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The pros and cons of RBI's massive build-up of forex reserves

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A recent paper by Ashish Saurabh and Nitin Madan, Department of External Investments and Operations, Reserve Bank of India (RBI), 'highlights the scope for looking beyond traditional ways to manage foreign exchange reserves in order to augment portfolio returns without undermining the predominant goals of safety and liquidity.'

The paper lists various options that can be considered by the RBI to increase yields on its forex reserves. These include increasing the duration of portfolio, investment in new product classes (including FX swaps, repos, and even equity index funds), active management of gold, and investment in new markets (including direct investment as well as in passive funds and ETFs). If risk-balanced higher yields are an objective of central banks, it is perhaps only a matter of time before they consider adding Bitcoin and other cryptocurrencies to their portfolio. After all, several large private financial institutions including hedge funds are seriously contemplating diversification into cryptocurrencies.

However, given that the objective of central banks is not profit, there are broader questions that need to be addressed when it comes to forex reserve management strategies: why do central banks accumulate forex reserves, what are the costs of accumulating excessive reserves, is it necessary for a central bank to pursue higher returns on these reserves, and how could this pursuit undermine their larger goals of safety and liquidity?

An important benefit of large reserves rarely discussed is the possibility for a country to expand its fiscal space. Modern Money Theory (MMT) articulates that there exists a spectrum of monetary sovereignty. Large forex reserves do place a country in a better position along the spectrum, enabling the government to leverage its own sovereign currency for national development.

However, the more commonly accepted reason to accumulate forex reserves is to enable central banks to avert financial crisis, particularly one which arises from the balance of payments that could trigger a plunge in the foreign exchange price of the domestic currency. The Guidotti-Greenspan rule considers a short-term external debt to forex reserves ratio of one as adequate. With reserves currently at US$ 640 billion and total short-term external debt by residual maturity at some US$ 225 in 2019, the ratio for India is close to three. Next, an import cover of three months is considered adequate. India has a cover of about 12 months, going by imports in September 2021. Finally, the potential demand for foreign assets arising from domestic sources is monitored by considering the forex reserves to broad money supply (M2). The benchmark is set at 20% for countries with full capital account convertibility. Even with partial capital account convertibility, India is adequately covered with forex reserves.

Given the ample forex reserves for precautionary purposes, it can be inferred that accumulation of reserves is mostly to ensure that the rupee remains depreciated to sustain exports. If this is indeed the case, then it seems that any effort to augment portfolio returns on forex reserves as proposed by Saurabh and Madan will only mean greater inflows of foreign exchange and consequently more pressure on the rupee to appreciate, pulling the RBI into a vicious circle of accumulating even larger reserves to keep the rupee depreciated.

The benefit accruing to exports from a depreciated currency in serving national interests must be viewed as an end in itself. The pursuit of higher returns becomes self-defeating if it results in putting additional pressure on the rupee to appreciate. Put differently, the RBI's achievements must be judged from the realization of its primary objectives by utilizing its delegated powers, not from accumulation of financial assets.

Even from a narrower perspective of pursuing higher yields on assets, there are costs associated with such strategies. Purchase of foreign exchange by central banks in markets leads to an infusion of reserve money into the banking system, dragging down money market interest rates. To ensure that interest rates remain within the target band, open market bond sales to drain out excess liquidity may be needed. If the interest on bonds exceeds the yield on reserves, the central bank loses.

Low-yielding reserves could also be used to pare down higher-cost foreign debt. Although somewhat dated, Dani Rodrik, in 2006, estimated the spread to be as much as 1% of GDP for some countries. However, the study did not consider the benefits that may accrue in terms of lowering costs of borrowing on account of the safety perceived by lenders with higher levels of reserves held by central banks.

There is also a moral hazard issue that arises with large reserves. Agents perceive lower lending risks, thereby lowering rates and easing terms, which encourages greater external borrowing and risk-taking by domestic firms. Enhanced inflows of foreign exchange will consequently put pressure on the domestic currency to appreciate, once again drawing central banks into a vicious loop.

At an even broader level, it is important to look at the repercussions of excessive reserves accumulation, not by any single central banks but by many major central banks, simultaneously. The neo-mercantilist policy of competitive devaluation of currencies not only distorts the optimal allocation of resources across markets but is ultimately a race to the bottom. It is for this reason that the Bank of International Settlements (**BIS**) has recommended that a strengthening of the domestic economy and financial institutions can deter the perceived necessity for central banks to accumulate large reserves. Moreover, efforts for cooperation among countries to provide some form of international insurance as, for instance, the opening of swap lines in times of emergencies may alleviate the need for large reserve accumulation. However, once again, the politics of such backstops cannot be ignored.

While short-term questions over augmenting returns of the RBI forex reserves may be pertinent, there are several broader questions that must be raised, not merely pertaining to reserves *per se* but even more generally on global structural imbalances spawned by the post-Bretton Woods international monetary system.

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