NOTE

DEVIL AND DEEP SEA

B J Writes :

The Reserve Bank of India (RBI) is trying to contain the ill-effects of large foreign capital inflows by raising Cash Reserve Ratio, mopping up liquidity by selling bonds and buying dollars to increase forex reserves. Each of these actions has some negative consequences. It is time that the Government thought of measures to solve the problem at its root-by imposing an entry tax on foreign investors. That will reduce the inflows and save India from these negatives.

The decline of the US dollar is forcing global investors to invest in other currencies just as the passenger quickly abandons a sinking boat to climb on to another. The rupee is emerging as one such favoured currency. Foreign investors are buying shares in Indian share markets in large quantities. Their objective is to make double gains-from appreciation of the rupee as well as from profits of the companies. Generally, this inflow is good news. But success often comes with new problems.

The inflow of investments in the Indian share markets leads to increased supply of dollars in the Indian market. Foreign investors deposit dollars with Indian banks and convert them into rupees with which they buy shares. The banks, in turn, sell these dollars in the forex market. Increased supply of dollars in the forex markets leads to lower price of the dollar. Correspondingly, the price of the rupee increases. This parallel movement is seen in the rupee-dollar exchange rate changing from Rs 49 two years ago to Rs 39 presently.

The increase in the value of the rupee has two contrary impacts on the economy. No doubt Indian importers stand to gain. This rise in the rupee has helped combat the negative effect of increase in price of oil lately. A 25 percent rise in the dollar price of oil results in only a 10-15 percent increase in the rupee price because the dollar has declined by about ten percent in that period.

But the exporters suffer, however. In this way the inflow of foreign capital has two opposite effects-the importers gain while the exporters lose.

The RBI is caught between the devil and the deep blue sea. The interest rate rises and hits businesses if it increases Cash Reserve Ratio or sells Government Bonds in larger quantities. Inflation increases if it prints money to buy dollars in the forex market. The RBI has adopted a mix of these measures. But that only means that the pain has been distributed. That does not remove the pain. □□□