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A "Bullet Proof" Balance Sheet?

Almost exactly two years back, when Dr. Raghuram Rajan took over as Governor of the central bank, the rupee was plunging thanks to fears about the possible impact of the end of monetary easing in the US. Dr. Rajan took prompt action and restored stability to the rupee's exchange rate. During the last couple of years, he has been widely praised for creating a "bullet proof" external balance sheet, backed by record level of reserves.

But is the quantity (and, more so, quality) of our reserves such as to justify the description "bullet proof"? While I have not come across any formal "model" to calculate reserves adequacy, at one time it was believed that reserves to finance say six months imports were adequate. Later, the outstanding short term credit was added. By these yardsticks, our reserves can be regarded as comfortable, if not quite "bullet proof".

But are these yardsticks adequate in the era of free capital flows? The recent experience of China, by far the largest holder of reserves of foreign exchange in the world, is worth recounting. After the stock market plunge in the middle of the year, there was a flight of foreign portfolio investors in the Chinese market; the yuan fell first in the offshore, and later in the domestic, market, despite huge sales of dollars by the Chinese central bank. The reserves fell almost $ 100 bn in August alone, and are down to $ 3.5 trillion, from $ 3.8 trn at end-2014. Last week China tightened capital controls to stem/discourage capital flight (Financial Times, September 10th). Clearly in the era of liberal capital account, we need to look at reserves adequacy not just from the "flow" perspective ('x' months' imports) but also from the "stock", or balance sheet, perspective. Where do we stand?

At the end of fiscal 2014-15, our net international investment position (IIP) was a **negative $ 363 bn**: assets of $ 518 bn (including reserves of $ 342 bn) and liabilities of $ 881 bn. The latter number included portfolio investments of $ 228 bn, trade credits of $ 83 bn; and external commercial borrowings of $ 183 bn. There are two major implications to the numbers:

⇒ The "reserves" are about equal to short term trade credits and portfolio investments;

⇒ They are not built out of the surplus of income over expenditure as in China's case (i.e. current account surpluses), but out of a continuous increase in external liabilities: **in other words, the "quality" of the reserves is poor**.

The current account deficit in the first quarter of the current fiscal year was $ 6 bn; in other words, unless there is an improvement in the trade balance, the negative IIP would increase by another $ 25 bn or so by March 2016. And, so far at least, there are few signs of any improvement in the trade numbers: exports have continued to fall for the last nine months. The RBI's latest annual report suggests that our domestic savings would continue to be less than domestic investments, translating into deficits on current account, for the foreseeable future (more on that in a later article).

The complacency about the IIP reminds me of an old Sanskrit saying: *"runam krutwa ghrutam pibet".* Loosely translated, it advocates continuous increases in borrowings to live beyond your means. (According to Jairam Ramesh's recent book on the 1991 balance of payments crisis, P V Narasimha Rao, the then Prime Minister, used the saying to describe our problem.)

But to come back to portfolio flows, analysts have estimated capital flight from emerging market economies over the last 13 months at around $ 1 trillion! The result is that currencies of most emerging economies have slumped against the dollar – even before US interest rates have risen. For India also net portfolio flows have been negative over the last couple of months and the rupee would have fallen much more than it has, but for RBI intervention, resulting in a fall in reserves for the last three weeks. The "bullet proof" balance sheet may not be up to a "stress test".

While the draft Indian Financial Code is specific about monetary policy, it has little to say about the exchange rate policy. Surely, the external value of the rupee is as important as its domestic counterpart?

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