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Kunal Kumar Kundu: Running on reserves

Last year, when some market participants were speculating that India might need to seek an International Monetary Fund (IMF) bailout, Reserve Bank of India (RBI)'s newly appointed Governor Raghuram Rajan was categorical about the fallacy of such arguments. Of course, the sustained depreciation of therupee after the announcement of a potential taper and subsequent depletion of foreign exchange reserves (by over $20 billion) did spark such a speculation. However, decisions to severely curtail gold imports and open up swap lines helped stabilise the nerves and the rupee. At the same time, while the weak rupee helped push exports, a persistently weak economy compressed imports, thereby imparting a greater degree of respectability to India's current account deficit, and talks of a potential IMF bailout no longer made the rounds.

However, the recent comment by Rajan that he would not feel comfortable if India's forex reserves were below the level of that of the Chinese, brought the focus back on potential shocks on the economy due to wide gyrations of the currency. What this also means is that Rajan believes the rupee would continue to follow a managed-float (rather than a free float) regime and thatRBI needs to play an active role in managing currency fluctuations. And the best way to do so would be to build a war chest of foreign currency reserves that would ensure RBI's intervention becomes more meaningful, especially in a highly uncertain external environment and foreign flows (especially hot money flows) that can change direction at the drop of a hat.

The recent sharp appreciation of the rupee, engendered by a spurt in portfolio inflows, (a reflection of a sudden sense of bullishness on the part of the market participants with regard to the potential impact of the likely election outcome) is a case in point. A mere look at the export performance does reveal the impact of currency movement. The recent appreciation of the currency has clearly taken it to an over-valued zone - especially in light of high inflation and poor levels of productivity. Not surprisingly, RBI seems to believe that the India's potential gross domestic product (GDP) growth has come down to six per cent and even less.

Having realised the fallacy of continuing to use the wholesale price index (WPI) in the calculation of the real effective exchange rate (REER), which gives a sense of the rupee being fairly valued even when it is actually over-valued, RBI has decided to switch from WPI to consumer price index in its calculation of REER, starting April 2014. Once done, it will likely indicate the fair value of the rupee to be between 61.5-63 to a dollar, much higher than the current rate. This would call for a higher level of intervention to prevent rupee appreciation and, at the same time, help shore up the reserves.

While the possibility of a potential IMF bailout seems negligible, Rajan is aware of the lurking dangers. The transcripts of the 2008 Federal Open Market Committee meetings show that the US Fed's actions are governed by strict national self-interest and not a wider sense of responsibility, despite a clear call for a co-ordinated approach immediately after the crisis. During the financial crisis, only a selective number of developing economies (such as Brazil, Korea, Mexico and Singapore) got access to dollar swap lines - essentially countries that had close economic ties to the US. Moreover, Fed officials viewed their dollar reserves as a form of implicit collateral for the swap lines. In other words, higher levels of reserves increased the chances of getting a dollar swap line at crunch time.

The pertinent question, however, is how high should the reserves be, especially given that there's a cost of holding excess reserves? Like many of the Asian countries, that started to pile up reserves post the 1997 crisis to prevent the recurrence of such situations, conventional views of reserve adequacy (enough reserves to cover short-term external debt i.e. Guidotti-Greenspan rule or reserves to cover six months of import) are no longer valid. India's forex reserves are now more than three times its short-term debt, while the import cover is now for more than 10 months. India's reserves have just crossed the $300-billion mark and currently account for approximately 16 per cent of the GDP, lower than the peak of 25 per cent achieved prior to the global crisis. In comparison, China, which no longer sees any value in acquiring further reserves, has total foreign exchange reserves that are more than ten times that of India's and about 40 per cent of its GDP.

While India's current level of reserves seem enough, extremely and unconventionally accommodative monetary policies in the developed world have resulted in the emerging markets being exposed to a tsunami of liquidity flows either way, likely increasing volatility and potentially, systemic risk. When a co-ordinated policy at the global level fails to materialise, acquiring reserves would seem to be the most logical safety net that potentially vulnerable countries would have to opt for. This, however, would lead to a far sub-optimal situation than it would otherwise have been.

The author is vice-president and India economist, Societe Generale.
These views are personal