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"The hullabaloo over interest rates

Reducing interest rates in India require many other preconditions in economic policies, administrative procedures and project implementation" by S L Rao

As Finance Ministers, Pranab Mukherjee, Chidambara and Jaitley have at times expressed public displeasure that the Reserve Bank kept interest rates in India so high. The logic was that the Bank seemed to believe that inflation could be kept in check with higher interest rates. So when inflation moderated they expected interest rates to fall. Lower interest rates were expected to stimulate industrial growth, and hence economic growth.

A more nuanced argument was that inflation was a result of increased money supply meeting a shortfall of goods and services. Restricting money supply and higher interest rates could bring down inflation. But India could suffer a crop failure or a shortage of onions or pulses. This would raise food prices, hurting lower income groups for whom food is a major portion of their household expenditure. Money supply and interest rates cannot moderate food inflation. It requires increased and better distributed supplies. The argument thus concludes that we are then left with un-moderated food prices and high interest rates. This adversely affects

industrial production and international competitiveness. If food price inflation cannot be influenced by monetary actions, why not reduce interest rates which could stimulate industry?

There might be merit in this argument. In India, the effects of monetary actions are mainly on industry and trade. The former is less than a fourth of GDP and may not be as much of a driver for growth. Experience suggests that lower interest for trade might not always get passed on in lower prices to consumers. It could therefore be argued as to which sector is so much benefited that economic growth will be stimulated?

Household expenditures might improve with easier loans and lower interest rates. In the last twenty years household borrowings have surged. When the economy has heavy household borrowings, lower interest rates could stimulate consumption and hence stimulate the economy. This is what developed countries have tried for the last many years with interest rates ruling from 0% in Japan to 2 or so in the USA and Europe. But their stimulating effect (except to an extent in the USA) seems to have worn out.

Indian households now have rising borrowings on credit cards for consumption and for house purchases. Lower interest rates would stimulate these expenditures and help stimulate the economy. However this effect hinges on consumer confidence about job stability and security.

Bank loans to farmers (except from cooperative banks) were limited at one time. 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 laborers. As public policies changed and 'priority' sector lending included farmers, banks began lending to them. These farmers were not dirt poor small farmers. However, governments through state owned banks (the majority) sought to curry for votes of farmers in times of distress. The practice of writing off farmer loans became common especially with 'left' oriented governments (e.g. Congress and Communists). This has greatly weakened bank finances and their balance sheets.

The financial position of state owned banks was further weakened by government interference in loans for infrastructure and industry. Sources of all finance for Indian companies have for many years been banks, self-generated from profits or advances from suppliers, other companies or directly as fixed deposits from the public at even higher rates. Cheaper 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. This is no longer the case.

The Tandon-Chore committees (1974 -1979) on working capital developed norms for commercial banks for lending for working capital. They were useful for companies to manage working capital carefully.

The pressure on RBI to reduce interest rates resulted from strong pleas from industry and trade trade associations that high interest rates were preventing faster industrial growth. However, other factors requiring government actions lead to project delays, shortfalls in production, and inflation. These are not addressed. RBI as custodian of low inflation, is understandably hesitant to add easing of monetary factors that might aid inflation.

Lending rates are 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 and 7.25% in India. Available information is that for top Indian companies, interest outflow was many times higher than ion many competing countries. Indian companies have good reason to agitate for lower interest rates.

The wholesale price index (wpi) is used by government to measure inflation. The cpi usually rises by more than the wpi. Inflation measured by wpi underestimates the impact of price rise on consumes.

The collapse in crude oil prices has led to a sharp fall in wpi. However cpi has not fallen at the same rate. 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 did reduce rates by 0.75% over 2014-15. However, banks did not reduce lending rates

correspondingly. This must have been to recoup some of their losses on account of government, mentioned earlier.

Banks are reluctant to reduce lending rates to healthy borrowers.

Long-term financing of debt after the demise of 'development finance' has not seen much new inflows for the purpose. Other countries finance utilities from household savings invested in safe long term instruments-insurance, gratuity, provident and pension funds, etc. Government controls their funds.

Reducing interest rates in India requires many other pre-conditions in economic policies, administrative procedures and project implementation. Lenders must be fully diligent in checking borrower capabilities before lending. Monitoring mechanisms must be in place and suitable actions taken 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, nor lower debt-equity ratios, and not demand long-term (25 years or more) guaranteed tariffs from project developers. Government permissions must be timely and co-ordinate. 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 for the poor. Agricultural policies must target

for more crop security and prices. Government must develop agricultural infrastructure, and prevent 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. It is not, today. (1121)