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OVER-RELIANCE ON FOREX RESERVES IS PROBLEMATIC, NOT USING THEM A LOST OPPORTUNITY

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Foreign Capital, Foreign Trade & BOP

Indian forex reserves have crossed an unprecedented mark — over half trillion US dollars, placing India only behind China and Japan in Asia. And while this may seem like a ray of hope amidst the economic turmoil in the country, one must scrutinise its utility. The issue is not about a "few extra" reserves but unused "excessive" reserves, which may indicate that the Indian government is likely anticipating the need of an enormous economic stimulus and hence, is banking on these reserves to support the failing Indian economy. If so, over-reliance on forex reserves to provide this stimulus may be dangerous and merely keeping reserves parked now is an opportunity lost.

The recent forex reserves surge was a result of two things: A spike in foreign institutional investments and savings in India's import bill. Foreign institutional investors reinvested in the Indian market in May-June after they exited their positions in panic in March. On the other side, a global fall in fuel prices has reduced India's oil import bill, allowing it to save up forex reserves. But why does India keep huge forex reserves despite the government's claim that the "fundamentals" of the economy are strong?

Sufficiency of forex reserves is sometimes measured on how many months' worth of imports a country can afford. While six months is considered sufficient, the RBI in December 2019 said it had enough to sustain for 10 months (the forex reserves were then $0.4 trillion). Today, the cover is 12 months! This is despite having a sufficient credit line from the IMF, should there be a credit shock. It is understandable for oil-rich countries to maintain high forex reserves — a single oil trade hiccup can derail their economy. Economists have theorised that holding high forex reserves is unnecessary — in fact, not using them to finance mega infrastructure projects are lost opportunities — and yet the Indian government has held these reserves in liquid, possibly for its feared D-day.

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Has the Indian government been anticipating an economic hiccup strong enough to derail the Indian economy for some time now? Indeed, excess forex reserves are likely the government's contingency fund, in case the economy suddenly topples. The pandemic has increased the government's insecurity. Another possibility is that the government is accumulating these reserves as "Plan-B" savings should its strategic disinvestment plans fail. Third, forex reserves are also likely a way for India now to maintain its global rating after multiple reductions in its GDP growth estimates.

Last but not least, the fundamental use of India's foreign exchange should be to ensure the Rupee (INR) stability. However, that hasn't been the case. Despite steadily rising reserves, INR fluctuated between 77 and 75 against the US dollar in the last two months, between 71 and 77 in the last three months, and 68 and 77 in the last year. INR has become one of Asia's worst currencies — and the RBI may allow it to devalue further to support its balance sheet, enabling it to transfer a big chunk of its realised profits as dividend to the starving government. With "Atmanirbharta" or "self-sufficiency" in the spotlight, even financing imports is out of the picture.

Neither will they be used to bid INR against other currencies, since investors will not hold INR. Not using forex reserves for their prime purpose despite having them in excess suggests that they are being held for an ulterior motive.

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But if the foreign funds' influx is a plus, over-reliance on these floating funds to stimulate the economy might be poorly informed. The potential of these funds to switch direction should not be underestimated. In March alone, foreign institutional investments in India fell by Rs 65,000 crore (due to the COVID panic). India's foreign exchange reserves registered this impact — they shrunk by $12,577 million over approximately the same period. Reversing the dip, investments went up in May and now in June (both months have added Rs 12-13 thousand crore in FII) with some big corporate deals that restored forex reserves to their early 2020 levels. 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.

This article first appeared in the print edition on July 1, 2020 under the title "An unreliable emergency fund". Jaffrelot is senior research fellow at CERI-Sciences Po/CNRS, Paris, professor of Indian Politics and Sociology at King's India Institute, London. Jumle is a project officer at TRAFFIC WWF India. Views are personal

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