

Indian Currency and Foreign Policy

Sangita Virendra Dumore

Associate Professor, Head Of The Commerce Department,
Lokmanya Tilak Mahavidyalay, Wani Ta. Wani Dist. Yavatmal

Abstract

Recently, a dramatic accumulation in foreign exchange reserves has been widely observed in developing countries. This paper explores the possible long-run impacts of this trend on macroeconomic variables in developing countries. We analyze a simple open economy model where increased foreign exchange reserves reduce the costs of liquidity risk. Given the amount of foreign exchange reserves, utility-maximizing representative agents decide consumption, capital stock, and labor input, as well as the amounts of liquid and illiquid external debt. The equilibrium values of these variables depend on the amount of foreign exchange reserves. A rise in foreign exchange reserves increases both liquid and total debt, while shortening debt maturity. To the extent that interest rates of foreign exchange reserves are low, an increase in foreign reserves also leads to a permanent decline in consumption.

However, when the tradable sector is capital intensive, the increase may enhance investment and economic growth. We provide empirical support for our theoretical analysis using panel data from the Penn World Table. The cross-country evidence shows that an increase in foreign exchange reserves raises external debt outstanding and shortens debt maturity.

Introduction

Recently, a dramatic accumulation in foreign exchange reserves has been widely observed in developing countries. Foreign exchange reserves grew at a slow but steady pace between 1980 and 1995; beginning in the late 1990s, however, there was a dramatic rise in the accumulation of reserves. Foreign exchange reserves have now reached record-breaking levels in many developing countries, especially in Asia and the Middle East. During the Asian financial crisis, less developed economies with smaller liquid foreign assets had difficulty averting panic in the financial markets and preventing sudden reversals in capital flows (see, for example, Corsetti, Pesenti, and Roubini 1999 and Sachs and Radelet 1998). Many developing countries thus came to recognize the importance of increased liquidity as a form of self-protection against crises. Replacing liquid, short-term debt with illiquid, long-term debt was a popular policy recommendation, at least initially.

A SMALL OPEN ECONOMY

The main purpose of our theoretical model is to investigate the long-run impacts of accumulated foreign exchange reserves on macroeconomic variables in developing countries. We consider a small open economy that produces two composite goods, tradables and nontradables, relying on external debt. Each representative agent in the economy maximizes the following utility function:

where bA_t = net liquid debt outstanding; bB_t = net illiquid debt outstanding; k_t = domestic capital stock; T_t = lump-sum tax; pN_t = the price of the nontradable good; r = real interest rate of liquid debt; and R_t = foreign exchange reserves. For simplicity, we assume that capital stock is tradable and that there is no capital depreciation. We also assume that $1+r < 1/\beta$, to assure the existence of the steady state. Since the numeraire is the traded good, the real interest rate and the price of the non-tradable good are defined in terms of tradables. Our model has two salient features that have not been commonly used in previous studies. One

is a liquidity premium $\rho(bA t/Rt)$, which makes the real interest rate of illiquid debt higher than that of liquid debt. The other is an insurance premium $\phi(bA t/Rt)$.

which increases as potential liquidity risk increases. In developing countries, sudden reversals in capital flows are less likely when the borrower shifts its external debt from liquid to illiquid debt. The lender thus requires an interest rate premium when issuing illiquid debt. The liquidity premium $\rho(bA t/Rt)$ in the budget constraint reflects this premium. Unlike the liquidity premium $\rho(bA t/Rt)$, the insurance premium $\phi(bA t/Rt)$ is included as an independent cost in the budget constraint because it is a direct cost of holding liquid foreign debt. In our model, the net supply of domestic debt is always zero, such that $bA t$ denotes net liquid foreign debt.

THE IMPACTS OF INCREASED FOREIGN EXCHANGE

To determine the long-run impacts of increased foreign exchange reserves on macroeconomic variables, we explore the impacts of an unanticipated change in R_t on various macroeconomic variables at the steady state. The government has several alternatives for financing an increase in the amount of foreign exchange reserves. However, because of Riparian equivalence, the method of finance will not affect resource allocation. We thus focus on the case where increases in foreign exchange reserves are solely financed by increases in the lump-sum tax T_t . In this case, the government budget constraint at period t is written as (8) $T_t = G^* + R_{t+1} - (1+rR) R_t$.

We next consider the impacts of increased foreign exchange reserves on macroeconomic variables. Recall that each of p_N , kT/n , and $kN/(N-n)$ relies solely on the rate of time preference, that is, $1/\beta$, and is independent of the amount of foreign exchange reserves at the steady state. This implies that an unanticipated increase in the foreign reserve has no impact on the real exchange rate or the capital-labor ratios of the two sectors, even in the long-run. However, the change in foreign reserves affects the steady state values of other macroeconomic variables such as consumption, capital stock, labor, and total output.

SOME INTERNATIONAL EVIDENCE

The main implication of our theoretical analysis is that an increase in foreign reserves has significant long-run impacts on several macroeconomic variables in developing countries. The impacts, however, depend on the parameter values as well as on the interest rates. The purpose of this section is to test this theory using panel data on a large number of developing countries. We first examine the relationship between foreign reserves and total external debt outstanding and their average maturity. In terms of liquidity, short-term debt is more liquid than long-term debt, because sudden reversals in capital flows are more likely when debt maturity is short. Shorter average foreign debt maturity can therefore proxy for the degree of foreign debt. Our theoretical analysis suggests that a rise in foreign exchange reserves not only increases foreign debt, but also causes a shift from illiquid to liquid debt. In the following estimation, we can therefore expect foreign exchange reserves to have a positive impact on total external debt outstanding and a negative impact on average maturity.

EVOLUTION OF RESERVE MANAGEMENT POLICY IN INDIA

India's approach to reserve management, until the balance of payments crisis of 1991 was essentially based on the traditional approach, i.e., to maintain an appropriate level of import cover defined in terms of number of months of imports equivalent to reserves. For example, the Reserve Bank's Annual Report 1990-91 stated that the import cover of reserves shrank to 3 weeks of imports by the end of December 1990, and the emphasis on import cover constituted the primary concern say, till 1993-94. The approach to reserve management, as part of exchange rate management, and indeed external sector policy underwent a paradigm

shift with the adoption of the recommendations of the High Level Committee on Balance of Payments (Chairman: Dr. C. Rangarajan). The Report, of which I had the privilege of being Member Secretary, articulated an integrated view of the issues and made specific recommendations on foreign currency reserves.

6 Level of Forex Reserves in India

The Indian approach to determining adequacy of forex reserves has been evolving over the past few years, especially, since the pioneering Report of the High Level Committee on Balance of Payments, culminating in Governor Jalan's exposition of the combination of global uncertainties, domestic economy and national security considerations in determining liquidity at risk and thus assessing reserve adequacy. It is appropriate to submit stylised facts in relation to some of the indicators of reserve-adequacy described here without making any particular judgment about adequacy.

CONCLUSION

To conclude, the theory and practice of foreign exchange reserves is as complex as any other contemporary economic issue. While it is not easy to provide answers to all the questions raised in the recent debate on foreign exchange reserves management policy, we in India have had such a long journey from the agony of 1991 to the comfort of today and this has come about only by dint of hard work and implementation of prudent policies which has made India, a respected model in the emerging world.

REFERENCE

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