Decline in Forex Reserves

For Prelims: Reserve Bank of India (RBI), Foreign exchange reserves, FPIs, Special Drawing Rights

For Mains: Impacts of Low Forex reserves on Indian Economy

Why in News?

According to the **Reserve Bank of India (RBI)**, India's **forex reserves** have fallen by USD 110 billion in the last 13 months.

What are Forex Reserves?

- **About: Forex reserves** are assets held on reserve by a central bank in foreign currencies, which can include **bonds, treasury bills** and other government securities.
    - Most foreign exchange reserves are held in US dollars.
- **Components:**
    - Foreign Currency Assets
    - Gold reserves
    - **Special Drawing Rights**
    - Reserve position with the **International Monetary Fund (IMF).**
- **Significance of Forex Reserves:**
    - Supporting and maintaining confidence in the policies for monetary and **exchange rate** management.
    - Provides the capacity to intervene in support of the national or union currency.
    - Limits external vulnerability by maintaining foreign currency liquidity to absorb shocks during times of crisis or when access to borrowing is curtailed.

What are Special Drawings Rights?

- The SDR is an **international reserve asset,** created by the IMF in 1969 to supplement its member countries' official reserves.
- The SDR is neither a currency nor a claim on the IMF. Rather, it is **a potential claim on the freely usable currencies of IMF members**. SDRs can be exchanged for these currencies.
- The value of the **SDR is calculated** from a weighted basket of major currencies, **including the US dollar, the euro, the Japanese yen, the Chinese yuan, and the British pound.**
- The interest rate on SDRs or (SDRi) is the interest **paid to members on their SDR holdings.**

What are the Reasons for the Decline in India's Forex Reserves?

- **Current Scenario:**
    - India's forex reserves have fallen by USD 110 billion since September 2021 where it stood

at a record high of USD 642.45 billion.
        - It needs to be noted that **Indian rupee is a freely floating currency,** and its **exchange rate is market determined.** The RBI does not have any fixed exchange rate.
    - Despite this drastic decline, **India has been faring much better than several reserve currencies,** EMEs **(emerging market economies)** and its Asian peers.
- **Causes of Declining Forex Reserves:**
    - **Defending Rupee**: The central bank has been selling dollars from the forex reserves to support the rupee amid pressures caused majorly by global developments.
        - The intervention is needed to curb the free fall of the rupee and reduce volatility in the market.
    - **Aggressive Policy of the US Fed**:
        - **Capital Outflows**: Capital outflows by **foreign portfolio investors (FPIs)** as the US Federal Reserve started the **monetary policy tightening and interest rate hikes.**
            - FPIs have begun to withdraw from the Indian markets. These FPIs were **sellers in financial and IT services** and **buyers in telecom and capital goods.**
        - **Valuation Loss:** The valuation loss, reflecting the **appreciation of the US dollar** against major currencies and the **decline in gold prices** also played a part in the decrease in foreign exchange reserves.
            - About 67% of the decline in reserves during the current financial year was due to valuation changes arising from an appreciating US dollar and higher US bond yields.

What are the Factors Affecting Exchange Rates?

- **Inflation Rates:** Changes in **market** inflation **cause changes in currency exchange rates.** For e.g., a country with a **lower inflation rate than another will see an appreciation in the value of its currency.**
- **Balance of Payments:** It consists of a total number of transactions including exports, imports, debt, etc.
    - A deficit in the current account due to spending more of its Forex on importing products than it is earning through the sale of exports causes depreciation, and it further **fluctuates the exchange rate of its domestic currency.**
- **Government Debt:** Government debt is a debt owned by the central government. A country with large government debt is less likely to acquire foreign capital, leading to inflation.
    - In this case, foreign investors will sell their bonds in the open market if the market predicts government debt within a certain country. As a result, a decrease in the value of its exchange rate will follow.

UPSC Civil Services Examination Previous Year Question (PYQ)

Prelims

Q. With reference to Balance of Payments, which of the following constitutes/constitute the Current Account? (2014)

1. Balance of trade
2. Foreign assets
3. Balance of invisibles
4. Special Drawing Rights

Select the correct answer using the code given below:

(a) 1 only
(b) 2 and 3
(c) 1 and 3

(d) 1, 2 and 4

Ans: (c)

Exp:

- **The Balance of Payments (BoP) is composed of two main aspects: Current Account and Capital Account.**
- The Current Account of BoP measures the inflow and outflow of goods, services, investment incomes and transfer payments. Trade in services (invisibles); trade in goods (visibles); unilateral transfers; remittances from abroad; and international aid are some of the main components of the Current Account. When all the goods and services are combined, together they make up the Balance of Trade (BoT) of a country. **Hence, 1 and 3 are correct.**
- Capital Account of BoP records all those transactions, between the residents of a country and the rest of the world, which cause a change in the assets or liabilities of the residents of the country or its government.
- Loans and borrowing by private or public sectors; **investments; and changes in the forex reserves** are some of the examples of the components of the Capital Account. **Hence, 2 and 4 are not correct. Therefore, option (c) is the correct answer.**

Mains

Q. Justify the need for FDI for the development of the Indian economy. Why there is gap between MoUs signed and actual FDIs? Suggest remedial steps to be taken for increasing actual FDIs in India. **(2016)**

Source: IE