Ecowrap

FOR EVERY $1 BN RBI SWAP, SYSTEM BENEFITS BY RS 256 CRORE EVERY YEAR : BUT LIQUIDITY TO REMAIN UNDER STRESS IN MAY

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In the past two decades, an increasing number of central banks have included foreign exchange swaps among the instruments to provide liquidity in the national currency. Central Banks of Australia, New Zealand, Russia offers FX swaps as a standing facility just like LAF in India. Most of Middle East Central banks use swap as an instrument to inject liquidity. For example, Central Bank of Oman offers the facility of Foreign Exchange Swaps to banks whereby the banks are permitted to swap US Dollars for local currency to meet their short term liquidity requirements, upto one month.

Against this background, the RBI decision to provide liquidity through swap transactions is a novel idea. In total, Rs 694.35 billion of durable liquidly was injected in the first leg through both the swap auctions. The novel swap transaction has some potential cost benefit for the system, with the benefits far outstripping the costs.

We estimate that the net system benefit of such swap transaction is Rs 77 billion for 3 years. On a per annum basis, this implies a benefit of Rs 26 billion. Alternatively, for every $1 bn swap, the system hypothetically benefits by Rs 256 crore per annum.

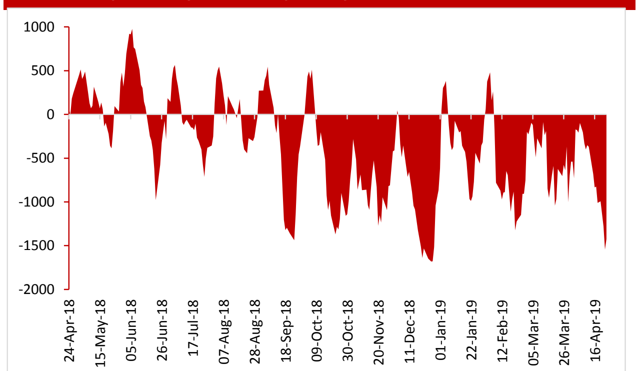
However, even though, RBI has done swap transactions, Government spending is currently significantly muted. From the last Friday of Mar'19 till today cash balances have increased by Rs 610 billion vis-à-vis draw down of Rs 1500 billion in the same period last year, indicating worsening systemic liquidity.

To compensate for such, the RBI has recently decided to conduct purchase of G-secs under OMOs for an aggregate amount of Rs 250 billion in May 2019. Such OMO recently was perhaps not feasible as the banks did not have enough securities. **We believe till Aug'19, the RBI could additionally do an OMO of Rs 400 billion**. Meanwhile, we believe that GST collection for Union Government for Apr'19 will be at Rs 1.11 trillion. Such higher GST collections coupled with recent Government build up of cash balances will ensure **liquidity deficit stays close to Rs 75000-Rs 1 lakh crore at least till elections get over.**

RBI FX SWAP : A NEW TOOL FOR LIQUIDITY MANAGEMENT

- Recently , RBI has announced auction of $5 billion of forex Buy/Sell swap for tenor of 3 years, to inject durable Rupee liquidity in the system. The auction was conducted on 26 Mar'19, which was oversubscribed. With its overwhelming success, RBI again auctioned the same amount with same tenure on 23 Apr'19. On both the occasions the market received it positively and the competition among participants has pushed up the forward premium from 776 paise in first auction to 838 paisa in the second auction. In total, Rs 694.35 billion of durable liquidly was injected in the first leg through both the swap auctions. The novel swap transaction has some potential cost benefit for the system, with the costs far outstripping the benefits.
- The swap transaction has 2 participants. The Banks working as authorized dealers and RBI. For RBI, there is a negative carry as the opportunity benefit of RBI investing the $ is nullified by the opportunity cost foregone of the concomitant liquidity that could have earned interest / investing in treasury bills among others. However, the negative carry of RBI is compensated from the forward premia income. Taking the situation of RBI earning on an average 2.5% yearly on the dollars it has received from banks, and exchange rate moving to 72.5, 74.5 and 76.5 in the coming three years, RBI can get returns to the tune of Rs 56 billion in 3 years. If we look at the returns generated from investing in T-Bills, the returns could be possibly at Rs 135 billion. Since RBI is getting Rs 80.billion from the forward premia, it will compensate for the negative carry due to interest rate differentials. For the Banks, this meets their liquidity needs and helps them generate investment. Assuming they get returns at the rate of 7.5% p.a., they make Rs 156 billion from this rupee injection during next three years and it will fully compensate the forward premia outgo of Rs 80 billion. The net system gain is therefore Rs 77 billion for 3 years. On a per annum basis, this implies a benefit of Rs 26 billion. Alternatively, for every $1 bn swap, the system hypothetically benefits by Rs 256 crore per annum.

Graph 1: System Liquidity Position (in Billion)



Source: SBI Research

Notional Cost Benefit for Swap Transaction (Rs billion)	
RBI Returns from Dollar Investment assuming 2.5% interest p.a	56
RBI Returns from Rupee Investment assuming 6.25% interest p.a	135
RBI Negative Carry	79
Amount gained by RBI from Forward Premia	80
Banks Return from Investment at the rate of 7.5% interest p.a	156
Net System Gain after adjusting for forward premia transaction between bank and RBI	77
Net System Gain Annualized per annum	26

Source: SBI Research

LIQUIDITY STILL IN DEFICIT MODE

- Even though, RBI has done swap transactions, Government spending is currently significantly muted. There is buildup of Government surplus cash balances held for auction. From the last Friday of Mar'19 till today cash balances have increased by Rs 610 billion vis-à-vis draw down of Rs 1500 billion in the same period last year, indicating the worsening systemic liquidity. For 2017 and 2016 also there was drawdown in this period to the tune of Rs 130 billion and Rs 1303 billion approximately.
- To compensate for such, the RBI has recently decided to conduct purchase of G-secs under OMOs for an aggregate amount of Rs 250 billion in May 2019 through two auctions of Rs 125 billion each. The first auction of Rs 125 billion will be conducted on 2nd May'19. Such OMO recently was perhaps not feasible as the banks did not have enough securities. For an equivalent transaction.
- In fact, the increase in FALLCR for computing LCR by 2% in a phased manner till 1 Apr'2020 by the RBI in April monetary policy was the correct step to rectify this anomaly. It allowed banks to use mandatory SLR further upto 2% of NDTL as High Quality Liquid Assets. This will release minimum additional securities around Rs 2.6 trillion, with Rs 660.00 billion every four months based on current NDTL. Thus, till Aug'19, the RBI could additionally do an OMO of Rs 400.00 billion.

GLOBAL EXPERIENCE OF SWAP TRANSACTIONS

- In the past two decades, an increasing number of Central Banks have included foreign exchange swaps among the instruments to provide liquidity in the national currency. The foreign currency, in this case, acts as collateral. However Central Banks don't rely on FX swaps as a sole or main instrument of liquidity provision to credit institutions.
- FX swap mostly used by the Central Banks especially in countries with open economy (substantial FX cash flows) and low capacity of the internal market of high-quality securities (which limits the potential for the reliance on securities-backed instruments). Australia and New Zealand are the examples of countries where Central Banks actually provided liquidity in the national currency through FX swaps.
- The Bank of Russia offers FX swaps as a standing facility just like LAF in India. The Bank of Russia may also conduct FX swap fine-tuning auctions and financial stability. In 2018, BoR has done FX swap of $ 16 billion and till now in 2018, the total is $3.5 billion.

LCR and Liquidity

Effective Date	FALLCR (% of NDTL)	Total HQLA carve out from SLR (% of NDTL)	Additional securities released (Rs lakh crore)
4 Apr'19	13.5	15.5	2.6
1 Aug'19	14	16	
1 Dec'20	14.5	16.5	
1 Apr'20	15	17	

Source: RBI, SBI Research

- Central Bank of Oman offers the facility of Forex Swaps to banks whereby the banks are permitted to swap US Dollars for Rial Omani (RO) to meet their short term liquidity requirements in RO. The swaps are offered for durations ranging from overnight up to a maximum of one month. The USD/ RO spot exchange rate is the mid rate between bid and offer rates as per CBO quotations, that is 384.5 baizas per USD.
- The Central Bank of Kuwait had also introduced a Kuwaiti dinar-U.S. dollar swap facility to provide liquidity to commercial banks in April 1978. The Central Bank of Saudi Arabia also provides liquidity to banks through foreign exchange swaps at its discretion.
- Other countries that have used currency swap are Belgium, Norway, United Kingdom, Malaysia, the United Arab Emirates, Bahrain, and Turkey.

REASONS FOR FX SWAP

- Central Banks use foreign exchange swaps for a number of reasons: (1) They prefer to have a wide range of intervention techniques at their discretion (possibly because they may wish to vary the predictability of their policy actions), (2) in many countries, the domestic short-term secondary market is not deep enough to permit market intervention (or is non-existent), whereas the market in foreign exchange is generally active; this makes it possible to trade large volumes in any one deal, (3) Unlike outright foreign exchange operations, swaps may not have any direct effect on the spot (or forward) exchange rate and (4) Swaps are a flexible instrument: technical procedures are informal, and swaps are inconspicuous and easily reversible.

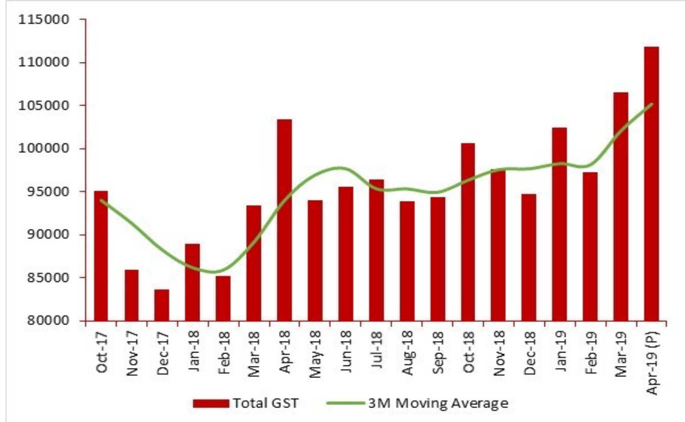
BENEFITS OF FX SWAP

- Because swap transactions are temporary, they are suitable for short-term technical adjustment—either to influence the general liquidity of the market so as to neutralize the effect of fortuitous or seasonal factors (e.g., connected with note circulation or with the semi-annual payment of oil taxes, as in Norway) or to bring about or maintain temporary market imbalances that can push interest rates in the desired direction. However, swaps can easily be rolled over so that a longer-term impact can be achieved, and, in addition, the maturity of swap operations has been extended and now ranges from 24 hours to 24 months.
- Central Banks foreign exchange swap operations may be conducted anonymously in the market at the maturities customarily traded there (1 week and 1, 3, 6, and 12 months), but more flexible contracts may be concluded bilaterally with banks. A common characteristic is that they generally involve U.S. dollars.
- FX swaps executed to support financial stability, providing credit institutions with foreign currency. For example, the European Central Bank and the Swiss National Bank had conducted such operations.

GST COLLECTION IN APR'19

- Meanwhile, we believe that GST collection for Union Government for Apr'19 will be at Rs 1.11 trillion, which is expected to be significantly higher than previous month collection of Rs 1.06 trillion.
- Such higher GST collections coupled with recent Government build up of cash balances will ensure that the systemic liquidity deficit stays close to Rs 75.000 - Rs 1 lakh crore at least till elections get over.

Graph 2: GST Collections (Rs Crore)



Source: SBI Research

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