Revisiting Reserves

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An ideal system of global liquidity for the official sector is one which both lubricates international commerce with low risk while facilitating the smooth adjustment of global imbalances when these represent an underlying disequilibrium, all in an environment of highly mobile international capital.

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In an article published in this journal early in the decade just ended (Deepak Lal, Suman Bery and Devendra K Pant, "The Real Exchange Rate, Fiscal Deficits and Capital Flows: India 1981-2000", *Economic & Political Weekly*, 22 November 2003), my co-authors and I had taken a sceptical view of the economic benefits to India of exchange market intervention and the associated accumulation of foreign exchange reserves. Using theory and empirical analysis, we argued that such policies were likely both to exacerbate inflation and reduce and misallocate investment. We believed that greater two-way flexibility of the nominal exchange rate was a superior method for managing the balance of payments, with capital controls primarily focused on limiting the growth of short-term bank debt, the most usual source of contagion in a crisis.

Our article appeared at the beginning of an era that vastly expanded the scale of such reserves accumulation by Asian emerging markets (and other critical groups such as the major oil-exporting countries). That era lasted till the global financial crisis of 2007-09. The crisis provided an important test of the protective value of such reserves accumulation. It also highlighted distortions in the global monetary order that this accumulation of reserves both reflected and aggravated. Accordingly, France has declared international monetary reform to be the centrepiece of its presidency of the G-20 which began in November.

Sea Change

Domestically there has been a sea change since the crisis in official attitudes towards exchange market intervention and the current account deficit. The present dispensation both at the Reserve Bank of India (RBI) and in Delhi appears to be taking a fairly relaxed view on exchange market intervention, capital controls and the current account deficit. This attitude has provoked alarm on the part of respected commentators such as Shankar Acharya and A V Rajwade on the possible harm being done to India's external competitive position. Indeed, the divergence between the present Indian stance on these matters and those of our Asian peers has led the *Economist*, normally a caustic critic of Indian macroeconomic management, to commend India's approach as a precursor of a new "Delhi consensus".

Accordingly this seems to be an opportune moment to revisit the issue of official international reserves from both domestic and international perspectives. Put differently, what interests should guide India as the debate on reforming the system of global liquidity gets underway? Regular readers of this column will note that it continues themes raised by me in two past columns in this series, one on who "owns" the nation's foreign exchange reserves, and a second on India's evolving priorities as a member of the G-20.

To review some of the earlier discussion, sovereigns hold international reserves, usually via accounts owned by their central banks, in three broad asset classes: gold, foreign exchange, and where relevant, in balances at the International Monetary Fund (IMF). What we are primarily concerned with here is the second category, namely, official foreign exchange assets. Foreign exchange reserves form only one part of a spectrum of foreign assets that a sovereign may choose to hold. Sovereigns, particularly those with strong commodity producing sectors, have increasingly also chosen to establish sovereign wealth funds to invest in less liquid, more volatile financial assets or real assets; these may or may not be held by the central bank.

In addition, in order for assets to qualify as official foreign exchange reserves, the IMF lays down certain requirements of liquidity and marketability, which are in principle subject to IMF audit. So what is being discussed here is the accumulation of liquid foreign exchange assets by a domestic monetary authority, supported by the issue of a monetary liability, which is normally counted as part of the monetary base (high-powered money).

Dual Role

From this formulation it is clear that official foreign exchange reserves play a dual role in domestic economic management in small, semi-open economies. They form an important part of the "backing" for the domestic monetary system. This is seen most clearly in the case of the gold standard in an earlier era, or currency boards such as those of Hong Kong today. In these situations changes in foreign exchange assets[1] provide the main source of change in high-powered money.

Such regimes are characterised by a fixed exchange rate against some recognised external anchor, and it is this external anchor which provides credibility to the monetary system. In such a regime, the stock of official reserves is a by-product of monetary flows in and out of the economy, either on current or capital account.

Given that much of the developing world has moved to flexible, though managed, exchange rates, there is today less focus on this monetary aspect of foreign exchange reserves. Instead there is more focus on the second face of international reserves, namely, their precautionary and international liquidity dimensions.

The problem is that there is no widely accepted benchmark of "adequacy" of international reserves in the current state of the global monetary system. However, given the propensity for herd behaviour by private providers of debt capital, emerging markets, particularly in Asia and including India have chosen to self-insure by amassing large stocks of official reserves, so as to limit the burden of adjustment borne by the exchange rate.

Indeed, the "monetary" and "precautionary" motives for holding foreign exchange reserves are linked, in that a sovereign with external liquid assets equal to its monetary base is capable of withstanding the most extreme speculative attack on its currency. By the same token, as the size of the monetary systems of emerging markets increase, their demand for liquid external assets will also increase. The IMF cites one estimate that as much as three quarters of the recent build-up in reserves by emerging markets can be explained by such precautionary motives.

Protective Value

Given India's success in protecting its financial system through the deft use of its reserves in the recent crisis, together with flexibility in the nominal exchange rate, I am now more persuaded of the protective value to India of a relatively large stock of reserves. This will also help to give confidence to India as it continues to liberalise its capital account, as it will and must.

In practice it is difficult to separate these monetary and precautionary motives from intervention in pursuit of export-dependent development strategies, which inevitably generate "beggar-thy-neighbour" concerns. This raises two issues: first, whether India benefits from aping such policies; and second whether India should support a stronger international framework to regulate the use of exchange market intervention for such purposes.

On the first, my view remains as it was in 2003: given both our fiscal position and the nature of our factor markets, we are better served by letting the market play the predominant role in reconciling the nominal exchange rate with the underlying trends in the real exchange rate. On the second, I would argue that it is better to strengthen the tools already available in this area, notably the Article IV consultations of the IMF, than resort to mechanistic rules on reserves accumulation.

Based on this analysis, I would suggest that the following principles might guide our officials as discussions get underway on international monetary reform.

First, the global liquidity regime should be one which both supports global growth and global financial stability. Arguably, the present dollar-based system has done more for the first than for the second goal. I personally am not convinced that there is a superior alternative as yet available, but India should actively engage in the debate.

Second, for the reasons mentioned above, international reserves play a qualitatively different, and more important precautionary and monetary role in emerging markets than in advanced countries. This difference must be recognised in any redesign of global rules.

Third, as argued by the IMF among others, incremental global demand for reserves by emerging markets is unlikely to diminish. There will be a corresponding increase in the demand for international assets which are liquid, free of credit and market risk and scalable without generating systemic instabilities of the kind identified by Robert Triffin half a century ago.

In sum, an ideal system of global liquidity for the official sector is one which both lubricates international commerce with low risk, while facilitating the smooth adjustment of global imbalances when these represent an underlying disequilibrium, all in an environment of highly mobile international capital. This is a difficult and important challenge which will be of increasing importance to India as it emerges as a significant global player.

NOTE

1 More specifically net foreign assets of the monetary authority.