RBI's currency strategy flooding the market with more foreign funds

The RBI's outstanding forwards book grew to $28.3 billion as of November from a negative $4.9 billion in the fiscal year 2019-20, highlighting the extent of its operations

The Reserve Bank of India's strategy to shift some of its currency intervention to the forwards market is adding to its problems. Its balancing act to keep the rupee stable amid heavy foreign inflows while also keeping excess liquidity in check is flooding the market with more foreign funds, prompting a vicious cycle of interventions.The RBI's outstanding forwards book grew to $28.3 billion as of November from a negative $4.9 billion in the fiscal year 2019-20, highlighting the extent of its operations. That's pushed the 12-month implied yields, which typically reflect the interest rate differential between India and US, to the highest in more than four years, fueling further inflows. The RBI's currency intervention works like this -- it buys dollars in the spot market to prevent sharp gains in the rupee. It then sells these dollars in the forwards market to offset the liquidity impact. However, banks need to deliver these dollars to the RBI at a later date, which drives up forward premiums. "The forwards curve has become a casualty of the RBI handling multiple objectives," said Abhishek Goenka, chief executive at India Forex Advisors Pvt. "Elevated forward premia continues to attract carry-seeking inflows and it becomes a self-fulfilling prophecy," he said. Selling market stabilisation scheme bonds or term reverse repos could be another way of mopping up liquidity, though the RBI may be averse to selling such bonds as it could lead to a spike in shorter rates, which the RBI may want to avoid, according to Goenka. The central bank will act on forward premiums when necessary, RBI Governor Shaktikanta Das said last week. "We are very watchful of the forward premia rates" he said. The 1-year annualized dollar/rupee forward premium rose two basis points to 5.1948 per cent on Thursday.

Deterring Importers

The rise in forward premium is also deterring importers to hedge their currency exposure while also impacting stable inflows into the bond market, according to Kotak Securities Ltd. "Speculators are gravitating to short the US dollar and buy rupee due to the high forward premium," said Anindya Banerjee, currency strategist at Kotak Securities said. "In order to prevent speculators from taking the rupee higher, the RBI is being forced to buy more dollars in the forwards market, which is pushing premia higher. This is a vicious cycle."?

Business Standard, 12th February 2021.