NOTE

The Vicious Circle

B J writes :

Reserve Bank of India has increased the Cash Reserve Ratio by 0.25 percent on top of increase of 0.50 percent made earlier. Cash Reserve Ratio determines the amount of money commercial banks have to deposit with Reserve Bank in form of security. The idea is to suck out liquidity from the banking system and encourage commercial banks to lend fewer amounts. Commercial banks will have to deposit larger amounts with Reserve Banks and will have fewer funds available for lending. Less home- and car loans will be given leading to less demand for cement and steel. Businesses will set up fewer factories and stock fewer goods in absence of loans. This will lead to lesser demand for goods in the market and cool down the economy and help control price rise.

The Reserve Bank has left Repo and Reverse Repo rates unchanged. These are the rates at which Reserve Bank lends to commercial banks or at which commercial banks deposit excess monies with the Reserve Bank. These rates are generally for short term lending. Banks prefer to borrow from the public for their long term requirements at rates more favourable than offered by the Reserve Bank under the Repo window.

The two steps taken by the Reserve Bank give contradictory messages. By leaving Repo rates unchanged, the Reserve Bank has encouraged commercial banks not to increase the rate of lending. By increasing the Cash Reserve Ratio, the Reserve Bank is encouraging commercial banks to lend fewer amounts. But reduced liquidity will increase pressure upon commercial banks to increase their lending rates. It must be recognized that the Repo window is used by commercial banks to manage short term requirements of liquidity. It has less relevance for long term rates which are determined by supply and demand of credit. Reduced supply of credit due to increase in Cash Reserve Ratio will certainly put upward pressure on lending rates.

The Reserve Bank is not likely to succeed in controlling prices by these measures because these measures deal only with the domestic component of the economy. The main reason for increase in price at present is not domestic but international. It is reported that Foreign Direct Investment (FDI) in the first three months of 2008 has been at record level of about $10 billion. Indian companies have also borrowed in foreign currencies hugely known as External Commercial Borrowings (ECB). Part of this huge inflow is nullified by sell off to the tune of $3 billion by Foreign Institutional Investors in the share markets. But the overall flow remains inward and huge. This appears to be the main reason for increase in prices.

Foreign banks are often involved in arbitrage. They borrow monies in countries with low rates of interest like Japan and lend the same in countries with high rates of interest like India. The interest rates in Japan, for example, are about 1-2 percent. Let us say foreign banks were lending in India at 10 percent at present. Now they will be able to lend at 11 percent. This will make it more attractive for them to borrow larger amounts in Japan and lend in India. The upward movement of bank lending rates in India will provide greater opportunities for

arbitrage and lead to more foreign capital inflows. The Government is continually increasing the caps on limits by Foreign Direct Investors in various sectors. This will provide encouragement to higher inflow of FDI. Thus, the reduction in demand due to reduced domestic lending will be more than nullified by increased inflow of foreign capital. □□□