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DOLLAR-RUPEE SWAP, A USEFUL TOOL

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Foreign Capital, Foreign Trade & BOP

The Reserve Bank of India's **decision last week to resort to a dollar-rupee swap**, instead of the traditional open-market purchase of bonds, to infuse liquidity into the economy marks a significant shift in the central bank's liquidity management policy. Under the three-year currency swap scheme, which is scheduled to open on Tuesday next week, the RBI will purchase $5 billion from banks in exchange for rupees. The central bank will infuse as much as 35,000 crore into the system in one shot at a time when liquidity generally tends to be squeezed. For the banks, it is a way to earn some interest out of the forex reserves lying idle in their kitty. Apart from injecting fresh liquidity into the economy, the move will have implications for the currency market even as it helps shore up the RBI's dollar reserves. Bond yields rose on the day following the announcement of the swap scheme last week, reflecting the prevailing opinion among traders that the RBI may gradually reduce its dependence on the regular bond purchase scheme to manage liquidity within the economy. While traditional open market operations distort the bond market, the new forex swap scheme will introduce new distortions in the currency market. The rupee's recent rally against the dollar has been halted by the RBI's decision to infuse rupees and suck out dollars through the swap scheme. Even so, it is worth noting that the rupee has appreciated significantly in value terms against the dollar since the low reached in October as foreign investors have begun to pour money into the Indian economy.

Overall, the dollar-rupee swap is a useful addition to the RBI's policy toolkit as it offers the central bank a chance to directly influence both the value of the rupee and the amount of liquidity in the economy at the same time using a single tool. In the aftermath of the liquidity crisis in the non-banking financial sector, it can be an effective way to lower private borrowing costs as well. The coming elections, which can lead to an increase in cash withdrawals from banks, may have also played a role in the RBI's larger decision to boost liquidity in the system. The way banks respond after receiving fresh liquidity from the RBI, however, will determine the success of the new liquidity scheme to a large extent. Businesses could benefit from the greater availability of liquidity, but only if banks aggressively pass on the benefit of lower rates to their borrowers. If banks choose to deposit the fresh RBI money in safe government securities at low yields, as they have done in the past, the *de facto* cap on the government's borrowing costs will remain intact. But if banks manage to find alternative ways to deploy their money, the RBI's new liquidity scheme could end up raising borrowing costs for the government, punishing it for fiscal indiscretion.

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