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India: too much of a good thing?

- **We expect the announcement of the early closure of RBI's swap facility to weigh on the INR. The significant capital inflows generated by the facility are needed to offset the weight on the currency coming from the extended closure of the Strait of Hormuz as well as weak monsoons and a potential super El Niño event.**

- **Allowing for current account, oil price and trade data to date as well as assuming the high end of our estimates for capital inflows from the RBI's swap facility as well as tax and ownership changes to foreign holdings of Indian equities and government bonds, USD/INR's long-term fair value ranges around 93-101 vs 89-96 in our initial estimates. We are keeping our forecast for USD/INR to remained capped around 96.00 in H226.**

- **Data so far suggests that RBI is only modestly unwinding its forward using capital inflows, it is early days, however. In the unlikely event that RBI is not using the inflows to unwind its forward book, the estimated long-term fair value range for USD/INR falls to around 93-100. If RBI unwinds its entire forward book using the capital inflows the estimated fair value range rises to about 94-101. If only the forwards with tenors less than 12M are unwound by RBI, USD/INR's fair value range is around 97-100.50**

- **The swap facility could form a new lever for RBI to infrequently intervene in FX markets to support the INR. But we are yet to see if this is a cost-effective way of supporting the currency. We do not think it will be and therefore think it will be used sparingly if at all by the central bank.**

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An early end to RBI's swap facility

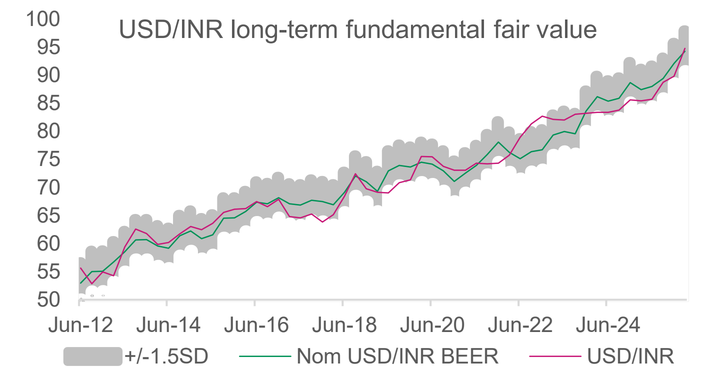
In a surprise move, RBI announced late on Friday 14 August that it will be closing its FX swap facility for attracting USD deposits from NRIs a month early. The facility will close on 31 August and was open on 8 June. The announcement came a week and a half after RBI Governor Sanjay Malhotra said there were no plans to close the facility early when answering a question on the facility at the RBI's post-monetary policy decision press conference. So, the announcement has caught the market off guard.

The response to the facility has likely surprised RBI to the upside, and that is probably the reason the central bank is closing the facility early. According to the central bank, the swap facility has attracted USD52.3bn in foreign currency deposits from NRIs and, adding in external commercial borrowings, the total inflow is USD56.85bn. There will be a rush of inflows in the coming weeks to take advantage of the facility while it remains open, potentially pushing aggregate inflows to around the USD70bn mark. The size of these inflows will depend heavily on the ability of local banks to process the transactions.

USD/INR's long-term fair value: still too early to tell

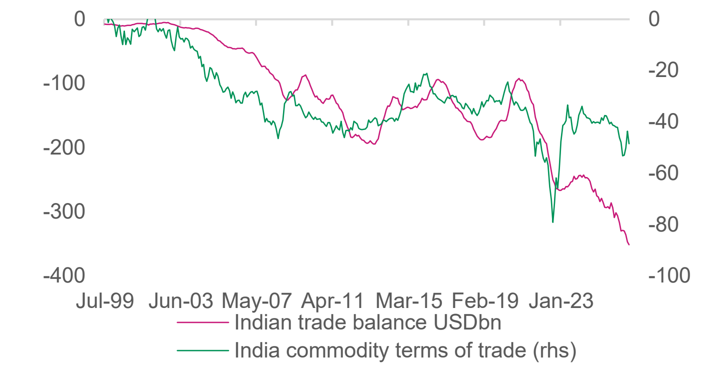
In India: plugging the current account hole & our forecasts, we estimated the long-term fair value of USD/INR to be in the range of 89-96 using our BEER model. We therefore forecast RBI's swap facility as well as changes to the taxes and foreign ownership regulations on Indian equities and government bonds to USD/INR at around 96 (Figure 1).

8Fig 1. USD/INR still trading within its long-term fair value range



Source: Bloomberg, Crédit Agricole CIB

Fig 2. Persistently high energy prices are weighing on India's trade balance…



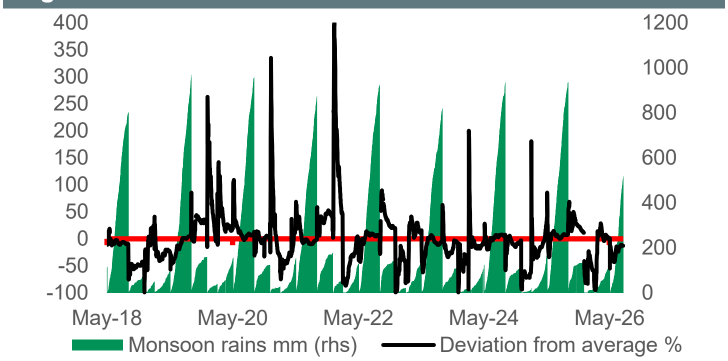
Source: CEIC, Crédit Agricole CIB

We made several assumptions when making this estimate:

1. **India's current account deficit:** the closure of the Strait of Hormuz will add 2% of GDP to India's current account deficit in 2026/2027. This assumption was based on higher prices for India's imports including oil, LPG, fertiliser and organic chemicals as well as some loss of exports.

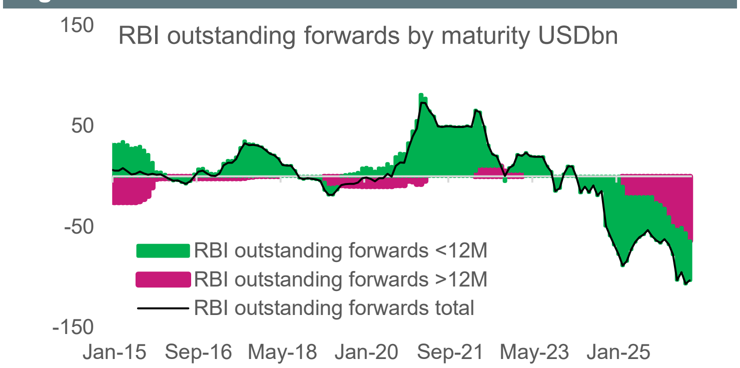
   The amount the closure of the Strait of Hormuz will add to India's current account deficit looks, if anything, to be a bit of an underestimate at this time (Figure 2). While we acknowledge India's effective re-routing of some of its exports and reduction in energy imports is limiting the impact of the closure on its trade balance, the closure looks like it will longer than we anticipated. We had expected a resolution to the crisis before the US's summer driving season. The weak monsoons will also weaken India's agricultural goods trade balance (Figure 3).

Fig 3. …so too is a weak monsoon season



Source: Bloomberg, Crédit Agricole CIB

Fig 4. RBI still has a substantial forward book to unwind



Source: CEIC, Crédit Agricole CIB

2. **RBI's unwinding of its forward book:** we assumed that RBI would use the capital inflows from the swap facility as well as changes to the tax and foreign ownerships regulations on Indian equities and that government bonds would be used to unwind the central bank's sizeable forward book with tenors of 12M or less.

   In June, RBI's outstanding forward book has fallen by USD3.3bn (Figure 4). While forwards with tenors less than 12M have declined by USD11.5bn to USD39.1bn, forwards with tenors over 12M have risen by USD8.1bn to USD64.2bn. It is yet to be seen if RBI increases the rate of unwinding of its forwards, especially during July and when the rate of capital inflows likely accelerated.

   In the unlikely event that RBI is not using the inflows to unwind its forward book, the estimated long-term fair value range for USD/INR falls to 93-100. If RBI unwinds its entire forward book using the capital inflows the estimated fair value range rises to 94-101. The unwinding of forwards with tenors less than 12M places the long-term fair value range of USD/INR around 97-100.50.

3. **Capital inflows:** we assumed a range for capital inflows from RBI's swap facility as well as foreign tax and ownership changes would lead to USD95-130bn in capital inflows. Within these inflows we assumed the swap facility by itself would generate USD40-60bn and the tax and foreign ownership changes to generate USD45-50bn in capital inflows.

   We do not know how effective the tax and foreign ownership changes have been in generating capital inflows. Portfolio flow data for the month of June is not yet available. But we do know RBI's swap facility has been highly effective and will likely end up attracting about USD70bn in inflows, even with the facility closing a month early. This is a bit higher than the range of our assumed range of USD40-60bn.

   Allowing for current account, oil price and trade data to date as well as now assuming the high end of our estimates for capital inflows given the strong response to RBI's swap facility, USD/INR's long-term fair value varies between about 93-101 (the bold numbers in Figure 3). We are therefore keeping our forecast for USD/INR to remained capped around 96.00 in H226.

Fig 5. Scenario analysis for USD/INR fair values based on capital inflows & the RBI's forward book unwind

	Low	Average	High	Low	Average	High	Low	Average	High
Estimated capital inflows USDbn	95	113	130	95	113	130	95	113	130
RBI unwind of forwards USDbn	0	0	0	-44.6	-44.6	-44.6	-95.3	-95.3	-95.3
Net capital inflow less RBI unwind USDbn	95	113	130	50.4	68.4	85.4	-0.3	17.7	34.7
Net capital inflow less RBI unwind % GDP	0.6%	0.7%	0.8%	0.3%	0.4%	0.6%	0.0%	0.1%	0.2%
USD/INR fair value	96.77	96.56	**96.35**	97.32	97.10	**96.89**	97.94	97.51	**97.72**
USD/INR fair value +1.5SD	100.36	100.14	**99.93**	100.90	100.68	**100.48**	101.52	101.09	**101.30**
USD/INR fair value -1.5SD	93.19	92.97	**92.76**	93.73	93.51	**93.31**	94.35	93.92	**94.13**

Source: Crédit Agricole CIB, RBI

A new instrument of intervention?

RBI's swap facility has been highly effective in attracting capital inflows and supporting the INR. But this facility comes at a cost to the central bank. RBI absorbs the currency hedging costs on the 3-5Y foreign currency deposits. This cost will depend on the prevailing exchange rate and forward premium at the time of the swaps' executions and may not be known for some time as they form a contingent forward liability. The cost will also depend on the ultimate amount of swap transactions that go through. These costs likely make the swap facility an expensive way to intervene in FX markets relative to FX intervention in spot and forward markets. So, we think the facility will be used sparingly if at all by the central bank.

Conclusions

We expect the announcement of the early closure of RBI's swap facility to weigh on the INR. The significant capital inflows generated by the facility are needed to offset the weight on the currency coming from the extended closure of the Strait of Hormuz as well as weak monsoons and a potential super El Nino event.

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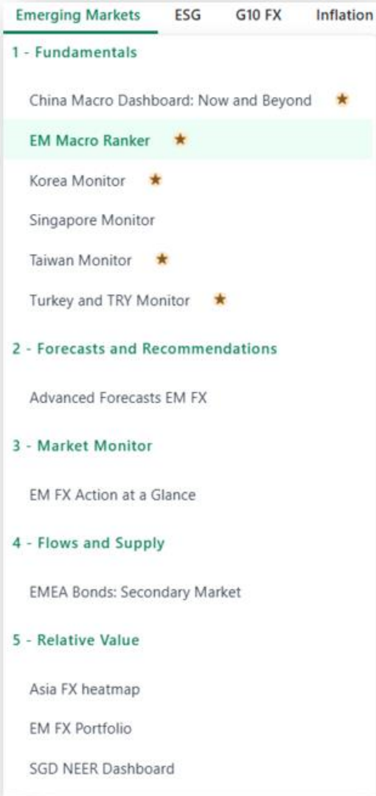

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Source: RMA by Crédit Agricole CIB

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