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Why interest rates should go up

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If, as policymakers claim, India is moving towards a market driven interest regime, then rates should be determined by demand and supply. Lower interest rates cannot be achieved through administrative diktats but by increasing the availability of capital in relation to demand, says A. V. Vedpuriswar.

Bank Rate VS PLR

	Dec93	Dec94	Dec95	Dec96	Dec97	Dec98	Dec99	Dec00	Dec01	Dec02
Average Bank Rate (%)	12	12	12	12	12	10.5	8	8	7	6.5
Prime Lending Rate (%)	19	19	15	16.5	15	14	13	12.5	12	12
Source:CMIE										

A Recent poll reported that the CEOs of many banks in the country expect interest rates to dip further. They feel interest rates can go up only if there is a substantial recovery in credit.

Such views symbolise the kind of muddled thinking which has come to characterise businessmen and policymakers in recent times.

The point that in the first place interest rates were brought down to expand credit has been forgotten. The reality is that though the Reserve Bank of India has significantly brought down the bank rate in the past 10 years with the stated objective of expanding credit and boosting business activity, bank lending to industrial clients has not really picked up.

Why is this so? Basic economic theory states that risk has to be priced efficiently for markets to work. If lower interest rates do not boost investment, it is clear that the risk pricing mechanism has broken down.

It will not be an exaggeration to state that banks in India have ceased to perform the role conceived for them; acting as well-informed investors who understand risk and know how to deal with it.

Indeed, the behaviour of banks, which are parking their funds in gilts and blue-chip securities, has a striking resemblance to that of risk averse retail investors.

The policymakers continue to make noises that India is moving towards a market driven interest regime. But their actions are not in line with their words. In a market regime, the price of a commodity must be determined by demand and supply.

The interest rate is nothing but the price of capital. When more people are willing to lend (sell capital) than borrow (buy capital), 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.

In a developed country such as Japan, interest rates have been close to zero for a long time now. This is because avenues for heavy capital investment, such as infrastructure, have been completely exhausted. But a country such as India, which does not have enough roads, telecom, power and water, is obviously short of capital.

It is really inexplicable how interest rates can come down when supply of capital is far short of demand. Indeed, we must encourage people to reduce consumption and save. Only then will the supply of capital for investments increase.

Instead, what lower interest rates are doing is to encourage a spendthrift culture among the country's citizens. The automobile boom and the growth of credit cards reflect this phenomenon.

It is now proved beyond doubt that any underpriced commodity tends to be misused. The Asian currency crisis was primarily because of cheap capital flowing into the region. This led to projects with low rates of return.

As long as governments pegged their currency to the dollar, the picnic continued. But once the peg broke, the effective cost of borrowing, that is, the currency depreciation plus the interest rate on foreign borrowings, proved too much of a burden for the domestic financial system.

As Nobel laureate Samuelson explained 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."

It is not right to blame banks for refusing to lend in the current situation. When interest rates are low, banks and financial institutions, have little incentive to lend to risky projects, as the return does not compensate them for the risk involved. It makes more sense for them to put their funds in government securities and blue-chip private sector bonds and earn spreads without taking any risk.

We must also understand the politics underlying interest rates. Two powerful constituencies are the main beneficiaries of lower interest rates — large corporates and the government.

Both do not deserve this pampering. Blue chips have never had any problem in getting access to funds. Such companies are now able to do so at even lower rates. And the government, already burdened with a huge fiscal deficit, clearly gains.

Naturally, the two parties are outdoing each other in their clamour for a further reduction in interest rates. Meanwhile, the small-scale sector, a key driver of growth in any economy, has been starved of funds. Even in the past, when interest rates were much higher, this sector struggled to get funds.

Now, in a lower interest rate scenario, getting access to funds has become much tougher.

The point which has been totally forgotten is that lower interest rates cannot be achieved through administrative diktats but by increasing the availability of capital in relation to demand.

To increase the supply of capital, India needs to reduce non-performing assets (NPAs) for which there have to be better bankruptcy laws. The legal system will have to be improved so that disputes relating to defaults can be resolved quickly. Such an improvement involves a lot of hard, painful work and cannot be achieved overnight.

India needs to improve capital productivity to free resources for infrastructural investments. Simultaneously, it should cut Budget deficit to reduce the demand for capital.

But the current thinking in the country is simplistic, illogical and faulty. It is that reducing interest rates will cut costs and overnight make Indian companies very competitive.

Competitiveness, as strategy guru Michael Porter has argued time and again, can come only through innovation, not artificial props.

For example, the exports of both Germany and Japan have not declined despite the sharp appreciation of their currencies against the US dollar in the past three decades. That is because the Germans and Japanese are more globally competitive than others.

There is a simple but powerful lesson here for the policy makers. And that is, there is no shortcut to economic progress.

We have to raise our sleeves and get down to some hard work. India will prosper only if this simple lesson is understood well.

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