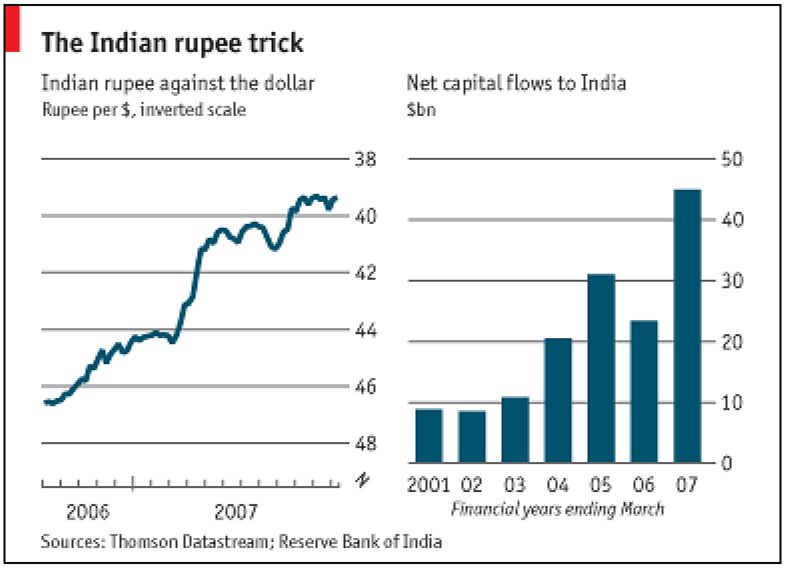
The uncomfortable rise of the rupee

Dec 13th 2007
From *The Economist* print edition

Is India suffocating from too much foreign attention?



INDIA, it is fair to say, is not yet reconciled to the new-found strength of its currency. One poor wretch, pressed against the car window at a Delhi traffic light, tries to change a dollar bill she presumably cadged off a tourist. She wants 50 rupees for it.

Alas, the dollar now fetches less than 40 rupees (see left-hand chart). India's currency has strengthened by about 15% against the greenback in the past year and by over 10%, on an inflation-adjusted, trade-weighted basis, since August 2006. The rupee's rise may be less dramatic than that of the Philippine peso, Brazilian real or Turkish lira. But it is uncomfortable nonetheless.

This vigour is due to a strong inflow of foreign capital, some of it enticed by India's promise, the rest disillusioned by the rich world's financial troubles. The net inflow amounted to almost $45 billion in the year to March, compared with $23.4 billion a year earlier (see right-hand chart).

Street children are not the only ones regretting this influx. India's IT industry, which first advertised India's virtues to the outside world, is now suffering more than most from the avid interest in the rupee. Worst hit, however, are India's labour-intensive manufacturers. Textile exports, for example, fell by 11.7% in the year to April. Kamal Nath, India's minister of commerce and industry, fears that exporters may shed 2m jobs.

The Reserve Bank of India (RBI), the country's central bank, has done its best to resist the appreciation, and, at the same time, contain inflation at home. As any student of macroeconomics knows, central banks struggle to achieve both objectives simultaneously in the face of strong inflows of capital. Printing rupees to buy the incoming dollars keeps the currency cheap but also adds to the money supply, stoking inflation.

To avert this danger, the RBI has tried to claw back the extra money by selling "sterilisation" bonds to banks and raising the reserves they must lock up in its vaults. But this sterilisation effort is hard to maintain. The RBI intermittently pauses for breath, letting go of the rupee. The market, anticipating its exhaustion, only tests it all the harder.

India's currency dilemma is also a deeper philosophical one. Just as the Reserve Bank straddles two objectives, so India is torn between competing visions of its future.

On the one hand, the country envies China its export success. The yuan remains keenly priced and closely shepherded. Why, then, reason many Indians, should their country handicap itself with a stubbornly strong exchange rate.

On the other hand, India has spent at least 15 years tentatively opening its capital account and liberalising its financial markets. It has had particular success in attracting foreign interest in its companies' shares, rather than the bonds or loans that got so many emerging economies into trouble in the past. Why not take advantage of this foreign money to pay for the investment the country so sorely needs? Ila Patnaik and Ajay Shah, of New Delhi's National Institute of Public Finance and Policy, point out that India has long yearned for a sustainable flow of foreign finance to supplement its domestic saving. Indeed, in 2002 its planning commission complained that the country's current-account deficit was less than half the size it had envisaged.

Nonetheless, some fear—and others hope—that the dearer rupee will prompt India to take a step backwards and tighten its controls on capital inflows. The RBI already circumscribes the freedom of firms to raise money abroad, and in October the regulator put a freeze on "participatory notes", an indirect way for foreigners to play the Indian stockmarket.

Might it go further? In the 1990s Chile threw some "sand in the wheels" of international finance by forcing foreign investors to deposit a fraction of their money directed toward the country in an interest-free account. The *encaje*, as it was called, remains the most fashionable and widely studied experiment in capital controls. It probably helped to deter short-term investments. But the overall volume of inflows did not slow and Chile's real exchange rate continued to appreciate.

The other Chilean lesson from that period is more orthodox and thus less talked about. The government showed admirable fiscal restraint, which relieved some of the upward pressure on domestic prices, and also left the exchequer with enough money and credibility to cushion the economic downturn when foreign capital eventually turned tail in 1998.

Control freak

Such controls might buy India a temporary respite, but they will hardly convert it into a Chinese export powerhouse. Ms Patnaik thinks India has already gone too far down the road of financial liberalisation to emulate the exchange-rate policies of its bigger neighbour. China can accomplish its feats of reserve accumulation and sterilisation only because the country's banks are so docile and its savers captive. The banks are force-fed sterilisation bills, which yield even less than the central bank earns on its foreign reserves. They nonetheless survive because they rely on a steady supply of deposits from China's savers, who have few other places to put their money.

In India, on the other hand, banks are less compliant and savers are more choosy. If the banks do not offer them an attractive interest rate, they will buy shares, property or jewellery instead. Hence the banks, in turn, will not buy the RBI's sterilisation bonds unless it offers them an adequate return.

The migration of capital from the rich world to the poorer one is a sign of a bleaker season to come in the world's biggest markets. This would, then, seem an inauspicious moment for India to bet its future on export-led growth. If it cannot resist the inflow of foreign capital, it should try instead to make room for it—by observing fiscal restraint—and to make the most of it—by investing it wisely. India may then have an economy worthy of a more expensive rupee; and its children may have better things to do than hang around at traffic lights trying to change a buck.