Perspective: India’s Forex Reserves Hit Record High

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

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

Why in News?

According to recent data from Reserve bank of India (RBI), India's Foreign Exchange (Forex) 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 bonds, treasury bills and **other** government securities.
- After the economic crisis of 1990-91, the **high level committe on** Balance of Payment 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?

- **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.

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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 appreciation **or** depreciation 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 the **US 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 foreign direct investment 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)

Prelims

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)