RBI's Foreign Exchange Swap Auction

Why in news?

The RBI is set to inject long-term liquidity worth $5 billion into the system through foreign exchange swap auction with banks for 3 years.

What is a swap auction?

- Under the swap, a bank would sell US dollars to the RBI.
- It will simultaneously agree to buy the same amount of US dollars at the end of the swap period.
- The swap transaction is materially different from OMOs (open market operations).
- OMOs refer to a central bank's buying and selling of government securities in the 'open market'.
- On the other hand, in swap transaction, only authorised dealers, mainly banks, will be allowed to deposit US dollars in exchange for rupees.
- This comes with an agreement to reverse the transaction at a fixed exchange rate at the end of 3 years.
- The final exchange rate will be decided by an auction where banks will bid on the forward premium they are willing to pay.
- Under the swap auction, minimum bid size would be $25 million and in multiples of $1 million thereafter.

What is the objective?

- The objective is to meet the durable liquidity needs of the system.
- This will inject rupee liquidity for longer duration through long-term foreign exchange Buy/Sell swap.
- The forex swap essentially puts more money in the hands of banks.
- They will, in turn, have discretion to decide whether to step up credit to lower-rated borrowers.
- The US Dollar amount mobilised through the auction would also reflect in RBI's foreign exchange reserves and in its forward liabilities.

How will it benefit?

- RBI has been regularly infusing cash into the markets through Open Market Operations (OMOs) since the IL&FS default last year.

- However, the liquidity situation is expected to worsen in the coming period due to advance tax and GST payments, as well as election spending.
- So RBI's pre-emptive move may help partly bridge this liquidity deficit.
- If successful, the auction is expected to immediately release $5 billion worth of rupee liquidity into the banking system.
- Also, banks which are currently short on SLR (Statutory liquidity ratio) securities and cannot participate in OMOs, will receive liquidity infusions too.
- Nevertheless, RBI needs to come up with a structural solution to address the liquidity issue that is endemic to India’s corporate bond market.

Source: Business Standard, Business Line