‘COMMENTARAO’ IN “THE TELEGRAPH” of

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“No interference, please

- The RBI, government and interest rates controversy**” by S L Rao**

Three Finance Ministers have publicly pressed RBI Governors to reduce interest rates so that economic growth was stimulated.

In the days of rigid central control, high personal income taxes and severe limits on salaries, borrowing by households was more commonly from friends and relatives, contributing to chit funds and moneylenders. The burden of paying high interest and of repayment made most people reluctant to borrow.

When we borrowed a small sum, hardly 10% of the construction cost for our first house, we paid an interest of 17%. The burden every month on our low salaries of the times was so great that we repaid it back soon.

There was little of bank loans to farmers (except from cooperative banks). Moneylenders were the principal source. Their rates were exorbitant. If a crop failed many farmers lost their mortgaged land because they could not repay, or they became bonded labourers. As public policies changed and ‘priority’ sector lending included farmers, banks began lending to them. These were rarely dirt poor small farmers. However, governments through state owned

banks (the majority) sought to curry farmer favour in times of distress, and wrote off farmer loans. This repeated action has weakened bank balance sheets.

Loans to companies have been for long at high rates. They could borrow from banks, other companies or directly as fixed deposits from the public at even higher rates. Development finance for building assets was for long from government owned financial institutions like IDBI and IFCI. The cost of long-term finance was lower than that of working capital. Companies borrowed long-term and used some of it for working capital. There was inadequate monitoring by lenders.

Since the 1990s, all banks (development financiers also became banks) were into long-term lending. This was bad practise; banks with mostly short-term deposits, were using them to lend long-term, leading to unbalanced bank portfolios.

Governments worsened the situation for bank viability by directing state opened banks to lend to favoured projects and 'crony' borrowers. Due diligence in lending was ignored. Governments also began to raise debt to equity ratios, especially for infrastructure projects, making banks carry most of the funding for them. Delayed government clearances (environment, land acquisition, rehabilitation, etc.) delayed project executions. Many bank loans became sticky or non-performing, and "debt restructuring" became common. Nationalized bank balance sheets became red.

The cost of working capital was high especially in relation to many other countries. This continues today. In 1974 and 1979 the government appointed the Tandon-Chore committees on working capital. Their purpose was to develop norms that commercial banks could use for lending for different elements in working capital. But it also became a text for companies to manage working capital carefully. A major element in costs, namely interest, could be minimized. It helped many.

The pressure on Finance Ministers-Mukherji, Chidambaram, Jaitley, to ask RBI to reduce interest rates resulted from strong pleas from Chambers of Commerce and trade associations that high interest rates were preventing faster industrial growth.

Of course low interest costs are only one factor to stimulate growth because it could stimulate investment. But there are many other factors in the realm of government actions. These make the RBI as custodian of low inflation, hesitant to add another factor aiding inflation.

The RBI’s base lending rate has been high and is so now. In comparison, it is 2.0% in Australia, 14.25 in Brazil, 0.5 in Canada, 0.05 in the Euro Area, 4.85 in China, 0.50 in Indonesia, 0.00 IN Japan. At 7.25% in India, lending rates to companies is much higher and make Indian industry uncompetitive.

F.E. reported that “the interest outgo as a proportion of the top line moved up by 33 basis points to its highest since FY 2008. Moreover, interest cost was still the only financial parameter that reported highest annual growth, compared to employee cost, raw material expense, operating profit and net profit. In fact, last three of P&L entries witnessed a decline in FY15 compared to the previous year”.

Available information is that for top Indian companies, interest outflow was many times higher in India than ion many competing countries. Indian companies incur very high interest costs, reducing their international competitiveness. So the industry has good reason to agitate for lower interest rates.

But interest paid by industry is only one part of a complex set of considerations. Lowering interest rates would expand demand and money supply to levels higher than production, and so lead to accelerating inflation. The wholesale price index (wpi) rose by 10.30 % (and higher earlier) in 2010. It fell sharply from 2014. Though government uses WPI to measure inflation, it does not indicate the real costs to consumers. WPI represents various traded items in the production process in the economy. The consumer price index (CPI) measures items of mass consumption and their direct effect on consumers. In India the cpi usually rises by more than than the wpi. Inflation measured by wpi underestimates the impact of price rise on consumers.

The collapse in crude oil prices since 2014 has led to a sharp fall in wpi. However cpi has not fallen at the same rate. Governments keep back some of the fall by raising taxes. Reductions in prices of consumer products (petrol, diesel, cooking gas) have been countered by rising prices of foodstuffs and especially of pulses, vegetables and fruits.

The RBI which sets interest rates through the borrowing rates of banks from RBI, did reduce rates by 0.75% over 2014-15. However, banks did not reduce lending rates correspondingly. This was to recoup some of their losses on other loans.

A significant portion of lending by nationalized banks is "sticky". Borrowers do not generate adequate revenues from operations; operations are non-performing (mostly due to delays in project execution). Interest payments and loan installments are not met by borrowers. This makes banks reluctant to reduce lending rates to the healthy borrowers.

The absence of long-term financing of debt after the demise of 'development finance' (subsidized long-term lending by IDBI and others), has not seen much new inflows for the purpose. Other countries finance utilities (power, roads, rail, etc.) from household savings invested in safe long term instruments-insurance, gratuity, provident and pension funds, etc. These are conserved to keep capital secure and investors accept lower returns on them. This is not so in India where government controls their funds. Investment in utilities hit the wall of delayed government

permissions, making utilities unsafe as secure long-term investment unlike in other countries.

Reducing interest rates in India require as many other pre-conditions that are in economic policies, administrative procedures and project implementation. It demands that lenders are fully diligent in checking borrower capabilities before lending. They must have in place monitoring mechanisms and take suitable actions when a loan is not being used in a way that will enable the project to be completed in time and start repaying the lender. Governments must not set priorities for lending for projects or people. Governments must not lower debt-equity ratios and also not demand long-term (25 years or more) guaranteed tariffs from project developers. Government permissions must be timely and co-ordinated. Long-term savings must be available for long gestation utility projects. Lenders should have speedy legal recourse against recalcitrant borrowers.

Policies must enable stable food prices so that inflation is not a concern. Agricultural policies must target for more crop security and prices. The government must develop agricultural infrastructure, and prevent excessive speculation. State-owned enterprises like FCI, Coal India, BHEL, state=-owned electricity undertakings, etc., must become efficient. There must be no interference in pricing of items like power or petro-products. For reduced interest

rates, lenders must have confidence that their money is safe.

Finance Ministers should know better than interfere with RBI assessments.

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