Syllabus subtopic: Indian Economy and issues relating to planning, mobilization of resources, growth, development and employment.

Prelims and Mains focus: about Forex and its constituents; why RBI is more keen on investing in US treasuries?

Context: In September 2008, the year that saw the global financial crisis unfold, deposits with other central banks formed more than 57% of the Reserve Bank of India’s (RBI’s) foreign currency assets. US Treasury bonds and other securities had a lower 40% share of the forex kitty.

- Fast forward to September this year, the share of foreign securities, which includes US government bonds, has surged to 63% and that of deposits with other central banks and the Bank for International Settlements has dropped. The share of the latter fell to about 29%.
- During this 11-year period, India’s central bank has increased foreign exchange reserves by 51% to a record $433.59 billion. Reserves were even higher at $454.50 billion as of 13 December. It would seem that much of this increase has been invested in foreign securities, predominantly government ones. To be sure, the central bank’s latest Report on Management of Foreign Exchange Reserves showed that the share of foreign securities has increased.

What explains the increase in the share of this asset class in RBI’s reserves?

- Part of the answer is obvious. Most global central banks have been on an unprecedented expansionary path in their monetary policies. Governments too have adopted a loose fiscal policy.
- In essence, dollars, euros and pounds have been printed more and more. Since government bonds are the safest asset class, central banks typically prefer to deploy forex reserves into these. And India’s central bank is no different.
- RBI goes by the mantra of safety, liquidity and returns when picking out asset classes to invest its forex reserves. Given that safety is of the highest importance, investing a large share of reserves in sovereign bonds of advanced economies is a prudent approach.
Another factor is the valuation. **US Treasury yields have plummeted since the crisis.** For instance, the US 10-year Treasury note’s yield has dropped by 1.8 percentage points since the crisis erupted in September. The UK gilt has dropped by an even bigger margin. When bond yields fall, the value of the bond holding increases as prices go up. Yields and prices move in opposite direction.

**Conclusion**

- Before the crisis, the RBI had preferred to park a big chunk of forex assets into fixed deposits because the bond yields were rising at that time. Perhaps they may have shifted now away from deposits to bonds since yields are on a downward spiral.
- Indeed, the Treasury International Capital data from the US Federal Reserve showed that India moved up to 13th place from 19th in October 2009 in terms of size of investment in US securities.
- Central banks like risk-free assets and what is better than US Treasury bonds. It should not come as a surprise that India’s central bank has grabbed them in a big way.