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RBI has enough to fight Fed-induced volatility

RBI has forex reserves of \$352 billion

Anup Roy | Mumbai
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Reserve Bank of India Governor Raghuram Rajan's assertion that the central bank was prepared to fight any eventuality arising out of a [US Federal Reserve interest rate](#) decision has soothed the market but investors are not sure how much volatility to expect. Everyone agrees, though, that [RBI](#) will not have to resort to sudden control measures, like those taken in 2013, to force bond yields to come down.

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In response to the rupee's sharp fall against the dollar and bond yields spiking, the [RBI](#) had in 2013 restricted banks' ability to take positions in the currency market and drained liquidity from the system. Bond yields shot up in July and the [rupee](#) depreciated to its lifetime low of 68.85 a dollar in August 2013.

RBI's toolkit includes intervention in the currency market, yield management, and liquidity management. Questions remain whether the central bank's intervention in the currency market will send out an exchange rate signal and how much [RBI](#) will have to spend on currency volatility.

REGULATOR IN ACTION

- [RBI](#) has forex reserves of \$352 billion
- Regularly intervenes in spot and forwards markets and has started intervening in the futures market

- Can use OMO to bring down bond yields
- Can also open liquidity facilities for [banks](#) to borrow money
- [RBI](#) might go for further rate cuts once volatility settles

[RBI](#) has built up formidable foreign exchange reserves, which at \$352 billion are adequate for seven and a half months of imports. This will still leave \$12-15 billion for intervention in the currency market, good enough to manage volatility, if not protect a level.

"Excessive currency volatility entails large systemic costs, compared to the costs of intervening in select segments," said Saugata Bhattacharya, chief economist at Axis Bank.

[RBI](#) regularly intervenes in the currency market to ease volatility. In October, it bought \$7 billion in the spot market and sold \$5 billion. The outstanding net forwards position at the end of October was \$2.5 billion. The central bank also sold \$355 million in the futures market in September.

"Sharp currency depreciations, if unchecked, trigger stop losses and margin calls, resulting in market overshoots and forced liquidation, thereby aggravating the fall," Bhattacharya said.

By selling dollars [RBI](#) will have to buy an equivalent amount of rupees and that could lead to a further liquidity squeeze. The market is short of at least Rs 90,000 crore liquidity. [RBI](#) could purchase bonds from the secondary market under its open market operations and improve liquidity.

This also sends a yield signal and the bond market usually picks up the indication promptly. Further, liquidity can be smoothened by extraordinary measures like increasing the limit on how much [banks](#) can borrow from the central bank and by conducting more term repos.

However, market participants expect volatility to end in about a week or two, depending on the Fed tone. Once the global markets settle down, Indian assets will regain strength.

"If there is volatility for 10 days and global markets settle down and commodity prices continue to remain soft, it will not be surprising if the [RBI](#) cuts its rates even before the next scheduled policy day," said Jayesh Mehta, head of treasury at Bank of America Merrill Lynch.

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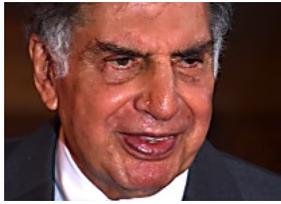
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