General Studies-3; Topic: Resource Mobilization

India's Forex Reserves

1) Introduction

- Foreign exchange (forex) reserves with the Reserve Bank of India (RBI) had recently crossed the $400-billion mark.
- The pace of reserve accretion has been one of the strongest within Asia in the past 12 months
- The rise in foreign exchange reserves comes as yield-hungry global investors take advantage of high real rates of interest and a strong rupee.

2) Reasons behind surge in forex reserves

- **Rise in capital flows**
  a. The Gross FDI inflows to India increased significantly in 2016-17
- **Low credit takeoff**
  a. As per the Economic Survey 2016-17 demonetisation had an impact on the credit takeoff
  b. The average gross bank credit to industry contracted by 0.2 per cent in 2016-17.
- **Narrowing Current Account Deficit**
  a. CAD narrowed down progressively to 0.7% of GDP in 2016-17 from 1.1% of GDP in 2015-16.
- **Narrowing trade deficit**
  a. India's exports turned positive at 12.3% in 2016-17 after an interregnum of two years.
- **Favourable BoP**
  a. India's balance of payments (BoP) situation improved in 2016-17
  b. This was largely as a result of low trade and CAD and rising capital inflows.

3) Benefits

- The ability to absorb shocks from external sources and the volatility in the global economy will increase.
- The 'excess reserves' can be utilized for undertaking currency swaps and extending lines of credit.
- Contribution to the multilateral bodies like the International Monetary Fund (IMF) will help India in deepening soft power.
- The surge in forex reserves will lead to an appreciation of the value of the rupee which will help India in reducing the import bill.
- The special drawing rights with the International Monetary Fund (IMF) with go up.
- The ratio of external debt to GDP fell
- RBI accumulated reserves at an accelerated pace between 2006 and early 2008, which helped India deal with the consequences of the 2008 global financial crisis.
- Rising reserves will reduce the currency risk for foreign investors.

4) Drawbacks

- The opportunity cost of reserves holding is high for the RBI,
- The appreciation of the rupee is likely to have an adverse impact on India's exports, more specifically on the 'invisibles'
- Excess liquidity would create challenges for the RBI to manage its monetary policy.
- Mopping up liquidity through a sale of government securities will affect the central bank's earnings and will have fiscal implications.

5) **Arguments to cut down forex reserves**

- There is a tendency to keep forex reserves equal to the value of six months of imports.
- Foreign exchange reserves are required to finance only the current account deficits, and not imports as a whole.
- By this yardstick, the foreign exchange reserves with the RBI are huge.
- If we take current account deficit at 7.5% of GDP, then there is a need of about $85 billion of foreign exchange reserves.
- At the end of March, foreign exchange reserves were equal to 78.4% of India's total external debt. This is a very large proportion.
- The proposal to cut down foreign exchange reserves had been put forward earlier by the Planning Commission in 2004-05.

6) **Way Forward**

- Given the lack of space on the monetary and fiscal front to support economic growth, part of the forex reserves can be used to support GDP
- If the funds are used to finance infrastructure projects, the returns will be much higher
- India can buy an inexpensive credit line from IMF or elsewhere which gives India the right to borrow if a crisis situation arise in future.
- Re-capitalisation of public sector banks, investment in overseas financial markets or repayment of costly external debt.
- RBI should devise methods to calculate the optimum level of forex reserves that India should maintain taking in view the short-term and long-term exigencies.