## Perspective: India's Forex Reserves Hit Record High

**For Prelims**: <u>Reserve bank of India (RBI)</u>, <u>India's Foreign Exchange (Forex) reserves</u>, <u>economic crisis of</u> 1990-91, <u>Balance of Payment</u>, <u>Gold reserves</u>, <u>Special Drawing Rights</u>, <u>International Monetary Fund (IMF)</u>, <u>Appreciation</u>, <u>Depreciation</u>, <u>Foreign Direct Investment</u>

For Mains: Impacts of Liberalization on Indian Forex Reserve and Indian Economy.

#### Why in News?

According to recent data from <u>Reserve bank of India (RBI)</u>, <u>India's Foreign Exchange (Forex)</u> reserves has increased to **USD 655.817 billion.** 

- Also, India's foreign currency assets (FCA), the biggest component of the forex reserves, rose to USD 576.337 billion.
- While the Gold reserves increased to USD 56.982 billion.
- According to RBI, at present India has forex reserve to cover around 11 months of projected imports.

#### What are Foreign Exchange Reserves?

- Foreign exchange reserves are assets held on reserve by a central bank in foreign currencies, which can include <u>bonds</u>, <u>treasury bills</u> and **other** <u>government securities</u>.
- After the <u>economic crisis of 1990-91</u>, the high level committe on <u>Balance of Payment</u> headed by C Rangarajan and Y.V. Reddy recommended that India should have a forex reserve for 12 months import requirements.

#### What are Key Components of the Forex Reserve of India?

- India's Forex Reserve include:
  - Foreign Currency Assets
  - Gold reserves
  - Special Drawing Rights
  - Reserve position with the International Monetary Fund (IMF).
- It should be noted that most foreign exchange reserves are held in US dollars.

#### What is the Purpose of Holding Forex Reserves?

- Usually, forex reserves are required by countries which can not make payments for their imports in their own currencies and need foreign currencies fot this purpose.
- In the case of India, the forex reserve mainly serves the purpose of economic safety by supporting and maintaining confidence in the policies for monetary and exchange rate management.

- Provides the capacity to intervene in support of the national currency.
- Limits external vulnerability by maintaining foreign currency liquidity to absorb shocks during times of crisis or when access to borrowing is curtailed.

#### What are the Significances of Rising Forex Reserve?

- **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.
- Managing Crisis: It serves as a cushion in the event of a Balance of Payment (BoP) crisis on the economic front.
- 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.

#### **Does Every Country Require Forex Reserve?**

 $\prod$ 

- No, every country need not have a forex reserve. Maintaining a forex reserve by a country depends on its purpose.
- In various countries forex reserve is used differently eg. in Singapore they have been used as sovereign wealth funds.
- While in India it is maintained for economic safety with respect to import bills management and exchange rate management for Rupee.
- Countries like the US and UK do not need to have large forex reserves as their currencies are internationally accepted.



#### What are Challenges of Low Forex Reserve?

- Economic crisis: Low forex reserves could trigger a Balance of Payment crisis, as seen in India during 1990-91 and in countries like Sri Lanka in recent years.
- Confidence of investors: Low forex reserve means low investor confidence in a country's economy causing a shift in investments.
- Rising Import Costs: With lower foreign reserves, the country may find it difficult to afford essential imports like crude oil, machinery, and raw materials, potentially causing supply chain disruptions.
- Inflationary Pressures: Low foreign reserves result in a higher demand for dollars, which makes imports more expensive. This increase in import costs can lead to higher prices for goods and services, thereby contributing to overall inflation.

### Foreign Currency Assets (FCA)

- FCAs are assets that are valued based on a currency other than the country's own currency.
- FCA is the largest component of the forex reserve. It is expressed in dollar terms.
- The FCAs include the effect of <u>appreciation</u> or <u>depreciation</u> of non-US units like the euro, pound and yen held in the foreign exchange reserves.

#### **Special Drawing Rights**

- The SDR is an international reserve asset, created by the IMF in 1969 to supplement its member countries' official reserves.
- The SDR is neither a currency nor a claim on the IMF. Rather, it is a potential claim on the freely usable currencies of IMF members. SDRs can be exchanged for these currencies.
- The value of the SDR is calculated from a weighted basket of major currencies, including theUS dollar, the euro, Japanese yen, Chinese yuan, and British pound.
- The interest rate on SDRs or (SDRi) is the interest paid to members on their SDR holdings.

#### **Reserve Position in the International Monetary Fund**

- A reserve tranche position implies a portion of the required quota of currency each member country must provide to the **IMF** that can be utilized for its own purposes.
- The reserve tranche is basically an emergency account that IMF members can access at any time without agreeing to conditions or paying a service fee.

#### Way Forward:

- Increase Exports: Implement policies to boost export competitiveness and reduce dependency on imports.
- Promote FDI: Create a favorable environment for <u>foreign direct investment</u> to bring in stable, long-term capital.
- Boost Domestic Production: Encourage domestic production of essential goods to reduce import dependency and enhance self-reliance.
- Strategic Commodity Reserves: Establish strategic reserves for critical imports like crude oil to buffer against global price volatility.
- Flexible Exchange Rates: Allow for more flexible exchange rate policies to absorb external shocks and reduce pressure on reserves.
- **Transparent Policies:** Adopt transparent and consistent economic policies to build investor confidence.
- Supply Chain Management: Implement advanced supply chain management systems to reduce disruptions and enhance efficiency

### UPSC Civil Services Examination, Previous Year Questions (PYQs)

#### <u>Prelims</u>

# Q1. Which of the following has/have occurred in India after its liberalization of economic policies in 1991? (2017)

- 1. Share of agriculture in GDP increased enormously.
- 2. Share of India's exports in world trade increased.
- 3. FDI inflows increased.
- 4. India's foreign exchange reserves increased enormously.

#### Select the correct answer using the codes given below:

- (a) 1 and 4 only
- (b) 2, 3 and 4 only
- (c) 2 and 3 only
- (d) 1, 2, 3 and 4

Ans: (b)

# Q2. With reference to Balance of Payments, which of the following constitutes/constitute the Current Account? (2014)

- 1. Balance of trade
- 2. Foreign assets
- 3. Balance of invisibles
- 4. Special Drawing Rights

#### Select the correct answer using the code given below:

- (a) 1 only
- (b) 2 and 3
- (c) 1 and 3
- (d) 1, 2 and 4

Ans: (c)

PDF Refernece URL: https://www.drishtiias.com/printpdf/perspective-india-s-forex-reserves-hit-record-high