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Musing Over the Soft Interest Regime. It Hurts.

By, D. R. Pendse.

[I claim to have been a business economist and have wholeheartedly supported and advocated policies that will accelerate India's industrial growth and tap the full potential of Indian industry. I have also adhered to the firm and repeated insistence of Mr J. R. D. Tata that I must speak out what I am convinced to be in the interest of industry and society and not become an industry lobbyist, rationalizing what industry captains want to plead. This article may be an example.]

In the teeth of the fiscal mess emanating from New Delhi and from most other state capitals, Mint Road Policies have been generally worthy of admiration. However, the recent reduction of the bank rate by 25 basis points to 6% and the injection of fresh liquidity of over Rs 3600 cr. by the lowering of the CRR also by 25 basis points seem neither to be in the interest of society nor even in the interest of business and industry. A fortnight after these decisions were announced, it is perhaps time now to muse over as to what we have achieved and what we have not.

1. It must be irritating that banks' deposit interest rates move down further and quicker than do the interest rates on their lending. Deposit rates during the last one year ending April 18, 2003 have for example gone down from 8.50 % to 6.25 %, a massive 26 % fall. And they have not yet stopped going down. In contrast, the prime lending rate is down from 12 % to only 11.50 %, barely a 4.2% reduction. So depositors are losing far more, in relation to any implicit gains to industry.

2. It is also a moot question as to how much do the triple-A corporates really depend on bank credit; and how much have the interest rates really softened for those other corporates who depend on bank credit.

3. What difference do the interest rates really make to the costs of production? Percentages undoubtedly must vary. But as a crude average, interest costs seem to be less than 7 % of the total expenditure of the corporate sector. More relevant will perhaps be the interest burden as percentage of gross profits. That is only a shade higher at about 9 % Even a reduction of two percentage points in the interest rates paid, will thus make a relatively miniscule change in the cost structure and therefore the competitiveness and profitability of Indian industry.

4. In the mid nineties when industry was booming and industrial production rose in double digits, interest rates were pretty high; but profitability being higher, they did not seem to hurt. Now, with demand very weak, with competition waiting in the wings and therefore with industry passing through a long patch of lacklustre performance, no amount of reductions of interest rates seem to be of any use. Loss to depositors is certain. Gain to industry is elusive

5. Indeed, in Japan, industry is caught in such an acute recession and for such a long time that there is no demand for bank funds; and the Japanese bankers have had to respond to

this by offering zero or even negative interest rates on deposits. In other words, depositors pay the banks for keeping their money.

6. The rationale for softening interest rates for commercial borrowers is of course sound. In practice however, banks respond to any RBI signals favouring softer rates promptly by reducing interest rates on deposits, on the rather spacious presumption that without such reductions, margins cannot be maintained. That could be a highly misleading presumption. Margins of Indian banks, more so the public sector banks, are too high in comparison with the mature economies. In the U.S., for example the margin between average cost of borrowing and the average return on lending is about 2.5 percentage points. In India it is over six percentage points. Why such a divergence? First because the Indian banks are bogged down under huge NPAs, [read, bad loans]. Secondly, the Indian banks' operations are relatively grossly inefficient and their administrative costs in relation to the size of their deposit base are far higher than those of most good banks in foreign countries. Precious little is being insisted on being done in terms of reducing their wide, wide margins; and even less is achieved.

7. In fact, as was seen above, banks reduce deposit rates much more promptly and much further than the lending rates. Thus banks use RBI's soft regime signals to further widen their margins and increase their own profitability, [or reduce losses]. In other words, the signal serves the purpose of being in effect a permission from the RBI to continue to sleep over the NPAs or the high administrative costs. It cannot be a coincidence that every time such a signal is given by the RBI, bank shares improve on the stock market !

8. Apart from the banks themselves, one other sure-shot beneficiary of soft interest regimes is the government of India, with its insatiable appetite for borrowed funds. In the bad old days, there used to be a big pent up demand from industry for bank credit at very high interest rates. But , under the stiff SLR requirements, banks had to, though they did not want to, lend to government nearly 40 percent of their funds and that too at artificially low interest rates. Now without any statutory obligation, banks are choosing to lend to government, close to 40% of their funds at low low interest rates,
[a] because in the absence of any matching demand from industry they are saddled with sizeable liquidity and
[b]because lending to government requires no provisioning!

9. If the banks and the government are the two sure-shot beneficiaries of the soft regime, one should be forgiven to wonder if that is not real objective behind these repeated soft doses.

10. We all know, and the RBI knows it better than everybody else, that the Central Government finances are in a critical mess. Should economic policies try to apply brakes on the government's profligacy or should they help the errant government by lowering the cost of borrowing? The RBI has a dual role, to regulate monetary policy and to be a banker to the Government. When the two conflict, must the latter always take a precedence?

11. I have somehow remained convinced that the single most important factor behind the rather prolonged industrial slowdown is the total erosion of consumer confidence and of the investor confidence. Scams, small bank failures, and the great UTI fiasco frustratingly disowned by the Government, have shattered this confidence. Citizens do not know why to save; they do not know where to invest. Their hard earned savings are fetching ever

declining nominal returns and even faster declining real returns. They fear the return of inflation, They are dismayed at the government merrily continuing its non-productive spending spree, and they helplessly watch the harsh reality of a never-ending industrial slowdown. This cannot be a useful backdrop for the revival of confidence. On top, they see Government spokesmen take such a casual attitude and they can't see a friend in the RBI swearing by a continued soft interest regime. It all hurts. Actually, industry should be under no illusions either that getting the RBI accept a softer regime and lower CRR are victories at the bargaining table deserving of celebrations., Before long, profligate governments and diffident citizens must hurt industry too.

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This article is likely to be published..
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