What should be done to the excess forex reserves held with the Reserve Bank of India?

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Abstract

The current paper debates on the policy perspective on maintaining the excess reserves by the Reserve bank of India (RBI). By drawing down different opinion from the literature, we argue that these precious reserves kept with RBI are idle and therefore holds opportunity cost. Against the backdrop of further rise in forex reserves and maintaining a contingency fund by the RBI merits the demand on future research to examine the optimum level of forex reserves which the central bank must kept with itself.

Keywords: Central Banking; Foreign Exchange Reserves; Monetary Policy

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The central bank has been maintaining the total reserve which includes Contingency fund (CF), Currency and gold revaluation account, Investment revaluation account and Asset development fund. These buffer shares basically managed for meeting unexpected exigencies. It has been showcased by the RBI as a cushion against the loss bearing bonds or other foreign exchange assets during an increase in interest rates or rupee appreciation, and other risks associated with the exchange rate depreciation. These funds would also be helpful to carry out bail out programs during banking and corporate sector defaults that may threaten financial stability. Therefore, the idea of keeping these contingency funds available with the RBI are in similar vein as keeping the forex reserves which includes components such as gold reserves, foreign currency assets, special drawing rights and reserve tranche position with the IMF.

The forex reserves held with most of the emerging market economies have witnessed a staggering rise since the global financial crisis. Following the global trends, the international reserves held with the RBI is around US $ 393.133 billion on November 2, 2018 which slipped

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from US $ 426.082 billion held on April 13, 2018. Since the balance of payment crisis of 1990s and adoption of financial liberalization, the stockpile of forex reserves in India is the highest currently. According to a study by Morgan Stanley in the year 2013, India has surpassed Brazil among nations that have high current account deficit (CAD) and consequent higher dependence on capital flows and therefore is considered as one among the "Fragile Five" nations. However, in another article Bhattacharya show that the country has been able to retain its top position in the holding of forex reserves among nations with high CAD. Therefore, it is important to understand the motives of RBI to hoard such exceptional bulk of forex reserves despite the fact that India has been implementing the managed flexible exchange rate regime since March 1993.

The need for forex reserves by most of the emerging market economies is to meet the precautionary motives. Nevertheless, excess accumulation of international reserves after certain threshold invites an opportunity costs. According to Sharma and Bhanumurthy, the existing financial resources for financing the developmental projects in India are scanty and the country has to attract the foreign capital onshore if it has to meet the requirements of its projects by keeping the domestic interest rate relatively high. Therefore, the international reserves held with the central bank can be channelized to the needy projects as hoarding these precious funds is not beneficial and coherent. The rationale of keeping these reserves idle for an extended period is misgiving. The RBI's reports in the past have also reflected that India has a surplus of international reserves than essential with a motive to hedge risk against any unforeseen financial instability. According to Professor Dani Rodrik, the opportunity cost of holding these reserves is high for a country like India which invests in low-yielding foreign currency assets namely short-term US Treasury or similar safer securities.

Academic scientists suggest that there must be an optimum level of reserves the central bank must keep in order to meet uncertainty and minimize the opportunity cost. Similar to these opinions YV Reddy in an inaugural address, recommended optimal forex reserves holding by the RBI must be equivalent to a summation of monthly import payments and debt service. Further, he strongly recommends including other primary indicators to the proposed method. Later Alan Greenspan, the chairman of Federal Reserve Board proposed a rule (popularly known as Greenspan-Guidotti rule) in a speech delivered at the World Bank Conference on Recent Trends in Reserves Management in 1999.In the rule, he proposes that the optimum forex reserves of the country must be based on all repayments and interests on foreign borrowings taken together. Greenspan also opined that a nation can be considered healthy if its forex reserves equals to one-year short-term borrowings. However, despite such globally acclaimed rules prevailing at international level, most of the countries do not follow them and hence there is no end to a staggering rise in the international reserves and the notion of keeping an additional CF is not rationale.

Moreover, the increase in the international reserves by the central bank can also be perceived as an implicit guarantee for the financial firms and non-financial firms borrowing lavishly in foreign currency. The hike in forex reserves can aggravate moral hazard problems as it inspires the entities to progressively borrow in foreign currency (which is considered to be a cheaper loan for their business) with the expectation that the central bank will bail them out in the event of considerable exchange rate depreciation. Hence, the reserves accumulated by the central bank reflect reserves as insurance provisions to the Indian entities which have generated high stocks of debt denominated in foreign currency and at times when exchange rate is depreciating. However, these claims need further investigation and empirical support.

There is always a tussle between the central government and the central bank which sometimes becomes much worse, but the much needed autonomy given to the central bank through RBI Act would jeopardize. However, the central bank must come up with a way to channelize the excess reserves into revenue making investment so that the opportunity cost of holding idle precious reserves idle is minimized and would eventually reduce moral hazard problems.

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