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Forex Reserves and its Impact on the Economy

July 2022 | THEME 367

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Forex Reserves and its Impact on the Economy

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"We will be remembered only if we give to our younger generation a prosperous and safe India, resulting out of economic prosperity coupled with civilizational heritage."

Dr. A. P. J. Abdul Kalam

The "SIB Students' Economic Forum" is designed to kindle interest in the minds of younger generation. We highlight one theme in every monthly publication. Topic of discussion for this month is **"Forex Reserves and its Impact on the Economy."**

Introduction to Forex Reserves

Foreign Exchange Reserves most commonly known as Forex Reserves are cash and other forms of reserve assets, which is maintained by the central bank of a country in-order to maintain the economic stability of its nation. It is also considered as one of the factors used to determine the value of a nation's currency in the global market. Reserves are maintained in the form of currencies of other nations, gold, bonds, treasury bills etc. Some of the most popular currency reserves are US Dollar, Euro, Japanese Yen, Swiss Francs and Australian Dollar.

Understanding Forex Reserves

Forex Reserves are basically the 'money in a nation's pocket' to buy/import goods from other nations. In simple terms, if one wishes to buy a product, the currency which is demanded by the seller needs to be provided as payment. The seller does so for various reasons, one among which may be because his raw material supplier accepts only that particular currency. Similarly, countries that export goods demand for payment in the currency they wish to acquire due to their own economic reasons. For example, when the Arab countries demand US dollar for their oil, it may be because they have to make payment for the vehicles they might have imported from USA in the form of US dollars.

Since all countries are dependent on each other for various resources like food, crude oil, electronics, textiles, rubber, defence equipments and materials, spices, services, automobiles, technology etc, acquiring the currency which is accepted by the seller nation is strategically vital for every nation's existence.

Post the 2nd world war, the US dollar was accepted by most of the countries as the currency for their transactions in the international market. Most countries also pegged their currency to US Dollar and considered it as a benchmark. This led to the growth of demand for the US Dollar thereby raising its value in the currency market. Countries in the Europe based on various treaties agreed to pool resources and formed the currency Euro as their currency for international transactions. In such manner, various currencies are used in the international market and holding such currencies means opening doors to the resources provided by those nations which accept these currencies.

Importance of Forex Reserves for the Economy

A nation's forex reserves are impacted by its imports and exports. To import goods and services, payment in foreign currency is required and to export, foreign currency is accepted. Therefore, one must understand that foreign currency is very important for engaging in trade in the international market. Some of the reasons why forex reserves are important are mentioned below –

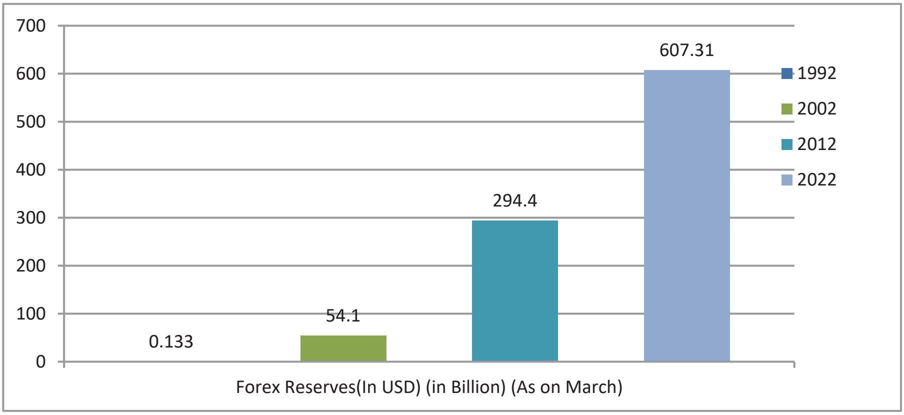
1- **Economic stability –** Availability of resources is vital for keeping the cycle of any economy running. Forex reserves gives access to such resources thereby ensuring that the growth of GDP of a nation is supported.

2- **Controlling the price of the domestic currency –** Foreign reserves are used to control the depreciation of the value of the domestic currency in the international market.

3- **Foreign Debt Obligations–** Various resources are purchased by nations over credit. The credibility of such nations is backed by the strength of their forex reserves.

4- **Attract Foreign Investments –** Foreign investments very much help in boosting the economic output and job creation in a positive manner. Foreign investors are keen to look for nations where there is greater economic stability and this indirectly gives a confidence to the investors regarding the safety of their funds invested.

Brief snapshot of the Forex Reserves of India



Factors which impact Forex Reserves

Some of the direct forces which impact the forex reserves of a nation are –

1- Volume and cost of Imports – Foreign exchange is used to settle payment transactions during imports. A country which imports more than what it exports, it will lead to trade deficit. This reduces the forex reserves.

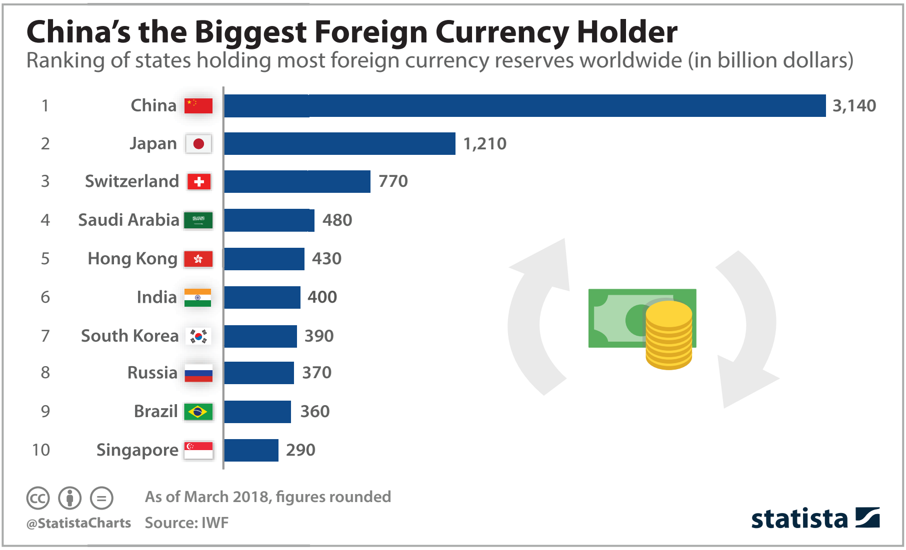
2- Volume and value of Exports – Foreign exchange is earned when goods and services are exported to other nations. A nation which exports more than what it imports will have trade surplus and therefore increase the forex reserves.

3- Foreign Direct Investments – When a nation becomes an attractive investment option based on its macroeconomic policies, it tends to become an attractive investment option for foreign investors. Therefore, the inflow as well as the outflow of funds from foreign investors tends to impact the forex reserves.

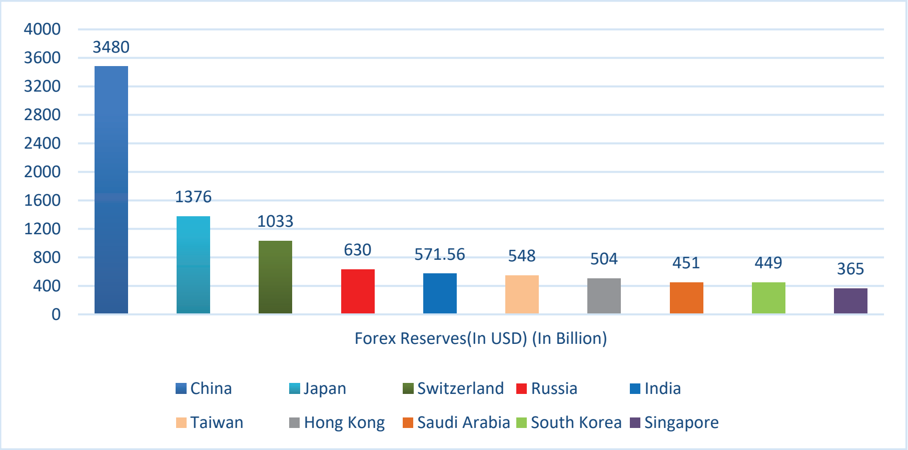
The Forex Reserve Race

Presently, from a strategic standpoint, nations are in a move to increase their forex reserves. India has been playing its part by launching various initiatives like Make in India, AatmaNirbhar Bharat, etc in its move to reduce its dependence on imports and promote exports.

In the year 2018 the top 10 countries with the highest forex reserves are



As on June 2022 the countries with the highest forex reserves are –



Conclusion

Growing Forex reserves leads to economic prosperity as the same also acts like insurance at the time of severe economic crisis. Therefore, forex reserves alone should not be considered as the indicator for economic strength of a nation. It simply reflects the efficiency of governance and one of the factors to understand the productivity of a nation. Sri Lanka has fallen into economic crisis due to depletion of its forex reserves. In the meanwhile, India's proactive efforts to boost its forex reserves have received praise from various economists including former RBI governor Raghuram Rajan. Based on the current levels of the forex reserves, Mr. Rajan claims that the RBI has done an excellent job in boosting the forex reserve levels and this will help India to avoid experiencing the economic issues faced by countries like Sri Lanka and Pakistan.

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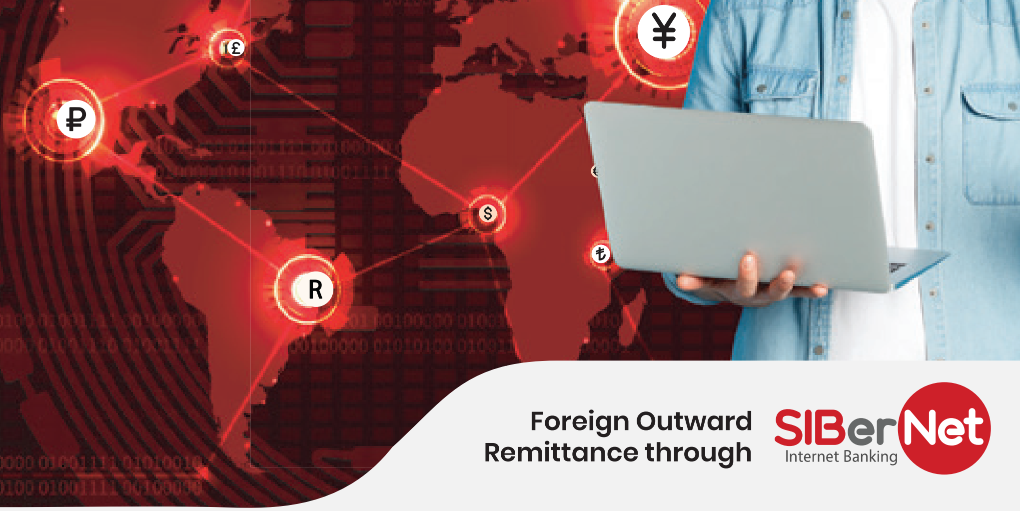

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Financial year - USD 100000

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Rate for conversion:

TT selling rate available at that point of time

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