchase agreements.

On Tuesday, banks placed Rs50,000 crore each in 14-day and 28-day deposits with the RBI (*see http://bit.ly/2g3tg9d*).

On Wednesday, RBI conducted auctions for 21-day and 91-day deposits, and collected Rs25,575 crore and Rs50,000 crore, respectively (*see http://bit.ly/2g55mrG*).It can be seen from the graphic that the magnitude of net injection had come down to less than Rs6,000 crore on Wednesday.

On Thursday again, RBI conducted auctions for banks to place 21-day and 56-day deposits with the central bank. The two auctions collected Rs10,565 crore and Rs14,175 crore, respectively (*see http://bit.ly/2fCVZRF*).

With net injection coming back close to zero, there were no long-period reverse repo auctions scheduled for Friday—RBI instead conducted 3-day and 7-day reverse repo auctions, which is in line with the "normal" duration of such auctions.

It will be interesting to see what the banks with the extra cash do once these deposits mature.

These deposits can also fuel speculation of a rate cut very soon.

Postscript: *It might be pertinent to* mention here that an auction on Friday to sell 30-year government bonds failed.

While there were actually more bids than the amount of bonds on offer, the price offered meant RBI chose to only sell part of the bonds on offer (*see http://bit.ly/2g4RA8K*).

This move by RBI only raises the intrigue on what the Monetary Policy Committee will do in its next review scheduled for 6-7 December.