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Research Paper Subject

Augmentation of India's Foreign Exchange Reserve: An Analysis

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ABSTRACT

The foreign exchange reserves comprise three stuff; gold, SDRs and foreign currency assets. As of November, 2011 India has over US $ 10,386 million of total reserves, foreign currency assets account the major share. Gold accounts for about US $ 5,228 million. In July 1991, as a part of reserve management policy, and as a means of raising resources, the RBI temporarily pledged gold to raise loans. The gold holdings thus have played a crucial role of reserve management at a time of external crisis. Since then, Gold has played passive role in reserve management. Hence, the present study entitled, 'Augmentation of India's Foreign Exchange Reserves'.

Keywords : Foreign Exchange Reserve, Gold, SDRs and Foreign Currency Assets

Introduction

Reserve assets comprise an imperative component of the financial report in the BOP statistics and a crucial component in the analysis of the economy's external position. In the word of H.E.Evitt, "The means and methods by which rights to Wealth expressed in terms of the currency of one country are converted into rights to wealth in terms of the currency of another country are known as foreign exchange". Foreign exchange reserves are the foreign currency deposits held by central banks and monetary authorities. However, the term foreign exchange reserves in popular usage commonly include foreign exchange and gold, SDRs and IMF reserve position. In other words, total of the country's gold holdings and convertible foreign currencies held in its banks, plus special drawings rights and exchange reserve balances with the International Monetary Fund (IMF) represent foreign exchange reserves.

Significance of Foreign Exchange

Consequence of maintaining foreign exchange reserves of the country can be emphasized on the following justifications;

- Foreign exchange reserves show the financial strength and the stage of development of the economy.
- The acceptance of currency at a predetermined rate makes the international trade easy.
- The foreign exchange ratio shows direct relationship between the prices of the commodities in the national and international market.
- The foreign exchange balances of a country directly affect the rates of exchange. A hard currency nation has stability in foreign exchange rate.
- The rising foreign exchange balances of a nation increases its credit worthiness in the international capital market.
- It increases the confidence in the monetary and exchange rate policies of the government.
- It enhances the capacity of the central bank of the country to intervene in the foreign exchange market and control any adverse movement and stabilize the foreign exchange rates to provide a more favorable economic environment for the progress of the country.
- During time of any crisis foreign exchange reserves come to the rescue of any country so as to absorb the distress related to such crisis.
- It also adds to the comfort of market participants that domestic currency is backed by external assets and hence it also helps the equity markets of the country, because due to strong reserves many people from foreign countries are willing to invest in the country having strong foreign exchange reserves.

However holding too much foreign exchange reserves is also not advisable because it involves the opportunity cost of money tied in reserves rather than investing somewhere else which could have earn higher return on the invested amount.

Objectives of the Reserves Management

The guiding objectives of foreign exchange reserves management in India are similar to those of many central banks in the world. The demands placed on the foreign exchange reserves may vary widely depending upon a variety of factors including the exchange rate regime adopted by the country, the extent of openness of the economy, the size of the external sector in a country's GDP and the nature of markets operating in the country. Even within this divergent framework, most countries have adopted preservation of the long term value of the reserves in terms of purchasing power and the need to minimize risk and volatility in returns as the primary objectives of reserve management. While liquidity and safety constitute the twin objectives of reserve management in India, return optimization becomes an embedded strategy within this framework. The basic parameters of the Reserve Bank's policies for foreign exchange reserves management are safety, liquidity and returns.

Proclamation of the Problem

Commencing the preceding argument, one can recognize the consequence of Foreign Exchange Reserves. The Reserve Bank, as the custodian of the country's foreign exchange reserves, is vested with the responsibility of managing their investment. The legal provisions governing management of foreign exchange reserves are laid down in the Reserve Bank of India Act, 1934.

The Reserve Bank's reserve management function has, in recent years, grown both in terms of importance and sophistication for two main reasons. First, the share of foreign currency assets in the balance sheet of the Reserve Bank has substantially increased. Secondly, with the increased volatility in exchange and interest rates in the global market, the task of preserving the value of reserves and obtaining a reasonable return on them has become challenging. It is in this context, there arise a need for analyzing the India's foreign exchange reserves. Hence, the present study entitled, 'Augmentation of India's Foreign Exchange Reserves'.

Objectives of the Study

1. To analyse the trend in the Movement of Foreign Exchange Reserves in India
2. To find out the share of each Component of Foreign Exchange Reserves
3. To identify the reasons for the prevailing trend in Foreign Exchange Reserves

Methodology

The study is based on secondary data. Data relating to foreign exchange reserves of the nation as well its each component represent secondary data for the study. They were collected from the publications of RBI. In addition, text books, journals and financial dailies were also referred to gain enriched knowledge on Foreign Exchange Reserves.

The study has covered a period of seven years from 2003-04. In order to make a better analysis, the following statistical tools were used:

* Percentage analysis * Trend analysis and
* Average.

Movements in Foreign Exchange Reserves

Reserve assets constitute an important component of financial account in the Balance of Payments statistics and are essential elements in the analysis of the economy's external position.

In India, foreign exchange reserves are defined as external assets which are eagerly available to and controlled by the Reserve Bank for meeting Balance of Payments financing needs, for interference in exchange markets to contain the volatility of exchange rate of the Rupee, and for other related purposes. Accordingly, at present, reserves include foreign currency assets of the RBI, gold, SDRs and the Reserve Tranche Position in the IMF, which conforms to international best practices as suggested in the IMF Manual. Movement in reserves is recorded in the balance of payments statistics after excluding changes on account of valuation. Valuation changes arise because foreign currency assets are expressed in US dollar terms and they include the effect of appreciation/depreciation of other major currencies (such as the Euro, Sterling, Yen, etc.) held in reserves vis-à-vis the US dollar.

Movements in foreign exchange reserves of the nation from 2003-2004 to 2009-2010 exhibited in Table 1

Table 1 : Movements in Foreign Exchange Reserves of India from 2004 to 2010

Year (End March)	Foreign Exchange Reserves			
	Rupees (crore)	Growth rate (%)	US Dollar (million)	Growth rate (%)
2004	4,90,129	-	1,12,959	-
2005	6,19,116	26.32	1,41,514	25.27
2006	6,76,387	9.25	1,51,622	7.14
2007	8,68,222	28.36	1,99,179	31.36
2008	12,37,965	42.59	3,09,723	55.50
2009	12,83,865	3.57	2,51,985	-18.64
2010	12,59,665	-1.88	2,79,057	10.74
Average	**9,19,335**	**21.64**	**2,06,577**	**22.27**

Source: Report on Foreign Exchange Reserves, RBI, Various issues

Table 1 helps to infer the following points:

* During the study period, there is an increasing trend in the foreign exchange reserves of the nation (in Rupees) except during 2010. It is increased from Rs.4,90,129 crore in 2004 to Rs.12,59,665 crore representing a growth of 2.57 times.

* A mixed trend is prevailing in the growth rate of foreign exchange reserves of India in Rupee terms. Highest growth rate in foreign exchange reserves is witnessed by the country during 2008 which may be due to capital and other inflows. Major sources of increase in foreign exchange reserves have been: (a) Foreign investment (b) Banking capital (c) Short-term credit (d) Other items under capital account, and (e) Valuation changes in reserves. In the year 2010, the country has experienced a negative growth rate in foreign exchange reserves.

* Throughout the period under study, foreign exchange reserves of the country in dollar terms is on the increasing trend expect during 2009. It is increased from USD 1,12,959 million in 2004 to USD 2,79,057 million representing a growth of 2.47 times. The valuation gain during 2009-10 accounts for 50.2 percent of the total increase in foreign exchange reserves. Besides the valuation gain, inflows under foreign investments and Non-Resident Indian deposits and SDR allocations by the IMF have contributed to the increase in foreign exchange reserves during 2009-10.

* The growth rate of foreign exchange reserves in US dollar terms exhibits a mixed trend during the study period.

* During the study period, the average quantum of foreign exchange reserves stood at Rs.9,19,335 crore and USD 2,06,577 million.

To conclude the Engagements in foreign exchange reserves position of India exhibits a fluctuating trend in both Rupee terms and Dollar terms during the study period.

Proportionate Sharing Components of Foreign Exchange Reserves from 2004 To 2010

Foreign Currency Assets

Foreign Currency Assets (FCA) are maintained in major currencies like US Dollar, Euro, Pound Sterling, Japanese Yen etc., the foreign exchange reserves are denominated and expressed in US Dollar only.

Legal Skeleton and Policies

The Reserve Bank of India Act, 1934 provides the overarching legal skeleton for deployment of reserves in different FCA and gold within the broad parameters of currencies, instruments, issuers and counterparties. The essential legal skeleton for reserves management is provided in sub-sections 17(6A), 17(12), 17(12A), 17(13) and 33 (6) of the RBI Act. In brief, the law broadly permits the following investment categories:

* Deposits with other central banks and the Bank for International Settlements (BIS)

* Deposits with foreign commercial banks;

* Debt instruments representing sovereign/sovereign-guaranteed liability with residual maturity for the debt papers not exceeding 10 years;

* Other instruments / institutions as approved by the Central Board of the Reserve Bank in accordance with the provisions of the Act; and

* Dealing in certain types of derivatives.

Movements in the FCA occur mainly on account of purchases and sales of foreign exchange by RBI in the foreign exchange market in India. In addition, income arising out of the deployment of foreign exchange reserves and external aid receipts of the Central Government also flow into the reserves. The movement of the US dollar against other currencies in which FCA are held also impact the level of reserves in US dollar terms.

Gold Reserves

Monetary gold is defined as gold to which the monetary authorities have title and is held as reserve assets. It comprises gold bullion and unallocated gold accounts with non-residents that give title to claim the delivery of gold. Gold accounts must be readily available upon demand to the monetary authorities to qualify as reserve assets.

Special Drawing Rights (SDRs)

SDRs are entitlements granted to the member countries enabling them to draw from the IMF apart from their quotas. IMF is an organization to monitor the proper conduct of the international monetary system and it is a source of liquidity for countries in need of foreign exchange to finance temporary Balance of Payments deficits. The main resource for IMF is the member's quotas. Quota represents the subscription by a member country to the capital fund of the IMF. The arrangement is similar to a bank, granting credit limit to its customer. When SDRs are allocated, the country's special drawing account with the IMF is credited with the amount of the allotment. When the country experiences need for foreign exchange it can sell SDRs for another country and get foreign exchange.

SDR is not a currency and has no patronage of any security. Nor is the IMF liable on the SDRs allocated. It is merely an asset created out of book entries. It is an independent reserve asset, supplementing other reserve assets, the volume of which could be increased or decreased according to the reserve needs of the international community. The real strength of the SDR lies in the undertaking by the member countries to abide by the Article of Agreement of the IMF and exchange SDRs for currencies. Every member participating in the SDR scheme is required to accept upto 200% of its allocation of the SDRs when offered by other countries and exchange with currency of its own or other countries. On its own, a member can hold SDRs above this constitutional responsibility.

Distribution

Distribution of SDRs is made to affiliate countries in proportion to their quotas. The decision to allocate SDRs is taken periodically by the Board of Governess taking into account the requirements of international liquidity.

Under its Articles of Agreement, the IMF may distribute SDRs to members in proportion to their IMF quotas. Such a distribution provides each member with an asset (SDR holdings) and an equivalent liability (SDR distribution). If a member's SDR holdings rise above its distribution, it earns interest on the excess; conversely, if it hold fewer SDRs than owed, it pays interest on the discrepancy.

Reserve Tranche Position (RTP)

The drawing of resources from the IMF by the member country is subject to the fund's tranche policies. The word tranche means slice in French. Under this policy, the member's right to draw from the fund is divided into five tiers or tranches. The borrowing that takes the IMF's holdings of the currency up to 100% of the country's quota is known as the reserve tranche.

Proportionate Sharing Components of Foreign Exchange Reserves during the study periods are exhibited in the Table 2.

Table: 2 : Proportionate Sharing Components of Foreign Exchange Reserves from 2004 to 2010 (USD million)

Year (end march)	Foreign Currency Assets (USD)	Special Drawing Rights (USD)	Gold (USD)	Reserve Tranche Position(USD)
2004	95.12	0.0017	3.71	1.43
2005	95.80	0.0035	3.17	1.01
2006	95.70	0.0019	3.79	0.49
2007	96.35	0.0010	3.40	0.23
2008	96.61	0.0058	3.24	0.14
2009	95.80	0.0003	3.80	0.39
2010	91.26	1.7938	6.44	0.49
Average	**95.23**	**0.258**	**3.93**	**0.597**

Source: Report on Foreign Exchange Reserves, RBI, Various issues

Inferences of Table 2 are given below:

1. Among all the components of foreign exchange reserves, Foreign Currency Assets dominates followed by Gold, SDRs and RTP.

2. During the study period, Gold reserves have increased from USD 3.71 million to USD 6.44 million. This is mainly due to the purchase of Gold from IMF during October 2009.

3. During the study period, SDR has been increased from USD 0.0017 million to USD 1.7938 million which is mainly due to the allocation of SDRs to India by IMF.IMF allocate SDRs depending upon the reserve holdings of the country.

4. During the study period, RTP has been decreased from USD 1.43 million to USD 0.49 million.

Reasons for Augment in Foreign Exchange Reserves

The quantum of foreign exchange reserves has augmented during the period under study due to the reasons listed below:

During the study period, there is a growing trend in the foreign exchange reserves which is mainly due to the increase in the inflows towards capital account. Foreign Direct Investment (FDI) is an important source of investment which increases the foreign exchange reserves. During the study period, there is an increasing trend in the FDI. It is increased from USD 4.7 billion in 2004 to USD 19.7 billion in 2010. The increased inflows to a greater extent helps to minimize the deficit balance prevailing in the current account.

Inflows into the current account have also been increased. An Indian export has increased from USD 63.8 billion in 2004 to USD 182.2 billion in 2010. Increase in the inflows towards Current Account is also due to surplus derived from invisible account.

RBI purchased 200 metric tons of gold during October 2009, which helps to increase the Foreign Exchange reserves of the nation.

As the result of the purchase of gold, IMF has allotted SDRs depending upon the reserve holdings which also add to the Foreign Exchange reserves.

Effective Exchange rate control also helps to prevent from adverse valuation change, which also has an impact in the augment in the Foreign Exchange Reserves.

Conclusion

Generally analysis of Foreign Exchange Reserves (in US Dollar terms) of the nation throughout the period under study reveals that the country had a raising trend except during 2009. An analysis of Foreign Exchange Reserves (in Rupee terms) of the nation throughout the period under study reveals that the country had a raising trend except during 2010. In short, for the last seven years there is an optimistic trend in the Foreign Exchange Reserves of the country.

The momentous augment in foreign exchange reserves enabled prepayment of certain high-cost foreign currency loans of the Government of India received from the Asian Development Bank (ADB) and the International Bank for Reconstruction and Development (IBRD)/ World Bank amounting to USD 3.30 billion during February 2003.It also helped the nation for the prepayment of bilateral loans to the tune of 90.1 million from 2003-2004 to 2009-2010.

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