Concerns with lowering interest rates

What is the issue?

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- There is a constant call to lower interest rates from RBI.
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- But banks are being conservative and takes bad lending decisions.
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What are the rationale behind lower interest rates?

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- The gross fixed capital formation rate has fallen continuously from 33.4 per cent in FY13 to 27.1 per cent in FY17, and quite clearly the private sector is not investing adequately.
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- At present, the capacity utilisation rate in industry is around 70-72 per cent, and there is stagnant demand.
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- Lowering interest rates sounds logical when economic growth is slow and there is a compelling need to increase investment.
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- Lower interest rates help to make companies more profitable even though interest outgo accounts for just around 3-4 per cent of total cost.
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- When lending rates come down, all loans get re-priced at the new rate, hence there is an economic rationale for lowering rates.
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What are the impacts of lowering interest rates?

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- Lowering rates just for the sake of doing so could have some unintended

consequences, which may not be good in the long run.
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- **Financial crisis -**Lowering interest rates rapidly has the potential to generate a new kind of a bubble or crisis.
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- There could be adverse selection by banks when they are nudged to enhance lending to spur the economy.
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- **Inflation -**Easy money and higher deficits resulted in an increase in inflation which, combined with the phenomenon of higher oil prices, caused CPI inflation to remain in the double-digit range.
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- **Decrease productivity -**Large companies in the infra space is already grappling with their NPAs, in such a situation forcing banks to lower lending rates and enhance lending may become counter-productive.
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- **Real estate effects -**The segment which has shown higher growth in credit, which could be incentivised by lower rates, is housing.
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- But the sector per se has been challenged by demonetisation, followed by RERA and introduction of GST.
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- **Stock market rush -**Continuous reduction in interest rates has also caused a disruption in savings preferences.
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- There has been an undue rush for mutual funds, which in turn has resulted in some degree of irrationality in stock market movements.
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- The danger here is that when the stock market reverses in response to corporate prospects, the fall in value of these savings will affect households sharply.
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- **Purchasing power -** The extent that savers have stuck with bank deposits which give a return of around 6-6.75 per cent return.
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- The income earned by fixed-income households has been eroded.
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- This has affected purchasing power and is also evident in the limited discretionary spending for households that depend on interest income.
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What are the areas needs to be taken care?

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- Lowering interest rates should be viewed more as a policy response to the existing conditions.
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- It should not become an overriding objective as this can lead to adverse selection of borrowers in an effort to expand the balance sheet size.
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- While the immediate gains would be attractive it can lead to magnified proportions of NPAs in future.
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Source: Business line

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