Economics Research | India

Are we seeing an end to India's Quantitative Tightening?

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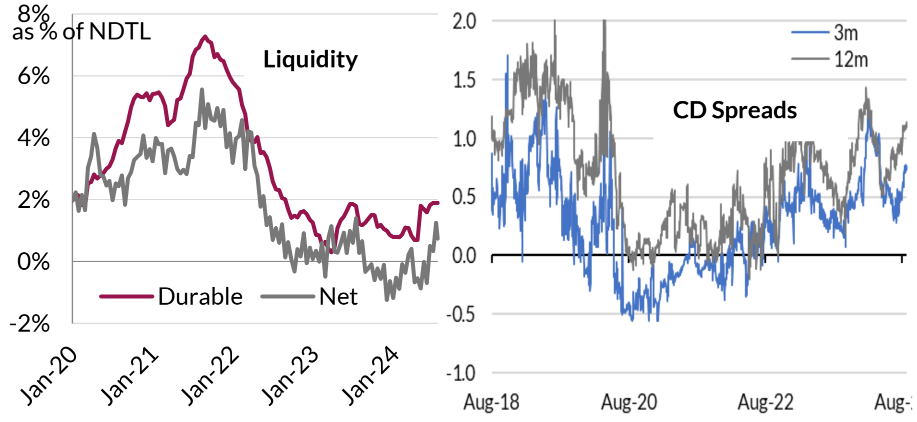
We believe the RBI's tight stance on liquidity is changing. The sharp liquidity withdrawal post 2022 meant deposit growth persistently lagged credit growth. Once LDRs peaked, bank-led money creation is also slowing, further weakening the credit impulse. CD rates remain elevated despite persistent LAF surpluses since early July and durable liquidity at 2Y high. For markets to believe, a stronger signal may be needed, like a CRR cut (still 0.5pp above 2015-19) or allowing higher LDRs (rise in bank equity also hurts deposits).

Exhibit 1: Surplus liquidity since June but CD spreads still high: stronger signal needed?



Source: RBI, Bloomberg, Axis Bank Research

"Weak" deposit growth can create bad feedback loops

With deposit growth lagging credit growth for 30 months now, the longest stretch since 2007 (Fig 2), the Loan-to-Deposit (LDR) ratio has risen to record highs (Fig 3). After the regulator expressed its discomfort with high LDR levels, banks pulled back on credit growth, delivering a negative credit impulse (Fig 4) to the economy. With some banks now starting to raise deposit rates, there is a risk that the impulse may weaken further. With credit weakening, growth in money supply (M3) has now slowed again to 10% YoY (Fig 5). When banks lend to non-banks, that creates new deposits and thus new money. Rising LDR was thus supporting money creation; as it moderates, money supply weakens further.

The reason(s) behind weak deposit growth: how money is created/destroyed

This is exacerbating the post-2022 slowdown in money creation as the RBI tried to drain the surplus liquidity it was forced to inject via FX intervention in FY21 and FY22. RBI's (direct) share of money (M3) has been 16-22% in the past; the rest is from banks (Fig 6), but on a rolling 12M/24M basis, it has only been 14% of incremental M3 (Fig 7). Now, if bank credit growth continues to slow (at a 2-year low now), money supply would worsen further. There is another driver (Fig 8): when bank profits & borrowings from non-banks rise, like FY22-24, deposits fall: bank liabilities move from deposits to equity/bonds.

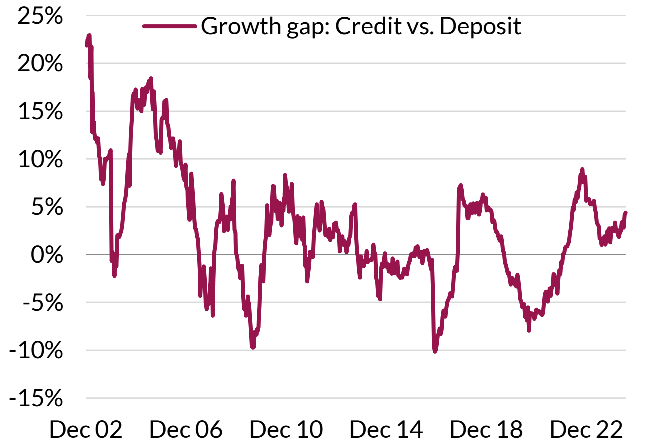
Persistent LAF surpluses indicate problem is understood, stronger medicine?

The RBI was following its revised Liquidity Management Framework (link) but money supply growth slowed. It is also possible that elevated real rates slowed down demand for credit and thus money creation.

A change of stance on liquidity may be visible. While a major driver of a 2Y high in durable liquidity (Fig 9) was the RBI dividend paid in 2H May, some of the recent FX interventions have also not been fully sterilized. Despite two months of net liquidity surplus, 3M/12M CD rates have remained elevated, likely as the market does not trust the surplus will last. A cut in CRR (still 0.5pp above 2015-19 levels) or allowing banks to raise LDR (will allow the higher equity to flow into credit and thus more money) can signal a neutral stance on liquidity even without changing the stance on rates. If so, the de-rating of banks may end.

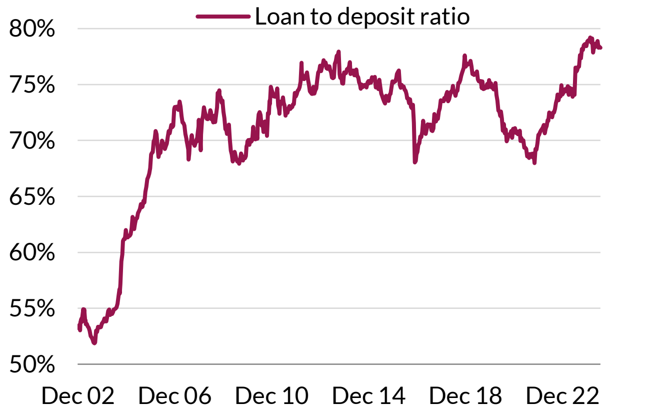
Focus Charts

Exhibit 2: Credit growth > deposit growth for 30 months



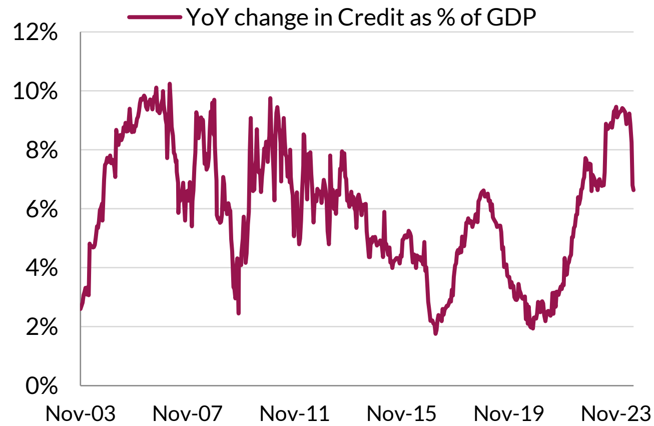
Source: RBI, Axis Bank Research

Exhibit 3: Pushing system LDR to all-time highs



Source: RBI, Axis Bank Research

Exhibit 4: Credit impulse has thus dipped sharply

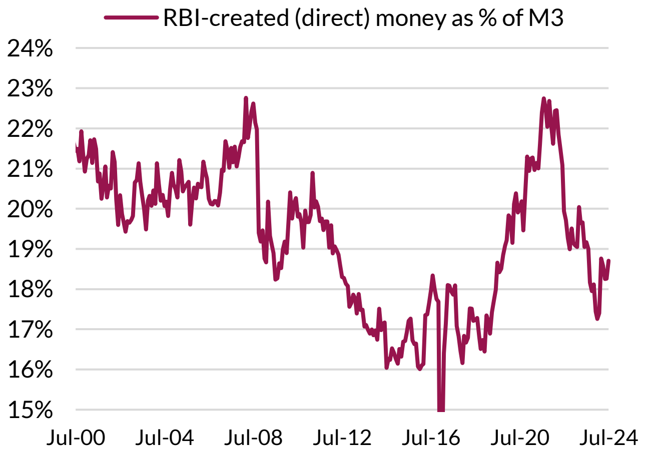


Source: RBI, Axis Bank Research

Exhibit 5: M3 growth has dipped back to 10% YoY

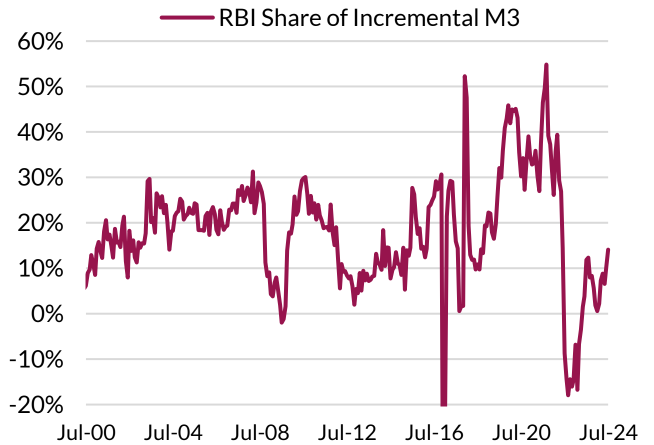
Source: RBI, Axis Bank Research

Exhibit 6: Share of RBI created money fell to 17%, rising now



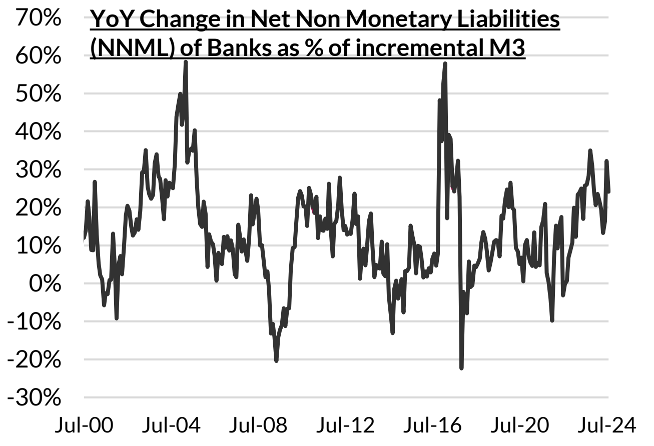
Source: RBI, Axis Bank Research

Exhibit 7: RBI share of incremental M3 bouncing from lows



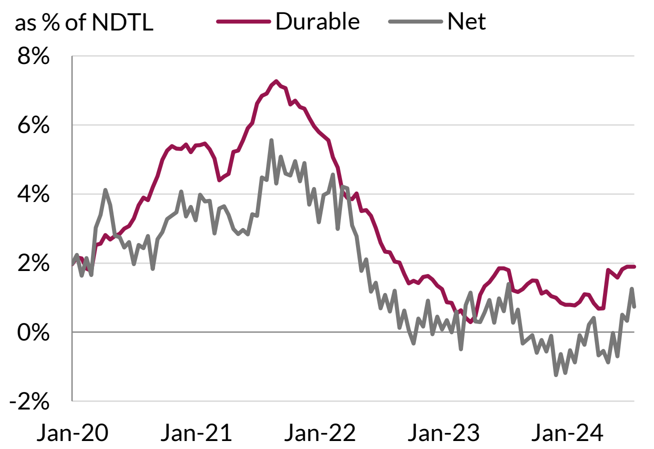
Source: RBI, Axis Bank Research

Exhibit 8: Banks create most of money in the economy via lending but liability transformation can "destroy" deposits



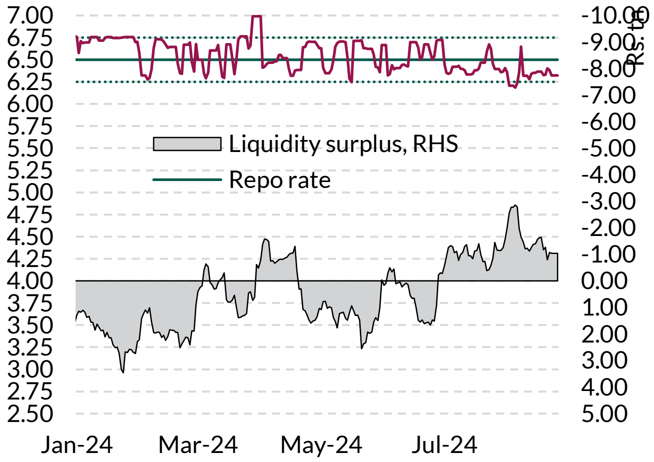
Source: RBI, Axis Bank Research

Exhibit 9: Durable liquidity surplus at 2Y high….a signal of change in stance?



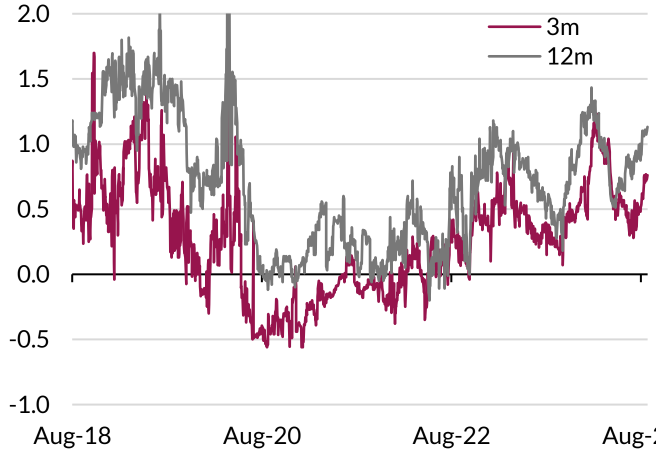
Source: RBI, Axis Bank Research

Exhibit 10: Liquidity in surplus for the last two months



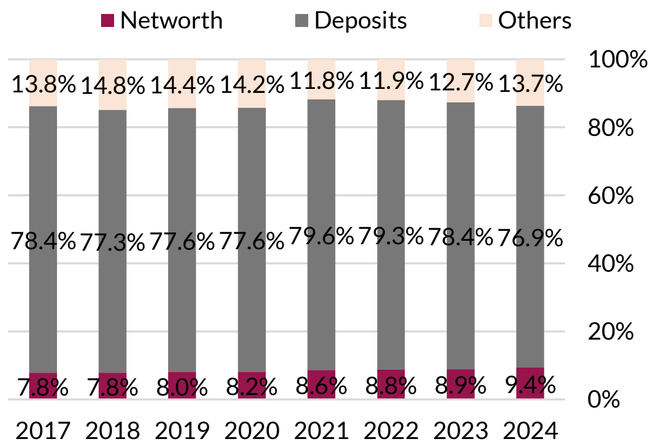
Source: RBI, Axis Bank Research

Exhibit 11: Despite easy liquidity, CD rates still elevated



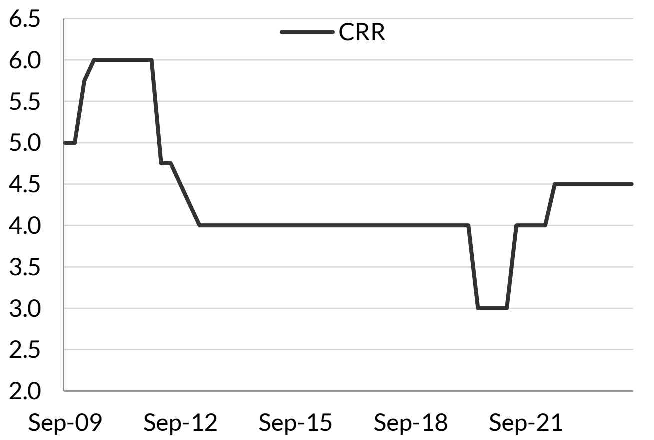
Source: RBI, Bloomberg, Axis Bank Research

Exhibit 12: Liability structure of banks implies higher LDRs



Source: RBI, Axis Bank Research

Exhibit 13: CRR still 0.5pp above 2015-19 levels



Source: RBI, Axis Bank Research

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