News: The country's foreign exchange reserves crossed the $450 billion mark for the first time ever on the back of strong inflows which enabled the central bank to buy dollars from the market, thus checking any sharp appreciation of the rupee.

Prelims and Mains focus: About quantitative easing, forex reserve, its composition and significance

Background

During the taper tantrums of 2013, (or the collective reactionary panic after the U.S. Federal Reserve said it would apply the brakes on its Quantitative Easing programme), India’s foreign exchange reserves fell to $274.8 billion in September of 2013, prompting the Centre and RBI to unleash measures to attract inflows. It has been a steady rise for the reserves since then, with $175 billion added in the last six years.

What does this mean?

India’s foreign exchange reserves were at $451.7 billion on December 3, 2019 — an increase of $38.8 billion over end-March 2019.

At $451.7 billion, the country’s import cover is now over 11 months. The rise in foreign exchange reserves will give the central bank the firepower to act against any sharp depreciation of the rupee, currency.

The Reserve Bank has always maintained that it intervenes in the foreign exchange market to curb volatility and does not target a particular level of exchange rate.

Foreign investment

Net foreign direct investment rose to $20.9 billion in the first half of 2019-20 from $17 billion a year ago while net foreign portfolio investment was $8.8 billion in April-November 2019 as against net outflows of $14.9 billion in the same period last year.

Net investment by FPIs under the voluntary retention route has amounted to $6.3 billion since March 11, 2019.
Why the Foreign Exchange Reserves frequently fluctuate?

The Foreign Exchange Reserves are expressed in terms of the US dollars are subject to variations due to the appreciation/depreciation of non-US currencies such as the euro, pound and yen held in the reserves.

The components of India’s FOREX Reserves include:

1. Foreign currency assets (FCAs)
2. Gold Reserves
3. Special Drawing Rights (SDRs)
4. RBI’s Reserve position with International Monetary Fund (IMF).

Note: FCAs constitute largest component of Indian Forex Reserves and are expressed in US dollar terms.

Differences Between Helicopter Money and QE

Helicopter money is a theoretical and unorthodox monetary policy tool that central banks use to stimulate economies. Economist Milton Friedman introduced the framework for helicopter money in 1969, but former Federal Reserve Chairman Ben Bernanke popularized it in 2002. This policy should theoretically be used in a low-interest-rate environment when an economy’s growth remains weak. Helicopter money involves the central bank or central government supplying large amounts of money to the public, as if the money was being distributed or scattered from a helicopter.

Contrary to the concept of using helicopter money, central banks use quantitative easing to increase the money supply and lower interest rates by purchasing government or other financial securities from the market to spark economic growth. Unlike with helicopter money, which involves the distribution of printed money to the public, central banks use quantitative easing to create money and then purchase assets using the printed money. QE does not have a direct impact on the public, while helicopter money is made directly available to consumers to increase consumer spending.