PERSPECTIVE

Interest Rates

Why they should go up in India

It is really inexplicable how we can go on reducing interest rates when we do not have enough money to invest. Our aim should be to encourage people to reduce consumption and save so that the money can be invested in fixed assets, which will facilitate future consumption.

For the past few years, businessmen, economists and even politicians have been pressing for lower interest rates. The RBI brought down the interest rates significantly during the period 1995-2000. Average bank rate declined from 12 percent in '95-96 to 7.8 percent in 2000. So did PLR from 16.5 percent to about 12 percent.

The main argument for lower interest rates was that they would encourage investment. Strangely enough, this has not happened. Despite regular cuts in interest rates, credit off take has not increased appreciably. Consequently, our growth rates are still unsatisfactory, especially when compared to developing countries like China.

The time has come to explode the myth that we need lower interest rates. To start with, let us define interest rate. It is nothing but the rate of return the lender expects for the risk he takes by putting his money in the borrower's hands. When more people are willing to lend than borrow, interest rates should go down and vice versa. Clearly, interest rates should be low in capital surplus countries and high in regions with a capital deficit. For example, in a developed country like Japan, interest rates have been close to zero for a long time now, while in a developing country like Brazil, short-term interest rates have been in excess of 15 percent for a long time.

One doesn't need to be an Amartya Sen to appreciate that India is a country where infrastructure of all kinds is grossly inadequate. We do not have enough roads, telecom, power and water. On the social front, we do not have enough schools. Traffic crawls in even the more developed regions. Power cuts are rampant in most parts of the country. And water shortage is a common phenomenon even in islands of prosperity, like Bangalore. Educational and medical facilities are also in short supply. In short, we are a country facing an acute shortage of funds to execute critical development projects. It is truly a sad commentary on the state of affairs, that even in this dismal scenario, we have not seen an appreciable increase in infrastructure spending.

It is really inexplicable how we can go on reducing interest rates when we do not have enough money to invest. Our aim should be to encourage people to reduce consumption and save so that the money can be invested in fixed assets, which will facilitate future consumption. Any commodity that is underpriced is likely to be misused. This was evident in the Asian currency crisis, which resulted primarily from easy funds available at low interest rates flowing into the region. As long as governments pegged their currency to the dollar, the picnic continued. But once the peg broke, the effective cost of borrowing, i.e., the currency depreciation plus the interest rate on foreign borrowings, proved to be too much of a burden for the domestic financial system. As the Nobel Prize winning economist, Samuelson explains in simple terms, "The market interest rate serves two functions: It rations out society's scarce supply of capital goods for the uses that have the highest rates of return and it induces people to sacrifice current consumption in order to increase the stock of capital."

When interest rates come down, individuals are likely to splurge money on consumption goods through hire purchase. That is why we are seeing a boom in the sales of consumer durables. Banks and financial institutions may have little incentive to lend to risky projects as the return may not compensate them for the risk involved. PSU bankers also face the threat of CBI raids if a loan becomes non performing. So the logic of the banks in the past 3-4 years has been: "Why lend money to SSIs? Let us put our funds in government securities and blue chip private sector bonds. That way we can also meet the RBI's directives on Statutory Liquidity Ratio (SLR)." Meanwhile, market savvy foreign banks such as Citibank have functioned more like money lenders, operating in segments where people are prepared to pay higher rates of interest. The result is that the small scale sector, starved of funds, is stagnating. In contrast, almost all the major developed economies including Germany, Italy USA and Taiwan have a thriving Small and Medium Enterprise (SME) sector.

Who really benefits from lower interest rates? There are two powerful beneficiaries - large corporates and the government. Blue chips, can get funds at lower rates. And the government, already burdened with a huge fiscal deficit can heave a big sigh of relief as interest payment is the single largest expenditure item in the union budget.

All developed economies generally have lower interest rates than developing economies. But this does not mean that by lowering interest rates, development can be speeded up. True, resources should be priced competitively. But the more important issue in development is using scarce resources intelligently. The only way to reduce the price of a resource is to increase its supply or reduce demand and not through administrative diktats. If we want to increase the availability of capital, we need to reduce Non Performing Assets (NPAs), for which we need better bankruptcy laws. We also need to improve productivity so that resources can be freed up for other areas of investment. And to reduce demand, we need to cut the obscene budget deficit, to do which we have to eliminate all unproductive expenditure. Obviously these options are difficult. On the other hand reducing interest rates is an easy option, though it will bring no real benefits. Our country needs to do the difficult things first. As someone aptly put it, "Anything that is easily obtained is not worth striving for."

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