

Qoncept

EXPLAINER

Liquidity: A Frequently Used Term in Financial News, Explained

You may have read headlines such as:



For somebody on the outside, these phrases can sound as though India periodically runs short of money and the Reserve Bank of India has to refill it.

Liquidity is fundamentally about the availability of money, where that money is sitting, and how readily it can be used. Once we understand those three ideas, most of the jargon begins to disappear. Let us start far away from central banking.

Liquidity Begins with a Very Ordinary Idea

Imagine that you own ₹50,000 in a savings account, ₹5 lakh in a fixed deposit, ₹10 lakh of listed shares, and a house worth ₹1 crore — total wealth of ₹1.155 crore.

Now suppose you unexpectedly need ₹1 lakh tomorrow. The house may be your valuable asset, but it cannot ordinarily pay tomorrow's bill — selling it takes time. The listed shares can generally be sold relatively quickly, though their value may change. The fixed deposit can usually be accessed subject to its terms. Money in your savings account is available almost immediately.

All these assets have value. They do not have the same **liquidity**. At the household level, liquidity asks: **how easily can I convert something I own into spendable money without delay or loss?** That is market or asset liquidity.

But when the RBI and bond markets talk about **banking-system liquidity**, they are asking a different question.

Banking-System Liquidity Is Not Household Liquidity

Banks keep balances with the RBI because they need central-bank money to meet reserve requirements and settle obligations across the financial system. When bank A's customer transfers money to a customer of bank B, it is not merely an app notification moving between two phones — behind the scenes, the banks themselves eventually have to settle financial claims. These settlement and reserve balances are central to **banking-system liquidity**.

This gives us an important distinction: your bank deposit is money for you. A bank's reserve balance with the RBI is settlement money for the banking system. The two are linked, but they are not the same thing.

This is also why it is **incorrect to describe banking-system liquidity as "the amount banks can lend."** A bank's ability to make loans depends on its reserve liquidity - capital, deposits and other funding, credit demand, risk limits, regulation, and the availability of suitable borrowers all matter. Banking liquidity is instead about whether the **banking system has an excess or shortage of immediately usable reserve liquidity relative to its needs.**

The RBI describes the call-money market as a market for bank reserves, and says liquidity management should address shortage or excess liquidity at the system level rather than the funding position of individual institutions.

Think of India's Banking System as a Large Water Network for the rest of this explainer...

Imagine the banking system as a large network of water tanks connected to a reservoir. Every bank has a tank. Money flows in and out throughout the day - deposits and repayments arrive, loans are disbursed, customers transfer money between banks, the Government collects taxes and spends money, people withdraw currency, and the RBI conducts bond and foreign-exchange transactions.

At the end of all these flows, some banks have spare liquidity and others require funds, so banks borrow and lend among themselves. But if the system as a whole has more liquidity than required, the excess ultimately tends to be absorbed by the RBI. If the system as a whole is short, the RBI can supply liquidity through its operating framework.

That is banking-system liquidity in its simplest form: **the aggregate excess or shortage of reserve liquidity in the banking system.**

Surplus and Deficit Liquidity

We can now define the two conditions without jargon.

 Surplus liquidity	 Deficit liquidity
Surplus liquidity: Banks collectively have more reserve liquidity than the system currently requires. The RBI consequently absorbs excess funds.	Deficit liquidity: Banks collectively require additional reserve liquidity. The RBI injects funds into the system.

There is a sign convention worth knowing. The RBI's published liquidity-operations table uses **Injection (+)** and **Absorption (-)**. So a negative net operation can actually indicate a **surplus** system, because the RBI is absorbing money and a positive figure can indicate a **deficit**, because the RBI is supplying money.

The Rule: Follow the Rupee

Almost every liquidity event becomes easy to understand if you ask: **where was the rupee before the transaction, and where is it after the transaction?**

Event	Where money moves	Effect on banking liquidity
Government spends	Government/RBI → bank accounts	Adds
Taxes are paid	Banks → Government/RBI	Drains
Public withdraws currency	Banks → cash with public	Drains
Currency returns to deposits	Public → banks	Adds
RBI buys G-Secs (OMO)	RBI → sellers/banking system	Adds
RBI sells G-Secs (OMO)	Banking system → RBI	Drains
RBI buys foreign currency spot	RBI pays rupees	Adds
RBI sells foreign currency spot	Market pays rupees to RBI	Drains
CRR is reduced	Required reserves released	Eases reserve constraint
CRR is raised	More reserves must be maintained	Tightens reserve availability

This table is provided solely for explanation purposes and should not be construed as implying any obligation on the RBI to undertake these actions.

System Liquidity Versus Durable Liquidity

We now have enough plumbing to understand one of the most important distinctions: not every liquidity change deserves the same RBI response.

Situation A: taxes create a temporary liquidity drain

Suppose companies make sizeable advance-tax payments at the end of a quarter. Their bank accounts are debited and the funds move into the Government's cash balance with the RBI, reducing reserve liquidity available to the banking system. If the Government is expected to spend a large part of that money within days - through salaries, pensions, subsidies, transfers or contractor payments - the rupees will flow back into commercial bank accounts. The initial deficit is therefore a **transient or frictional liquidity**: it reflects the timing gap between Government receipts and expenditure, not a lasting change in monetary policy.

Situation B: A change in the RBI's balance sheet

Now suppose that, ahead of Diwali, households and businesses withdraw substantially more cash from banks. Currency moves from bank balances into wallets, cash boxes and tills, draining reserve liquidity from the banking system - unlike a short-lived timing mismatch... This drain may persist until the cash is redeposited after the festive period. The shortage could persist for months unless the RBI offsets it. This is a **durable liquidity issue**... The source has altered the banking system's underlying reserve position rather than merely shifting rupees temporarily into the Government's account.

The key difference is therefore not the size of the liquidity movement, but its **expected persistence and reversal mechanism**. A tax payment may create a large deficit and still be temporary if Government expenditure is likely to return the funds soon. A smaller drain may be durable if nothing in the ordinary course will reverse it. Under the RBI's revised framework, short-lived mismatches are generally handled through VRR or VRRR operations with tenors from overnight to 14 days, primarily seven days; persistent reserve needs are addressed through longer-term variable-rate operations, FX swaps and OMOs.



Understanding "Core Liquidity"

Indian market commentary sometimes uses **core liquidity** as a convenient estimate of the underlying or durable liquidity position, often adjusting headline banking liquidity for Government cash balances. That shorthand can be analytically useful — but it should not be presented as though

Core liquidity = banking-system liquidity + Government cash

were the RBI's formal definition or an immutable accounting identity. The RBI's own framing is more robust: durable reserve demand is met through changes in the **Net Domestic Assets and Net Foreign Assets on the RBI's balance sheet**, with OMOs, long-term variable-rate operations and FX swaps identified as the durable-liquidity instruments.

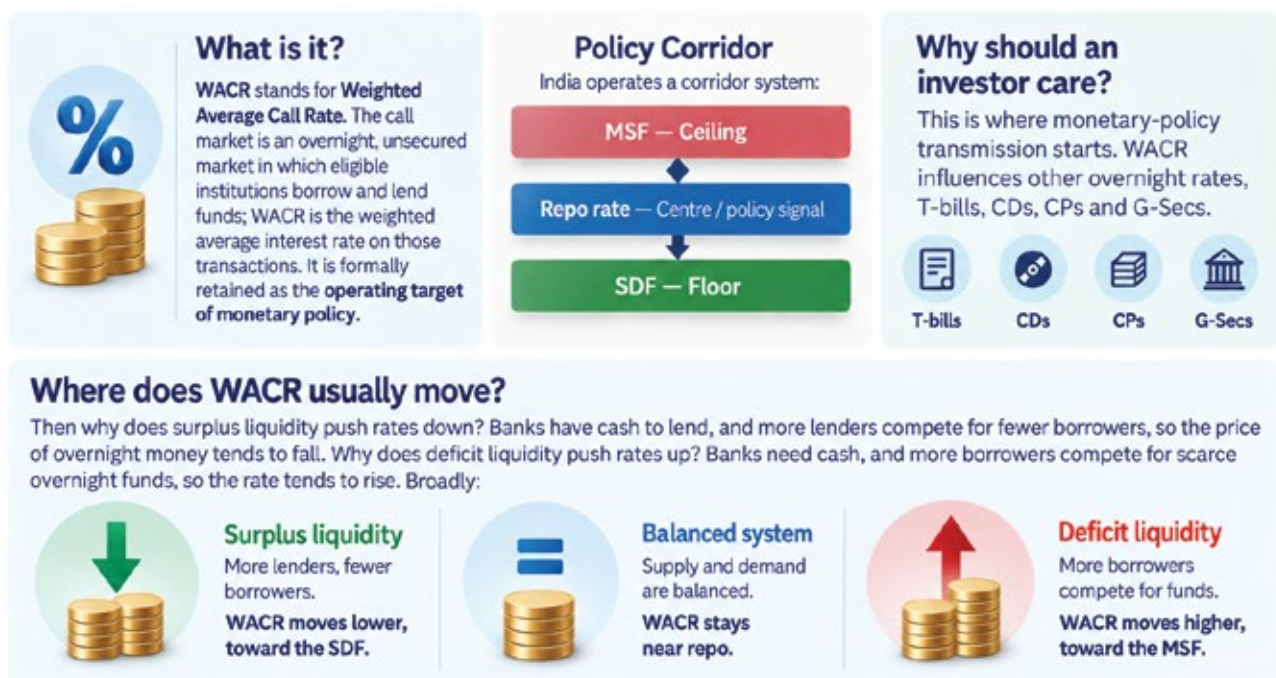
For a reader, therefore: **banking-system liquidity** tells us the system's current excess or shortage of reserve liquidity. **Durable liquidity** tells us whether the underlying reserve impact is likely to persist. That formulation travels much better across different market cycles.

RBI Is Not Trying to Maximize Liquidity

This is crucial. If liquidity is useful, one might reasonably ask: why not keep the banking system permanently supply with money? Because the RBI's objective is not "maximum liquidity" — it is **appropriate liquidity**.

Too little liquidity can push money-market rates higher than intended and impair transmission. Too much can push them materially below the intended policy setting. The RBI's framework is built to maintain an optimum level of system liquidity so that the overnight weighted average call rate aligns with the policy repo rate.

WACR: The Heartbeat of India's Liquidity Framework



The RBI's revised framework retains a symmetric corridor, with the SDF 25 basis points below repo and the MSF 25 basis points above repo. As a recent reference point, June 2026 rates stood at **SDF 5.00%, Repo 5.25%, MSF 5.50%**¹. This is not an iron law for every single day, since liquidity distribution, market frictions and participant behaviour also matter — but the RBI's standing facilities and liquidity operations are specifically designed to keep the operating rate contained and aligned.

Liquidity Management Is Not Monetary Tightening or Easing by Itself

An RBI liquidity injection is not automatically a rate cut. An RBI liquidity absorption is not automatically a rate hike.

Why? Because the **policy rate** and **liquidity operations** perform related but different jobs. The repo rate communicates the central monetary-policy setting; liquidity operations help make market rates consistent with that setting.

Repo rates indicate markets broadly where the RBI wants the price of overnight money anchored; liquidity management helps the system operate around that price.

How Does Liquidity Reach the Rest of the Yield Curve?

The effect is strongest closest to the overnight market and becomes less direct as maturity increases — like ripples from a stone dropped into water.



Why Short-Term Rates Respond Fastest

Imagine banks suddenly have ₹4 lakh crore more liquidity than they need. They must put that money somewhere... lend overnight, buy T-bills, buy CDs, buy CP, participate in repo markets, or place eligible surplus funds with the RBI. More money competing for short-term assets raises their prices and lowers their yields, other things equal. This is why the short end of the bond curve becomes highly sensitive to liquidity, while the long end responds far less directly.

Then Why Can Banks Issue Expensive CDs in a Surplus System?

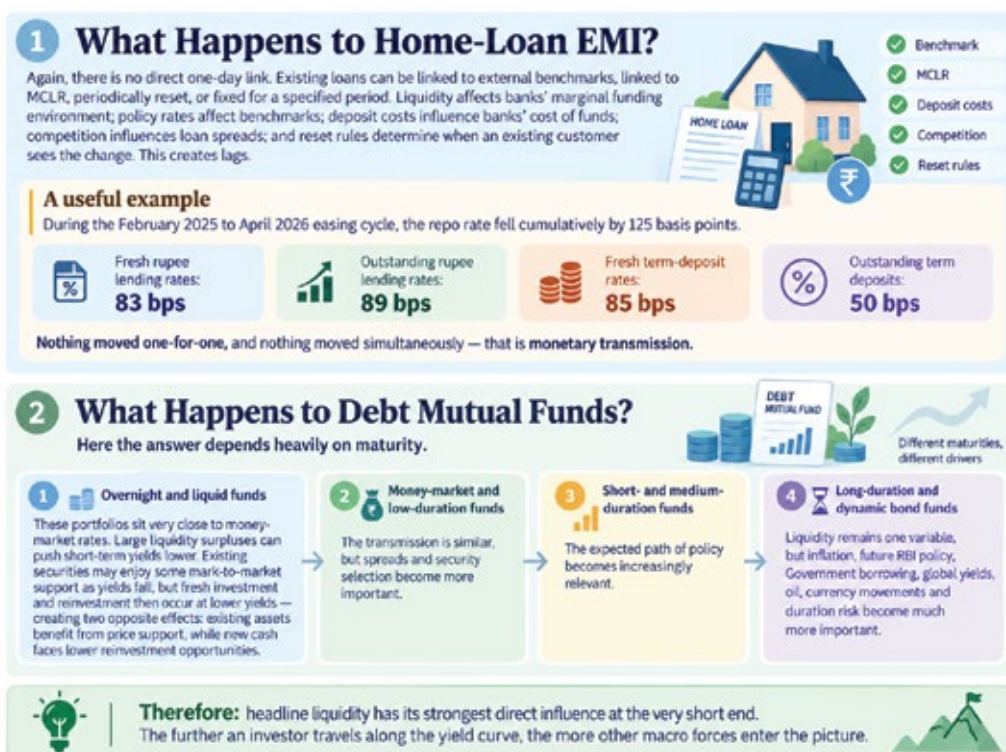
This apparent contradiction is one of the ways to test whether someone really understands liquidity, because: **system liquidity is an aggregate; bank funding is individual.**

Bank	Liquidity position
A	+₹80
B	+₹40
C	-₹50
System	+₹70

The system is clearly in surplus, yet bank C still requires ₹50. If A and B do not lend freely to C — perhaps because of internal limits, their own expected outflows, or funding preferences — C may still need to raise deposits or CDs. So it is possible to have **system-wide surplus + individual-bank funding pressure.**

The RBI has specifically discussed this **skewness in liquidity distribution**, noting that on some days when system liquidity was in deficit, some banks were still placing large surpluses under the SDF while others borrowed through repo operations or the MSF. In practice, strong credit growth and deposit competition can keep some banks active in wholesale funding even while aggregate banking liquidity is comfortable.

What Does Surplus Liquidity Do to Fixed Deposit?



Can Extra Liquidity Be a Problem?

Yes! Although not in the simplistic sense that “more money is bad.” If reserve liquidity becomes abundant, WACR and other overnight rates can trade too low relative to the policy repo rate, meaning financial conditions at the short end may become easier than intended. The RBI may then absorb excess liquidity to restore alignment.

That is why liquidity absorption need not be hawkish — it may simply mean “**We chose a policy rate. We now want market rates to reflect it.**” Similarly, injection during a temporary liquidity squeeze may simply prevent an unintended tightening.

Does Excess Liquidity Automatically Cause Inflation?

No. The connection exists, but several steps lie between the two. A highly simplified chain runs: **reserve liquidity → bank funding conditions → credit availability and interest rates → borrowing → spending and investment → aggregate demand → possible effect on prices.**

Every arrow matters. If households do not borrow, companies do not invest, banks remain cautious, or economic supply expands alongside demand, the inflation effect can be very different. It is wrong to say “₹1 lakh crore injected = ₹1 lakh crore of new spending = inflation” — monetary transmission simply does not work that mechanically.

Thus, Liquidity is best understood by following where the rupee moves, how long the effect is likely to last, and whether the RBI must respond. It shapes overnight rates and short-term markets directly, but it is only one part of the broader monetary and investment landscape.

Source: 1: RBI

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