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Durable liquidity and the swap: some key issues

Mar 14, 2018

The RBI has announced a buy/sell exchange rate swap to infuse durable liquidity into the banking system. This will be done through an auction on the 26th of March and infuse roughly Rs 35,000 crore of rupee liquidity at the end of the month. The structure of the auction is somewhat simple but it is worth summarizing the key features. Thus the RBI's circular lays down the following steps:

- A bank shall sell US Dollars to the Reserve Bank and simultaneously agree to buy the same amount of US Dollars at the end of the swap period.
- The market participants would be required to place their bids with the premium that they are willing to pay to the Reserve Bank for the tenor of the swap. Successful bids will get accepted at their respective quoted premium.
- Once the auction window is closed, all the bids would be arranged in descending order of the swap premium quoted and the cut-off premium would be arrived at the premium corresponding to the notified US Dollar amount of the auction. Successful bidders would be those who have placed their bids at or above the cut-off premium. All bids lower than the cut-off premium would be rejected.

Why a swap and not an open market auction?

It might be tempting to see the measure in the context of the usual tightness in liquidity in the last fortnight of March that comes on the back of tax payments and a seasonal spike in the liquidity needs of both corporates and households. (We estimate this to be around Rs 2,00,000 crores this year). That might be a trifle misleading.

This transient deficit could have been met through the repo window. Instead, this measure is based on premised on more medium term concerns -- the need for

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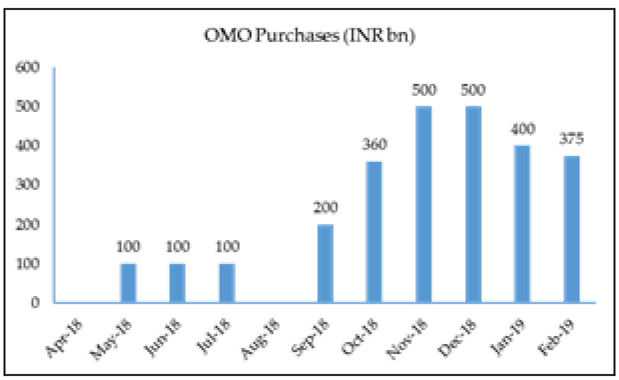
durable liquidity of the system factoring in elements like the impending elections that could entail bunched-up government spending and associated borrowing to finance this. Thus the fact that it is scheduled for the last fortnight does not mean that it is essentially a response to a temporary seasonal shortage.

Why this innovation? The choice of instruments for infusing durable liquidity is between a regular open market operation (OMO --that is to buy government securities from banks in exchange for rupees) and the swap. However, with a string of these open market operations, banks' holdings of government securities have dwindled (see chart). **There is a risk that more OMOs could mean inadequate bond holdings both for repo operations and to meet regulatory needs. Besides, sustained purchases of large amounts of government bonds tend to distort the yield curve**. This de facto, amounts to aggressive yield management for G-secs*. Thus, it is legitimate for the central bank to want to avoid this route and use this swap instead*



What happens to forward premia and the spot rate?

The swap mechanism effectively means that the central bank is selling a large amount of 3-year forwards through this auction. Thus forward premia is likely to come down not only for this tenor (trading at 5 per cent before the announcement) but across the board as liquidity infusion pushes down rates across the board. ***However, while the short term tenors could see a larger fall (as greater liquidity pulls shorter term interest rates down), our assessment is that the***

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decline in premia might see more limited declines as the tenor increases and this would result in in some steepening. ***Overall, the downward shift in the forward curve might not be large.***

Softer premiums could have a number of effects especially if this becomes a more regular measure for durable liquidity management:

- It could encourage entities like NBFCs that have been allowed to borrow offshore without fully hedging their exposure (RBI has reduced the mandatory hedge coverage from 100% to 70% for ECB loans with a maturity of 3-5 years) to cover a larger fraction of their exposure.
- More importantly lower hedge would incentivize domestic corporates to borrow abroad and bring in offshore funding needed to fill a rising domestic saving investment gap.
- It could also see more foreign inflows into the domestic corporate debt market.

While the market perhaps legitimately sees this announcement as a signal that the RBI is uncomfortable with the recent appreciation of the INR, the effective impact on the spot rate could be neutral. Banks are likely to bring in offshore funds to fund the auction and the depreciation impact of higher liquidity on the INR could be negated by larger USD inflows. Clearly the announcement had only a temporary effect on the spot INR yesterday. **We see 69-69.50 as the near term range for the spot INR and were it to pierce this level, the next major resistance emerges only at 68.40-68.50 levels**

In the longer term if indeed it shores up capital inflows it is INR positive.

Is the swap entirely unfamiliar?

Clearly the buy/sell swap as an explicit liquidity management tool is an innovation and a one-shot auction amount of USD 5 billion is a significant amount. However,

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the RBI has been using swaps quite consistently to intervene in the currency market with concomitant spill-over to liquidity.

INR mn	Dec-18	Jan-19
Net Purchase/ Sale of Foreign Currency (Spot)	607	293
Outstanding Net Forward Sales (–)/ Purchase (+)	-2426	-3032

Will there be a shortage of cash dollars in the market?

Opinion is somewhat divided on this but the bottom-line is that even if there is a temporary shortage **it is unlikely to be large**.

- For one thing, inflows have been solid (Net FII inflows at USD 2.3 bn since March 1) over the 10 days and were this continue there would be enough dollars in the system to facilitate this auction without an acute cash dollar shortage. Besides there is a prospect of large lumpy inflow related to the foreign acquisition of an impaired domestic asset.

- Banks have a facility of borrowing and bringing in dollars (50% per cent of their unimpaired Tier 1 capital) that they can use to participate in this auction. The incentive for this would be the difference in cost between the funds sourced through this auction and the cost of raising funds locally.

- There has been a plethora of overseas borrowing by both Indian companies and banks and some of the funds raised could have bolstered the current extant dollar positions of banks.

Some of the recent dollar bond issuances

ReNew Power raised $375 in March 2019
Shriram transport raised $400 mn in February 2019
SBI raised $1.25 bn in January 2019
REC raised $700 mn in November 2019

Expected fund raising

M&M Finance	$500 mn
BPCL	$500 mn
NTPC	$500 mn
IOCL	$500mn
HDFC Ltd	$ 500mn - $1 bn
Canara Bank	$ 350-500 mn

Does this mechanism have a clear bias towards foreign banks?

There is a perception in the market that this mechanism appears to 'favour' foreign banks who have access to cheaper dollar funding. Besides domestic banks run the risk of bidding uncompetitively in the auction and being 'stuck' with dollar funds that they might not need given their stable rupee funding base. This is perhaps an exaggeration. While there is likely to be some foreign bank participation in the auction, **the extent of this would be determined ultimately by how much they plan to expand credit in India. This would require further capital infusion in a market with a low sovereign rating, something that they might be reluctant to do.** While the risk of hit or miss is indeed true for Indian banks, it might not necessarily mean borrowing three-year dollar funds that they could be saddled with. They could for instance borrow shorter term, participate in the auction and then decide on their course of action depending on the results. ***Thus we argue against the claim that the auction will by its very nature be dominated by foreign banks***

The bond yield impact

The long end of the G-Sec yield curve has typically responded positively to conventional OMOs used to infuse durable liquidity and the raft of OMO related

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auctions over the past year has kept yields particularly for the benchmark 10 year bond down. However, there was growing apprehension in the market that durable liquidity infusion through OMOs would be lower going forward. The reduction in OMOs would exert downward pressure on bond prices. This could exacerbate as the swap might be construed to imply a reduction in the OMO quantum especially if it becomes a permanent facility for durable liquidity infusion.

Clearly this risk has to be balanced against the comforts that a rate cut that is widely anticipated in the 4thApril policy and the RBI's forward guidance might bring .That said, a 25 bps rate cut should have been baked quite considerably into current bond prices. Besides there is large supply of government paper due to hit the markets. **Unless the RBI's forward guidance is singularly dovish, the risk of reduced OMOs could set a floor to the 10 year yield at 7.30-7.35 levels.**

The caveat here is that estimates of OMO purchases are premised on durable liquidity calculations based on the old model of monetary targeting that attempts to estimate the demand for money in the system given income growth and inflation. It is possible, however, that OMOs are not based on these long term projections but are more 'reactive' to emerging liquidity deficits with the clear objective of preventing excessive hardening of yields. Were that the case, then the fears of ratcheting yields are perhaps misplaced.