



India’s external current account deficit (CAD) remains manageable. However, net capital inflows dried up during the last two years, resulting in the RBI losing foreign exchange reserves. The problem was compounded by the US-Iran war since February 28, 2026. Short-term initiatives by the government and the RBI, including reduction of special excise duties on petrol and diesel, liberalisation of external commercial borrowings (ECBs), reduction of net open position by authorised dealers (ADs) and interventions in the forex market, were not enough to arrest the rupee’s depreciation. Both the RBI and government announced a slew of measures on June 5, for further liberalisation of capital account transactions, including limited period offer for dollar mobilisation under special swap schemes.

The RBI made the swap schemes attractive for banks to raise fresh FCNR(B) deposits and swap the foreign currency with the RBI for rupees on a fully hedged basis. Moreover, the RBI exempted these deposits from CRR, SLR, PSL requirements, removed the interest rate ceiling and allowed leveraging against primary dollar deposits, which enabled banks to offer better rates to NRIs.

The RBI wanted dollars. It got so much that it closed its special FCNR(B) swap window a month ahead of the original deadline. By August 31, banks reported \$136.37 billion in forex inflows

under the dollar-rupee forex swap facility, of which \$127.23 billion came through FCNR(B) deposits. The experiment was highly successful, surpassing all previous such attempts. The rationale for the dollar hunt was straightforward. A stronger foreign-exchange position gives the RBI more room to deal with pressure on the rupee and provides a cushion against external shocks. Foreign portfolio flows can be volatile, while other stable sources of foreign capital were not coming in quickly enough. FCNR(B) deposits offered a relatively quick way to bring in foreign currency, although at a cost.

AFTER THE SWAP
The more interesting part of the story begins after the swap. The dollars went to the RBI, and equivalent rupees credited to banks. Those rupees can be lent, invested, and used to repay liabilities with a time lag or can be simply parked with the RBI. The RBI data showed a net liquidity absorption of around ₹11 trillion through its LAF window on September 15, 2026. The RBI’s dollar deluge has, rather unexpectedly, created another liquidity challenge, managing excess liquidity that came with it. The scale makes the problem harder to ignore. The question is no longer simply whether the RBI should absorb the liquidity. It is how much to absorb, for how long and through which instrument.

The first task of the RBI should be to determine how much of the surplus is temporary and how much is likely to persist

The RBI has several options, but each comes with its own trade-offs. The variable rate reverse repo (VRRR) is the most straightforward short-term tool that aligns well with the policy rate. It absorbs surplus funds for a specified period without permanently changing banks’ balance sheets. That makes it useful when liquidity is temporary. If the surplus persists, the RBI will have to keep on rolling over the huge amount under short term VRRR operations. The RBI also went for long term VRRR, but there was a lukewarm response from banks.

Standing deposit facility (SDF) gives banks a safe place to park excess cash with the RBI, but at 25 basis points below the repo rate. As the situation is exceptional, the RBI has the option to temporarily suspend daily fine-tuning, widen the corridor by reducing SDF rate to 3.5 per cent. This will not only activate defunct fixed rate reverse repo but also encourage banks to invest these funds in G-secs until demand for credit picks up. As a result, the benchmark yield may remain under 7 per cent. The RBI may have to tolerate the call rate softening below the repo rate for a while. Banks, reluctant to participate in long-term VRRR or refraining from investment in G-secs, must bear the loss compared to interest offered on deposits.

Option for a hike in CRR does not exist. While CRR is exempted on FNNR(B) deposit, a system-wide increase in CRR would be blunt and could affect banks unrelated to the FCNR(B) inflows. A temporary incremental CRR on the additional deposits mobilised under the swap scheme could violate the very exemption given to such deposits.

The OMO (open market operations) sales can absorb liquidity more durably, but large government bond sales can

push yields higher and raise borrowing costs. The RBI has gone for such option and announced ₹1 trillion OMO sales during September 2026. This is not enough, given the size of liquidity surplus. India also has a history of selling G-secs under Market Stabilisation Scheme (MSS) to deal with large and persistent liquidity arising from capital inflows. On a burden sharing principle, the government should agree as the RBI has already absorbed costs related to swap and VRRR.

Outright forex interventions or FX sell-buy swaps offer another route, allowing the RBI to manage foreign exchange positions and rupee liquidity better. Banks may not buy dollars as their NOP (net open position) is limited to \$100 million only. However, banks can buy it on behalf of their customers like oil marketing companies, without violating the NOP guidelines.

The larger point is that absorbing a surplus of this size involves trade-offs. Every instrument has a cost, whether it is paid by the RBI, banks, government, or the bond market. The real choice is which cost is easier to absorb. The RBI should therefore not try to sterilise every rupee simply because it has entered the system.

Some liquidity will naturally move into credit and investments sooner or later. The first task should be to determine how much of the surplus is temporary and how much is likely to persist. In the near term, a combination of 14-day VRRR and SDF can manage the immediate surplus, supplemented by longer-tenor VRRR. If a sizeable portion proves durable, OMO sales, sell-buy forex swap, and eventually G-sec sales under MSS could come into play.

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