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TIME FOR RBI TO LEAN WITH THE WIND IN THE FOREIGN EXCHANGE MARKET?

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Surplus liquidity as given by outstanding Net LAF stands at Rs 5276 billion as on 22 Nov, with average surplus being Rs 4150 billion so far in the current fiscal. One factor which is increasing market liquidity is RBI's dollar purchases to prevent further appreciation of Rupee. India is classified under the 'managed float' exchange rate regime of the IMF. The Reserve Bank intervenes in the foreign exchange market to contain excessive volatility as and when necessary and to manage the liquidity conditions. This effectively makes RBI's job hard as it is always "leaning against the wind". In FY09 when Rupee was continuously depreciating RBI made $34.92 billion net sale to support Rupee. Compared to this, in the current fiscal till Sep'20, RBI has made net dollar purchase of $43.6 billion.

In the current fiscal RBI has already accumulated $93 billion in forex reserves so far. Past data indicates it was only in FY08 that RBI had accumulated forex reserves more than this amount. In FY08, forex reserves increased from $200 billion to $309 billion, an accretion of $110 billion. In the current environment of liquidity surplus should RBI continue its intervention in the market and prevent rupee's appreciation or should it allow the rupee to appreciate? We believe there are **potentially two problems** if we continue to add to our forex kitty and hence liquidity – **First**, the peculiar conundrum when bank loan rates are lower than equivalent rated bonds, e.g. 15 year old spread at a negative 60-70 basis points. Such type of irrational pricing, because of abundant liquidity, can impact banking sector profits and initiate asset liability mismatch, if the spread is more prevalent for lower rated borrowers, a sure recipe for financial instability in the future. However, it is also true that high rated corporates float bid for getting competitive pricing of their long term or short-term loan requirements and various banks participate in the same. **Second,** we believe inflation is unlikely to come down in a hurry in current fiscal and it might be only in March that it could get below 5%. A higher inflation per se is consistent with almost negligible consumption of services currently and thus a statistical artefact in computation of headline CPI. Unfortunately, CSO is working with a broken CPI methodology and that is distorting inflation numbers to the higher side. Our question is can the RBI justify such a sizable liquidity with a higher inflation by clearly enunciating about the so called methodology where food has a disproportionately higher weight? In fact, it was only a few weeks before the revised CPI(IW) was launched with much lower weightage of food. Thus, naturally, the CSO basket demands revision and also a shift to Pasche Index, whereby weights keep on changing as is the norm globally!

The situation is going to get tough. Looking at the global scenario, dollar is expected to remain weak due to fragile US economic conditions. Also data from 1968 shows that dollar index has performed well under the Republican regime vis-à-vis Democratic regime and thus US election results have led to significantly improved capital inflows in emerging markets including India. India has already witnessed record inflows of $18 billion so far this fiscal. Interestingly, in the merchant market (in both spot and forward segment) there was an excess supply of $40 billion during Apr'20- Sep'20 (till 18th). However in the interbank market the trend is quite opposite and there has been excess demand of $27 billion in the same period and this must have increased significantly by now. Overall, merchant dollar supply is far higher than demand as they anticipate a stronger rupee and hence may be holding to long position in dollars, without even adequate hedging. This is being balanced by excess dollar demand in interbank market, but the net effect is a large supply of dollars. **Thus, and also given higher domestic inflation, it would do no harm for RBI to lean with the wind and let rupee appreciate which would reduce imported inflation when metal prices are rising, and clear the liquidity overhang to some extent**. **In fact, the large supply of dollars will ensure that rupee will not appreciate significantly from the current levels and this could potentially play to the advantage of RBI even if it takes a hands off approach to rupee appreciation for the time being!**

RUPEE EXCHANGE RATE POLICY SINCE FY2008

- India is classified under the 'managed float' exchange rate regime of the IMF. The Reserve Bank intervenes in the foreign exchange market to contain excessive volatility as and when necessary and to manage the liquidity conditions. Over time, the job of RBI has become tougher as Rupee movement vis-à-vis US Dollar has progressively turned more volatile. The time span between the 2008 crisis and the ensuing Eurozone debt crisis saw an extremely fluctuating domestic currency, as global sentiments deteriorated. After the hit the currency took, like all the emerging market currencies during the taper tantrum, Rupee movement has become comparatively less volatile. However, from last year, Rupee has again become more volatile owing to trade wars, dim global and local growth prospects. This year also, Rupee plummeted after COVID was declared a pandemic and the nation went into lockdown. However, Rupee has recovered significant lost ground recently.
- If we look at the crisis in 2008, in FY08, RBI had made net purchases of $78.2 billion as Rupee was fairly stable during the beginning of crisis and RBI was not pushing for any more appreciation of Rupee. However, the Rupee started depreciating against the US dollar from the beginning of February 2008 on account of FII outflows, rising crude oil prices and heavy dollar demand by oil companies. The cascading effect of the global financial crisis on the domestic foreign exchange market was felt through the dollar liquidity shocks emanating from the lower level of net capital inflows.
- Consistent with its policy objective of maintaining orderly conditions in the foreign exchange market, the Reserve Bank sold foreign exchange to meet the mismatch in the market. Despite the deepening of the financial crisis and weakness in economic activity in the US, the flight to safety considerations helped the US dollar to strengthen against most currencies during 2008-09, including the Indian rupee.

- As the external shocks deepened, Rupee breached the level of Rs 50 per US Dollar in 2008. To support Rupee, RBI's made $34.92 billion net sale in FY09 and in FY10 $2.6 billion as Rupee slowly recovered.
- In the current pandemic, Rupee has recovered lost ground and RBI has started purchasing large amount of dollars after selling net $5.2 billion in March and April. Till Sep'20, RBI has made net dollar purchase of $43.6 billion, thereby increasing Rupee liquidity.

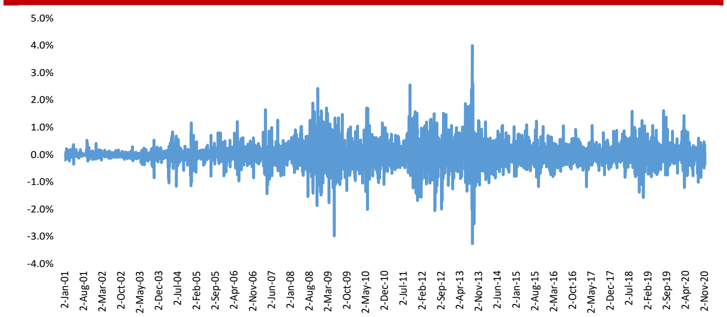
LIQUIDITY TO REMAIN IN SIGNIFICANT SURPLUS THIS FISCAL

- Liquidity surplus as on Sep'20 taking CIC, forex reserves intervention of RBI, Net OMO, GOI surplus cash balances, Net LAF, CRR balances is around Rs 1848 billion. Currency in circulation has reached Rs 27,334 billion, an increment of Rs 2861 billion so far this year. Assuming CIC to reach a level of Rs 28,000 billion by Mar'21, it represents liquidity leakage of Rs 3500 billion in FY21. Furthermore, RBI has purchased Rs 3179 billion of forex so far till Sep'21. Assuming another Rs 1120 billion be purchased by RBI in remaining months total additional forex purchase by RBI would be around Rs 4229 billion.
- RBI has done net OMO purchase of Rs 572 billion, so net OMO purchase of Rs 1500 billion is assumed this fiscal based on current trends. Taking deposits growth of 9.7% this year, incremental CRR comes to Rs -1305 billion (4% of NDTL of Rs 144248 billion in FY20 and 3% of NDTL of Rs 148823 billion in FY21). As CRR is reduced it represents addition to liquidity in FY21 compared to FY20. Taking all these things into account, net surplus liquidity will come at least around Rs 4 lakh crore which the RBI has to absorb using daily Net LAF as per the requirement.

RBI FACES CHALLENGES IN CURRENT STATE

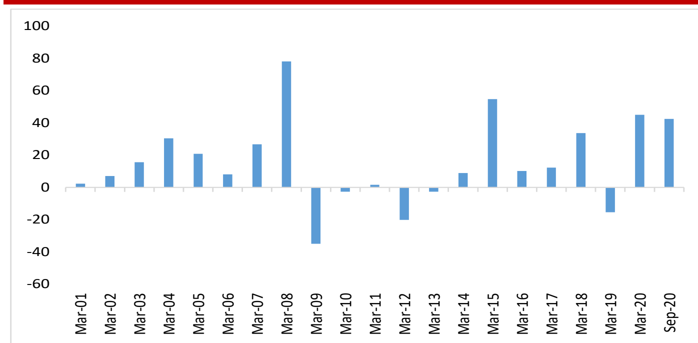
- In the current fiscal RBI has already accumulated $93 billion in forex reserves so far. Past data indicates it was only in FY08 that RBI had accumulated forex reserves more than this amount. In FY08, forex reserves increased from $200 billion to $309 billion, an accretion of $110 billion.
- In the current environment of liquidity surplus should RBI continue its intervention in the market and prevent rupee's appreciation or should it allow the rupee to appreciate? If the Rupee is forcibly allowed to not appreciate then it will be a problem for market players. Also, continuous management of rupee by RBI will require buying of US dollars and increasing supply of rupee liquidity in the market, which in turn could push upward pressure on inflation.
- Also, huge liquidity overhang for an extended period could hamper financial stability. Excess liquidity leads to lower interest rate which means cheap money is available for companies and people to borrow. Flushed with liquidity, lenders might lend to borrowers with weak credit profile. For instance, there is news that even AA rated borrowers are being provided Repo rate linked loans at near 6% interest rate which is even more competitive than the rates offered in corporate bond market. This indicates that lenders could be indulging in risk under pricing, any adverse movement in interest rates could impact bank profitability and hard earned financial stability. However, the good thing is the trend of retiring high cost debt using low cost debt. Classification of outstanding loans of Scheduled Commercial Banks indicates that by Mar'20 private corporate sector has around 35% of their total loans and advances at (6% to 9%) bracket and less than 5% at less than 6% rate of interest.

Rupee Daily change (%)



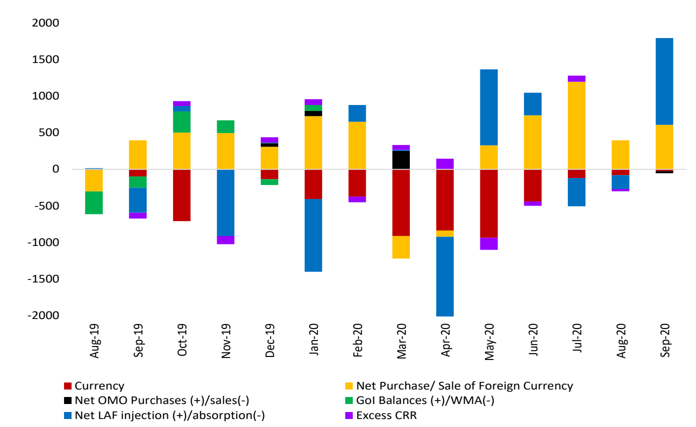
Source: SBI Research

Net Sale/Purchase of USD ($ billion)



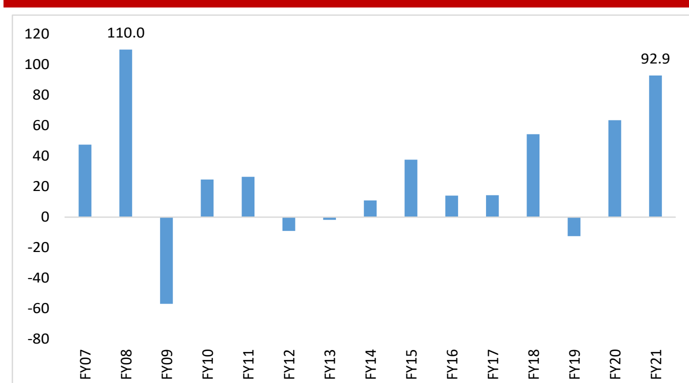
Source: SBI Research, - indicates sale

Liquidity Management (Rs billion)



Source: SBI Research

Foreign Exchange Reserves ($ billion)



Source: SBI Research

US ELECTIONS AND DOLLAR VALUE

- Data from 1936 shows that Republicans have enjoyed at least two continuous terms in White House and this is the first time when Republican candidate Mr Donald Trump was ousted by Democrat Joe Biden.
- During Trump's regime, dollar index had weakened from 102.21 at the end of December 2016 to 96.445 at the beginning of 2020. However, compared to the previous regime dollar had shown some strength as US economy had witnessed better growth. Data from 1968 shows that dollar index has performed well under the Republican regime vis-à-vis Democratic regime. In 2020, as global uncertainties increased dollar index had strengthened and crossed 100. However, dollar saw erosion in gains as the concerns about US economy grew. With slow economic recovery of the US amidst rising Covid cases dollar is seeing further weakness.
- Also, reduced uncertainty surrounding elections has led to improved capital inflows in emerging markets including India. After the 2008 election also, the outcome of the general elections, which generated expectations of political stability, buoyed the market sentiment and strengthened the rupee, especially in the second half of May 2009. India has already witnessed record inflows of $18 billion so far this fiscal. Coupled with current account surplus in H1FY21, RBI was leaning against the wind considerably to stop rupee from appreciating.

TURNOVER IN THE FOREX MARKET

- Daily forex turnover declined significantly in August with the negative equity market, following the rise in COVID-19 cases.
- In the merchant market (in both spot and forward segment) there was an excess supply of $40 billion during Apr'20- Sep'20 (till 18th Sep). However in the interbank market the trend is quite opposite and there has been excess demand of $27 billion in the same period. But the overall dollar supply is higher than demand.

CONCLUSION

- Currently, India is seeing higher inflation because of supply side constraints and changes in the consumption pattern. In this situation it would do no harm for RBI to lean with the wind and let rupee appreciate which would reduce imported inflation and somehow clear the liquidity overhang.

History of US elections and dollar index performance

Candidate	Political party	Year	Continuous runs of political party	Dollar Index end period average for subsequent 4 years	Growth rate average for subsequent 4 years
Richard M. Nixon	Republican	1968	2	116	2.8
Richard M. Nixon	Republican	1972		102	2.6
Jimmy Carter	Democratic	1976	1	90	3.3
Ronald W. Reagan	Republican	1980	3	126	3.1
Ronald W. Reagan	Republican	1984		101	3.8
George H.W. Bush	Republican	1988		88	2.2
Bill Clinton	Democratic	1992	2	90	3.3
Bill Clinton	Democratic	1996		101	4.5
George W. Bush	Republican	2000	2	97	2.4
George W. Bush	Republican	2004		83	2.0
Barack Obama	Democratic	2008	2	79	1.0
Barack Obama	Democratic	2012		93	2.2
Donald Trump*	Republican	2016	1	95	2.5

Source: SBI Research, * excludes 2020

Turnover in the foreign exchange market ($ mn)

Month	Merchant			Interbank			Grand Total
	Forward Excess Demand	Spot Excess Demand	Total Excess Demand	Forward Excess Demand	Spot Excess Demand	Total Excess Demand	
Sep'20 (Till 18th)	676	-2133	-1,457	1461	2964	4,425	2,968
Aug'20	1650	-13461	-11,811	4595	3181	7,776	-4,035
July'20	2,239	-8,466	-6,227	341	7,248	7,589	1,362
Jun'20	1,726	-12,647	-10,921	943	6,354	7,297	-3,624
May'20	1,495	-7,603	-6,108	1,661	-202	1,459	-4,649
Apr'20	1,691	-5,476	-3,785	2,663	-3,326	-663	-4,448
Mar'20	9,343	-4,694	4,649	4,937	-9,601	-4,664	-15
Feb'20	3,053	-8,884	-5,831	1,875	3,693	5,568	-263
Jan'20	4,471	-8,532	-4,061	-628	4,109	3,481	-580
Dec'19	5,897	-11,599	-5,702	2,838	3,520	6,358	656

Source: RBI

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