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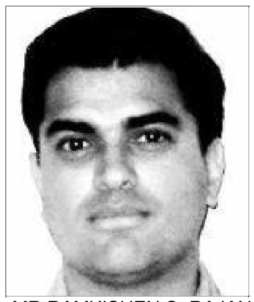
`Startling' portion of India's new reserves in US treasuries

D. Murali



MR RAMKISHEN S. RAJAN

Chennai May 6 As recently reported, Indian financial institutions and the central bank have been investing heavily in US treasury securities. Total investment stood at close to $20 billion in February.

Are there any patterns or trends in the investment by developing countries in US treasury securities?

"No obvious trends, except India and Brazil seem to be more aggressive buyers while some like Korea are selling and the OPEC and Russia seem to be diversifying out of US assets," comments Mr Ramkishen S. Rajan, Associate Professor, School of Public Policy, George Mason University, US, interacting with *Business Line.*

He finds the India data `rather startling'. Why so? "It shows that until last year about 7 per cent of India's reserves were in the US short-term treasuries, and over the last year the share has risen to 10 per cent implying around 20 per cent of the new reserves over the year have been invested in short-term US assets," reasons Mr Rajan.

"Part of the reason for this appears to be the fact that a large part of India's reserve build-up recently has been because of short-term capital inflows and there may be some concern that these reserves will be drained suddenly in the event of a sell-off. The RBI is, therefore, comfortable holding more of these new reserves in relative liquid assets."

The average yield on three-month US treasury bill in February was 5.08 per cent, while the RBI's reverse repurchase (reverse repo) rates were 6 per cent, implying a deficit, reported the media.

Now, is the `deficit' worrying? "The negative interest rate differential between the US treasuries and RBI repo illustrates the fiscal costs of sterilisation. Herein lies the conundrum," says Mr Rajan.

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He explains the puzzle as follows: "Intervene in forex markets to prevent `excessive' exchange rate appreciation especially because the appreciation could reverse course just as quickly if there is a sell-off.

"The reserve accumulation implies under-valuation of the rupee in the short term so there is further capital inflows of the short-term nature. Given the existing inflationary concerns, the RBI has to sterilise aggressively (i.e. mop up the liquidity consequences of forex intervention) and in the process it faces the fiscal losses."

Mr Rajan wonders why there is this much concern about ensuring such a large proportion of new reserves are maintained in liquid the US assets, given the size of India's existing reserve assets.

"The RBI appears to be over cautious about ensuring liquidity and it also suggests that they may be especially concerned about possible panic selling and withdrawals," he postulates.

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