STUDY NOTES · BASIC CONCEPT

What is liquidity in the banking system? What is Repo?

Indian Economy

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1. Liquidity refers to the availability of funds that banks can use to meet withdrawals, settle payments, fulfil regulatory obligations and provide loans.

In the banking system, liquidity is not simply the amount of currency circulating among the public. It also includes banks' balances with the RBI and their ability to obtain funds in money markets or through central-bank facilities.

RBI Governor warns banks on build-up of risks, says no room for complacency

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Monetary Policy Committee (MPC): Repo Rate | Current Affairs | IAS Mentoring

2. Why does liquidity matter?

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1. Payments: Banks need sufficient funds to settle transactions with other banks.
2. Credit: Banks with adequate liquidity are generally better positioned to meet legitimate loan demand.
3. Interest rates: A shortage of liquidity can push short-term money-market rates upward.
4. Financial stability: Sudden liquidity stress can make it difficult for banks to meet immediate obligations, even if their assets are valuable over the longer term.

5. Monetary policy: Liquidity conditions influence how effectively the RBI's policy-rate decisions affect market interest rates and lending rates.

Liquidity versus solvency

These concepts are often confused in economic reporting.

Liquidity	Solvency
Ability to meet payments when they fall due	Ability to meet liabilities with the value of assets over time
Can be affected by temporary cash-flow pressures	Depends on the overall financial position and asset quality
May improve through short-term borrowing	Cannot necessarily be fixed through short-term borrowing
Example: A bank temporarily lacks settlement funds	Example: A bank has losses large enough to undermine its capital position

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A bank can be solvent but temporarily illiquid. RBI liquidity operations are designed to address funding conditions; they are not a substitute for resolving insolvency or serious capital deficiencies.

3. What is a repo operation?

A repurchase agreement (repo) is a transaction in which a bank obtains funds by providing eligible securities to the RBI, with an agreement to repurchase those securities later under specified terms.

In simple terms, the RBI lends money to a bank against collateral for an agreed period.

Step 1: Bank needs funds : A bank faces temporary liquidity pressure.

Step 2: Bank provides eligible securities : The bank enters a repo transaction with the RBI.

Step 3: RBI provides funds : Liquidity becomes available to the bank for the agreed tenor.

Step 4: Repo matures : The bank repays the funds and the transaction is reversed according to its terms.

Why is collateral important?

Collateral reduces the RBI's exposure if the borrowing bank fails to meet its obligations. The securities accepted, the applicable terms and the eligible counterparties are governed by RBI rules.

A repo is therefore different from an unsecured loan. It is also different from the RBI purchasing government securities outright, because a repo is a temporary, reversible transaction.

4. What is a variable-rate repo (VRR)?

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A variable-rate repo is a repo operation in which the interest rate is determined through an auction rather than being fixed at a predetermined rate for that particular operation.

The RBI announces the operation's terms, including the amount, tenor and bidding arrangements. Eligible participants submit bids, and the allocation and applicable rates follow the auction rules.

Fixed-rate repo versus variable-rate repo

Feature	Fixed-rate repo	Variable-rate repo
Interest rate	Set at a predetermined rate for the facility or operation	Determined through the relevant auction
Main use	Providing funds under a standing or specified fixed-rate arrangement	Fine-tuning liquidity according to prevailing market conditions
Market signal	The rate is known in advance	Bids reveal participants' demand for funds at different rates
Flexibility	Less responsive to variation in bidding demand	Allows the RBI to adjust liquidity through auction-based operations

A variable-rate repo is particularly useful when the RBI wants to address temporary liquidity needs without changing its overall monetary-policy stance.

UPSC point: The interest rate discovered in a particular VRR auction should not automatically be described as a change in the RBI's policy repo rate.

5. Why does the RBI inject liquidity?

Banking-system liquidity changes continuously. Tax payments, government expenditure, currency demand, foreign-exchange operations and regulatory requirements can all affect the amount of funds available to banks.

The October 2026 operation comes amid reports of tax-related outflows and tighter liquidity conditions.

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Major factors affecting banking-system liquidity

Factor	Likely effect on banking-system liquidity
Large tax payments	Can temporarily transfer funds from bank accounts to government accounts, depending on settlement arrangements
Government expenditure	Usually adds funds to the banking system when payments are made
Increased currency withdrawals	Can reduce banks' available reserves as cash is supplied to the public
RBI purchase of foreign currency	Generally injects rupee liquidity when the RBI buys foreign currency, subject to the transaction's settlement and offsetting operations
RBI sale of foreign currency	Generally absorbs rupee liquidity when the RBI sells foreign currency
Cash Reserve Ratio changes	Can alter the funds banks must maintain as cash balances with the RBI

Factor	Likely effect on banking-system liquidity
Repo operations	Can temporarily inject funds into eligible banks
Open Market Operations	Outright purchases generally inject liquidity; outright sales generally absorb it

These effects are not always one-directional in practice. Their final impact depends on offsetting transactions and the RBI's other liquidity-management measures.

What are tax-related outflows?

When businesses and individuals pay taxes, funds move from their bank accounts to government accounts. Depending on where the funds are held and how payments settle, this can temporarily reduce the liquidity available to commercial banks.

When the government subsequently spends those funds, money flows back into the banking system.

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This helps explain why liquidity conditions can fluctuate around major tax-payment dates even when there has been no change in the RBI's policy rate.

6. What is the difference between liquidity management and monetary policy?

Monetary policy is the broader framework through which the RBI influences inflation, economic activity and financial conditions. Liquidity management is one of the tools used to implement that policy.

Monetary policy	Liquidity management
Concerns the overall monetary-policy stance	Concerns the availability and distribution of funds in the banking system
Includes policy-rate decisions and the inflation-targeting framework	Includes repo auctions, standing facilities and other liquidity operations

Monetary policy	Liquidity management
Influences borrowing costs and aggregate demand	Helps keep short-term money-market conditions orderly
Usually assessed over a broader economic horizon	May respond to daily or temporary fluctuations as well as persistent conditions

The RBI may inject liquidity without changing the policy repo rate. It may also absorb liquidity while maintaining the same policy rate.

For example, if a tax-payment cycle creates temporary pressure on banks' cash balances, the RBI can inject funds for a short period. Once the pressure subsides, the funds may return through repayment or other liquidity operations.

This is why an announcement of a ₹1 trillion liquidity injection should not, by itself, be interpreted as a monetary-policy easing through a rate cut.

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7. Important RBI instruments for managing liquidity

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The RBI has several instruments that operate differently and are suited to different circumstances.

Instrument	Basic mechanism	Usual liquidity effect
Repo	RBI lends against eligible securities	Injects liquidity
Variable-rate repo	Auction-based repo for a specified tenor	Injects liquidity
Standing Deposit Facility (SDF)	Eligible banks place funds with the RBI without providing collateral under the facility	Absorbs liquidity
Marginal Standing Facility (MSF)	Eligible banks borrow overnight funds from the RBI under specified conditions	Injects liquidity
Open Market Operations (OMO) purchase	RBI purchases government securities outright	Generally injects durable liquidity

Instrument	Basic mechanism	Usual liquidity effect
Open Market Operations (OMO) sale	RBI sells government securities outright	Generally absorbs durable liquidity
Cash Reserve Ratio (CRR)	Banks maintain a specified proportion of net demand and time liabilities as cash balances with the RBI	A higher CRR generally reduces lendable funds
Reverse repo	RBI borrows funds from banks against securities under the applicable facility	Absorbs liquidity

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8. CRR: A crucial concept for understanding liquidity

The Cash Reserve Ratio is the proportion of a bank's Net Demand and Time Liabilities (NDTL) that it must maintain as cash balances with the RBI, in accordance with applicable requirements.

A higher CRR generally leaves banks with fewer funds available for lending or other uses. A lower CRR generally releases funds into the banking system.

However, it is important to distinguish the ordinary statutory CRR from the separate foreign-exchange-related reserve measure discussed in recent reporting.

On 12 October 2026, Reuters reported that the RBI had introduced a 20% cash-reserve requirement for banks on certain foreign-exchange derivatives used to hedge current-account exposures. Banks argued that the measure tied up liquidity and increased hedging costs. This was a specific measure relating to foreign-exchange derivatives, not simply a general announcement that the standard statutory CRR had been raised to 20%.

Why does this distinction matter?

Ordinary statutory CRR	Special reserve requirement on specified FX derivatives

Applies to the prescribed base of bank liabilities, under the statutory framework	Applies to the specified transactions or exposures covered by the relevant measure
Affects banks' reserve requirements more broadly	Targets a particular category of foreign-exchange activity
Used as a general monetary and liquidity instrument	Can be intended to influence the cost or volume of particular FX transactions
A change may affect a wide range of bank funding conditions	Its effect depends on the covered transactions and compliance rules

The special measure can affect liquidity because funds that banks must set aside are no longer freely available for other purposes. The extent of the impact depends on the measure's scope and banks' responses.

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9. How does a liquidity injection affect interest rates and credit?

When the RBI injects liquidity, eligible banks obtain additional funds. This can ease pressure in the money market, although the final effect depends on the overall supply and demand for funds.

RBI injects liquidity

Short-term funding pressure may ease

Money-market rates may moderate

Bank funding and credit conditions may improve

The effects are conditional, not automatic.

Possible benefits

1. Banks may find it easier to meet short-term payment obligations.
2. Money-market rates may move closer to the RBI's intended operating conditions.
3. Temporary funding pressures may be reduced.
4. Banks may be better positioned to meet credit demand if lending is constrained by liquidity.

Why might lending rates not fall immediately?

The cost of loans depends on more than liquidity. It also reflects the policy repo rate, deposit costs, credit risk, bank capital, operating expenses, loan demand and competition.

A short-term liquidity injection therefore does not guarantee lower interest rates for every borrower. Nor does it automatically lead to a large increase in lending.

10. Can a liquidity injection cause inflation?

An important UPSC concept is that liquidity management and inflation control must be considered together.

Additional liquidity can support economic activity when funding conditions are tight. But the effect on inflation depends on whether the funds contribute to additional spending, how much spare productive capacity exists and how the RBI manages liquidity over time.

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Situation	Possible implication
Temporary liquidity shortage with stable inflation expectations	An injection can smooth financial conditions without necessarily causing significant inflation
Weak demand and unused productive capacity	Easier funding may support output and employment
Persistent excess liquidity combined with strong demand	May contribute to demand pressures, depending on broader conditions
Supply-side shock, such as a sharp rise in energy prices	Liquidity alone cannot remove the underlying supply constraint
Inflationary pressures remain high	The RBI may need to balance liquidity support with its price-stability objective

The important distinction is between providing short-term funds to banks and permanently expanding the money supply. A repo operation is temporary and must be repaid, although repeated operations and broader policy actions can influence financial conditions over time.

11. What does the ₹1 trillion operation tell us about the economy?

The announcement indicates that the RBI is responding to short-term funding conditions in the banking system. It should not automatically be read as evidence of a banking crisis or a sudden change in the overall monetary-policy stance.

Three points are particularly relevant:

- First, liquidity is dynamic. Tax payments and other flows can change banks' available funds quickly.
- Second, the RBI has multiple instruments. A short-term repo auction allows it to respond without necessarily changing the policy repo rate.
- Third, context matters. The size of the operation should be considered alongside system-wide liquidity, money-market rates, bank credit growth, inflation and other RBI actions.

The operation's actual effect will depend on the amount allotted, the demand for funds, the auction rate, repayment at maturity and any offsetting liquidity movements.

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12. Prelims revision table

Term	Meaning
RBI	India's central bank
Liquidity	Availability of funds to meet payments and financial obligations
Repo	A collateralised transaction through which the RBI provides funds against eligible securities
VRR	Variable-rate repo, where the applicable rate is discovered through an auction
CRR	Cash Reserve Ratio maintained by banks with the RBI against prescribed liabilities
NDTL	Net Demand and Time Liabilities, a prescribed base used for reserve requirements
SDF	Standing Deposit Facility, through which eligible banks place funds with the RBI

Term	Meaning
MSF	Marginal Standing Facility, a facility through which eligible banks can borrow overnight funds from the RBI
OMO	Outright purchase or sale of government securities by the RBI
Monetary-policy transmission	The process through which policy decisions influence money-market rates, bank rates and economic activity
Liquidity versus solvency	Ability to meet immediate payments versus overall capacity to meet liabilities
Inflation	Sustained increase in the general price level

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