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The new unorthodoxy

Should the RBI take a feather from Brazil's cap?

Brazil caused a stir among international investors in late October by imposing a 2 per cent tax on foreign investment into the Brazilian stock market. A useful tool for managing short-term capital flows, or just a political gesture for the benefit of hard-pressed exporters?

Brazil, like India, has survived the world downturn with its growth story largely intact. The major challenge has been appreciation of the Brazilian real (R\$) against the dollar of well over 30 per cent this year, as the liquidity injected in the old world to save banks has flowed towards the higher yields and earnings growth in the major emerging economies. This is too fast an adjustment for comfort in Brazil, and the authorities have been looking for ways of giving foreign investors in Brazilian securities a cold shower.

The new tax knocked nearly 3 per cent off the market's value on announcement, and will divert some capital flowing into the Brazilian stock market – up by the same 75 per cent or so as India this year in local currency, but 140 per cent up in US dollar terms – into ADR trading in New York. Brazil was expected to restore taxes on foreign investment in the domestic bond market, which were only lifted late last year, but the decision to attack portfolio investment in equities came as a jolt.

Portfolio equity flows, once liberalised, have rarely been targeted by short-term capital controls, in contrast to inflows into bonds and bank loans. Chile's successful experiment with controls in the 1990s left most equity flows untouched. Malaysia's controls following the Asian crisis in 1998 put a penalty on taking the proceeds from stocks as well as bonds out of the country. The biggest challenge to market orthodoxy came from Hong Kong's bold decision to intervene by buying shares in 1998 to defeat a simultaneous bear raid by hedge funds on the currency and stock markets.

Could the Reserve Bank of India (RBI) ever consider throwing "sand into the gears" of international capital flows by trying to slow down equity portfolio investment into the country?

D. Subbarao, RBI governor, repeated at the IMF meeting in early October that managing another wave of volatile capital inflows is one of his worries. As evidence of the reviving appetite for risk, he noted that foreign

institutional investors had invested a net \$13.6 billion in the Indian market between 1 April and 18 September, against an outflow of \$5.2 billion in the same period last year, a turnaround of nearly \$19 billion.

Slow recovery in the old world could compound this effect. Subbarao argues that interest rates here may have to rise earlier than in the industrialised economies, reflecting India's faster growth and its supply-side bottlenecks. A widening gap in yields will attract even larger capital inflows.

In response to an unwelcome flood of foreign capital, said Subbarao in text-book manner, he had three options: let the currency appreciate; intervene and let the monetary aggregates go awry; or intervene and mop up the resulting liquidity, at a cost to the public purse. But he has a fourth option, Brazilian-style, of making capital inflows marginally less attractive.

The RBI has been admirably pragmatic about using such controls to prevent excessive inflows of foreign loans, but there are, of course, plenty of arguments against throwing sand into the gears of the equity markets. Like any other short-term tinkering with capital flows, it is likely to have a small and temporary effect on the currency, and would only be worth contemplating in an emergency, and in the context of a longer-term plan for adjusting to an appreciating exchange rate. The strong reputation of India's equity market for consistent regulation and policy would be damaged, although perhaps only with a limited number of investors for a short time. And given the prominent role of the stock market in attracting foreign capital into India, there is reason to be exceptionally careful before interfering with it.

The one argument for not ruling out this alternative, in the event of a sharp and uncontrolled appreciation of the rupee, is that it sounds slightly unorthodox or shocking. A useful legacy that India and other BRIC countries have carried over from the Asian crisis in 1997-98, strongly re-affirmed by the recent global collapse, is that they do not need convincing that finance has to serve the interests of the wider economy, whatever it takes. The bonus controversy in the US and UK shows, to an astonishing degree, that this lesson has still not been learnt in the countries that suffered most from the financial crash. ♦