

Role of RBI in Forex Reserves

What is the issue?

There is a widespread misconception that the Reserve Bank of India (RBI) has been depleting India's foreign exchange (forex) reserves to defend the rupee.

What are foreign exchange (forex) reserves?

- Forex reserves are assets maintained by monetary authorities to check the balance of payments, deal with the foreign exchange rate of currency and to maintain financial market stability.
- The RBI Act, 1934 and the Foreign Exchange Management Act, 1999 govern the foreign exchange reserves.
- **Composition-** India's forex reserves can be broken into four categories.
 - Foreign currency assets
 - Gold
 - Special drawing rights
 - Reserve Tranche Position
- **Purpose-** The main purposes of maintaining forex reserves are
 - To ensure that the RBI has backup funds if the rupee rapidly devalues or becomes altogether insolvent
 - To check the rupee depreciation by selling the dollar in the Indian money market
 - To support our imports since all international transactions are settled in US dollars
 - To limit any vulnerability because of a sudden disruption in foreign capital flows, which could happen during a crisis
 - To establish a good image for the country at the international level thus helping in attracting foreign trade

What is the status of forex reserves in India?

Most foreign exchange reserves are held in U.S. dollars, with China being the largest foreign currency reserve holder in the world.

- **Current status of reserves-** India's foreign exchange reserves stood at \$532.66 billion in September 30, the lowest level since July 2020.
- This has come at a time when the Indian rupee breached the key 82 per dollar level.
- The Indian currency has weakened nearly 10% so far this year, with the central bank defending the rupee via dollar sales that have depleted its forex reserves.
- **Reason for decline in reserves -** The RBI has attributed the fall in the forex reserves to a fall in the foreign currency assets (FCA), which is a major component of the

overall reserves.

- RBI has said that about 67% of the decline in reserves during FY2022 is due to valuation changes arising from an appreciating US dollar and higher US bond yields.

To know more about dip in forex reserves, click [here](#)

What is the role of RBI in forex reserves?

- **Custodian**-The RBI acts as the custodian of the country's foreign exchange reserves and manages exchange control.
- It dominates the market as a regulator, a player and the jury.
- **Dollar/rupee rate**- The RBI Act stipulates that the Central Government orders the rate at which the RBI shall buy or sell forex to banks.
- This rate in turn, will be governed by India's obligations to the International Monetary Fund (IMF).
- The dollar/rupee rate has thus been subjugated to the United States from British India days.
- **Exchange control**- The forex market is regulated by the RBI with impregnable exchange control regulations.
- The RBI does not permit a bank to purchase dollars from the RBI and speculate in the interbank market.
- Selling these dollars in the overseas cross currency market is prohibited by the central bank.
- **Currency volatility**- The RBI also intervenes on the basis of understanding with another bank to calm dollar/rupee volatility.

Where does the real problem lie?

- **Import/export policy**- If the RBI sells 1 billion dollars in the market and a bank buys these dollars to remit them abroad for an importer customer.
- Then the funds would have gone abroad anyway since the importer, holding an import licence, can remit funds abroad as a matter of right.
- So, 1 billion of forex reserves depletion is caused not because of the RBI's intervention but because of the import licence granted by the Ministry of Commerce.
- **Twin deficits**- [India's twin deficits](#), trade and current accounts, are matters of concern.
- There is a need to entangle the trade control regulations (flow of goods/services) and exchange control regulations (flow of funds in exactly an equal and opposite direction).
- **Further depletion**- India's overall forex reserves will deplete further this year due to a ballooning current account deficit and interventions by the central bank to support the rupee.

References

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