Dollar-Rupee Swap

For Prelims: Dollar-rupee swap auction, liquidity management initiative, inflation , Balance of Payments (BOP) crisis, Marginal Standing Facility (MSF), Standing Deposit Facility (SDF), Monetary Policy.

For Mains: Monetary Policy.

Why in News?

Recently, the **Reserve Bank of India (RBI)** conducted a **USD 5 billion dollar-rupee swap auction** as part of its liquidity management initiative. This move will lead to infusion of dollars and sucking out of the rupee from the financial system.

- This will reduce the pressure on **inflation** and **strengthen the rupee.**

PYQ

Q. With reference to Indian economy, demand-pull inflation can be caused/increased by which of the Following? (2021)

1. Expansionary policies
2. Fiscal stimulus
3. Inflation-indexing of wages
4. Higher purchasing power
5. Rising interest rates

Select the correct answer using the code given below:

(a) 1, 2 and 4 only
(b) 3, 4 and 5 only
(c) 1, 2, 3 and 5 only
(d) 1, 2, 3, 4 and 5

Ans: (a)

What is a Dollar–Rupee Swap auction?

- It's a **forex tool** whereby the **central bank uses its currency to buy another currency** or vice versa.
- **Dollar–Rupee Buy/Sell Swap**: The central bank buys dollars (US dollars or USD) from banks in exchange for Indian Rupees (INR) and immediately gets into an opposite deal with banks promising to sell dollars at a later date.

- **Dollar-Rupee Sell/Buy Swap:** When the central bank sells dollars, it **sucks out an equivalent amount in rupees**, thus reducing the rupee liquidity in the system.
- These swap operations carry **no exchange rate or other market risks** as transaction terms are set in advance.

What is the RBI Planning to do?

- The RBI **sold USD 5.135 billion to banks and simultaneously agreed to buy back the dollars** at the end of the swap settlement period.
- The intent here is that the central bank acquires dollars from the seller, **charging the lowest premium possible for the two-year tenor.**
- Accordingly, **banks that bid at the lower range of the auction are successful at the auction.**
    - Assuming a dollar rate of Rs 75, the system liquidity will shrink by Rs 37,500 crore.

PYQ

Q. The problem of international liquidity is related to the non-availability of (2015)

(a) goods and services
(b) gold and silver
(c) dollars and other hard currencies
(d) exportable surplus

Ans: (c)

Why is RBI resorting to it now?

- Surplus liquidity in the system is pegged at **Rs 7.5 lakh crore**, which needs to be curbed to keep a tab on **inflation.**
- Usually, the central bank will resort to traditional tools such as **increasing the repo rate** or increasing the **Cash Reserve Ratio (CRR),** but this can have a **negative implication on the economy.**
    - This negative implication can be seen in **incomplete transmission of monetary policy.**
- Therefore, the RBI used a different toolkit - **Variable Rate Reverse Repo Auction (VRRR)** last year.
- However, the recent VRRR auctions were **undersubscribed by banks**, as the cash market offered instant and better yields, forcing the RBI to consider a longer-term liquidity adjustment tool such as forex auctions.

What's the Impact of the swap?

- **Reducing Liquidity:** The major impact will be that liquidity which currently averages around Rs 7.6 lakh crore will shrink.
- **Checking Depreciation of Indian Rupee:** Dollar inflow into the market will strengthen the rupee which has already hit the 77 level against the US dollar.
- **Containing Inflation:** The RBI normally brings down liquidity in the system when inflation threatens to rise sharply. Inflation is set to rise due to following factors:
    - **Rise in Oil Prices:** With crude oil prices rising sharply in the wake of the **Russia-Ukraine war**, inflation is set to rise in the coming days.
    - **Outflow of Institutional Investments:** **Foreign portfolio investors** have been pulling out funds from India. They have withdrawn Rs 34,000 crore from Indian stocks in March 2022 so far, putting severe pressure on the rupee.

What is the Liquidity Management Initiative?

- The “liquidity management” of a central bank is defined as the **framework, set of instruments and especially the rules the central bank follows in steering the amount of bank reserves in order to control their price (i.e. short term interest rates) consistently with its ultimate goals (e.g. price stability).**
    - Bank reserves are the cash minimums that financial institutions must have on hand in order to meet central bank requirements
- Liquidity Management Initiative is a tool used in monetary policy by the RBI, that allows banks to borrow money through repurchase agreements (repos) or for banks to make loans to the RBI through reverse repo agreements.
- Various Instruments under this framework are:
    - **Repo/reverse repo auction**
    - **Marginal Standing Facility (MSF)**
    - **Forex Swaps**

PYQ

Q. If the RBI decides to adopt an expansionist monetary policy, which of the following would it not do? (2020)

1. Cut and optimize the Statutory Liquidity Ratio
2. Increase the Marginal Standing Facility Rate
3. Cut the Bank Rate and Repo Rate

Select the correct answer using the code given below:

(a) 1 and 2 only
(b) 2 only
(c) 1 and 3 only
(d) 1, 2 and 3

Ans: (b)

Source: IE