STUDENTS' ECONOMIC FORUM

A monthly publication from South Indian Bank

To kindle interest in economic affairs...
To empower the student community...

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Theme 329

"RBI'S FOREX SWAP AUCTION"

28th Year of Publication

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SIB STUDENTS' ECONOMIC FORUM

APRIL, 2019

Theme No: 329: **"RBI's FOREX SWAP AUCTION"**

A well informed customer will make the policy makers as well as organizations which produce goods and render services more responsive to the customer needs. This will also result in healthy competition among organizations and improve the quality of its products.

The "SIB Students' Economic forum" is designed to kindle interest in the minds of younger generation. We highlight one theme in every monthly meeting of the "Forum". This month the topic for discussion is RBI's Forex Swap Auction.

What is Forex Swap?

The RBI has different tools through which it injects liquidity into financial markets. Adjusting repo rates and purchasing/selling Government bonds by conducting open market operations (OMO) are a couple of tools which the RBI uses regularly either to increase or decrease the currency supply in the market. The 'swap auction' is one such tool, which is done to increase the supply of rupees in the market. Technically, this activity is being termed as a USD/INR Buy/Sell Swap Auction.

Banks are generaly holding huge amount of forex reserves from which they give Dollars to RBI who in turn will pay equivalent value of Rupee. Simultaneously, the Bank will agree to buy the same amount of US Dollars at the end of the swap period. The buyback rate is called forward rate. The participating banks have to bid in the auction by quoting a forward premium in terms of paisa that they will pay to buy back the dollars. For example, if the spot exchange rate is ₹ 70 to a dollar and

Bank A quotes a premium of 250 paisa while bidding for $50 million, then the bank will get ₹ 350 crore ($50 million multiplied by the exchange rate of 70). After three years, the bank has to pay back approximately ₹ 362.50 crore ($50 million multiplied by the exchange rate of ₹ 70 plus premium of 250 paisa) to the RBI to buy back $50 million.

The RBI had on 26th March 2019, conducted a Forex Swap Auction to meet the liquidity requirements before the closure of FY 2018-2019. At the time, it had put on offer of $5 billion for tenure of 3 years and had received a total of 240 offers worth $16.3 billion. This response prompted RBI to announce second forex swap auction to be conducted on April 23rd. The second dollar-rupee swap auction received a total of 255 bids worth $18.65 billion against a similar offer of $5 billion for tenure of 3 years.

Why was it announced?

- ✓ **To Infuse Liquidity into the System**
  RBI has already bought large amounts of Government bonds via Open Market Operations to infuse liquidity. So RBI opted for an alternate tool now.

- ✓ **RBI is stepping up efforts for monetary transmission**
  Though RBI has reduced Repo rate in the recently concluded Monetary Policy Committee, there has been no effective transmission i.e. the lending rates have not come down. Also this has not led to infusion of liquidity or higher outflow of credit from the banking sector.

- ✓ **RBI expects that there will be liquidity crunch in the coming days in the system**
  The Lok Sabha Elections 2019 in India - whenever elections are conducted in India, money circulation generally increases. There will be a drain of funds from Banks, which will infuse liquidity pressure in the Banking sector.

Transfer payments by the Central Government (PM –Kisan) and State Governments could potentially increase the demand for currency.

- ✓ **Rupee appreciation in the recent times**
  Rupee has appreciated by more than 2.50% in the previous month and this will have a considerable impact on our exports as well as imports. Our exports will start fetching lower returns and our imports will become more and more cheaper. When imports become cheaper, the inward flow into Indian market will suddenly increase impacting negatively on overall Indian Economy or in other words it will affect the domestic manufacturing sector. It is also expected that Rupee will appreciate because the Foreign Institution Inflows have increased and there will be further infusion of the Forex Reserves into Indian Economy. This will again appreciate the Indian Rupee.
- ✓ Significant Dollar inflows from deals such as Arcelor Mittal's bid for Essar Steel. This bid will bring in $6Billion into Indian market and this dollar infusion will lead to appreciation of Rupee.
- ✓ Many private equity and acquisition deals in the pipeline will further add to Rupee appreciation.

What are the Impacts?

- ✓ Increased liquidity in the market.
- ✓ Greater inflow of Forex Reserve into the chest of RBI. Now it is over $400 Billion.
- ✓ To a certain extent it will contain the appreciation of Rupee by infusing Rupee into the market.
- ✓ It may prompt the Banks to reduce the interest rates in the market.
- ✓ Difference between the spot rate and the forward USD/INR currency rate may be narrowed down.
- ✓ Decline in forward premium (especially long term) will lower dollar hedging cost for imports.
- ✓ Banks can keep holding Govt. bonds (No need to mortgage them for collateralized borrowing.)

- ✓ The shadow banks or NBFCs face liquidity crunch in the system and post default of IL&FS, there has been an increased financial stress on these NBFCs. With infusion of Rupee into the system, RBI expects that lending to these NBFCs may also start picking up soon.

Any concern?

- ✓ Generally such infusion of liquidity into the system may lead to inflationary trends in the market.

  From a common man's perspective, this type of auction is expected to improve fund availability with the banks. Whether this will moderate borrowing costs in the short term though needs to be seen. But only the Category-I banks are allowed to participate in the auction, not all players in the financial services sector will be able to get the benefits. Also, if the participating banks decide not to loosen up on credit to specific segments such as NBFCs, the credit crunch for them is likely to continue.

Extra Reading **Open Market Operations (OMO)**

RBI either sells or buys Government securities through the market. Whenever RBI sells Government securities it means that it is going to reduce the liquidity from the system and whenever RBI repurchase Government securities, it leads to infusion of liquidity to the system.

For example, a Bank say X, holds on to a cash of ₹ 500. RBI sells Government securities worth ₹ 250 to Bank X and in turn Bank has to pay ₹ 250 to RBI. Through this OMO, ₹ 250 is being taken out thereby reducing liquidity in the system. The vice versa happens when RBI intends to infuse liquidity into the system.

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