Publication: The Hindu Business Line	Date: December 14, 2020
Edition: All	Page no: 6

What to do with forex reserve riches

Importing capital goods for long-term capacity building could be one option, or parking funds in high-return instruments

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India's foreign exchange reserves have seen a sharp accretion this fiscal (of close to $100 billion) with reserves hitting $580 billion as on December 12. Such a sharp surge has led to an opening of what seems like a Pandora's Box of discussions around reserve adequacy, usage of the reserves to finance infrastructure development in the country and return on investment from the reserves.

Currently the forex reserves are tilting towards adequate or more than adequate, as suggested by various metrics. Moreover, given the central bank's focus on safety and liquidity of these reserves, the current investment portfolio generates low returns.

So what are the possible avenues of usage of the portion of 'excess reserves' and options to maximise returns for the central bank?

One common advice is to use these funds for financing infrastructure development. Funding infrastructure development using excess foreign capital could lead to questions over the independence of the central bank, with the fine line of distinction between aligning its objectives with that of the government and maintenance of credibility.

Moreover, using forex reserves for infrastructure funding could lead to difficulties in monetary management and lead to the increase in government debt.

Since a portion of forex reserves would have to be converted to rupees, that would lead to an increase in money supply. The dollars would ultimately be bought by the RBI to maintain stability in its exchange rates and prevent further appreciation, leading to increase in monetary base.

This would generally call for sterilisation operations by the RBI (to stabilise price levels), which would lead to issuances of government bonds, thus leading to increase in costs and higher debt.

The other option is to use the reserves for capitalising state-owned banks, as done by China in the early 2000s. The first tranche of capitalising of state-owned banks was done by transferring of foreign exchange assets and that did not have much of an impact on the domestic currency. It, however, exposed the state-owned banks to currency risks as the capital injected was primarily in dollars.

The more recent initiatives of capitalising banks in China have been done tosecure foreign-exchange funding to support China's 'One Belt, One Road', initiative. This, in turn, would have limited impact on domestic exchange rates or liquidity conditions. In this context, capitalising state-owned banks in India through foreign assets thus exposing them to currency risks would not be feasible and rupee payments by conversion of the foreign assets would lead once again to the same complications of increased sterilisation costs and debt and monetary management, as with financing domestic infrastructure projects.

A problem of plenty ISTOCK.COM

A more constructive option would be to use the excess reserves to import goods thus leading to dollar payments abroad. The target import goods could be pre-decided in consultation with the government aimed at improving productive capacities of the economy, enhancing infrastructure development or towards building capabilities of strategically important technology and defence sectors.

This would solve the dual objectives of acquiring growth enhancing assets as well as mitigating any adverse complications to monetary management.

An alternative fund

Another option would be to park a certain portion of the excess reserves to an alternative fund that then utilises these to invest in possibly lesser liquid avenues but those that generate higher returns. This could be in line with the 'heritage funds' of the likes established in Singapore and Korea.

Given the contradictory or conflicting objectives of reserve holdings by the central bank and the use of excess reserves to generate higher returns, it would be prudent to create a separate legal entity for investment management akin to a Sovereign Wealth Fund.

This could be managed by independent investment managers with the profits from these investments being transferred to the Reserve Bank, which would then feed into dividend payouts to the government, addressing the problems of apt use of excessive forex built-up and appropriate and more desirable returns on investment of these reserves.

So, to conclude, the excessive build-up of forex reserves calls for an opportune time for the central bank, in consultation with the government, to look at alternative ways to use these funds.

The two most feasible options include either import of capital goods directed towards building long-term productive capacities in the country or setting up an investment entity with the objective of maximising returns.

These options would create alternative avenues of garnering long-term returns/income or funding development in the country without the risks and inherent complications and implications on monetary management and central bank independence of usage of reserves within the country.

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