SPEECH

FOREIGN EXCHANGE RESERVES MANAGEMENT: AN INDIAN PERSPECTIVE*

S. S. Tarapore**

I am grateful to the Cityforum for giving me the opportunity to make this short presentation on Indian foreign exchange reserves management. Given the deep and abiding interest in India, it is only appropriate that the concerns should be fully addressed at this forum. As I see it there are two strands of concerns. First, the macro implications of capital inflows and the sustainability of such flows and second the underlying rationale and practice of Indian foreign exchange reserves management.

2. As you are all aware, India experienced a major foreign exchange crisis of unprecedented intensity during 1990 and 1991; there was an unsustainably large current account deficit, the budget deficit which was large was being monetised by the Central Bank, double digit inflation was raging and the growth of the economy came to a grinding halt. In the first instance, the desideratum of crisis management was that a default in international payments would not be acceptable to the Indian authorities and therefore, sufficiently harsh measures were implemented as part of a strategy to quickly stabilise the economy. When the definitive economic history of India is written, July 1991 will be a watershed when for the first time a credible stabilisation package was dovetailed to a medium-term structural adjustment programme covering trade and exchange rate policy, industrial and fiscal policy, monetary policy and financial sector reforms. While the overall reform process was initially criticised as being far too gradualist, as the reform has entered into the fourth year it is being increasingly recognised internationally, that the Indian reform process is enduring and irreversible. As the exchange rate correction, and a tightening of monetary-fiscal policies were put through, the foreign exchange situation became more manageable. Foreign currency assets rose from a low point of less than US $ 1 billion in July 1991 to US $ 5.6 billion by March 1992. By March 1993, the foreign currency assets rose to US $ 6.4 billion with a surge to US $ 15 billion by March 1994; furthermore, there was a qualitative strengthening as short-term liabilities in terms of swaps, short-term money market borrowings and bulk borrowings from banks were repaid. With a transparent foreign investment policy, liberalisation of the access of Indian corporates seeking to raise funds in international markets and the opening up of the secondary capital market to foreign institutional investors has resulted in a surge in capital flows into the country and the foreign currency assets (excluding gold) in November 1994 were US $ 19.6 billion (Table 1). The sharp rise in the reserves has generated within the country a viewpoint that a further build up of reserves should be prevented. While it is argued in some quarters that an import cover of 8 months is totally unnecessary, it is pertinent to note that such a level of import cover had been scaled in 1977-78.

3. When India's foreign exchange reserves are juxtaposed with those of China, Malaysia, Thailand, Brazil and some other developing countries it does appear that India's foreign exchange reserves are fairly modest (Table 2).

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* Address by Deputy Governor, Shri S.S.Tarapore at the Third City of London Central Banking Conference organised by the Cityforum Limited, London on November 21,1994.

** I am indebted to Mrs. Usha Thorat, Joint Chief Officer, Department of External Investments and Operations and Mr.Michael D.Patra, Director, International Finance, Department of Economic Analysis and Policy, Reserve Bank of India for their invaluable help.

4. I would now like to directly and openly discuss the question of interest to foreign investors namely the sustainability of the capital inflow and the country's capacity to withstand a possible outflow in the future. The Indian authorities are aware of the need for prudent policies and there are sufficient indicators that the inflows have not been dissipated.

5. In September 1994, the Government and the Reserve Bank of India entered into a historic formal agreement to terminate, in a phased manner, the automatic monetisation of the budget deficit and the Government is now financing its deficit by borrowing outside the Reserve Bank at market-related rates of interest. Moreover, a cautious monetary policy has been pursued and gradually interest rates are being aligned more closely to international markets. Thirdly, the Reserve Bank has been undertaking large active open market operations to sterilise a part of the inflow. We are aware that sterilising the inflows does bring in its wake problems of rising interest rates and resurgence of capital flows. A legitimate question which could be raised is why the Indian experience should be an exception to the rule of countries being unable to handle the capital flows and more particularly of being unable to handle the outflow when it takes place.

6. I am emboldened to suggest that there are certain reasons for expecting that the Indian experience would be different. First, the sheer size of the economy and the relatively small international trade and payments sector implies that foreign inflows account for only a small segment of total investment in the country. Secondly, the gradual step-by-step reform has an element of stability and predictability and hence is conducive to longer-term capital inflows. Thirdly, India has a history of intolerance to double digit inflation and therefore, has an inbuilt insurance against instability. Fourthly, the restraint in domestic currency expansion during a period of a massive build up of foreign exchange reserves points to inherent strength to withstand any eventuality of an outflow.

7. Apart from the standard indicators of monetary stability, it is useful to track the net foreign exchange assets (NFA) to currency ratio. This ratio has moved up from a little less than 32 per cent in March 1993 to 60 per cent in March 1994 and further to 71 per cent in November 1994. A sharply rising NFA/currency ratio during the period of the inflow gives an element of comfort to the foreign investor as it indicates that domestic currency expansion has been moderated and when the outflow starts, there will be sufficient foreign assets to meet the currency contraction. When this ratio reaches 100 per cent it would, in a sense, meet one of the crucial requirements of a Currency Board System which provides little or no room for imprudent policies and has a less forgiving attitude to such policies. It is pertinent to mention that up to 1956 under the Reserve Bank of India Act, 1934, holdings of foreign securities had to be equivalent to at least 40 per cent of the issue of currency. While not advocating a mechanistic currency board system, a rising NFA/currency ratio is an assurance that when currency contracts, as a result of the operation of the foreign trade multiplier and/or a loss of confidence resulting in a reversal of the capital flow, the foreign currency assets will be large enough to sustain a currency contraction to the pre-inflow period. While I would not wish to exaggerate the importance of a rising NFA/currency ratio suffice it to say that the foreign investor is secure; the domestic economy, albeit, could well face considerable tightness when such an outflow takes place.

8. Ultimately, the discipline of the market would prevail. It is not what the home country authorities or foreign governments think of a country's policies but the foreign investors' assessment of a country's policies. It would be no exaggeration to say that in the present context, the optimism of foreign investors regarding India exceeds the cautious perceptions of the Indian authorities and hence there is considerable scope for a steady inflow of capital into India.

9. The paramount objective in the current financial year is to bring about a four percentage points reduction in the inflation rate and monetary policy is being strongly oriented to this objective. It is to this end that monetisation of the budget deficit has been avoided and active open market operations are being undertaken to ensure that the inflows are not dissipated into inflation.

10. Foreign investment which was less than $ 0.6 billion in 1992-93, surged to $ 4.1 billion in 1993-94 and is expected to be well over $ 5 billion in 1994-95; it could reasonably be expected to continue at that level for at least the next few years. Of the foreign investment inflow in 1994-95, about 20 per cent could be direct investment, about 35 per cent through foreign institutional investors and about 45 per cent through Euro-issues by Indian corporates. While this surge in foreign investment has occurred, the excessive reliance on costlier non-resident deposit schemes, with exchange rate protection from the authorities, has been phased out. Moreover, repayments to the IMF have been large in 1994-95 and would also be large in 1995-96. The substitution of debt with non-debt creating flows has had salutary effects for the management of external debt. In 1993-94, the accretion to the country's stock of debt was only US $ 644 million, a sharp contrast to the pace of debt accumulation of the late eighties. The debt service ratio, reflecting the sustainability of external debt fell from a little less than 31 per cent in 1992-93 to 25 per cent in 1993-94 and is expected to decline further in the ensuing year.

11. It would be relevent to briefly refer to the run up to the present exchange rate policy. In July 1991, there was a two-step depreciation of the rupee of a little less than 20 per cent and in March 1992 a dual exchange rate was introduced. In March 1993 the exchange rates were unified and a market related system was introduced. The dollar buying rate of the Reserve Bank of US $1 = Rs.31.37 has now remained unchanged for about 19 months. Under the market determined system the pegged rate of the Reserve Bank can be described as passive intervention i.e., the Reserve Bank would not intervene if the fundamentals led to a depreciation of the rupee though the peg does prevent an appreciation; an appreciation would not be justified on the basis of fundamentals as Indian inflation rates are higher than in the US.

12. In recent years not only has there been a large increase in the foreign exchange reserves but a major improvement in the quality of capital flows reflecting a significant strengthening of international confidence in the economy. The Indian authorities recognise that so long as sound and transparent macro-economic policies are pursued, international confidence would be maintained and it is in this context that the Reserve Bank of India views the paramount objective of monetary policy as being the control of inflation.

13. I would now like to turn to the second major area of interest viz., the strategy of foreign exchange reserves management of the Reserve Bank of India. Central Bankers the world over are generally reticent about the management of their foreign exchange reserves - and this is how it should be. Since Central Banks necessarily have to interface with banks and other institutions in international markets it is in the best interests of a Central Bank to broadly explain the rationale of its reserves management strategy. Let me assure this audience that despite our reticence, the rationale of our policy is clearly one of observing strong prudential norms and eschewing speculative positions. The Reserve Bank of India Act ensures that the investment of our foreign exchange reserves is in totally safe assets by restricting investments essentially to Government paper and deposits with commercial banks and the Bank for International Settlements. The law does limit our making full use of market instruments which have developed in more recent years and till amendments are made in the present enactment, we would have to operate within this limitation.

14. Our investment strategy has had to be altered as there have been major changes in the exchange rate system and also because the level of reserves has risen sharply. Under the dual exchange rate system introduced in March 1992, authorised dealers had to surrender 40 per cent of all current receipts to the Reserve Bank and the Reserve Bank in turn met the requirements for certain specified imports and debt service payments; moreover, the foreign currency non-resident deposit inflows and outflows passed through the reserves; as such there was a large volume of transactions through the reserves. In such a milieu it made sense to have a pattern of investments which followed closely the country's pattern of liabilities. With the unification of the exchange rate in March 1993, there was a reduction in transactions passing through the reserves and as the level of reserves rose sharply, it was no longer feasible to deploy the reserves based on the pattern of the country's liabilities.

15. In the era of fixed exchange rates Central Banks were risk averse and the correct stand which they took was one of being totally neutral in international foreign exchange markets. Central Banks can no longer take such a stance and risk averse though they may be, the changes in exchange rates require them to necessarily take a view of exchange rate developments. It would be difficult to classify a Central Bank's stance in such a complex market but at the cost of an over-simplification let me say that the Reserve Bank of India's approach to foreign exchange reserves management can be described as one of a 'loss minimisation strategy'. Our view is that an income maximisation strategy involves serious risks which a Central Bank had best avoid. The international foreign exchange market has sufficient innovative abilities to do business with Central Banks like ours which are risk averse. While our strategy does, prima facie , appear to be rather unambitious I would like to reveal that our rates of return have been comparable to the standard indices for comparable investment in the foreign exchange markets.

16. While from the strict viewpoint of foreign exchange reserves management, the domestic currency impact should be treated as notional, it is just not possible for Central Banks to delink their investment strategies from the domestic accounting and balance sheet effects. A number of Central Banks face this problem especially when the home currency is strong. I would be less than honest if I were not to concede that we in the Reserve Bank do have concerns about our domestic balance sheet. The Reserve Bank of India follows extremely exacting accounting norms and practices and an illustration of some of these procedures would provide a better appreciation of our concerns to those who interface with us.

17. First, we make provisions for losses on the entire portfolio which is affected by a valuation change and not merely on a cash basis. Secondly, while we follow the prudent practice in securities valuation of mark to market, the practice is asymmetrical in that depreciation provisions have to be made on a monthly basis from current income and any subsequent recovery of prices does not allow for a claw back of the losses. Thirdly, when there is movement of the reserves from a weaker currency to a stronger currency, the loss on conversion, over the holding rate for the month, has to be immediately treated as a loss charged to current income but the valuation gain in the stronger currency is treated as a valuation change and cannot be treated as current income. A pressure on the domestic currency balance sheet cannot be treated lightly as ultimately an efficiently run Central Bank is also judged on the basis of its balance sheet. Herein lies the paradox: the stronger a country's currency in the international markets the weaker its local currency balance sheet and the weaker the currency in international markets the stronger the local currency balance sheet. While a Central Bank has to recognise these pitfalls, it cannot totally disassociate itself from the ground realities of a local currency balance sheet. I have belaboured on these matters as I believe that an

understanding of these matters would help a better interface between Central Banks and their constituents abroad.

18. Finally, before I conclude, it would not be appropriate to do so without a brief reference to Central Banks and gold even though this is a subject which is to come up at tomorrow's session. Right from the time that William Jennings Bryan said that man should not be crucified on a cross of gold there have been advocates that gold would sooner or later be demystified from the international payments system; yet this has not happened. While in the 1960s initially Jacques Rueff was a lone voice stressing the importance of gold in the payments system, there was a major revival in Central Bank holding of gold with General Charles de Gaulle's clarion call in 1965 wherein he pronounced the death sentence on the gold exchange standard and called for a return to an international monetary system based on gold.

General de Gaulle's verdict was:

"International exchanges should rest ... on an indisputable monetary basis bearing the mark of no particular country ... one does not see ... in this respect that there can be any criterion, any standard, other than gold". (The Banker, March 1965.)

19. It is of interest to note that while it was France that gave the clear call for restoration of gold, the large build up of official gold stocks was undertaken by Germany and Italy between 1955 and 1960 while the build up by France was between 1960 and 1965. In the event all these three countries benefited greatly when the fixed peg of US $ 35 per ounce was discontinued (Michael D. Bordo and Anna J. Schwartz 'The Changing Relationship Between Gold and Money Supply', World Gold Council Research Study No.4). Had developing countries responded to General de Gaulle's call they would have been better off today!

20. The Reserve Bank of India has a modest holding of a little less than 12 million ounces, of which about two-thirds was acquired before 1965, and among the developing world India has the second largest holding after China. Indian consumer demand for gold has been legendary and over the years various initiatives have been taken to wean away the public from gold. In March 1992, a scheme for import of gold by non-resident Indians was introduced and since the inception of the scheme a little under 10 million ounces have been imported under the scheme and the price differential between Bombay and London has fallen from 60 per cent to 20 per cent. Again, under the Gold Bond Scheme 1993, a little over 1.3 million ounces were mobilised. The present Indian law is extremely restrictive as regards active management of the gold reserves by the Reserve Bank and while we are seeking legal amendments the present management has to be clearly classified as being dormant. It is pertinent to note that while the Indian gold reserves have remained dormant, they were activated in the critical period of the foreign exchange crisis of 1991 and the pledging of gold to obtain loans provided a powerful signal for corrective action. In the ultimate analysis gold does play an important role as it provides the bedrock of the foreign exchange reserves of the country.

21. To briefly sum up, I do believe that prudent foreign exchange reserves management together with the overall policy of monetary control has instilled considerable confidence in the Indian economy. I hope that a better understanding of the rationale for a cautious policy on investment of the reserves would provide for a better appreciation of Indian reserves management in the Reserve Bank of India's interface in international financial markets.

Table 1 : Movements in India's Foreign Currency Assets and Import Cover

Year (April-March)	End year Foreign currency assets (U.S.$ mn)	Annual change In Foreign currency assets (U.S.$ mn)	Import cover (months)
1970-71	584	—	2.9
1971-72	661	77	2.8
1972-73	629	–32	2.7
1973-74	736	107	2.4
1974-75	782	46	1.6
1975-76	1,657	875	3.3
1976-77	3,240	1,583	6.3
1977-78	5,305	2,065	8.9
1978-79	6,421	1,116	8.0
1979-80	8,324	–97	6.4
1980-81	5,850	–474	4.5
1981-82	3,582	–2,268	2.8
1982-83	4,281	699	3.2
1983-84	5,099	818	3.9
1984-85	5,482	383	4.4
1985-86	5,972	490	4.2
1986-87	5,924	–48	4.0
1987-88	5,618	–306	3.4
1988-89	4,226	–1,392	2.1
1989-90	3,368	–858	1.7
1990-91	2,236	–1,132	1.0
1991-92	5,631	3,395	3.3
1992-93	6,434	803	3.4
1993-94	15,068	8,634	7.6
1994-95 (November 11)	19,611	4,543	8.2

Note : Import cover is calculated by taking average monthly level of imports in a year against assets at the end of that year.

Table 2 : Gold Reserves at the end of June 1994 : Selected Countries

(US $ Million unless otherwise specified)

Country	Gold (Million Fine Troy Ounce)	Gold at Market Prices*	Total Reserves	Gold/Reserves (Per cent)
Developed Countries				
U.S.A.	261.8	1,01,549.8	1,66,229.8	61.1
Canada	5.0	1,951.4	13,600.4	14.3
Australia	7.9	3,064.8	15,050.8	20.4
Japan	24.2	9,400.0	1,23,959.0	7.6
Austria	18.6	7,212.0	24,841.0	29.0
Belgium	25.0	9,714.3	23,702.3	41.0
France	81.9	31,753.7	57,289.7	55.4
Germany	95.2	36,925.1	1,20,817.1	30.6
Italy	66.7	25,864.6	58,564.6	44.2
Netherlands	34.8	13,489.0	47,567.0	28.4
Spain	15.6	6,059.8	47,720.8	12.7
Switzerland	83.3	32,308.5	65,247.5	49.5
U.K.	18.4	7,153.8	47,073.8	15.2
Developing Countries				
China	12.7	4,927.0	38,027.0	13.0
India#	11.8	4,546.0	24,649.0	18.4
Indonesia	3.1	1,202.6	12,117.6	9.9
Korea	0.3	128.0	21,812.8	0.6
Malaysia##	2.4	924.9	33,456.9	2.8
Pakistan	2.0	791.4	3,087.4	25.6
Philippines	2.9	1,117.3	7,644.3	14.6
Thailand	2.5	958.2	28,333.2	3.4
Turkey	4.0	1,551.8	5,830.8	26.6
Hungary###	0.1	42.9	6,813.9	0.6
Lebanon	9.2	3,576.9	7,129.7	50.2
Saudi Arabia	4.6	1,784.6	10,240.6	17.4
Brazil	3.4	1,319.0	42,611.0	3.1
Chile	1.9	725.5	11,491.0	6.3
Venezuela####	11.5	4,470.0	12,002.0	37.2

* London market price at the end of June 1994. .

\# November 11, 1994

\## End May 1994

\### End December 1993

\#### End March 1994

Table 3 : India : Movements in the Ratio of RBI's Net Foreign Assets to Currency in Circulation

(Rupees billion unless otherwise specified)

End of	RBI's Net Foreign Currency Assets (NFA)	Currency in Circulation (C)	NFA/C (Per Cent)
March 1991	79.8	352.8	14.4
March 1992	188.4	637.4	29.6
March 1993	226.5	713.3	31.8
March 1994	514.2	853.4	60.3
November 11, 1994	698.7	982.4	71.1

Table 4 : Reserve Bank of India's Gold Holdings

End of	Gold Holdings (Million fine troy ounces)	Gold Prices (London) (US $ per fine troy ounce)
1964	7.066	35.00
1965	8.025	35.00
1966	6.954	35.00
1967	6.954	35.00
1968	6.954	38.63
1969	6.954	41.08
1970	6.954	35.94
1971	6.954	40.80
1972	6.954	58.16
1973	6.954	97.33
1974	6.954	159.25
1975	6.954	161.03
1976	6.954	124.82
1977	7.356	147.72
1978	8.362	193.24
1979	8.560	306.67
1980	8.594	607.86
1981	8.594	459.75
1982	8.594	375.80
1983	8.594	422.47
1984	8.737	360.30
1985	9.397	317.18
1986	10.449	367.68
1987	10.449	446.52
1988	10.449	437.15
1989	10.449	381.28
1990	10.692	383.51
1991	11.282	362.18
1992	11.348	343.42
1993	11.457	359.73
1994 (November 11)	11.800	385.25