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STCI
Primary Dealer Ltd

Macroeconomic Theme: FCNR (B) Deposits & Other Measures

FCNR (B) Deposits-Surfing the Liquidity Wave

Highlights:

- ***The FCNR(B) deposit scheme has seen inflows of USD 127.2 Bn that have been much higher than the expected USD 100 Bn and have caused a problem of plenty for systemic liquidity.***
- ***The dollar inflows translate to INR liquidity of ~₹ 13 lakh crore and now pose a liquidity problem for the central bank as domestic banks swap the USD with RBI and get rupee liquidity to on-lend in the domestic market.***
- ***The INR has struggled to appreciate meaningfully against the USD, despite the strong dollar inflows and, so far, has appreciated only 0.36 per cent since the concessional swap facility was announced.***

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The inflow of foreign capital was substantially higher than expected under the Foreign Currency Non-Resident (Banks) FCNR(B) scheme, with the concessional FX swap facility offered by RBI to the banks. This measure to attract foreign capital was taken against the macroeconomic backdrop of significant capital outflows due to global uncertainty caused by trade barriers and war. FY2025-26 is the first year since FY2000-2001, when the economy witnessed negative net foreign investment of USD 11.1 Bn. The trend has continued in Q1 FY2026-27 and is not expected to improve in the next two quarters as global conditions remain fickle, with crude oil prices crossing the USD 100 per barrel threshold, while global bond yields are reaching multi-period highs. While the outcome of the swap scheme has been positive, it raises fundamental questions about the need for such capital at a cost to the central bank, as well as the liquidity and long-term impact of such flows.

Attracting capital comes at a cost: For emerging markets, capital flows occupy a crucial function of signaling to the world the relative health of the economy. The macroeconomic reality is that any country spending beyond its means needs to borrow capital from abroad to fund its spending gap (current account deficit or CAD). Since the beginning of FY2025-26, the steep tariffs imposed by the US administration on India, and the conflict in West Asia disrupted the flow of capital and the financial year saw net foreign investment turning negative for the first time since FY2000-2001.

FPIs sold USD 16.6 Bn worth of Indian assets and FDI investments were down to USD 6.7 Bn. The rupee depreciated by ~11 per cent during the period and has been struggling to appreciate even after the FCNR(B) scheme has garnered more dollar capital than expected. The 10Y UST-IGB yield spread has narrowed significantly, and it would take higher rates to attract foreign capital, for which RBI has offered bearing the cost of hedging for banks. This has made it feasible for banks to offer higher rates on fresh FCNR(B) deposits of 3-5Y maturity. A much greater incentive was to allow banks to offer leverage on the same to depositors.

The BoP Angle-Foreign Investment and Banking Capital: Since investment capital, or capital tied to market returns i.e. foreign portfolio investment (FPI) and foreign direct investment (FDI) was envisaged to be harder to come by in the current scenario of continued global uncertainty, and rising advanced economy interest rates, RBI implemented a slew of measures to attract foreign capital. Banks were incentivized to raise fresh foreign currency deposits, with RBI bearing the hedging cost, i.e. the forward premium, and allowing the leverage of these deposits for non-resident depositors to place them as collateral for loans. In terms of accounting, external liabilities will increase for India, and in Balance of Payments (BoP) terms capital account flows will be larger to the extent for Q1 and Q2.

Unlike the 2013 Taper Tantrum episode, India is no longer a part of the Fragile Five, and we expect a CAD of 1.5-2 per cent for FY2026-27 despite the global trade and geopolitical headwinds. The USD 127 Bn flows could lead to a surplus on the capital account of USD 60-70 Bn by the end of the year, with an estimated CAD of USD 48-55 Bn contingent on crude oil prices and the commodity matrix.

FX Reserves: As banks swapped the dollars for rupees with RBI, foreign currency reserves rose by USD 55-60 Bn to USD 741 Bn as on 28th August 2026, i.e. near the end of the scheme from a pre-FCNR(B) level of USD 682 Bn as on 5th June 2026. Revaluation effects would be moderate for now, as USD/INR has appreciated by 0.3-0.4 per cent during the period. The largest channel of foreign capital remains the FCNR(B) deposits, with 93 per cent of the inflows in non-resident deposits as opposed to foreign currency borrowings. Since the deposit inflow was faster and larger than RBI's estimates, RBI had announced a premature closure of the scheme on 31st August, as against 30th September 2026 specifically for the FCNR(B) deposits.

Liquidity Management: The rupee liquidity impact has been significant as the inflows of USD 127 Bn, assuming all the dollars have been swapped by now with the RBI for rupees, would translate to an injection of ~₹13 lakh crore into the domestic banking system liquidity. While a liquidity surge was expected by RBI, the magnitude of flows seems to have been underestimated, taking a cue from the premature closure of the FCNR(B) concessional swap facility. The systemic liquidity surplus has ballooned from ₹ 0.85 lakh crore on 1st June 2026, to a record high of ₹ 10.7 lakh crore as on 4th September 2026. Core liquidity is estimated to be around ₹ 13-14 lakh crore, adding the notable cash surplus that the Government is holding. Money market rates show a disconnect due to the huge liquidity surplus. While the operating target Weighted Average Call Rate (WACR) fell briefly below the SDF rate, the market repo and TREPS rates have shown the full impact of the wave of liquidity with the rates hovering near 4 per cent creating an arbitrage opportunity for money market borrowers to borrow in these instruments and lend it to RBI at a rate close to the repo rate, or 5.24 per cent at the VRRR variable rate auction.

Chart 1: The Liqudity Wave (₹ Lakh Crore)

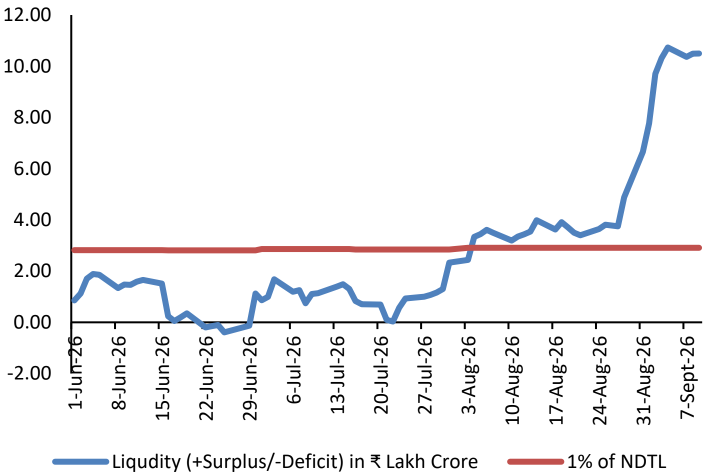
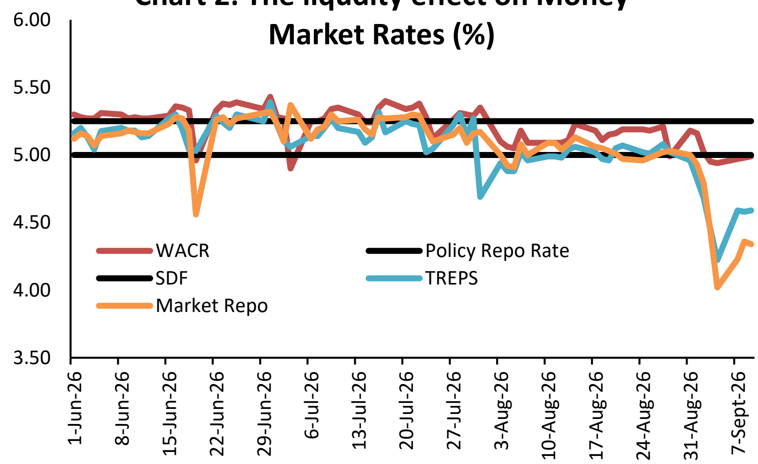


Chart 2: The liqudity effect on Money Market Rates (%)



Source:RBI, CCIL

The behavior of interest rates: The steep fall in money market rates, especially the WACR, should be a cause of concern for RBI and it might enter a phase of monetary tightening soon. As global and domestic price turbulence feeds into the growth-inflation dynamics, the possibility of an interest rate hike seems closer. Tracking the turn of events as markets interpreted the August MPC policy meeting as a dovish outcome, while the MPC minutes for the same meeting were seen as hawkish, and the rise in G-sec yields indicate an expectation for the monetary tightening going ahead. Hence it becomes imperative to tackle the excess liquidity problem. So far, RBI has been inclined to correct the situation by conducting longer tenor (30 and 26 day) VRRRs, with an option for premature withdrawal of funds, although the market response has been lackluster with banks preferring to park excess funds in the SDF and overnight VRRRs.

Possible Solutions to the Problem: While RBI can use multiple tools to withdraw excess liquidity from the banking system, an increase in the Cash Reserve Ratio (CRR) or an Incremental Cash Reserve Ratio for that matter, appear to be not only counterintuitive but also counterproductive as the deposits raised after 8th June 2026 under the FCNR (B) scheme are completely exempt from any CRR or SLR maintenance, as per RBI's circulars. Moreover, a blanket CRR hike would be punitive to banks which have not raised these deposits or raised them in a much smaller measure. In our view, an MSS-CMB could be an optimal solution to absorb the excess liquidity as was done previously during the 2016 Demonetization exercise to neutralize the surge in deposits banks were receiving.

While it would mean getting the go-ahead from the Union Government, as the exchequer bears the interest payment cost under MSS, this seems to be the least disruptive method. While other short term and durable methods are also in RBI's tool kit, such as the VRRRs of variable maturity with the optionality of premature withdrawals, and OMO sales which is the traditional measure to sterilize RBI's currency interventions, the sequence of implementing these methods will matter as the economy enters the busy season, with a natural strain on liquidity expected owing to the seasonal/festive currency demands and tax outflows. The case of using part of the robust dollar inflows to extinguish some of the outstanding short forward foreign currency positions in time will also help in alleviating the excess liquidity to an extent.

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