

# **Rising Forex Reserves - Cautious Approach**

#### What is the issue?

- India's forex reserves crossed \$500 billion for the first time ever in the week ended June 5, 2020.
- However, the nature of factors contributing to it and the economic uncertainties posed by the pandemic call for a cautious approach.

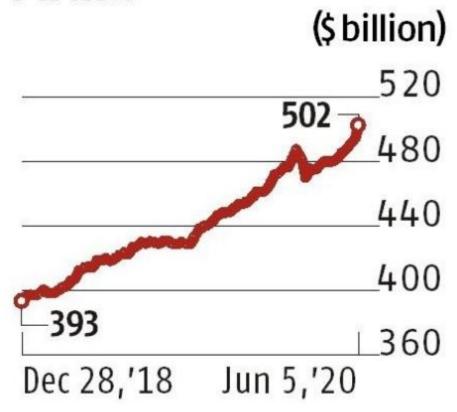
### What are forex reserves?

- Forex reserves are external assets accumulated by India in the form of
  - i. gold
  - ii. SDRs (special drawing rights of the IMF)
  - iii. foreign currency assets (capital inflows to the capital markets, FDI and external commercial borrowings)
- These are controlled by the Reserve Bank of India.

## Why is the present reserves position encouraging?

- The RBI was able to increase its reserves by \$79 billion over the past year (FY19) and by \$29 billion since the beginning of the 2020-21 fiscal year.
- The \$500 billion mark comes as an encouraging development amidst the current gloomy economic scenario, given the COVID-19 pandemic.
- The reserves will be useful if global financial conditions deteriorate further, causing turbulence in currency markets.

# HALF-A-TRILLION MARK



## What were the contributing factors?

- The dollar-rupee swap auctions conducted in March and April 2020 have helped increase reserves to some extent. [Click <u>here</u> to read on swap auction]
- But besides this, there is also a couple of other unplanned and some fortuitous developments as well.
- Notable among them are the rising <u>external commercial borrowings (ECB)</u> and an <u>unexpected trade surplus</u>.
- Global central banks are pumping in enormous amount of money into the global economy and moving interest rates lower.
- With this, Indian companies have found it easier to raise funds overseas at cheaper cost.
- Resultantly, ECBs raised in FY20 were 127% higher compared to FY19.
- In the first two months of 2020-21 fiscal, corporates had already borrowed over \$2 billion.

# What is the need for caution though?

• Increased overseas borrowing has downsides too.

- Corporates can struggle to roll over the loans if the rupee continues depreciating or if the interest rate cycle overseas turns adverse.
- It is also essential to be cautious about the favourable trade balance.
- This is because the current trade surplus is caused mainly by declining demand.
- Merchandise imports were sharply lower in April and May 2020, in line with contraction in global trade.
- Once domestic demand revives with the economy unlocking, demand for petroleum and other products is likely to revive.
- So, there might be pressure on the trade balance once again.
- On the other hand, <u>foreign portfolio investments</u> have not been too robust in 2020.
- FPIs (Foreign Portfolio Investors) have turned net buyers in equities in May and June 2020.
- However, they could turn net-sellers again if risk-aversion spikes.
- That might cause outflows from global emerging markets, if the pandemic does not settle down by the end of this year.
- Likewise, foreign direct inflows were strong until March 2020.
- Inflows in FY20 were 40% higher compared to the previous fiscal year.
- But, direct investments are likely to be much lower in FY21 as businesses struggle to stay afloat amidst the pandemic.
- <u>Remittances</u> from NRIs are also likely to be lower with many overseas Indians witnessing pay-cuts or job losses.

### How does the future look?

- Given the above uncertainties, the RBI is being only prudent in its strategy to continue buying dollars.
- This adds to the buffer as well as helps to keep the rupee weak, making it competitive in the export market in relation to its peers.
- [Notably, the Indian currency is down 4.5% so far in 2020.]
- Other countries have also witnessed an increase in their forex reserves in the May and June 2020.
- This highlights the fact that India needs to be ready to face future turbulence.

Source: BusinessLine

