High Forex Reserves

Why in News

As per the **Reserve Bank of India (RBI)** data, India's foreign exchange (forex) reserves touched a record high of USD 541.431 billion in the week ended 28th August 2020.

Key Points

- **Forex Reserves:**
  - **Definition:** Foreign exchange reserves are assets denominated in a foreign currency that are held on reserve by a central bank. These may include foreign currencies, bonds, treasury bills and other government securities.
  - **Objectives Behind Holding Forex Reserves:**
    - Supporting and maintaining **confidence in the policies for monetary and exchange rate management**
    - Provides the capacity to intervene in **support of the national or union currency.**
    - **Limits external vulnerability** by maintaining foreign currency liquidity to absorb shocks during times of crisis or when access to borrowing is curtailed.
  - **Forex Reserves in India:** Forex reserves are external assets accumulated by India and controlled by the RBI in the form of:
    - **Gold**
    - **SDRs** (special drawing rights of the **International Monetary Fund** - IMF)
    - **Foreign currency assets** (capital inflows to the capital markets, Foreign Direct Investment and external commercial borrowings)
    - **Reserve Position with IMF**
  - **Forex Reserves Storage:** The **RBI Act, 1934** provides the **legal framework for deployment of reserves in different foreign currency assets and gold** within the broad parameters of currencies, instruments, and issuers.
- **Reasons for High Forex Reserves:**
  - Rise in investment by **foreign portfolio investors and** increased foreign direct investments **(FDIs).**
    - The sharp jump in reserves started with the Finance Ministry’s announcement in 2019, **cutting** corporate tax **rates.**
  - **Fall in crude oil prices** has brought down the oil import bill, saving precious foreign exchange.
  - **Dollar outflow** from **overseas remittances and foreign travels** have fallen steeply.
- **Significance of rising forex reserves:**
  - **Comfortable Position for the Government:** The rising forex reserves give **comfort** to the government and the RBI in managing India’s **external and internal financial issues** at a time of **major contraction (23.9%) in economic growth.**

- **Managing Crisis:** It serves as a **cushion in the event of a** Balance of Payment (BoP) **crisis** on the economic front.
    - It is **enough to cover the import bill** of the country for a year.
    - Assist the government in meeting its **foreign exchange needs and external debt obligations.**
- **Rupee Appreciation:** The rising reserves have also helped the **rupee to strengthen against the dollar.**
- **Confidence in Market:** Reserves will provide a level of **confidence to markets and investors** that a country can meet its external obligations

Using Forex for Infrastructure

- **Arguments in Favour:** There was a demand from some quarters that forex reserves should be used for infrastructure and other development needs in the country because of:
    - **Adequate Forex Reserves:** Sufficiency of forex reserves is sometimes measured on how many months' worth of imports can a country afford. Six months is the safer limit and at present reserve is sufficient for the whole year.
    - **Adequate Contingency Arrangement**: In case of a credit shock, India can mitigate any balance of payment crisis situation, as there are sufficient arrangements for foreign exchange reserves in the form of a credit line from the IMF and many central bank **liquidity swap agreements** with countries like Japan.
    - **Leveraging Forex as a Last Resort:** Tax revenues, in this fiscal year, will be affected by lower-than-expected economic activity. Also, non-tax revenue will remain subdued as the RBI has already given a huge dividend payment to the government in 2019.
        - Thus, the lack of considerable space both on the monetary and fiscal front to support economic growth, part of the country's forex reserves can be used for stimulating the economy.
- **Arguments Against:** The RBI had opposed the plan. Reasons may include the considerations of:
    - **Oil Price unpredictability:** Current low crude oil prices are due to several issues, one such is the **price war between Russia and Suadi Arabia.** As soon as a common ground is agreed between the two, the crude prices will tend to rise again.
    - **Unreliable Portfolio Investments:** Another issue is the high ratio of volatile flows (portfolio flows and short-term debt) to reserves which is around 80%. This money can exit at a fast pace. FIIs by their nature are investments based on speculation.
        - Therefore, the current surge in forex reserves should not be treated of permanent nature.
        - In March 2020 alone, foreign institutional investments in India fell by Rs. 65,000 crore.
    - **Confidence of High Forex:** High forex reserves also help India to maintain its global rating, especially in the context of falling GDP growth rate.
        - The depletion in forex reserves may have a negative impact on these ratings, which in turn may reduce foreign investment inflows into India.
    - **Volatility in Indian Rupee:** RBI has been fundamentally using India's foreign exchange to ensure rupee stability.

Way Forward

If the government intends to use forex reserves as an emergency fund, it should ensure that they do not shrink just when they are most needed. Apart from it, there is a need for separate attention to carry out structural reforms that can really pull out the Indian economy from persistent slowdown.

Source IE