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Banks still resisting rate cuts as liquidity row with RBI drags on

By Reuters | Updated: May 25, 2016, 12.53 PM IST

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NEW DELHI: [The Reserve Bank of India](#) has stepped up fund injections in the two months since Governor [Raghuram Rajan](#) pledged to gradually erase a cash deficit in the financial system, but commercial banks say it is still not enough for them to sharply lower interest rates.

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The central bank has slashed rates by 150 basis points (bps) since the start of last year, bringing the policy rate to a five-year low of 6.50 percent, but the country's banks have cut lending rates by less than half that, frustrating Rajan's efforts to revive weak private investment.

The issue will be front and centre at the RBI policy review on June 7, when Rajan is expected to leave rates on hold. He has made clear his focus will now be on ensuring that the aggressive rate cuts over the last year are fed through to the economy.

Bankers say that there is not enough liquidity in the market for them to lower rates and lend more freely while still being sure they can fulfil their liquidity requirements.

At the RBI's last review on April 5, Rajan committed to erasing the liquidity deficit to near zero. The central bank has since injected Rs 40,000 crore (\$5.92 billion) via open market operation (OMO) bond purchases, which excludes Wednesday's ongoing auction for Rs 15,000 crore. Alongside, RBI bought around Rs 8,000 crore from foreign exchange interventions.

That should provide the market with enough liquidity for banks to lower rates and lend more, two RBI officials said.

But bankers say it is still nowhere enough, and that stripping out seasonal or temporary fluctuations India continues to have a daily core liquidity deficit of around Rs 1 lakh crore (\$14.81 billion), little changed since the RBI's pledge.

These cash shortages increase banks' funding costs, making it harder for them to lower lending rates, according to bankers, who say they plan to press the issue with the RBI.

"Neutral liquidity needs to be achieved as quickly as possible," said Ananth Narayan, regional head of financial markets for ASEAN and South Asia at Standard Chartered Bank.

Yet the central bank fears injecting too much money into the system would spark inflation.

The amount of currency in circulation has already surged since October - largely due to spending related to recent state elections.

And cash withdrawals from banks hit Rs 17.5 lakh crore in the week ended May 13, the biggest weekly total in 15 years.

The RBI says the this money will at some point make it back into the financial system and that more cash injections now could result in excess liquidity.

"Basically, the focus is on inflation control," said one of the RBI officials.

Bankers believe the central bank can remove any excess liquidity via open market bond sales - something the RBI has been reluctant to do because it fears it would make inflation management more volatile. The RBI's last open market operation bond sale was in July 2015.

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