

## Indian Forex Reserves

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After the balance of payment crisis of 1990-91, when our import cover fell to a low of 3 weeks of imports, India has made commendable efforts to avoid any such future crisis. Raising the total forex reserves from \$5.8 billion in 1990-91 to \$141.5 billion in 2004-05, required several policy changes from the Indian government. Here we try to analyze the major components of our forex reserves, and try and understand the implication of each such component for India.

Apart from the various loans and grants available to India, the three main components of foreign reserves are FDI, FII and remittances. Lets look at them one by one and try and understand their importance.

**1) Foreign Direct Investment (FDI) :-** FDI is the movement of capital across national frontiers in a manner that grants the investor control over the acquired asset. To put it in simpler terms, it refers to the investment which foreign companies make in Indian companies. This investment may be in the form of a joint venture or through a merger or acquisition. It can also be in the form of a fully owned subsidiary of a foreign company. Firms which source FDI are known as 'multinational enterprises' (MNEs). In case of FDI, investor control stated above is defined as owning 10% or greater of the ordinary shares of an incorporated firm or having 10% or more of the voting power for an unincorporated firm.

FDI can be said to server three main purposes. They are:-

- 1) FDI for investment in the form of minority stakes in various Indian companies.
- 2) FDI can bring new technology in the country. For instance, if GM plans to start a plant in India, it might bring along with it the various new technologies and machineries which it uses in its plants in other countries.
- 3) FDI can help get better market access. This can be achieved in two ways. One by asking other countries to open their markets as well. If India opens up the retail sector for FDI, it can easily leverage this in WTO to ask other countries to open up other sectors in their country. The market access can also be increased by piggybacking on the MNE to access markets accessible to it. For instance Sona Kyoto Steerings gets access to markets accessible to GM if GM opens a plant in India and uses steerings manufactured by Sona Kyoto.

The last two purposes can be easily served by direct investment in new facilities or the expansion of existing facilities. This is also called **Greenfield investment**. Greenfield investments should be the primary target of India's promotional efforts because they create new production capacity and jobs, transfer technology and know-how, and can lead to linkages to the global marketplace. This is the principal mode of investing in developing countries. While the other mode namely "Mergers and Acquisitions" is the principal mode of investing in developed countries.

**2) Foreign Institutional Investment (FII) :-** FII refers to the investment made by foreign institutional investors in various stocks, mutual funds and other similar financial

instruments in India. Large financial institutions invest in share markets across the world to hedge their risk and maximize their gains. Such investment in a foreign country is known as FII.

FII is **very volatile**, in the sense that they can be withdrawn any time. Finance Minister Chidambaram says, "All kinds of capital flows into the country are welcome." "But," he adds, "There is a hierarchy of preferences." And he lists the hierarchic order of preferences as Remittances first, Foreign Direct Investment next, Foreign Institutional Investment third and Venture Capital, the last.

When the Finance Minister expressed his preferences, he implied something serious. And that is the high risk that the capital not preferred by Chidambaram carries. **In 2005 alone the FIIs have net-invested \$10 billion in Indian stocks.** This **short-term money**, also known as **hot money**, moves around the different stock markets of the world by digital waves. It has no loyalty other than to instant gain. It only looks at how different markets move and flows to the market which offers better terms on a day and to the next, better market the next day.

See the risk this hot money carries. Out of the total foreign money invested in Indian companies the hot money lodged by FIIs **in Indian stocks is said to be around \$45 billion** and the balance, FDI. This \$45 billion that has come in has appreciated in stocks to \$80 billion, almost doubling in value. A part of this money can fly off the moment it finds a small advantage elsewhere. And when it leaves it generally brings down the stock market as the local money cannot take its place adequately.

**It will force down not just the stock values, but also the currency, the Rupee, values.** More, when it leaves, it will also paste a certificate of **no confidence on the Indian economy**, just as its entry was seen as a measure of confidence in India! India need not perform badly, nor does someone else need to perform better, for hot money to leave India. If the US raises its interest rates substantially for its own domestic reasons, it offers better returns on this hot money, and the hot money can desert the Indian stocks and fly off to US. This will bring down the Indian stock and forex market and thus encourage other investors to pull out their money too. **The hot money mixed in Indian forex reserves is over \$90 billion** that is about 60 percent of the total.

**3) Remittances :-** Remittances refer to the flow of **foreign exchange through Indians working abroad.** To make it simple, the money which you will send back to your parents or friends, once you are working for Lehman NewYork, will contribute to remittances. As Mr. Chidambaram says, remittances are the most preferred form of foreign exchange. Let us try and understand why..

1) The flow of remittances is the **least influenced by economic downturn and remains a stable source of income.** A recession in India will immediately drive away all FIIs and **will stop the flow of fresh FDI.** However, remittances will still keep coming, at least at a stable rate. If we look at the figures, remittances to India have increased at about 13 percent a year since 1991. The movement of remittances around the trend has been low, which definitely goes on to prove that remittances are the most stable type of external flows in India.

2) Remittances are also a very important source of income for households, in particular in developing countries. The fact that remittances are not influenced by economic downturn, makes it a stable source of income. Analytical studies have also shown that remittances contribute to poverty reduction in home countries.

It is estimated that forex remittances into the country from Indians living abroad could touch a record \$37bn during '05-06. This is an increase of around \$5bn as compared to \$32bn in '04-05. Significantly, remittances from Indians and entities are higher than all capital flows put together. Thus, this segment shores up our external sector year after year by keeping current account deficit in check.

Now since we understand the basic components of foreign exchange, it will be interesting to understand the importance of the huge forex reserves we have built. We will also try and propose a strategy to make the best use of these forex reserves. But I guess all this should be left for the next article on forex. As of now, I leave it to you guys to think over it and if possible send me your suggestions...

Cheers,

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Students are welcome to discuss their doubts on this topic with me via mail or messenger. Suggestions are also welcome ☺.