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Subhrajit Chanda



BBA. LL.B. (Hons.) (Amity University, Rajasthan); LL. M. (UPES, Dehradun) (Nottingham Trent University, UK); PH.D. Candidate (G.D. Goenka University)

Subhrajit did his LL.M. in Sports Law, from Nottingham Trent University of United Kingdoms, with international scholarship provided by university; he has also completed another LL.M. in Energy Law from University of Petroleum and Energy Studies, India. He did his B.B.A.LL.B. (Hons.) focussing on International Trade Law.

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With this thought, we hereby present to you

RETHINKING ECONOMIC STRENGTH: A STUDY ON THE ROLE OF FOREX RESERVES IN ASSESSING FINANCIAL HEALTH

AUTHORED BY - VIVASWAN DEV BALAJI SHARMA

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Abstract

Foreign exchange reserves are regarded as one of the pillars of a nation's economic strength, which provides stability against external vulnerabilities and shapes the global perceptions of financial credibility of the country. However, in an increasingly interconnected world, the significance of these reserves extends far beyond their numerical value. This paper examines the role of foreign exchange reserves in assessing the financial health of a nation, with a particular focus on India's economic journey.

The study begins by exploring the concept, components, and functions of foreign exchange reserves, emphasising their role in supporting international trade, ensuring currency stability, and enhancing investor confidence. It highlights how countries with adequate reserves possess greater resilience during economic disruptions, such as global recessions, financial crises, or geopolitical shocks. India's economic experience ranging from the severe balance of payments crisis of 1991 to its present position as one of the world's largest reserve holders illustrates how reserves can transform a nation's financial standing and influence its global engagement.

At the same time, the paper argues that foreign exchange reserves alone cannot fully represent a country's financial health. While India's reserves reflect external strength and macroeconomic stability, domestic indicators continue to highlight structural challenges that reserves cannot compensate for. Thus, forex reserves, though critical, present only a partial view of national financial well-being.

The paper also analyses the legal framework governing foreign exchange management in India, primarily through the Foreign Exchange Management Act (FEMA), 1999. FEMA's shift from

stringent regulation to structured management reflects India's broader economic liberalisation and its evolving approach to external sector stability. By examining both legal and economic dimensions, the study shows how policy choices, institutional mechanisms, and reserve strategies shape the nation's ability to withstand shocks and maintain financial credibility.

Keywords:

Foreign Exchange Reserves, Financial Health, Economic Stability, FEMA 1999, Balance of Payments Crisis, Currency Management.

Introduction

In the modern globalised world, nations are increasingly interdependent, and international trade has expanded rapidly. Within this interconnected economic environment, foreign exchange reserves have become one of the most crucial assets of a country. These reserves are held by the central bank in the form of foreign currencies, gold, Special Drawing Right, and Reserve Tranche Position with the International Monetary Fund. They play a significant role in safeguarding the economy against external shocks and ensuring macroeconomic stability. They are particularly valuable during periods of financial stress, enabling a country to meet external payment obligations and maintain confidence in its economic resilience of the country during the time of crisis.

Foreign exchange reserves serve as an important indicator of a nation's financial strength. Countries with substantial reserves are perceived as less likely to default on their external commitments, thereby making them more attractive to international investors. In contrast, nations with inadequate reserves often face currency volatility, reduced investor confidence, and limited ability to manage external crises. For this reason, foreign exchange reserves are frequently used as a parameter for assessing a country's financial health.

India offers a significant example of the importance of these reserves. Today, India holds one of the largest foreign exchange reserves in the world, which has significantly contributed to its reputation as a stable and reliable destination for investment. However, this was not always the case. In 1991, India faced a severe balance of payments crisis, with reserves sufficient for only two weeks of imports. This crisis led to a dramatic loss of investor confidence and forced the country to pledge its gold to secure emergency financial assistance. The situation compelled

the government to introduce sweeping economic reforms under the Liberalisation, Privatisation, and Globalisation framework. Although initially they were challenging for the economy, however, in the long run, these reforms paved the way for long-term economic stability and a sustained accumulation of reserves.

While the foreign exchange reserves are undoubtedly crucial, they cannot be considered the sole measure of a nation's financial health. Internal economic indicators such as per-capita income, unemployment levels, fiscal deficit, debt, and overall productivity also play an essential role in assessing the true economic condition of a country. Thus, forex reserves must be understood as one among several components that reflect the strength of an economy.

This paper seeks to examine the importance of foreign exchange reserves in ensuring economic stability, analyse their components and legal framework, and evaluate their role in assessing a nation's financial health—with specific reference to India's past and present reserve position.

Conceptual Foundations of Foreign Exchange Reserves

Foreign exchange reserves refer to external assets held by a country's central bank, which is used to support the national currency and manage international financial obligations. Section 2(n) of the Foreign Exchange Management Act, 1999 defines "foreign exchange" to include foreign currency and certain instruments payable in foreign currency or Indian currency under specific circumstances. These reserves are essential for facilitating international trade, maintaining exchange rate stability, and strengthening confidence in the country's economic resilience.

Foreign exchange reserves act as a safeguard during periods of financial stress. They allow a nation to meet import requirements, service external debt, and absorb sudden economic shocks without defaulting on international commitments. Historically, countries with adequate reserves have been able to withstand global recessions or geopolitical disturbances with far greater stability. On the other hand, inadequate reserves often lead to currency depreciation, balance of payments crises, and the erosion of investor confidence. Thus, the size and composition of a country's reserves are widely regarded as significant indicators of economic strength.

Components of Foreign Exchange Reserves

According to the Reserve Bank of India (RBI), India's foreign exchange reserves consist of four major components:

1. Foreign Currency Assets (FCAs)
2. Gold Reserves
3. Special Drawing Rights (SDRs)
4. Reserve Tranche Position (RTP) in the IMF

Foreign Currency Assets (FCAs)

Foreign Currency Assets constitute the largest portion of India's reserves. These include holdings of major international currencies such as the US Dollar, Euro, British Pound, Japanese Yen, and Chinese Yuan. FCAs are typically invested in sovereign bonds, treasury bills, and deposits with foreign central banks and commercial banks.

The RBI selects currencies based on factors such as safety, liquidity, returns, and their acceptance in global trade. Globally recognised reserve currencies particularly the US Dollar, forms a substantial share of India's FCAs due to their stability and universal acceptance in international transactions. For instance, India's crude oil imports are predominantly invoiced in US Dollars, making dollar reserves essential for external payment stability. The RBI also uses FCAs to manage exchange rate volatility by selling or purchasing foreign currency in the domestic market. Of India's approximately 700 billion dollars as forex reserves, around 580 billion dollars consists of foreign currency assets.

Gold Reserves

Gold forms a significant and increasingly valued component of India's reserves. Gold is held in physical form by the RBI in the form of high-quality bullion. Gold provides a reliable and historically stable store of value. Unlike foreign currency assets, gold is immune to unilateral sanctions or freezes by foreign governments. The freezing of Russia's foreign reserves during the Russia-Ukraine conflict highlighted the geopolitical risks associated with overreliance on foreign currency assets. India in the last few decades, has increased its gold holdings, which now constitute roughly 11% of total reserves.

Special Drawing Rights (SDRs)

Special Drawing Rights are international reserve assets created by the International Monetary Fund (IMF). Although, they are not a currency by themselves, they represent a potential right or a claim on freely usable currencies of IMF member nations. Their value is determined by a basket of major global currencies: the US Dollar, Euro, British Pound, Japanese Yen, and Chinese Yuan.

SDRs enhance the liquidity position of a country and can be exchanged for hard currency if required. Countries also earn interest on their SDR holdings. India currently holds around 18 billion dollars' worth of SDRs, contributing to the stability and diversity of its reserve composition.

Reserve Tranche Position in the IMF

The Reserve Tranche Position represents a portion of India's quota contribution to the IMF. It is an immediately available reserve asset that India can draw upon without stringent conditions or service charges. This makes the RTP a dependable liquidity buffer during times of external stress. India's RTP stands at approximately USD 4 billion.

The Legal Framework Governing Foreign Exchange in India

The management of India's foreign exchange reserves operates within a clearly defined legal and institutional framework that ensures these reserves are handled efficiently and responsibly. The most important legislation governing foreign exchange in India is the Foreign Exchange Management Act (FEMA), 1999, which replaced the earlier Foreign Exchange Regulation Act (FERA), 1973. While FERA was regulatory and highly restrictive in nature, FEMA marked a clear shift toward a more liberal and facilitative approach, in line with India's broader economic reforms after 1991.

FEMA provides the legal foundation for how foreign exchange transactions are monitored and regulated in the country. The Act empowers the Reserve Bank of India (RBI) to oversee the foreign exchange market and ensure that India's external sector functions smoothly. Under Section 3, only persons authorised by the RBI are allowed to deal in foreign exchange, which ensures that all such activities are controlled and legally compliant.

Under Section 11, the RBI has the authority to issue directions to authorised persons and to ensure the strict compliance with FEMA. This includes the power to inspect books, accounts, and records when needed. In cases where a person fails to pay penalties imposed under the Act, Section 14 permits civil imprisonment after following due legal procedure.

The adjudication of FEMA violations is carried out by officers appointed by the Central Government, and the Act also provides a clear appellate mechanism for parties who wish to challenge the adverse orders. Enforcement powers are strengthened under Section 36, which establishes the Directorate of Enforcement (ED). This body is responsible for investigating suspected violations, conducting searches, and seizing documents where necessary.

The Central Government and the RBI are both given significant rule-making powers under FEMA. Under Section 41, the Central Government may issue directions to authorities involved in implementing the Act. Under Section 46, it may frame rules, while Section 47 authorises the RBI to create regulations governing foreign exchange transactions.

Together, FEMA, the RBI, and the Directorate of Enforcement create a legal structure that regulates India's external financial dealings, maintains orderly foreign exchange markets, and indirectly supports the management of foreign exchange reserves by ensuring that inflows and outflows remain transparent, monitored, and legally compliant.

Foreign Exchange Reserves as Instruments of Financial Stability

Foreign exchange reserves play a central role in maintaining the financial stability of a country. They act as a protective shield during periods of economic turbulence, help stabilise the national currency, support balance of payments management, and significantly shape investor confidence. The experience of several economies' shoes how reserves function as a first line of defence against external shocks. During the 1997 Asian Financial Crisis, for instance, many Asian currencies experienced sharp depreciation, but countries such as Singapore and Malaysia were able to manage the volatility far more effectively because they possessed substantial reserves, allowing them to intervene decisively in the foreign exchange markets.

A similar pattern was seen during the 2008 global financial crisis. Although the Indian rupee depreciated considerably, India's sizeable reserves at the time ensured that the country could

finance several months of essential imports. The Reserve Bank of India actively used the reserves to smooth the exchange rate volatility, increase liquidity, and maintain external payment capacity without resorting to emergency financial assistance. This capacity to absorb shocks was once again evident during the COVID-19 pandemic, when global supply disruptions and capital outflows placed significant pressure on emerging markets. India's large reserve position reassured investors and provided the central bank with sufficient flexibility to manage external pressures while stabilising the domestic financial environment.

Another essential contribution of foreign exchange reserves lies in maintaining balance of payments stability. When a country's import commitments and external obligations exceed its export earnings, forex reserves act as a crucial buffer that allows the economy to continue functioning without immediate recourse to external borrowing or currency devaluation. India's severe balance of payments crisis in 1991, when its reserves had fallen to the equivalent of only two weeks of imports showed the consequences of the reserve inadequacy. The crisis forced India to pledge its gold and seek IMF support, and undertake structural reforms under the Liberalisation, Privatisation, and Globalisation policy framework. If India had substantial reserves at the time, many of these emergency measures might have been avoided. This historical experience continues to shape India's contemporary reserve management strategy and its emphasis on building strong external buffers.

Currency stability is another area where forex reserves play an important role. A volatile currency reduces the investor confidence and disrupts international trade. By intervening in the foreign exchange market, by selling dollars during periods of sharp depreciation or purchasing them during excessive appreciation, the RBI uses the forex reserves to maintain the market conditions and prevent in destabilising fluctuations. Stable exchange rates are important for exporters, importers, and investors, all of whom rely on predictable currency movements. During the COVID-19 period, India's ability to prevent a steep fall in the rupee was directly linked to the strength of its reserves, which enabled the central bank to intervene effectively.

Reserves also have a significant impact on investor confidence. Countries with ample reserves are seen as less vulnerable to external shocks, which makes them more attractive destinations for foreign investment. As noted by India's Union Minister for Commerce and Industry, Mr. Piyush Goyal at the CII Business Summit 2025, India's strong reserve position has played a substantial role in reinforcing investor trust. The same can be contrasted while examining the

situation in Sri Lanka in 2022, where foreign exchange reserves fell below 2 billion dollars, which led to a dramatic loss of investor confidence, due to which investors started pulling out money from the country, which further aggravated the financial crisis in Sri Lanka. Credit rating agencies also give considerable weight to reserve adequacy when assessing sovereign risk. Higher reserves generally mean lower borrowing costs and improved access to global financial markets.

Finally, foreign exchange reserves strengthen a nation's negotiating power in international economic relations. Countries with strong forex reserves can negotiate better for external loans and trade agreements from a position of stability rather than vulnerability. India's difficulty in securing external financing during the 1991 crisis stands in stark contrast to its present ability to negotiate on far more favourable terms, which is supported by its large forex reserves which has increased the bargaining power of India due to the presence of economic stability due to high forex reserves. In this way, reserves do not merely stabilise the economy, they also enhance the strategic autonomy of the nation.

A Holistic Assessment of Economic Strength

Foreign exchange reserves undoubtedly play an important role in shaping a country's financial stability. They influence investor confidence, support the balance of payments, and helps in maintaining currency stability during crises. India's own experience illustrates this clearly. When the country faced the 1991 balance of payments crisis with dangerously low reserves, it was compelled to undertake major economic reforms that reduced policy autonomy and forced the economy to open up under the Liberalisation, Privatisation, and Globalisation framework. The crisis also led to the devaluation of the rupee and a significant expansion of the RBI's role in monetary management. This episode made policymakers aware of the importance of maintaining adequate reserves, after which India consistently worked toward strengthening its external buffers. Today, with more than USD 700 billion in reserves, which is one of the highest in the world. Thus, India appears externally strong and resilient. On the surface, this might suggest that India possesses a robust and healthy economy.

However, relying solely on foreign exchange reserves to judge the financial health of a nation gives an incomplete and often gives a misleading picture. A country's economic well-being depends heavily on internal factors such as fiscal deficit levels, inflation, unemployment,

productivity, and per-capita income. Despite being among the top reserve holders globally, India ranks relatively low in per-capita income and performs modestly on several other macroeconomic indicators. In many social and developmental measures such as living standards, inequality, access to infrastructure, and human capital, India still faces significant challenges. Therefore, if India's financial health were assessed only on the basis of its forex reserves, the country would appear far stronger than it actually is.

A more accurate assessment of a nation's financial health requires looking beyond foreign exchange reserves and examining its internal economic fundamentals. One of the most important among these is the fiscal position of the government. In India, the fiscal deficit has remained high, which stands around 4.4% of GDP in the fiscal year 2025-26, while the combined public debt is estimated to be over 56.1% of GDP. Such figures indicate long-term fiscal pressures that cannot be mitigated simply by holding large forex reserves. Inflation is another critical indicator. India has frequently experienced inflation rates above the RBI's target band, with consumer inflation averaging around 6% in recent years. However, in India, commodity prices are generally considered to be inflated more than they are desired to be. Persistent price rise directly affects household budgets, reduces savings, and creates uncertainty in consumption patterns. Employment level trends also reveal the underlying strength of an economy. Despite strong external indicators, India continues to face labour market challenges. The overall unemployment rate has remained around 7-8% in the last few years, and youth unemployment has remained significantly higher, which remains around 17-18%. These figures point to a structural mismatch between the skills of the workforce and the needs of the economy. High reserves cannot compensate for weak job creation or underemployment, which directly affects household income and long-term productivity.

Per-capita income further highlights this disparity. India's per-capita GDP is around 2,500 dollars, which places it near the lower end of global rankings, around 130th in the world. This suggests that while India's aggregate GDP and forex reserves appear strong, individual economic wellbeing in India remains a challenge. Similarly, India ranks 130th on the Human Development Index report 2025, which reflects the lagging conditions in education, healthcare, and life expectancy. These human development indicators are crucial for long-term prosperity of the country. Inequality also plays a major role in assessing financial health. India is among the most unequal major economies, with the top 10% of its population holding over 58% of national income, according to the World Inequality Report. High inequality reduces social

cohesion, strains public resources, and limits the impact of economic growth on the broader population. Infrastructure gaps in transportation, logistics, digital services, and urban planning further reflect internal challenges that forex reserves alone cannot address.

These statistics show clearly that while India's more than 700 billion dollars in reserves have strengthened its global standing and improved external stability, yet it offers only a partial picture of its true financial condition. Only by balancing these external and internal indicators, we will be able to form an accurate understanding of India's economic strength and the challenges that remain for sustainable, inclusive growth.

Conclusion

Foreign exchange reserves are one of the most important components of a nation's financial stability. They provide protection against external shocks, support balance of payments, help stabilise the currency, and strengthen investor confidence. In this sense, forex reserves serve as a valuable indicator of a country's macroeconomic resilience. After the 1991 balance of payments crisis, India consciously prioritised reserve accumulation, which has contributed to its reputation today as a relatively safe and reliable economy in the global landscape.

However, foreign exchange reserves alone cannot assess the true financial health of the country. A comprehensive assessment must also consider internal and structural indicators such as per-capita income, employment levels, distribution of wealth, poverty rates, fiscal discipline, inflation trends, and the quality of human development. These factors directly shape the lived economic experience of citizens and determine whether macroeconomic stability translates into real and inclusive growth.

Thus, while forex reserves remain an essential part of evaluating economic strength, relying on them as the sole measure would offer only a partial and misleading understanding of the country's true financial condition. A balanced approach by combining the external stability with internal economic and social fundamentals is necessary to assess the genuine health and long-term sustainability of the national economy.

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