Should India hold $400 billion of forex reserves?

Foreign exchange (forex) reserves with the Reserve Bank of India (RBI) have now crossed the $400-billion mark. This is being celebrated by many people. This column takes a different view.

Suppose a country uses fixed exchange rates. If the demand for foreign exchange is high and the exchange rate cannot be increased to induce a reduction in demand, then the central bank needs to have adequate reserves so that it can supply foreign exchange and meet the excess demand. In contrast, under a flexible exchange rate regime, the price of foreign exchange can adjust to bring about a balance between demand and supply. In this context, foreign exchange reserves are not required under a flexible exchange rate regime.

It is true that under a flexible exchange rate regime, flexibility can give way to considerable volatility in the foreign exchange market. In this case, it helps to have foreign exchange reserves with the central bank. However, this need arises a lot more if the central bank has multiple objectives than in the case where the central bank has adopted inflation targeting. In the latter case, there is less uncertainty for currency markets. The price mechanism works better there and the need for stabilization with forex reserves is less.

The RBI has been using flexible exchange rates since the early 1990s; prior to that it followed a fixed exchange rate regime (which is, in fact, an important reason why there was a balance of payments crisis in 1990-91). Furthermore, it formally adopted inflation targeting in June 2016 (previously the RBI followed multiple indicator approach, which arguably played a role in the events culminating in near-crisis in the currency market in 2013). Given the two important changes in policy regimes, there is no compelling need for the RBI to maintain very large reserves now. This is incidentally true not just of India but most other emerging economies that are similarly placed.

The proposal here to cut down foreign exchange reserves had been put forward earlier by the erstwhile Planning Commission in 2004-05, but it was criticized. The criticism was not always valid. For example, the critique by Arvind Panagariya (now at Columbia University), in his 2008 book, *India: The Emerging Giant*, was actually about the short-run adjustment process involved in shifting from foreign exchange reserves to investments in infrastructure projects rather than about the issue of optimal level of reserves in the long run. These arguments, missed the woods for the trees. It is worth revisiting the proposal.

Often there is a tendency to keep forex reserves equal to the value of six months of imports. However, foreign exchange reserves, as Kaushik Basu (Cornell University) emphasized, 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 (which is extremely high), then there is a need of about $85 billion of foreign exchange reserves. The actual reserves are $400 billion.

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. This is particularly true when short-term debt is only 23.8% of the total debt. There are some difficulties with the concepts used but the essential story that foreign exchange reserves are large relative to the flows of hot money (including the portion of equity investments, which is hot money) remains unchanged—more so if other policies are also adopted.

The ministry of finance (MoF) can, according to Anton Korinek at Johns Hopkins University in a series of papers, impose a tax on capital inflows or outflows, if these are sudden and large. Such a tax can discourage large capital flows; the rupee will then neither appreciate nor depreciate too much.

If instead of maintaining large forex reserves, the funds are used to finance, say, useful infrastructure projects, the returns will be much higher. So, the opportunity cost of foreign exchange reserves is very high. In contrast, if the tax policy is used, the revenues will rise for the MoF (and the costs of large forex reserves are not incurred by the RBI). So, the proposed tax policy is superior to the policy of using forex reserves to stabilize the rupee.

There is yet another safeguard available. India can buy an inexpensive credit line from the International Monetary Fund or elsewhere. Such a credit line is an option that gives India the right (but not obligation) to borrow if a crisis situation were to arise in future. This instrument, as this author has shown in several papers, reduces the need for large foreign exchange reserves. India already has a credit line to the tune of $50 billion. Additional credit lines can be bought. So, forex reserves can be much less.

It is true that China’s reserves are much larger than those of India but that is a different story. The yuan had remained undervalued for long, which pushed exports. The large reserves are then a cumulative effect of that policy. However, that story is over and not really replicable now. Also, though China’s reserves were $3.84 trillion in 2014, they have now come down to $3.1 trillion. It appears that they will come down further. Also, $800 billion out of the foreign exchange reserves is China’s sovereign wealth fund.

If the RBI must have large foreign assets (though there is really no need), then it can be divided into two parts. One part can be the standard foreign exchange reserves which are liquid and give a low return (1% or less). The other part can be a sovereign wealth fund, which is relatively illiquid and gives a high return.

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