Forex Reserves: No cause for celebration*

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Multiple indicators reveal that the pre-pandemic deceleration in growth segued into a deep recession that persists six months after the first reported Covid-19 case. But official optimism hasn't waned. Some spokespersons promise a V-shaped recovery. Others clutch at every straw in sight. One such is evidence of record and rising levels of foreign exchange reserves (gold, foreign currency assets and SDR holdings) with the Reserve Bank of India (RBI). On August 7, 2020, total reserves stood at $538.2 billion, which, even if the economy were not in the midst of the ongoing recession, would be adequate to cover almost a year's worth of imports.

Reserves provide insurance against an exit of foreign investors, as during the initial months of the pandemic, which could trigger a collapse of the currency. They also allow the central bank to intervene in foreign exchange markets to stabilize the rupee, when faced with a surge in foreign exchange inflows. In fact, in recent times the problem has been an excess supply, relative to demand, of foreign exchange in the market. A part of the reason why reserves have risen to record levels is intervention by the RBI to purchase dollars and prevent appreciation of the rupee, given the excess supply of foreign exchange. Rupee appreciation would hurt exporters, who are already affected adversely by the global economic contraction.

Thus, the high levels of reserves are the result of increased availability of foreign exchange and an acceleration in reserve accumulation after the onset of the Covid pandemic. Between end-March 2020 and May 8th of this year, total reserves with the RBI had risen by $7.5 billion. Around a month later, on June 12, the increase in total reserves relative to March-end 2020 had shot up to $29.8 billion. Over the subsequent two months or so, reserve increase relative to March-end touched $38.6 billion (on July 10) and $60.4 billion (on August 7). Thus, over the three-month period ending August 7, India's foreign reserves had risen by $52.9 billion. This compares with a fall in reserve levels of $11.7 billion over financial year 2018-19 and an increase of $64.9 billion over financial year 2019-20 as a whole.

Needless to say, part of the increase would be explained by valuation effects, especially those resulting from the spike in the price of gold, which would had raised the value of the central bank's gold hoard. However, the increase in the value of gold held by the central bank over the 3-month period ending August 7 was just $7.5 billion, whereas the increase in the value of foreign currency assets held by the RBI amounted to $44.7 billion. Accumulation of reserves with the central bank is substantially the result of its operations aimed at stabilizing the exchange rate of the rupee when faced with the excess supply of foreign exchange.

This raises the question: What explains the excess supply of foreign exchange in the economy? One obvious explanation is the reduction in demand for foreign exchange resulting from the sharp fall in global oil prices and the decline in demand for imported oil and non-oil goods and services because of the severe economic recession. The price of Brent crude in July 2020 was a third lower than a year ago, and the oil import bill over April-July 2020 was, at $19.61 billion, 56 per cent lower than in the corresponding period of the previous year. Non-oil imports also shrank, so that overall imports were 40 per cent lower during April-July when compared with the same period in 2019. As a result, over April to July, the merchandise trade deficit narrowed to $14 billion from $59 billion in the same period of the previous fiscal year. After accounting for surpluses in the trade in services, India's overall trade deficit of $33.5 billion during April-July 2019 has been transformed into a surplus of $14 billion in the four months ending July 2020. While overall current account figures are yet to be released, there can be no doubt that the demand for foreign exchange has considerably shrunk.

Paradoxically, this recession and Covid-crisis induced shrinkage of demand for foreign exchange has been accompanied by an increased flow of foreign currency into the country. Initially a panic bear run resulted in large net outflows of foreign institutional investments, especially of debt. Over the five months ending May 2020, cumulative net outflows of FII investments stood at $17.4 billion of which $14.2 billion was on account of debt outflows. But matters have changed since, because of the large infusion of liquidity by the US Fed and the European Central Bank, in response to the Covid-induced crisis. The availability of cheap money has diverted attention away from real economy risks world over, including in emerging markets like India. Indian markets have recorded net FII inflows of $3.4 billion in June 2020, $450 million in July and $4.2 billion in just the first half of August.

But besides FII flows, the surfeit of dollars in the Indian market is also due to a rush of global liquidity into direct purchases of equity in Indian companies, including its banks. The most visible of such inflows was that which financed the purchase of a total stake of 33 per cent in Reliance JIO from Reliance Industries by 14 different global investors, with Facebook and Google acquiring 9.9 and 7.7 per cent respectively. Those investments which occurred between mid-April and mid-July amounted to Rs. 1,52,055 crore or more than $20 billion. In the case of banks, ICICI Bank, Axis Bank and HDFC have reportedly mobilized $4.7 billion through share sales in the first half of August, Blackrock has acquired a stake worth around $1.4 billion in Bandhan Bank, and other investors have bought into in sundry smaller players.

Thus, a combination of factors account for India's strength on the external front as reflected in its foreign exchange reserves, which are now the third largest in Asia after China and Japan. Of these factors there is only one which is an unreservedly positive contributor from India's point of view, which is the decline in oil prices that has brought down the country's oil import bill quite substantially. While it is likely that the oil market will remain depressed for some time into the future, some possibility of a rise in oil prices driven by production cuts jointly enforced by the OPEC Plus grouping, which includes Russia, cannot be ruled out.

The other contributing factors all come with negative implications attached to them. The contribution of the reduced merchandise trade deficit and overall trade surplus, which includes the benefits of the oil price decline, is also a reflection of the recession and output contraction accompanying the pre- and post-Covid crises. Thus, any increase in the level of reserves resulting from this factor is more a reflection of weakness rather than of strength.

Matters would have been different if trade and current account surpluses during periods of normal or buoyant growth helped add to reserves. Reserves accumulated through trade and current account surpluses are reserves earned and accumulated, and therefore available to the central bank without any commitment of associated payments or capital repayment. The IMF defines reserves as external assets that are readily available to and controlled by monetary authorities for direct financing of external payments imbalances, for indirectly regulating the magnitudes of such imbalances through intervention in exchange markets to affect the currency exchange rate, and/or for other purposes.

When assets are pre-committed they are not readily available because the central bank may need to access those assets at short notice to meet those commitments. This is case with inflows on account of portfolio investments, which have short term foreign exchange liabilities associated with them, inasmuch as any interest, dividend or capital gain associated with those assets can be transferred to the holder abroad in foreign exchange, and the asset itself can be redeemed and the capital withdrawn as the net outflows in the months preceding June this year illustrated. What this implies is that any increase in reserves resulting from such inflows are borrowed reserves and not reserves earned, as through positive net exports for example.

An element of commitment is associated with foreign direct investment as well for two reasons. To start with the distinction direct and portfolio investment is blurred, since any investment in excess of 10 per cent of a firm's equity by a single investor is treated as FDI, though some of those investors may not have a long term interest in the target and the investments may be undertaken with the objective of extracting capital gains rather dividend earnings. Secondly, dividends can be repatriated in foreign exchange and the investor has the right to sell his assets and repatriate the value in foreign exchange. So, there is a commitment to meet foreign exchange obligations associated with that investment even in the case of FDI. This makes FDI a less preferred way than net exports as a way of attracting the capital that helps build reserves, even without taking into consideration the implications for non-resident control over parts of the domestic economy.

In sum, the sudden and sharp spike in India's foreign exchange reserves in recent months is the result of recessionary conditions and the speculative rush of investors riding on cheap capital into Indian equity and debt markets in search of quick and high yields. It can hardly be a cause for comfort let alone celebration and must not be used as means to divert attention from the severe crisis that has engulfed the economy.

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