Foreign Exchange Reserves

6.64 A strong balance of payments position in recent years has led to a steady accumulation of India's foreign exchange reserves. During 2003-04, India's total foreign exchange reserves (including gold, SDRs and reserve position in the IMF) amounted to US$ 113.0 billion. The annual accretion for the year was US$ 36.9 billion. At present, India is the sixth largest reserve-holder in the world.

6.65 A rapid growth in India's foreign exchange reserves has been consistent with the trend of reserves growth seen in developing Asia. As a group, economies of developing Asia have been the largest contributors to the reserves held by emerging market and developing countries, for almost a decade. During 2003, developing Asia, with total reserves of US$ 666 billion, accounted for almost half of the total reserves held by all emerging markets and developing countries (US$ 1,378 billion). Within developing Asia, China holds the largest volume of reserves. Taiwan, Korea, and India, are the other high reserve-holding economies in the region.

6.66 The fast accumulation of reserves in the Indian economy has drawn attention to the sources of reserve accretion. A recent study conducted by the RBI identifies capital flows as the largest contributor to growth of reserves during the period 1991-92 to end-December 2003-04 (Table 6.14). In recent times, valuation gains, arising from a steady appreciation of the major non-US dollar global currencies (Euro and Pound Sterling in particular) against the US Dollar, have contributed significantly to growth of reserves.

6.67 The high growth of reserves has also raised questions about an 'optimum' level of reserves and the possible implications of the reserve build-up on overall macroeconomic management. Issues relating to an 'optimum' or adequate level of reserves have been addressed in Box 6.5. Regarding the impact of reserves on macroeconomic management, one of the concerns relates to a concomitant growth in money supply and its impact on domestic price levels.To strengthen the monetary authority's ability to conduct exchange rate and monetary management operations, the Market Stabilisation Scheme (MSS) was introduced in April 2004. The MSS intends to absorb liquidity of a more enduring nature through the issue of Treasury Bills/ dated Governemnt securities. The ceiling on issuance of such bills/securities under MSS is initially placed at Rs. 60,000 crore for 2004-05.

Table 6.14: Sources of accretion to foreign exchange reserves since 1991-92

(in US$ billion)

	Categories	1991-92 to 2003-04 (upto December 2003)
1.	Reserve outstanding as on end-March 1991	5.8
2.	Current account balance	-28.4
3.	Capital account (net)	119.0
	a. Foreign investment	60.3
	b. NRI deposits	23.3
	c. External assistance	11.8
	d. External commercial borrowings (including short term credit)	12.1
	e. Other items in capital account	11.5
4.	Valuation change	4.4
5.	Gold valuation	1.0
	Total (2+3+4+5)	**96.0**

Source: RBI.

Note: Totals may not tally due to rounding off of decimal points.

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Box 6.5 : Reserve adequacy

India's total foreign exchange reserves (including gold, Special Drawing Rights (SDR) and reserve with the IMF) have increased from US$ 5.8 billion at the end of March 1991 to US$ 118.5 billion at the end of April 2004. The rate of accretion to total reserves has been particularly remarkable during the last three financial years. In the three years since 2001-02, annual addition to total reserves has been US$ 11.8 billion, US$21.3 billion and US$36.9 billion. The spectacular rise in reserves has drawn attention to the issue of what is an 'adequate' level of reserves for the country.

There are certain common indicators for determining the adequate level of reserves for an economy. These indicators aim to determine the extent of external vulnerability of a country and the capability of reserves in minimizing these vulnerabilities. These indicators are:

1. **Import adequacy:** The number of months of imports that can be financed by the reserves held by the country.
2. **Debt adequacy:** The ability of reserves to cover external payment obligations, particularly short-term debt liabilities. This is measured by the ratios of reserves to total external debt and short-term debt.
3. **Monetary adequacy:** The extent of capital flight that can occur in the event of a financial crisis. This is measured by the ratio of reserves to broad money and reserve money.

Since 1991-92, India has made significant progress in all the reserve adequacy indicators. The import cover of reserves has increased from just over five months in 1991-92 to almost 14 months in 2002-03. The reserves to external debt ratio has shot up from 10.8 per cent in 1991-92 to 72 per cent in 2002-03. Over the same period, the reserves to short term debt ratio has gone up from 130.4 per cent to 1650.9 per cent. The ratios of reserves to reserve money and broad money have improved from 24 per cent and 7.5 per cent respectively in 1991-92, to 97.1 per cent and 20.8 per cent respectively in 2002-03.

While the level of foreign exchange reserves held by India at present can be termed comfortable in terms of all the commonly applied adequacy indicators, it is also important to reflect upon the costs of holding reserves. Two issues are significant in this regard. These are the returns earned from deploying the reserves in various securities (according to the guidelines laid down by the RBI Act, 1934) vis-à-vis the interest paid on external debt and the costs of building up reserves through sustained open market operations. While the first issue entails the direct economic cost of holding reserves, the second, apart from involving costs of intermediation for the banking system, includes the consequences of prolonged sterilization on domestic money supply and price levels. Given the trends of sustained accretion, the issue of reserve adequacy requires to be addressed in the light of the costs and benefits likely to manifest from holding on to the current high level of reserves.

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