What are Foreign Exchange Reserves?

Foreign-exchange reserves (also called **forex reserves** or **FX reserves**) is money or other assets held by a central bank or other monetary authority so that it can pay if need be its liabilities, such as the currency issued by the central bank, as well as the various bank reserves deposited with the central bank by the government and other financial institutions. Reserves are held in one or more reserve currency, mostly the United States dollar and to a lesser extent the EU's euro, the British pound sterling, and the Japanese yen.

Foreign exchange reserves should ideally include foreign bank notes, foreign bank deposits, foreign treasury bills, and short and long-term foreign government securities. However, they also include gold reserves, special drawing rights (SDRs), and International Monetary Fund (IMF) reserve positions.

This broader figure, along with SDR’s, gold reserves and IMF reserve positions is more readily used.

Thus, in a nutshell, Foreign Exchange Reserves include-

- Reserves held in US Dollars, The Euro, The British Pound or the Japanese Yen
- Foreign bank notes, foreign bank deposits, foreign treasury bills and short term and long term foreign government securities
- Gold reserves
- Special Drawing Rights and International Monetary Fund reserve positions

Foreign-exchange reserves are called reserve assets in the balance of payments and are located in the capital account. Hence, form an important part of the international investment position of a country.

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Why hold Foreign Exchange Reserves?

Holding international reserves assets allows a central bank to purchase the domestic currency, which is considered a liability for the central bank (since it prints the currency).

Thus, the quantity of foreign exchange reserves can change as a central bank implements monetary policy, but this dynamic should be analysed generally in the context of the level of capital mobility, the exchange rate regime and other factors. Hence, in a world of perfect capital mobility, a country with fixed exchange rate would not be able to execute an independent monetary policy.

Non-sterilization will cause an expansion or contraction in the amount of domestic currency in circulation, and hence directly affect inflation and monetary policy.

Sterilization means the intervention by the central bank to influence the exchange value of the domestic currency, by buying and selling of foreign currency.

For example, to maintain the same exchange rate if there is increased demand, the central bank can issue more of the domestic currency and purchase foreign currency, which will increase the sum of foreign reserves. Since (if there is no sterilization) the domestic money supply is increasing (money is being 'printed'), this may provoke domestic inflation.

Since the amount of foreign reserves available to defend a weak currency (a currency in low demand) is limited, a currency crisis or devaluation could be the end result. On the other hand, this is costly, since the sterilization is usually done by public debt instruments. In practice, few central banks or currency regimes operate on such a simplistic level, and numerous other factors (domestic demand, production and productivity, imports and exports, relative prices of goods and services, etc.) will affect the eventual outcome.

Besides this, the belief that the world economy operates under perfect capital mobility is clearly flawed.

As a consequence, even those countries and their central banks that strictly limit foreign exchange interventions often recognize that currency markets can be volatile and may intervene to counter disruptive short-term movements (that may include speculative attacks). Thus, intervention does not mean that they are defending a specific exchange rate level.

Hence, the higher the reserves, the higher is the capacity of the central bank to smooth the volatility of the Balance of Payments and assure consumption smoothing in the long term.

CURRENT SCENARIO OF INDIA'S FOREIGN RESERVE

India's foreign exchange reserves, already at an all-time high, were growing at a brisk pace. From $275 billion on September 6, 2013, when the currency crisis was at its peak, the next 18 months saw reserves increasing by $66 billion to $341.4 billion on March 27, 2015.

The rupee had hit its nadir on August 28, 2013 — 68.83 a dollar. Since then, it has appreciated nine per cent. The fortunes of the currency and reserves have changed, initially due to a few bold and innovative steps by Reserve Bank of India (RBI) Governor Raghuram Rajan and, subsequently, due to improving investor sentiment with a new government coming to power at the Centre in May 2014.

While the currency has stabilised on the back of rising foreign exchange reserves — the import cover is about 10 months, against less than eight months in August 2013 — and a healthier macroeconomic position, with improvement on the current account deficit and fiscal deficit fronts, concerns remain. Geopolitical tensions could flare up oil prices and foreign fund outflow could be triggered by speculation of an interest rate rise by the US Federal Reserve. A huge chunk of foreign flows since March 2014 has been in debt; this is interest-sensitive and any tightening by the Fed could reverse these flows and exert pressure on the rupee.

RBI is aware of the downside risks to the exchange rate, as is reflected by its action of dollar mop-up. The chief economic advisor of the finance ministry has, however, clearly stated the kind of reserve accretion the government is looking at. Citing the example of China, the Economic Survey 2014-15 said India could target foreign exchange reserves of $750 billion-$1 trillion.

Foreign Exchange Reserves in India increased to 360300 USD Million in December 30 ,2016 from 359670 USD Million in the previous week. Foreign Exchange Reserves in India averaged 199901.39 USD Million from 1998 until 2016, reaching an all-time high of 383643 USD Million in December of 2009 and a record low of 29048 USD Million in September of 1998.

THE FOREIGN EXCHANGE RESERVES OF INDIA CONSIST OF BELOW FOUR CATEGORIES.

- **Foreign Currency Assets**

Foreign currency assets expressed in US dollar terms include the effect of appreciation/depreciation of non-US currencies (such as Euro, Sterling, Yen) held in reserves.

- **Gold Reserves**

The Reserve Bank holds 557.77 tonnes of gold; of which, 265.49 tonnes are held overseas in safe custody with the Bank of England and the Bank for International Settlements (BIS). Gold as a share of the total foreign exchange reserves in value terms (USD) stood at about 5.6 per cent as at end-March, 2016.

- **Special Drawing Rights**

Special Drawing Rights (SDRs) are supplementary foreign exchange reserve assets defined and maintained by the International Monetary Fund. It was created in 1969 to supplement a shortfall of preferred foreign exchange reserve assets, namely gold and the US dollar, the SDR's value is defined by a weighted currency basket of four major currencies: the Euro, the US dollar, the British pound, and the Japanese yen Currently, the value of one SDR is equal to the sum of 0.423 Euros, 12.1 Yen, 0.111 pounds, and 0.66 US Dollars. This basket is re-evaluated every five years, and the currencies included as well as the weights given to them can then change.

- **Reserve Tranche Position**

The primary means of financing the International Monetary Fund is through members' quotas. Each member of the IMF is assigned a quota, part of which is payable in SDRs or specified usable currencies ("reserve assets"), and part in the member's own currency. The difference between a member's quota and the IMF's holdings of its currency is a country's Reserve Tranche Position (RTP).Reserve Tranche Position is accounted among a country's Foreign Exchange Reserves.

Foreign exchange reserves and the balance of payment

BOP of a country is schematic representation of all the transaction undertaken by resident of the country with the resident of the other countries vice-versa during a particular period.

If a country’s demand for imports is more than its exports. In such a case, the country’s ability to import would be limited by the foreign exchange it has earned from its exports, or from what is called the ‘current account’ – unless it chooses, as countries often do, to finance their deficit by borrowings, i.e. from the ‘capital account’. To the extent that the deficit is not financed by the capital account, it will experience a reduction in its foreign currency ‘cash balance’, i.e. a fall in its forex reserves. In the same way, forex reserves will increase if the exports are more than the imports.

Deficit/Surplus of the current account + Deficit/Surplus of the capital account = Net change in foreign exchange reserves

Components of BOP

I. Current Account Balance ($–6,119 million) – CAB calculated by adding our balance of trade, factor income (interest and dividends from international loans and investments) and net transfer payments.

Balance of trade (or trade balance) is the most significant component of our Current Account. It is calculated by deducting India's total imports of goods and services from its total exports of goods and services.

II. Capital Account: To finance a country's current account deficit, it is very important for the government to encourage international capital flows into the country. All the foreign money which flows into India or Indian money which flows to some other countries, in the form of capital investments, gets counted under capital account. What are the sources of India's capital account? Here we have it:

Foreign Investment

(i) Foreign Direct Investment (FDI) ($10,003M) – FDI refers to an investment made by a foreign entity into India that involves establishing operations or acquiring tangible assets, including stakes in other businesses. Here, the investor seeks to control, manage or have significant influence over its Indian operations, either by establishing its own subsidiary or entering into a joint venture with an Indian entity.

Foreign Institutional Investments (FIIs) – Overseas institutional investors investing in Indian securities, either debt, equities or other financial assets listed here in India, comes under foreign institutional investments.

ADRs/GDRs –**($273M)** Foreign investors can also invest in an Indian company through the purchase of American Depository Receipts (ADRs) or Global Depository Receipts (GDRs). ADRs or GDRs are essentially negotiable instruments, denominated in US dollar or any other currency, representing a publicly-traded issuer's local currency equity shares.

External Commercial Borrowings (ECBs)– ECBs are money borrowed by Indian corporates from foreign sources in the form of commercial loans, credits, notes, bonds or preference shares. ECBs open another avenue of credit at lower international rates for Indian commercial borrowers.

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LEVEL OF FOREX RESERVES IN INDIA

The Foreign exchange reserves of India are mainly composed of US dollar in the forms of US government bonds and institutional bonds. The main component is foreign currency assets. As per the data furnished by the Reserve Bank of India in its weekly statistical supplement, India's total foreign exchange reserves stands at US$368.231 billion for the week ended November 11, 2016. In this, foreign currency assets (FCAs) were US$343.927 billion, while gold reserves were US$20.46 billion. Gold reserves in India constitute nearly 15 per cent of forex. India is, coincidentally the world's largest gold consuming nation. India is at 8th position in List of countries by foreign-exchange reserves, just below Republic of China (Taiwan), Russia and South Korea. The Economic survey of India 2014-15 said India could target foreign exchange reserves of US$750 billion-US$1 trillion. Foreign exchange reserves act as the first line of defence for India in case of economic slowdown, but acquisition of reserves has its own costs. Foreign exchange reserves facilitate external trade and payment and promote orderly development and maintenance of foreign exchange market in India.

Reserve Bank of India Act and the Foreign Exchange Management Act, 1999 set the legal provisions for governing the foreign exchange reserves. Reserve Bank of India accumulates foreign currency reserves by purchasing from authorized dealers in open market operations. Foreign exchange reserves of India act as a cushion against rupee volatility once global interest rates starts rising.

In 1980, India had foreign exchange reserves of over U$7 billion, more than double the level (U$2.55 billion) of what China had at that time.[4]

India was forced to sell dollars to the extent of close to U$35 billion in the spot markets in Financial Year 2009 due to 22% depreciation in rupee (against the dollar) in the same fiscal year 2009. Foreign exchange reserves of India reached milestone of $100 billion mark only in 2004. In 2009, India’s purchase of 200 tonnes of gold from the International Monetary Fund, worth US$6.7bn (€4.57bn, £4.10bn) .

MANAGEMENT OF FOREX RESERVES

Management of Forex Reserves is basically a process of ensuring that an adequate amount of foreign assets is readily available with the authorities for meeting certain defined objectives for the country. The onus for managing the reserves is on a reserve management entity which is RBI, in case of India. RBI has dual role to play- one is of monetary authority & other is of custodian of reserves. As a monetary authority, RBI has to ensure macroeconomic financial stability in general & external stability in particular. As a custodian, RBI has to ensure the liquidity, safety & yield on deployment of reserves.

- **Two important aspects of managing the reserves are:**

1) Assessing the benefits of holding the reserves
2) Assessing the opportunity cost of managing the reserves

The major benefit of holding the sufficient reserves is that it acts as a buffer during the forex market pressures & thereby helps to prevent the external crisis, especially the ones which emerges from the capital account. For emerging economies like India, higher levels of forex reserves provide assurance to the global community that external liability will be paid and exchange rate will be stabilized as and when required. The flip side of higher level of forex reserves is that it locks domestic currency in foreign currency assets which otherwise could be used for increasing domestic investment. On the other hand, for emerging economies like India, the lower level of foreign exchange reserves is a curse as it limits the ability of central bank to intervene in forex market to stabilize exchange rate and equalize the balance of payment which could ultimately lead to depreciation of domestic currency. Depreciation of home currency will further lead to inflation.

However, maintaining such level of Forex reserves results in the loss of opportunity cost. This opportunity cost is basically the investment made in purchasing the reserves which otherwise could have been used for increasing the domestic capital. So, there is always a cost associated with holding higher than adequate or inadequate level of foreign exchange reserve. Management of reserve basically tries to minimize this opportunity cost against the benefits arising from holding the reserves which is very crucial for a country like India.

RECENT DATA ON MANAGEMENT OF RESERVES BY RBI (Half-yearly Report- September 2016)

- MANAGEMENT OF GOLD RESERVES: RBI was holding 557.77 tonnes gold of which 265.49 tonnes were held with the Bank of England & the Bank for International Settlements (BIS). The amount of gold in total FOREX reserves was 5.75% in September 2016.
- MANAGEMENT OF FOREIGN CURRENCY ASSETS: At the end of September 2016, the total foreign currency assets were 346.7 Billion USD out of which 229.0 Billion USD was invested in securities, 95.7 Billion USD was deposited with other CBs, BIS & IMF and the remaining 22.0 Billion USD was deposited with the overseas branches of commercial banks.

RESERVE ADEQUACY LEVEL

- IMPORT COVER: According to half-yearly RBI report on management of forex reserves, the import cover was 12 months in September 2016.

- RATIO OF SHORT-TERM DEBT TO FOREIGN EXCHANGE RESERVES: According to half-yearly RBI report on management of forex reserves, the ratio of short-term debt to Reserves was 21.8% in September 2016.
- COMBINATION METRICS: Currently, it is not used in India.
- OPERATIONAL RESERVE MODEL: Currently, it is not used in India.
- ARA EM Metric: The metric has been developed by the IMF & it aims to balance simplicity with completeness, while permitting comparability across countries. The metric is different for different type of economies. The reserve is considered to be adequate for precautionary purposes if the value of reserves lies between 100 to 150 percent of the composite value of ARA EM metric. For emerging economy like India, the following table is applied. The weights given to different components in this metric for emerging economy (Managed Float system) are:

Short-term Debt	30%	Broad Money	5%
Other Liabilities	15%	Exports	5%

- LATEST POSITION OF FOREX RESERVE:

	September 2016 (Billion US $)	December 2016 (Billion US $)
Foreign Currency Assets (FCA)	346.711	336.582
Gold	21.406	19.9829
Special Drawing Rights (SDR)	1.487	1.4324
Reserve Tranche Position (RTP)	2.386	2.299
Total	371.99	360.2968

Compiled by

Vikash sharma