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RBI Pays a Stiff Price: Hot Money Worth $34 Billion Will Be Flowing Out of India

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A huge amount of dollars will be flowing out of the country in the coming weeks as non-resident Indians redeem the deposits they made three years ago under an ill-conceived special scheme to shore up the external value of the rupee. The new governor of the Reserve Bank of India should resist pressures to devalue the Indian currency.

A large sum of $34 billion (or approximately ₹2,27,800 crore assuming an exchange rate of ₹67 to a dollar) is due to flow out of India soon. These funds were mopped up in September 2013 amidst a bloodbath that had taken place in the foreign exchange (forex) market at that time when the value of the rupee against the American dollar had come down to an all-time low of over ₹68 to a dollar. The Reserve Bank of India (RBI) had then opened a "swap window" for banks. Through this window, banks could sell dollars to the RBI "spot" and buy them back "forward."

(Simply put, a spot contract is a contract for buying or selling a currency for payment and delivery on a spot date, usually after 48 hours, whereas a forward contract is one where the terms of the contract are agreed to at present but payment and delivery takes place at a much later date in the future.)

The scheme resulted in the RBI having to incur huge losses. The RBI's losses translated into direct gains for banks. These gains were shared with non-resident Indians (NRIs) who were offered the highest-prevailing interest rate in international markets on their dollar deposits of three-year maturity periods in designated Foreign Currency Non-Resident (Bank) (FCNR-B) accounts. NRIs grabbed the opportunity and pumped in $34 billion swiftly to India. The RBI achieved its objective of shoring up the value of the rupee vis-à-vis the dollar and the forex market stabilised.

The time is opportune to analyse two issues: the scope and the implications of the swap window; and the way forward. Looking at the scope of the scheme first, banks conducted dollar–rupee swaps with the RBI at an annualised premium of 3.5% against the then prevailing market rate of 8.5%. The RBI thus absorbed a stunningly large loss of 15% in

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three years. The swap window also offered a free arbitrage opportunity to NRIs who borrowed dollars cheaply overseas, deposited these in the special FCNR-B scheme at a higher rate and pocketed the interest rate differential. It was money for jam! Which NRI would let go a central bank-sponsored arbitrage opportunity to earn big bucks? There was guaranteed return on investments, no taxes to be paid, no exchange rate risks to be borne and the funds were freely repatriable. These funds were leveraged manifold, thereby straining the RBI's coffers further. In every respect, this scheme was nothing short of a fiscal fiasco aimed at garnering hot and unstable dollars. Mercifully, the RBI's swap window closed on 30 November 2013. Otherwise, India would have been flooded with more dollars and faced with an imminent fiscal ruin.

Now, the way ahead: the special FCNR-B deposits are going to mature shortly. It will be prudent on the part of our policymakers to allow this $34 billion to flow out of the country as swiftly as possible. High-cost, hot money must be discarded. In any event, these outflows would hardly impact the market. Nor would these deplete forex reserves. The RBI had already covered its position while mobilising the funds three years ago. Now the RBI would simply take delivery of dollars from the international forex market, add these to its reserves and sell the dollars to commercial banks at the contracted 3.5% rate of annualised swap premium. Banks, in turn, would then remit the funds to NRI depositors towards redemption of these FCNR-B deposits. In other words, the country's forex reserves will remain the same and there will be no market volatility either.

Two concerns, however, remain. One, there would be some mismatch of maturities between RBI's forward purchase in the international market and redemption of the FCNR-B deposits. This would entail an additional swap risk for RBI. Two, banks would have to bear an exchange risk for interest payment on special FCNR-B deposits. However, any prudent banker would have already covered her or his position since the date of interest payments were predetermined.

The more important point to note is that the RBI's 2013 swap window has been nothing short of a rip-off. Former RBI Governor Raghuram Rajan condemned the scheme before demitting office. It appears that he was faced with a fait accompli when he joined the RBI as its governor on 4 September 2013. The swap window simply revived the earlier FCNR-A (Foreign Currency Non-Resident Account) deposit scheme that had been discarded 19 years ago. In 1994, the FCNR-A scheme was replaced by FCNR-B, shifting the exchange risk from the RBI to banks. The FCNR-A scheme had hit the RBI with a massive fiscal blow.

In the open-ended FCNR-A scheme, lasting through the 1980s, the RBI continued to absorb the entire dollar–rupee exchange risk, that is, till 1994 when it woke up from its slumber to stop the leakage from its coffers. By then, an irreparable fiscal injury had been caused to the RBI. This was a massive policy failure. In an environment when the rupee continued to depreciate against the dollar for a decade, absorbing the dollar–rupee exchange forward premium meant that the RBI was taking the fiscal hit on itself and the country paid a stiff

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price. Why a discarded, abandoned and condemned scheme was revived defies logic.

Current RBI Governor Urjit Patel must now better target swap deals in international forex markets. With India's forex portfolio (assets and liabilities) expected to hover around a trillion dollars in a couple of years from now, the RBI may now consider participating aggressively in currency markets abroad. Instead of hurting itself in a premediated manner, the RBI must swap and switch currencies in an attempt to earn extra dollars with a defined loss absorption limit. Commercial banks in India have talented experts in this area who may be inducted into the RBI's dealing room in order to achieve this objective.

In a free foreign exchange market, the forward delivery of a currency yielding a higher rate of interest will always be at a discount. This offers arbitrage opportunities which the RBI itself must explore and avail of instead of allowing NRIs to arbitrage at its expense. With a $2 trillion economy and record forex reserves of $371 billion, it is about time the RBI modified its risk-averse policy of swapping and switching currencies internationally. Given the challenges that are involved in conducting such activities these have to be done under the guidance of experts. The Ministry of Finance has no such expertise. The RBI must act on its own without involving the government. By following forex trading patterns that combine caution with aggression, the central bank could improve the country's fiscal situation.

Patel must refrain from succumbing to international pressures to weaken the rupee. Rajan resisted these pressures valiantly. Under Rajan's stewardship of the RBI, the rupee stabilised and forex reserves were bolstered. Governor Patel surely knows that India has in the past given in to international pressures to artificially depress the external value of the rupee. On 6 June 1966, the Indira Gandhi government which had as Finance Minister Sachin Chaudhuri, a lawyer by profession, succumbed to US pressure and devalued the rupee by a hefty 35%. Many believe the former Finance Minister T T Krishnamachari had to be sacked since he had stoutly resisted American pressure.

Subsequently, in 1981, the rupee's free fall was hastened with the International Monetary Fund (IMF) sanctioning its biggest ever 5 billion SDR (special drawing rights) loan to India. The country's economic sovereignty was subjugated to the IMF. When the Foreign Exchange Management Act 1999 (FEMA) was notified on 1 June 2000, the proviso to Section 6(2) read that "provided that Reserve Bank shall not impose any restriction on the drawal of foreign exchange payments due on account of amortisation of loans or for depreciation of direct investments in the ordinary course of business". Mark the words, "depreciation of direct investments." This simply means: depreciation of the rupee. Even Parliament had to enact a law recognising depreciation of the rupee. Indeed, the Indian rupee is perhaps among the few currencies in the world whose value has invariably travelled southwards with the notable exception of the period between 2013 and 2016 when Rajan headed the RBI.

Even Section 40 of the RBI Act 1934 still mentions "obligations to International Monetary

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Fund” as a factor to determine rupee’s exchange rate. I am inclined to believe that Rajan’s term as RBI Governor was not extended because of his firm stand not to weaken the rupee despite the pressures that came on him. It is not surprising that calls to depreciate the rupee have resurfaced soon after Rajan’s exit. On 18 September, Swaminathan S Anklesaria Aiyar wrote in the *Times of India* that if the “rupee drifts down, RBI should smile and do nothing.” With great respect to the learned author, I disagree with his views vehemently.

The depreciation of the rupee would fuel inflation and exporters would defer repatriating export proceeds if they can earn extra bucks by just waiting and doing nothing. The forward premia on dollar–rupee swaps would soar and servicing external commercial borrowing would become expensive. A weakening rupee will also diminish dollar returns to a foreign investor and would dampen the investment climate in India. It is a time-tested proposition in India that exports cannot be given a boost by fiscal incentives alone. The government must accept its failures to boost exports and should not shift its responsibility on the RBI. The RBI must be given credit for stabilising the rupee. The government is, in any case, empowered to offer fiscal incentives to exporters which it does.

As already argued, the redemption of $34 billion of FCNR-B special deposits will be an outflow of hot money and will not adversely impact the country’s economy. The biggest challenge now is to continue the policy followed by the RBI under Rajan to stabilise the rupee, not depreciate it. Patel’s actions in this regard will be closely watched.