Source : www.thehindu.com Date : 2022-10-14

FALLING RESERVES AND THE BOGEY OF THE RBI’S ROLE

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Banking, NPAs and RBI

‘Policymakers deserve better inputs on the sensitive matters impacting India’s economy’ | Photo Credit: Getty Images

There is a widespread misconception that the Reserve Bank of India (RBI) has been depleting India’s foreign exchange (forex) reserves to defend the rupee.

The RBI cannot simply fritter away India’s forex reserves, held mostly in dollars, by charging its “nostro” account with the Federal Reserve Bank of New York, New York. The RBI is the custodian of India’s forex reserves and is responsible for managing their investments economically. The central bank may not have been adventurous in switching currencies to boost the value of reserves. But to suggest that the RBI has depleted India’s forex reserves from $642 billion to $537 billion, i.e., from September 8, 2021 to September 30, 2022, by intervening (selling dollars) in India’s inter-bank forex market is manifestly erroneous.

The RBI’s intervention and dollar/rupee exchange rate are surely linked, but the question is of depletion of forex reserves. To grasp this concept, we need to know who the market players are and how the RBI regulates them.

The market players are only banks licensed by the RBI, and the RBI. Individuals and corporates cannot enter the market. They can deal only with their respective banks. Therefore, the RBI dominates the market, being the regulator, a player and the jury. Thus, it is facile to argue that the dollar/rupee rate is “market determined” and that the RBI has no role in it. Section 40 of the RBI Act, 1934 (“Transactions in foreign exchange”) stipulates that the Central Government orders the “rate” at which the RBI shall buy or sell forex to banks (authorised persons). This “rate”, in turn, will be governed by India’s “obligations to the International Monetary Fund [IMF]”. The dollar/rupee rate has thus been subjugated to the United States from British India days. It is little wonder then that the rupee fell from 8/dollar to about 82/dollar (in 2022), from November 1981, when the IMF approved the biggest ever $5 billion Special Drawing Rights (about $6.25 billion dollars) loan to India. Although 100/dollar is *Door Ast* (‘far away’), the target is achievable. Such is the hegemony of dollar holders to slam poor rupee holders to make them poorer still.

The forex market is regulated by the RBI with impregnable exchange control regulations. All the player (banks) are required to be square or near square in their forex positions (spot or forward) at the close of business hours each day. This “overnight limit” is prescribed for each bank by the RBI. Even during the day, the prescribed “daylight limit” cannot be breached. The RBI enforces these limits strictly.

Assume that on a particular day the RBI sells (intervenes) one billion dollars in the market and one bank buys these dollars to remit them abroad for an importer (goods/services) customer. If that be so, then the funds would have gone abroad anyway since the importer, holding an import licence, can remit funds abroad as a matter of right. So, one billion of forex reserves depletion is caused not because of the RBI’s intervention but because of the import licence granted by the Ministry of Commerce.

The second possibility could be of the purchasing bank wishing to speculate. This possibility is impermissible since the RBI does not permit a bank to purchase dollars from the RBI and speculate in the interbank market. Selling these dollars in the overseas cross currency market is also prohibited by the central bank. So, unless there is demand from a bank's customers to remit dollars abroad, the RBI will just not be able to sell the dollars in the interbank market due its own regulations.

Sometimes the RBI intervenes (sells dollars) on the basis of a tacit understanding with another bank to calm dollar/rupee volatility. If such a bank buys $1 billion without any merchant base to effect remittances abroad, then that bank would try to sell these dollars to other banks which need to remit funds abroad for their own customers. Before the close of business hours, the bank has to offload excess dollars to the RBI to remain within the "overnight limit".

Therefore, the RBI's intervention cannot deplete forex reserves. Instead, the cause of forex reserves depletion is an unimaginative import/export policy of the Ministry of Commerce without keeping the RBI in the loop. If the diagnosis by the spin doctors is wrong, then the condition of the patient (i.e., the health of the economy) can only worsen.

India's twin deficits, trade and current accounts, are matters of concern. It is imperative that trade control regulations (flow of goods/services) and exchange control regulations (flow of funds in exactly an equal and opposite direction) are administered rigorously by enmeshing the two, preferably, by a separate cell within the RBI. "Control" may not be a popular word, but India remained unscathed after the Lehman Brothers crisis in 2008 only by deft handling of exchange control regulations by the RBI. The future is surely not dark, but uncertain.

The bogey of the "RBI depleting forex reserves to defend the rupee" has been let loose. The disinformation campaign continues. The rupee's free fall has been bleeding the economy with inflation, a flight of capital and escalating import costs.

Finally, policymakers deserve better inputs on the sensitive matters impacting India's economy.

Bishwajit Bhattacharyya is Senior Advocate, Supreme Court of India, a former Additional Solicitor General of India and a former country manager, international banking, in a foreign bank

Our code of editorial values

END