RBI Forex Swap
Implications for Markets

The Reserve Bank of India adopted a new tool of monetary management by offering an INR/USD swap for a tenor of three years. As part of the swap, RBI offered to buy up to US$5 billion from the market on a spot basis and sell the same amount of USD back after three years at a fixed forward rate. On the other leg, the RBI released Rupee liquidity for a period of three years. In the process the RBI's forex assets would rise by US$5 billion and its forward liabilities would rise by the same amount. After the success of the first auction held on 26th March, a second swap is scheduled on 23rd April.

On the face of it this is just a new tool for liquidity management. Normally the RBI has two tools for adding Rupee liquidity:

1) Open market operations (OMOs) by purchase of Government securities
2) Purchase forex from the market

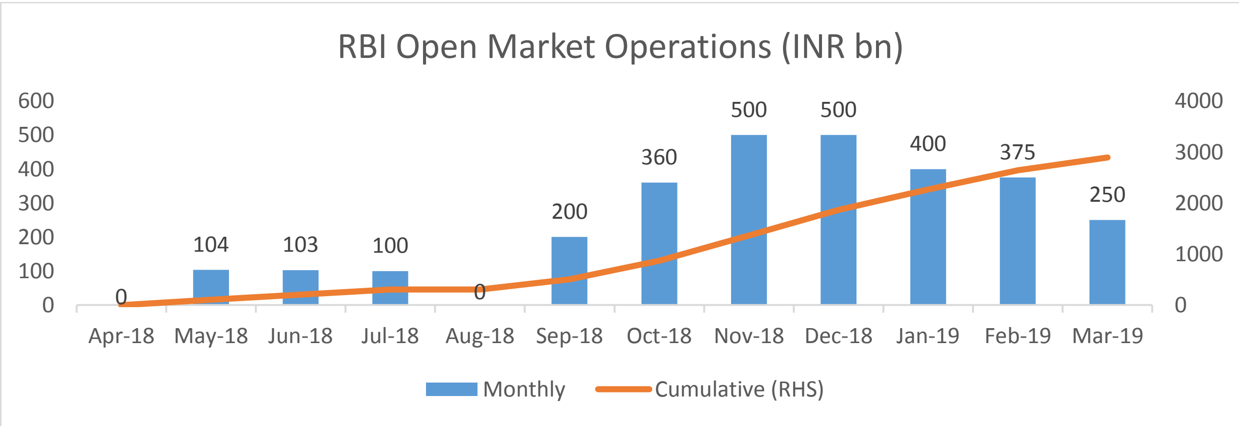
In addition, the RBI also intervenes to add liquidity through short-term measures such as overnight and term repurchase agreements (repos). The swap facility is an intermediate facility in that it is a longer term liquidity solution as compared to repos used so far while still retaining a definite end period unlike outright OMO or FX purchases. The RBI includes the swap as another tool in durable liquidity addition.

In a way, the swap is like a repo: instead of buying G-Secs in the spot market with a forward sale leg, the RBI will purchase USD in spot with a forward sale leg. Both tools release liquidity into the banking system.

If the RBI can just do an outright FX purchase, why go through the motions of a swap? We believe that the RBI has managed to deliver three outcomes with this one tool.

Adding nearly ₹ 35,000 crores in liquidity

The first swap netted $5.02 bn, adding ₹ 34,561 crores to banking system liquidity. This liquidity is available for three years and is seen as "durable" in nature. During the course of the financial year 2018-19, the RBI has added about ₹ 2.89 lakh crores of liquidity through open market purchases of government securities. Nearly 90% of this (₹ 2.59 lakh crores) has been done since September alone.



Source: RBI, Bloomberg, Axis MF Research

This extraordinarily large intervention came to offset two sources of outflows: increase in currency in circulation and decrease in forex reserves thanks to supporting the Rupee in the first half of the year. The RBI appears to want additional tools to add liquidity without stepping up its OMO purchases. The RBI purchases this year account for 72% of the market borrowing by the government this year. Central banks are very wary of being such large buyers of government debt as this can be seen as monetary financing of the fiscal deficit.

A Strong Signal On the Rupee

Source: Bloomberg, Axis MF Research

Last year, the worry was of a sharp decline in the value of the Rupee. The start of this calendar year was also not positive with INR trailing most of its EM peers. However, the recent surge against the greenback has seen the INR return to the top of the currency performance charts. Normally in such a situation, RBI would have intervened in the foreign exchange markets to stem the sudden rise in currency. This is the opposite of the scenario last year where the INR depreciated sharply. The swap allows RBI to intervene without being seen as giving a direction on the currency. At the same time, they have engineered a dollar shortage that has arrested the INR strength. By dressing this up as a liquidity tool, the RBI also avoids criticism that it is trying to devalue the currency for competitive reasons.

An interesting parallel goes back to 2013-14. Then too we saw a large depreciation in 2013 followed by a sharp appreciation in 2014. The RBI then intervened directly in the spot markets to arrest the currency strength.

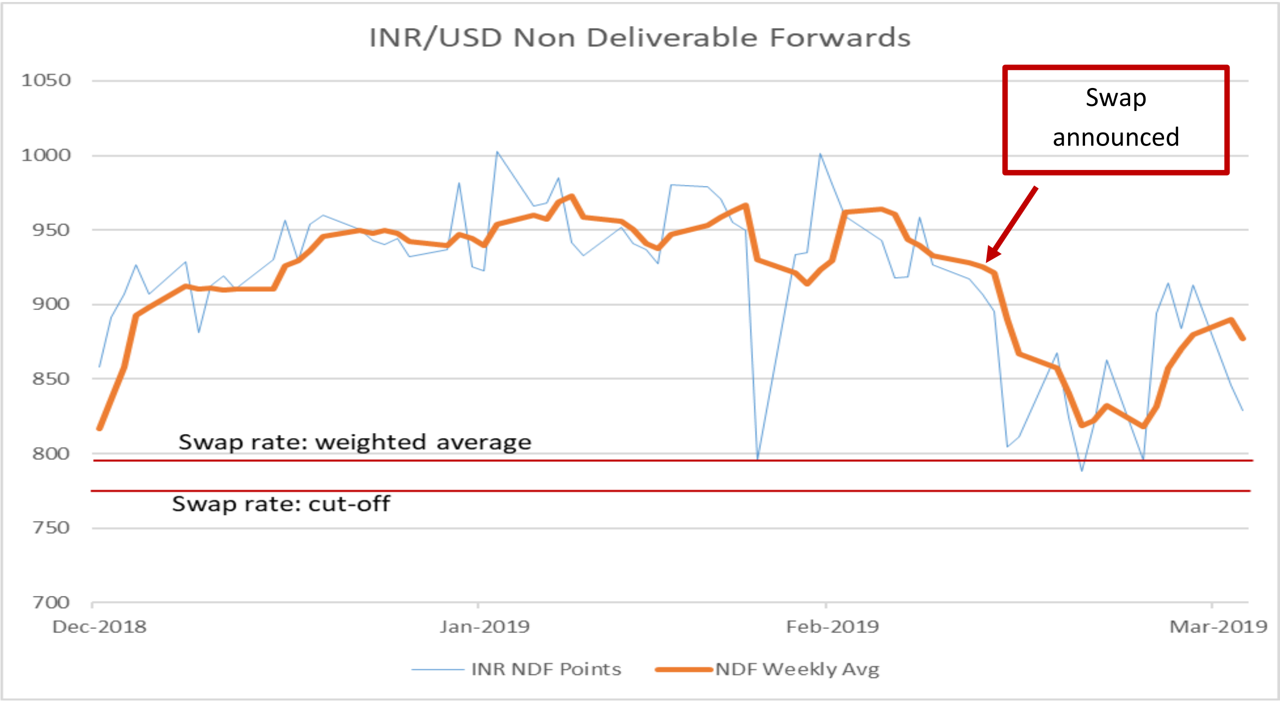
The reserves added provide additional ammunition for the RBI in case the INR comes under pressure in the next few years. Put it in another way, the added reserves give the market additional confidence in the RBI's ability to manage currency volatility.

A medium-term rate cut?

By structuring the transaction as a swap, the RBI in effect is releasing Rupees into the system with the understanding that the Rupees will be given back to RBI at the end of three years. In a sense then the domestic leg looks like a term loan given by RBI to banks with USD as collateral. The rate of interest on this loan is the forward price of the dollar. This is much the same as a repo transaction where the loan rate is subsumed into the forward sale leg price of the collateral asset.

The going forward rate for three-years on USD/INR can be observed only in the non-deliverable forward market. Before the announcement of the swap, the forward rate was about 925 paise (i.e. forward USD would be 79.25 if spot was at 70). With a spot around INR 70 per USD, we can work out that the effective forward rate was 4.4%. In the swap, RBI set a cut-off of 776 paise forward with a weighted average rate in the transaction at 792 paise. That translates to 3.70% at cut-off and 3.77% on weighted average basis.

Which is to say, the RBI was willing to offer INR at a rate that was about 70 basis points lower than the market!

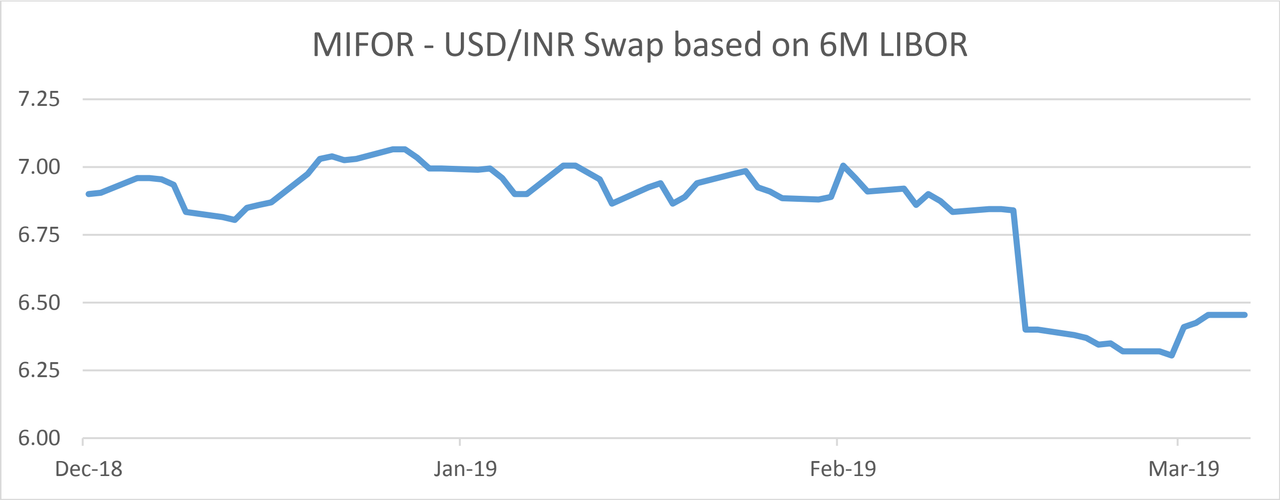


Source: Bloomberg, Axis MF Research. X axis labels refers to the month end NDF points (Non deliverable forward points)

On a hedged cost basis that is a large drop in borrowing cost the RBI is signaling. If one were to borrow overseas at a USD rate of 3% (say), the hedged cost in INR terms would have been 7.4% (3% + 4.4% hedging cost). Now with the swap the hedged cost would drop to 6.7%.

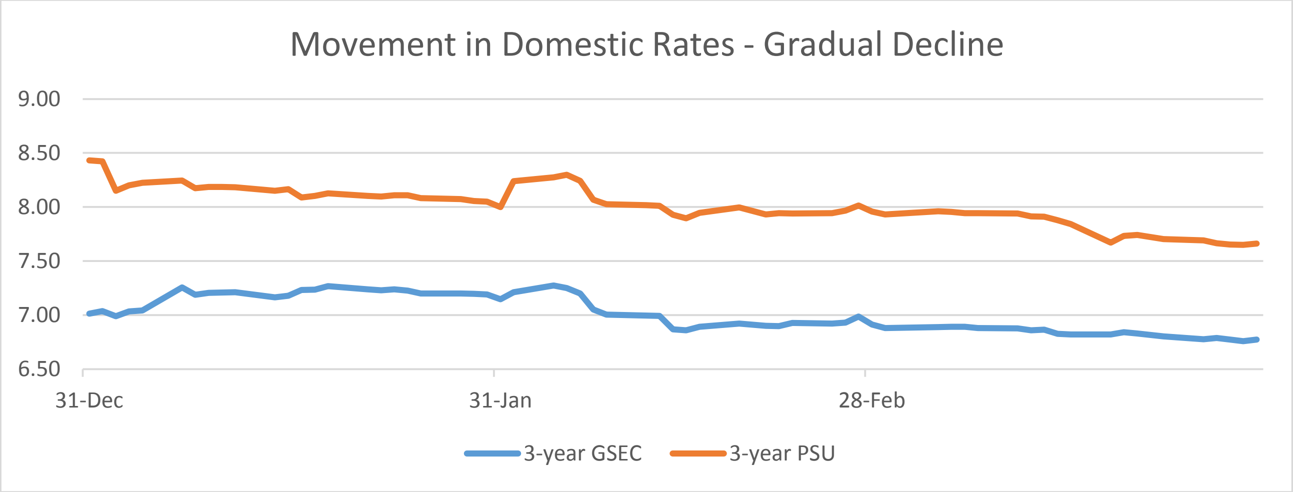
In a way this is a medium-term rate signal by RBI. Normally the RBI would only give out overnight rate signal through the repo rate changes. The market will also try to infer the RBI's longer term intentions through its readings of the open market operations. Here, the RBI has given an explicit signal that it wants to bring down hedged cost of borrowing.

The hedged cost is itself a signal to domestic markets. Issuers would prefer to borrow overseas if the hedged costs drop below domestic rates. By providing a "rate cut" on medium term hedging costs, the Reserve Bank is in effect signaling that it wants medium term domestic rates to head lower. The world market has seen this signal. MIFOR – which is the effective hedged cost of doing a three-year dollar swap versus six-month LIBOR + hedging cost – has dropped sharply since the announcement of the swap: from around 6.85% all the way down to a low of 6.30%. That drop of 55 bps is the market digesting the 70bps drop the RBI was signaling.



Source: Bloomberg, Axis MF Research. X axis labels refers to the month end swap rates.
MIFOR – Mumbai Interbank forward offer rate

Domestic rates markets have not priced this in. Despite the signal on rates and the reaction from offshore markets, Indian bond yields have dropped by far less than these other markets. Three-year G-Sec rates have dropped by less than 10 bps – which is more of a reflection of the added liquidity and perhaps pricing in of a possible April rate cut. AAA-rated corporate bonds have seen a somewhat larger drop of about 35 bps.



Source: Reuters, Axis MF Research

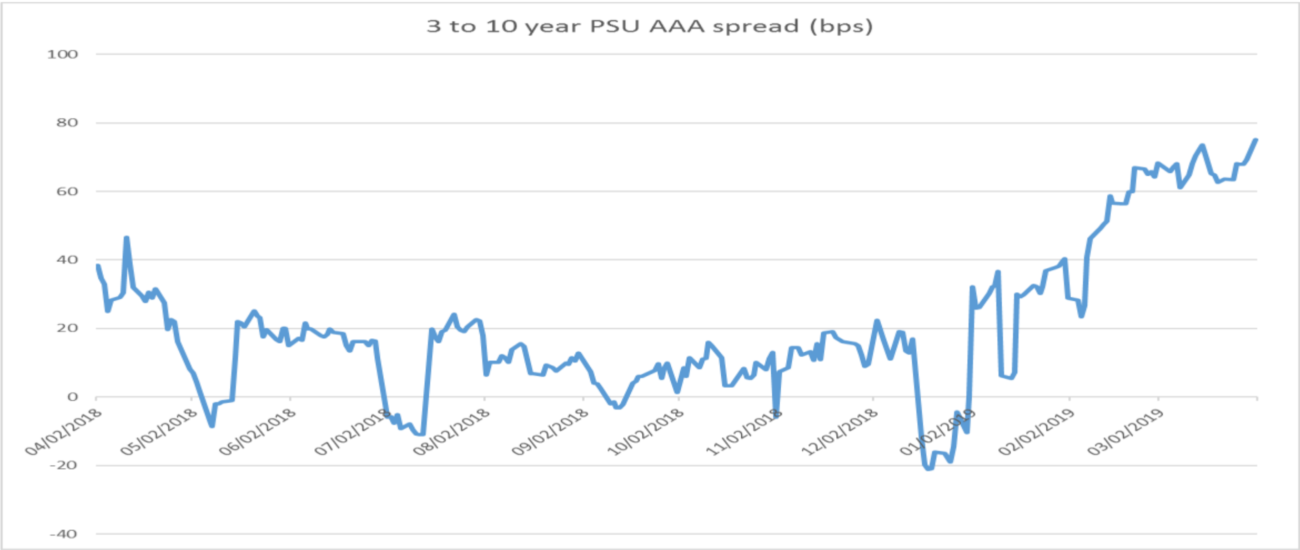
Implications

Central banks rarely adopt new tools without a larger objective. On the face of it, this could be as simple as a new tool for liquidity management. However, peering between the lines, we can see a signal to two markets: a message of stability to the foreign exchange market and a message of lower rates to bond markets.

Think of this as a sort of forward guidance. When central banks do not want to cut spot rates they can use other tools to indicate that they want longer rates to come off. We believe that the RBI is signaling that they want lower market rates to aid transmission of policy rate cuts to the real sector.

Short-term yields have fallen relative to the peaks last year. But in a rate cut environment and with this swap signal from RBI we continue to believe that short bonds offer a mix of good yield pickup relative to cash & the opportunity to participate in potential gains as further rate cuts are delivered and liquidity is added to the system.

The yield curve beyond the short end has been flat for a long time offering little value. But with short bond yields dropping so much, the opportunity to play longer rates has arisen. We are adding to longer term corporate bonds across our funds.



Source: Bloomberg, Axis MF Research

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