Dollar Swap Auction by RBI

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Manifest Pedagogy

New mechanisms of liquidity management along with issues related to RBI are of particular importance for prelims. The impact of such events could be a key to answer questions in Mains and Interview. Along with the dollar swap window. Issues regarding interest rate regimes, external benchmarking etc need to be clearly understood.

In news

RBI swap auction gets bids more than thrice the notified amount

Placing it in the syllabus

Indian Economy; Banking

Static dimensions

- What is Swap auction?
- Other tools used by RBI

Current dimensions

- Why is it important?
- How it impacts?
- Why RBI used swap auction rather than conventional OMO?

Content

What is Swap auction?

It is one of the tools of RBI through injects which it injects liquidity into financial markets. RBI is using this for the first time and as of now it is fixed for a period of three years.

Adjusting **repo rates** and purchasing 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 being done **to increase the supply of rupees in the market**. Technically, this activity is being termed as a USD/INR Buy/Sell Swap Auction.

Through this auction, the **RBI will buy US dollars from banks totalling to $5 billion. In turn the RBI will pay rupees to the participating banks** at the current spot rate. Simultaneously, the banks will agree to buy-back the same amount of dollars from the RBI after three years – the tenor of this auction.

Why is it important?

Following factors explain the importance of the swap auction;

- Indian financial markets have been undergoing liquidity problems since the IL&FS crisis emerged last year.
- Liquidity deficit in the banking system had widened during march and Year-end demand for funds by businesses, high currency in circulation and fresh government borrowings pushed the average liquidity deficit.
- The demand for rupees is expected to spike as a result of a huge spending towards the ongoing general elections to Loksabha.
- For the RBI, the auction will help boost its forex reserves by another $5 billion. The reserves as on March 15, is $405.6 billion.
- Cooling down the heightened government treasury bill market rates

Why RBI used swap auction rather than conventional OMO?

- First reason could be the risk that more OMOs might leave banks with insufficient bond holdings both for repo operations (pledging bonds as collateral) and their regulatory commitments.
- Second reason is the RBI's fundamental discomfort with the very idea of OMOs. Large purchases of government bonds by RBI tend to distort the yield curve that effectively serves as a benchmark for the interest rates on all loans of different maturities. OMOs also gives GoI a free ride by keeping its borrowing costs artificially low. This implicitly encourages fiscal indiscipline
- Third reason is that by supplying a large amount of forwards, RBI wants to pull premia down. The one-year forward premium is, incidentally, down by a third of a percentage point since the announcement of the swap on March 13. This creates incentives for borrowers in foreign currencies to hedge their positions (lock into future contracts for dollars), reducing a risk of a blowout if the rupee suddenly reverses direction. Low premia would also attract foreign flows into domestic markets, like corporate bond market, with the additional benefit now of hedging risk of exchange-rate depreciation at a low cost. Thus, RBI wants to create a stable and low-risk flow of dollars over the medium or long term to ensure that the economy is not capital-starved.
- The third possible reason is that RBI is signalling its discomfort with the appreciating rupee. The assumption could be that the commitment to buy the large amount of dollars all in one shot through the swap would arrest the rupee rise.

How it impacts?

- From a common man's perspective, this auction is expected to improve fund availability with the banks. Whether this will moderate short-term borrowing costs need to be seen though.

- 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 or lower their rates.
- 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.
- From a business perspective, importers hedge costs are likely to fall as increased liquidity for rupees is likely to reduce forward rates. Indeed, the forward premiums have been falling ever since the RBI announced this auction in March.

The RBI is deploying a new weapon to enhance market liquidity. Whether it will hit or miss the target, will be known only over time.