DSP CONVERSE

TOPICAL CONVERSE: OMO & LIQUIDITY?

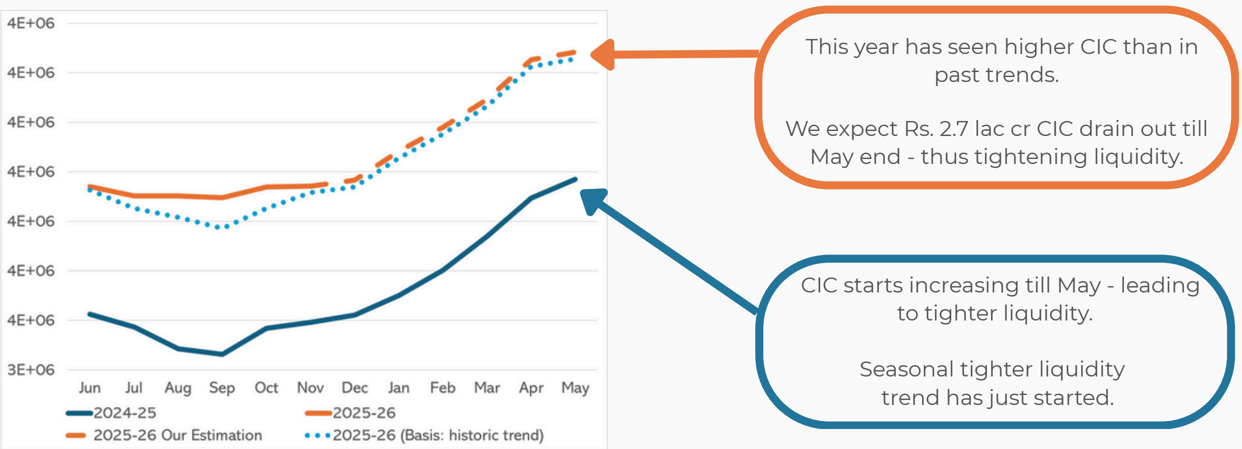
HOW MUCH OMO TO EXPECT ?

The size of Open Market Operations (OMO) that the RBI will do should depend on (i) expected tightness in liquidity, and (ii) expected liquidity target of RBI depending upon their view on growth. In this note we (i) try to project liquidity and thereafter (ii) identify the RBI's target liquidity and finally RBI OMO size.

PART I : HOW AND WHY WILL LIQUIDITY TIGHTEN?

Currency-in-circulation (CIC): CIC is highly seasonal. The upcoming Q3 and Q4 have higher outflow - driven by festive season and harvest - that will lead to liquidity tightening. We assume (i) past 5-years trend will continue this year, (ii) 5% YoY increase, and (iii) the CIC increase in Q3 will be a bit less than in past years as the CIC decrease in Q2 was also a bit less than earlier.

Chart: Seasonality in CIC to lead to liquidity tightening



Principal/Coupon payments by Govt. to RBI: RBI holds Govt bonds, which have increased substantially post covid. The cash flows from these G-secs to RBI will lead to liquidity drain out through the year, but larger RBI dividends in May will give that liquidity back. Thus, the higher GSec holding of RBI will create more volatility in liquidity through the year. RBI should receive GSec payments ~Rs. 40K cr till April.

Chart: The RBI's G-sec holding is calculated by OMO auction. Secondary mkt OMO make principle payments only larger than mentioned.

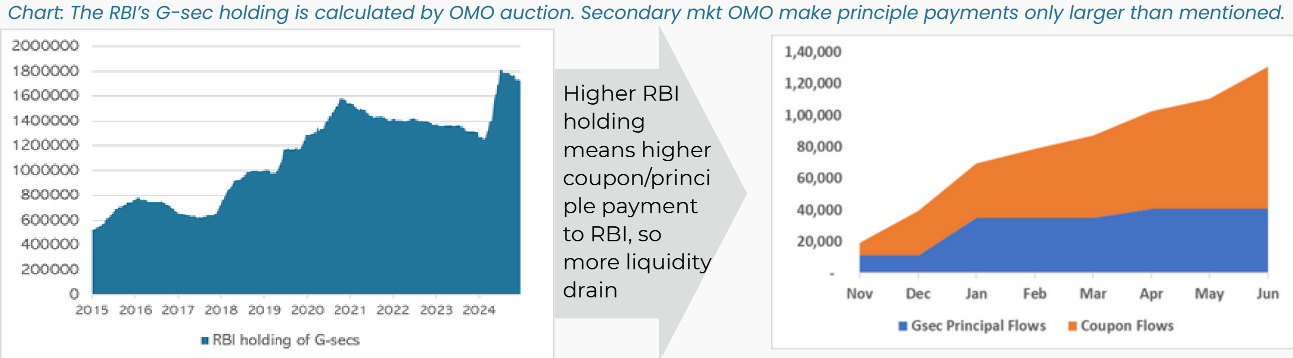
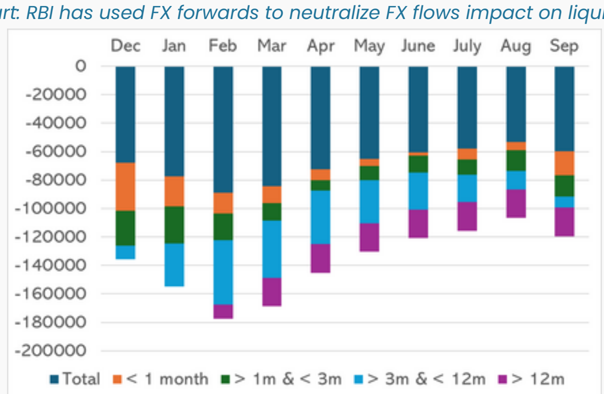


Chart: RBI has used FX forwards to neutralize FX flows impact on liquidity

RBI's change in FX balance sheet: When RBI sells FX, it buys rupees against it thus reducing liquidity (and vice-versa). It is difficult to predict this number as there is too much uncertainty on FX inflows.

Moreover, we expect RBI to keep the on-balance sheet FX stable by altering the off-balance sheet FX forwards - thus ensuring not much in change in RBI FX intervention. The same way RBI increased & decreased the FX forwards this year.



Increased CRR due to higher Bank deposits (NDTL): The increased bank deposits leads to higher CRR to be kept by the banks with RBI. This higher amount leads to draining of liquidity. Assuming a YoY NDTL increase of 10%, the CRR will increase by Rs. 28K cr.

DSP CONVERSE

PART II : RBI'S LIQUIDITY TARGET, AND OMO PROJECTIONS?

Based on the above mentioned points, core liquidity will be close to zero by May, if RBI were not to act.

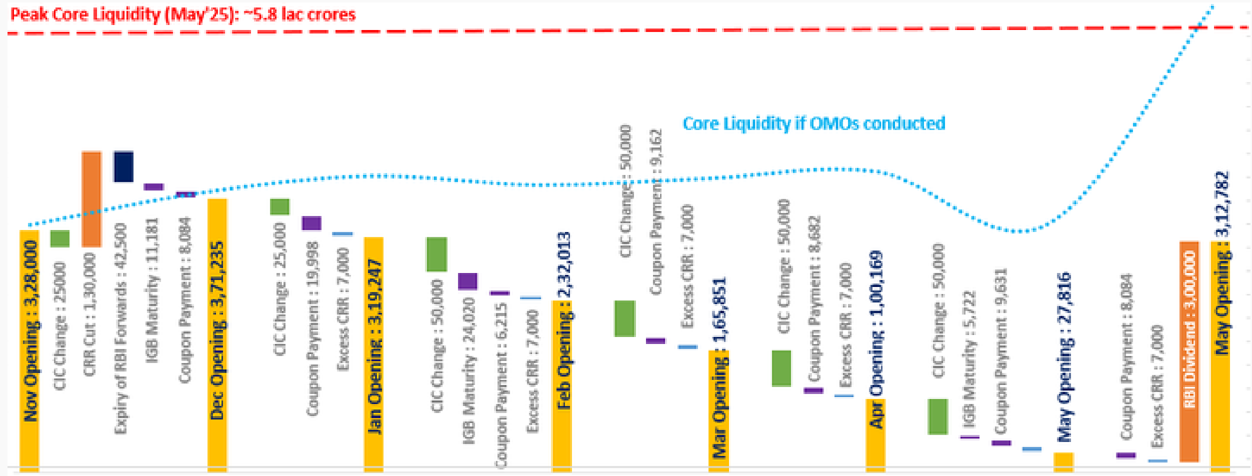
We expect RBI to act. Recent RBI statements/actions indicate a dovish stance: (i) Gov stating that yields should be 20bp lower, (ii) no VRRR despite overnight rate falling much below repo, (iii) RBI purchases of bonds. Thus, RBI may continue to support growth over the few months.

While we do not expect RBI to go overboard, we expect RBI will target a core liquidity oscillating around the Rs. 5.5 lac cr level - a level at which RBI had paused liquidity infusion in 2025.

However, a dividend of Rs ~3 lac cr should be paid out in May. Thus an additional Rs. 3 lac cr of OMO would bring liquidity liquidity close to Rs. 6.0 lac cr by May end - which remains our target.

An OMO should lead to a rally in bonds. While it may not be a 50bp move of early 2025 (~Rs. 5.2 lac cr OMO), but we expect yields to move 25bp (~6.20%) on back of Rs. 3 lac cr OMO.

Chart: Final liquidity projections (i) RBI OMO, and (ii) without RBI OMO



Note: RBI dividend assumed to be ~Rs 3 lac cr (coupons should only increase the divided). Also IGB (Indian Govt bond) means G-sec.

Month open core liquidity | Principal & coupon payment to RBI | CRR requirement change | CIC change | One-off events

Core liquidity target based on (i) peak liquidity of 2025, and (ii) maintaining banking liquidity ~ 1.5% NDTL

Core liquidity assuming 75K/m OMO from Dec to Mar. The concentration will vary and not be uniform.

PART III: Q&A

Q: But RBI G-sec holdings did not matter earlier. What's the big deal this year?
A: For past few years, RBI switched near-term maturities with longer maturities with Govt.. This time, however, RBI after many years has allowed them to mature without switching.

Q: Will RBI dividend increase the same amount as coupon and payments it receives?
A: No. Only the coupon payments flow back to dividends, as they reflect in the RBI's profit and loss statement.

Q: How did we calculate RBI G-sec holding?
A: All the auction OMO, minus the switches. The principal payments will only be larger due to secondary OMO (which is significant chunk). The coupon payments we took as ratio of RBI holding vs total outstanding Gsec.

Q: Will the RBI's OMO still amount to ₹3 lakh crore if Bloomberg Index inclusion takes place?
A: If the Bloomberg Index inclusion materializes, the RBI OMO should reduce. The reduction will be less than Bloomberg index flows i.e. USD ~18b. Why? Because RBI will use FX inflows to exhaust forwards as well. Thus a combination of Bloomberg index + lower RBI OMO will only be more positive than RBI OMO alone.

Q: But the FX flows will impact liquidity! Why ignore?
A: Yes they will. But we ignored for two reasons. Firstly, no one can predict FX flows. Its guesswork which is almost always wrong. Secondly, if FX flows are significant on either side, RBI will increase or decrease its forward book - negating the impact of FX flows.

Q: Why does RBI need to target liquidity in 2026 similar to 2025?
A: It doesn't have to. But we expect it to. While the growth remains robust, but we don't expect RBI to change its liquidity stance - as the risk to growth remain similar in 2026. Secondly, with India's nominal growth the Rs. 5.8 lac cr of liquidity of 2026 relates to Rs. ~6.4 lac cr in 2026. Our target for 2026 is lower than those levels.

Q: But isn't OMO also driven by RBI's need to drive yields lower?
A: At times yes, at times no. Currently, the need for OMO arises from liquidity. This will anyways bring yields lower. Does RBI want yields to be even lower than that? Only time will tell. Too early to jump to conclusions.