COMMENT

Forex and Price Rise

The government is unlikely to succeed in its efforts to control price rise. The policies being implemented have limited reach just as air-conditioner cannot cool the room in the desert. One needs desert cooler in the desert. The government is trying to cool the price rise with wrong policies.

The main reason for increase in prices is huge inflow of foreign investment. Proof of this is in the rising Sensex. The surge in stock markets is substantially due to these inflows. Foreign investors deposit dollars with the Reserve Bank of India which prints rupee notes in equal measure and provides to them for the purchase of shares on the Mumbai Stock Exchange. This printing of notes leads to increased circulation of money in the Indian economy and price rise as well.

The government has made a two-point plan to control this. RBI has increased the Cash Reserve Ratio from 5.5 percent to 6 percent. Banks will have to now deposit cash in larger quantity with the RBI. This will suck out some notes out of the system. The large number of notes given to foreign investors by the RBI will come back to it through the banks. The commercial banks, in turn, will have fewer funds available for giving loans to borrowers. This reduction in commercial lending will reduce demand for goods in the market. Industries will postpone their plans to set up a new factory because loan is not sanctioned and this will lead to less demand for cement, steel and labour and bring the prices down.

The second element of the price control strategy is to cut import duties of goods such as edible oils and cement. This makes imported goods cheaper and prevents domestic manufacturers from charging high price for their produce.

The beneficial effect of these measures on prices is, however, undone by another policy. The RBI is increasing forex reserves. It is reported that the RBI has bought foreign currency assets to the tune of $5 billion in the week ending February 9 taking India's total forex reserves from $180 billion to $185 billion. The dollars deposited by the foreign investors with the RBI are being flushed out of the system through this route just as the heat from the stove in the kitchen is taken out through the chimney. The RBI has the choice of selling these dollars in the Indian foreign currency market or depositing them with the Bank Of America in New York for the purchase of US Treasury Bonds. It has decided to do the latter. The purpose is to protect Indian exporters. The supply of dollars would increase if RBI sold dollars in the domestic market. That would lead to a decline in the price of dollar against the rupee. A cheaper dollar would benefit Indian importers and hurt the exporters. The importer would have to pay only say, 40 rupees for a dollar worth of imports against 44 rupees presently. On the other hand the exporter will get only 40 rupees for a dollar worth of exports against 44 rupees he is getting presently. The RBI has chosen to protect the interest of the exporters in maintaining a high price of the dollar. In consequ-ence, imports will be less because importers will have to pay more and exports will be more because exporters will get more rupees for a dollar of exports.

This strategy will have two negative consequences for the economy. The increase in Cash Reserve Ratio will leave fewer funds available with the banks for lending and force them to raise the interest rates. This will dampen the growth rate of the economy from

say, attainable 10 percent to present 9.2 percent. Second, the sending of dollars to the Banks in New York by the RBI is making the United States stronger. That country is getting a cheap inflow of dollars on which it pays low rates of interest of about 5%. Further the price of the dollar is likely to decline according to most analysts. This wilI lead to a huge loss for the country. The value of forex reserves held in dollars will decline.

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