Interest Rates
- An Insight

Rajaram Ajgaonkar

FORUM
OF FREE ENTERPRISE

"Free Enterprise was born with man and shall survive as long as man survives".

\- **A. D. Shroff**
Founder-President
Forum of Free Enterprise

SHAILESH KAPADIA

(24-12-1949 - 19-10-1988)

Late Mr. Shailesh Kapadia, FCA, was a Chartered Accountant by profession and was a partner of M/s G.M. Kapadia & Co. and M/s Kapadia Associates, Chartered Accountants, Mumbai.

Shailesh qualified as a Chartered Accountant in 1974 after completing his Articles with M/s Dalal & Shah and M/s G.M. Kapadia & Co., Chartered Accountants, Mumbai. Shailesh had done his schooling at Scindia School, Gwalior and he graduated in Commerce from the Sydenham College of Commerce & Economics, Mumbai, in 1970.

Shailesh enjoyed the confidence of clients, colleagues and friends. He had a charming personality and was able to achieve almost every task allotted to him. In his short but dynamic professional career, spanning over fourteen years, Shailesh held important positions in various professional and public institutions.

Shailesh's leadership qualities came to the fore when he was the President of the Bombay Chartered Accountants' Society in the year 1982-83. During his tenure he successfully organized the Third Regional Conference at Mumbai.

Shailesh was member, Institute of Fiscal Studies, U.K.; member of the Law Committee and Vice-Chairman of the Direct Taxation Committee, Indian Merchants' Chamber. He was also a Director of several public companies in India and Trustee of various public Charitable Trusts.

He regularly contributed papers on diverse subjects of professional interest at refresher courses, seminars and conferences organised by professional bodies.

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INTRODUCTION

There is so much of debate on the current interest rate scenario not only in India, but also in the global economic context. Much of this debate across-the-world is driven by the dilemmas confronting the central banks, while framing and calibrating the monetary policy strategy to deal with complexities of their respective economic situation. Thus, nearly eight years after the onset of global financial crisis in 2008, most central banks, especially of advanced countries, are still relentlessly pursuing base rates or key policy rates closer to zero; and several of them – Sweden, Denmark, Switzerland and Japan, for example – are having negative interest rate policy for the last couple of years or more.

In contrast, in the Indian context, the RBI Governor has invariably to deal with the daunting task of managing the impossible trinity of inflation, growth and exchange rate stability, while steering the path of 'appropriate' interest rate policy for the country. At present, the focus for the RBI is to ease the interest rates and liquidity in the system with a view to bringing about economic revival and without sacrificing the anchor of inflation control and financial stability. While falling interest rates are welcome from the perspective of business and industry – as this saves their cost of operations and facilitate improvement in their profitability and competitiveness – from the perspective of savers or depositors, this causes erosion of their nominal incomes and even their real standards of living.

These and many such complex issues need to be clearly explained and understood in a right perspective, while analyzing the interest rates policy. But that is not so easy. Hence, the FORUM has decided to publish this booklet, authored by the Chartered Accountant, Rajaram Ajgaonkar. It is reproduction of what has already been published in the latest Bombay Chartered Accountant JOURNAL, May 2016. The author seeks to articulate the whole set of facets governing the interest rates scenario in both theoretical and practical framework. Essentially, our avid readers would be able decipher three significant constituents in the author's insight into the prevailing interest rate scenario, namely,

First, major factor affecting interest rates such as monetary policy; the growth rate; liquidity; uncertainty in environment; and inflation; as well as other factors like quality of security, tenure of loan, end use of funds, credit worthiness of borrowers, et al;

Second, the phenomenon of negative interest and major effects of low interest rates. In particular, he has precisely brought out seventeen different points relating to low interest rates, some of which are seen to be positive from the perspective of borrowers and of the economy in general, but some could be patently negative from the point of view of savers, senior citizens and the economy. Incidentally, some of the spokespersons of the RBI have been arguing in recent times that the people at large and senior citizens in particular would have to live with the falling interest rates scenario as a consequence of falling inflation rate.

Third, the Indian scene in which the author reflects on systematic efforts in the country to reduce inflation rate to pave the way for easing of interest rates. Mr. Ajgaonkar opines that "India has recently started its journey towards low interest rates and is likely that on the back of sustained economic growth, the country may continue its journey towards further lowering of the rates, albeit gradually".

All in all, we compliment the author for the clarity and precision with which he has dealt with such an intricate subject. FORUM believes that this booklet would serve very useful purpose of educating not just the students and researchers, but also professionals. And by way of good reference guide, it would create better awareness amongst the general public on the evolving interest scenario in the country.

Sunil S. Bhandare

Editor

Interest Rates - An Insight

Rajaram Ajgaonkar*

Introduction

Interest can be described as the price demanded by the lender from a borrower for the use of the lender's money. Though, in exceptional circumstances, interest can be agreed as a fixed amount, irrespective of the principal invested and the period for which it is invested; generally interest is agreed at a particular rate for an agreed period. Interest is mostly expressed in terms of annualized percentage, which is called as rate of interest. Interest can be termed as fees paid by a borrower to a lender on borrowed amount as compensation for foregoing the opportunity of earning income or utilizing it otherwise. In simple terms, interest for a lender is a kind of rent for money. For a commercial borrower, it is a cost of capital for his business. For a personal borrower, it is a cost of preponing consumption.

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Generally, Interest is paid at the agreed rate and it is payable periodically, by the lender to the borrower. unless otherwise agreed upon, interest accrues to the borrower on a daily basis. If the interest amount is not paid to the lender, it can also be compounded at the agreed rate. though interest can accrue on a time proportionate basis, the lenders and borrowers can agree to settle the same after a particular period, on compounded basis. Compounding of interest envisages not only paying interest on principal borrowed but also paying interest on unpaid accrued interest, which remains with the borrower for the contracted time. When interest is not compounded, it is called simple interest.

Major factors affecting Interest rates

The major factors having an impact on the interest rates in an economy are as follows.

Monetary policy

A central bank in the country controls money supply in its economy through its monetary policy. If it loosens the policy, it expands money supply, thereby increasing liquidity. higher liquidity results in a higher supply of credit. If the demand for credit is not matching with the supply, the interest rates tend to fail. The policy measure of increase in money supply can push economic growth but can result in higher inflation. When the central bank tightens the money policy, interest rates tend to rise in the economy due to reduced supply of credit. Such a move may help in reducing inflation. The central bank has to do a balancing act. the change in repo rates can influence the rate of interest in an economy and they have positive co-relation.

The growth rate

High growth rate in an economy may increase the demand for credit thereby causing an upward pressure on interest rates. On the contrary, slowing growth rate reduces the need for credit, thereby having a negative pressure on the interest rate. When an economy is growing at a normal pace, the long term interest rates can remain stable, unless intervened by the central bank. Generally, the central bank does not allow pure economic forces to play and while the economy is growing, it may try to control the interest rate by measures such as adjustment of CRR, SLR etc.

Liquidity

The global liquidity levels at a given time as well as the local liquidity in the economy of a country can impact interest rates therein. When liquidity is high, the interest rate can remain low unless there is some other pressure of factors such as slow economic growth, high inflation, civil unrest etc. Lower liquidity will tend to increase the cost of capital, which is given in the form of interest. Excess liquidity can give impetus to carry trade based on currency movements, if the interest rates are low. In such a transaction, money is borrowed in a currency in which interest rates are low and it is lent at high interest rate in some other currency, mostly in some other country. In an economy in which, money is flowing in due to carry trade, the interest rates tend to soften. If they soften beyond a limit sc as not to remain attractive, it may result in reversal of carry trade. Likewise, if the interest rates in the currency of the country from where the carry trade has originated goes up, the funds may flow back to the country of that currency, unwinding the carry trade.

Uncertainty in Environment

When there is economic or political uncertainty in a country, the risk of investment increases resulting in hardening of interest rates in its economy. More the risk the lender needs to take, he demands higher rate of interest on the capital lent. When a country is going through an economic turmoil, the interest rates tend to harden substantially, not only due to risk of capital but increase in risk of doing business, which may result in reduced probability of getting the principal back, as per the agreed terms. Similarly, due to political crisis or situations of war or civil unrest, the interest rates may harden due to uncertainty, higher risks, risk to the security etc. Lenders are risk averse. More the risk, they seek more returns and so higher rate of interest.

Inflation

Interest rates in a currency have a positive correlation with the inflation of the home economy of the currency. If inflation is high in a country, it tends to increase interest rates in that economy. In an economy with high inflation, the reward required for capital borrowed also has to compensate the lender adequately for reducing the purchasing power of the money lent over the term of the loan. In an economy wherein inflation is low, interest rates tend to seek lower levels. Generally in an economy, over a long period, interest rates are higher than the inflation. The interest rates, net of taxes, tend to be atleast equal to inflation. Otherwise, person parting with money and taking risks of lending is not benefitted at all as his purchasing power may go down over a period even after receiving interest.

Othetr Factors

Other than the economic factors mentioned above, the following factors specific to the transaction of lending can affect interest rates.

Type, cover and quality of security

Better the quality of security, lower can be the rate of interest. Security, which can be easily encashed makes lender more comfortable and he can offer better terms. If the structure of security is complex and it is not easily encashable or if the lender may have to incur substantial cost to encash the security, he may claim a more aggressive rate of interest from the borrower. Further, if the security cover of the loan is higher, the rate of interest can be lower. Security cover is the value of security as compared to the amount lent and it is expressed in terms of number of times of a loan. Higher the security cover, more the safety of the lender and therefore he may soften the interest rate. Quality of security can also affect the interest rate. A security with stable valuation is preferred by the lenders. The security which fluctuates substantially in value may result in lender asking for a larger cover as well as higher rate of interest due to risk of the security.

Tenure of loan

Longer the loan period, lower could be the rate of interest. a lender takes full risk of the capital lent as soon as he parts with the money. If tenure of loan is very short, the total interest earned by the lender is quite small as compared to the money risked by him. In such a case the lender has to take the full risk of the money lent, till the money is repaid and the reward remains disproportionately meagre. Therefore, for short term loans, higher rate of interest is charged. However, in case of very long term loans, interest rates can be higher than the medium term loans. In such loans, the risk increases beyond the immediately foreseeable future and therefore the lender may charge a higher rate of interest. Such loans are also subject to the vagaries of market rate of interest. In fixed interest rate transactions, the yield to maturity of a loan remains constant but its market value may change. If the interest rates in an economy go up, its market value comes down and vice-versa. This happens more so in the case of loans issued in the form of bonds and debentures, which are listed for trading or otherwise tradable.

End use of the funds

If the end use of the fund is acquisition of a risky asset, then interest rates tend to be higher. A lender will lend to a business investing in manufacturing at lower rates than the business investing in research of technology as the risk of the latter is higher. If the end use is purchase of fixed assets which can be an additional security for the loan, the borrower may get softer terms. Therefore working capital loans generally carry a tad higher rate of interest than term loans given for acquisition of fixed assets.

Credit worthiness of the borrower

The credit worthiness of a borrower is based on his reputation, his net worth as well as his liquidity. The industry in which the borrower operates also makes an effect on his creditworthiness at a particular time.

A borrower operating in an industry which is not doing well has higher risk and therefore interest rate charged to him may be higher. The overall creditworthiness of a party can be expressed in its credit rating as certified by a reputed rating organisation. Better the credit rating of a borrower, lower the interest rate charged to him. Low credit rating can result in higher rate of interest being demanded and in some cases, the borrower may decide against lending or may recall the loan, if the terms so permit. The rating indicates the ability of the business to pay to creditors at a given time and it does not reflect integrity or other finer virtues of a borrower. In case of small borrowers where the credit ratings are not available, various ratios of the financial position of the borrower can be considered by the lender to determine the creditworthiness and therefore the rate of interest to be charged.

Industry of the borrower

A lender can charge differential rate of interest based on the trade or industry to which the borrower belongs to. The industry with longer gestation periods may be charged higher rate of interest as compared to shorter gestation periods. The industry which has seasonal demand only in a particular part of the year may be lent at a higher rate by a lender as compared to the business in an industry which is not seasonal.

Negative Interest

Interest being a type of fee paid by a borrower to the lender, it always used to be an income of the lender and an expense for the borrower. However, modern economy has been posing newer challenges to the world, which are dislocating the old beliefs and destroying the old theories. After the recent recession of 2009, the world has been finding it very difficult to bring economies of many developed countries out of low growth / stagnation. To give impetus to investment as well as expenditure, the developed economies encouraged borrowing. The interest rate is the main hurdle which reduces demand for credit and the central banks of many developed countries kept on reducing the benchmark interest rates in their respective economies to encourage the borrowers. The interest rates in developed economies like the US, Euro Zone, UK etc., were gradually reduced to near zero levels a few years back. Though some economies like the uS could recover due to the cheap credit doled out, the economies of Euro Zone and Japan have continued their stagnation. A few months back, to give push to growth, the European Central Bank reduced its policy rate of interest below zero percent, which means the lender will have to pay interest to the borrower for keeping his deposits. Since January 2016, even Japan adopted this policy of negative interest rate. Some countries like Sweden, Denmark and Switzerland have also adopted negative interest rates. Though this phenomenon does not appear logical, as central banks could dictate their terms in their respective economies, this policy has been adopted. This policy punishes the banks which hold cash instead of extending loans to businesses or to other weaker lenders to lend further. As an effect of negative rates, trillions of Dollars worth Government Bonds worldwide are now offering yields below zero meaning that the investors buying the bonds and holding them to maturity will not get their full money back. As of now, many banks are reluctant to pass negative rate of interest to their customers, due to fear of losing them; although it is applicable for inter-bank borrowings. However, sooner than later, they will have to fall in line and start charging their customers.

Major effects of low interest rates

1. A lender gets less income thereby affecting his/its income and his/its purchasing power to that extent.
2. Lower interest rates reduce the income in hands of many investors investing in deposits and fixed income earning securities, thereby reducing their taxable income and as an effect, it reduces the tax payment by the subjects. Lower interest rates can create a shortfall in tax collection, unless budgets are accordingly adjusted.
3. Citizens and especially senior citizens living on the interest of their investments have lesser interest income, which reduces their purchasing power. Low interest rates can affect their ability to buy

necessities and medicines, which can hamper their welfare.

4. Charities which run their operations out of the income earned from the deposits received from the donors have less income in their hands to use for the purpose of their object and administration. They will have to rely more on the donations which are in nature of current income for their operations.
5. Low interest rates can boost the economy as the entrepreneurs can borrow at cheaper cost for their businesses. It also increases the profit of businesses as interest is one of the major costs.
6. Very low interest rates can spur consumption by way of increased spending as the consumers have less incentive for saving. Increased consumption can boost the economy to an extent but it can hurt a developing economy which is in need of fresh capital.
7. The low interest rates can result in cheaper credit to consumers for buying consumer durables. It may lead to increase in sale of consumer durables such as cars, televisions, electronic gadgets etc., as well as expenditure on holidays and entertainment.
8. Low interest rates may generate a higher demand in an economy thereby increasing economic activity and correspondingly pushing up the growth rate.
9. Lowering interest rates may result in cheaper credit and lesser option for investors to invest their capital, which may result in a rise in stock and

property prices in that economy and continuation thereof can create a bubble like situation.

10. When interest rates are low, investors get more desperate to increase their earnings and therefore may patronise riskier class of assets. Over exposure to risky assets is against the interest of investors, as well as the economy.
11. Cheaper credit may push up capital intensive investment replacing labour which over a long period may create less job opportunities and therefore unemployment in an economy.
12. Low interest rates may increase consumerism in a society, which may result in excess personal borrowing by the subjects. If the economy slows down or goes into recession that may hamper the ability of the borrowers to repay the loans, resulting in substantial bad loans thereby derailing the banking system as well as economies. Excessive credit defaults or bankruptcies may result in low morale and low consumer confidence, which may affect the overall health of an economy.
13. Lowering of interest rates can give a boost to corporate profits due to lower expenses, thereby increasing the share prices of the companies, especially those which have large outstanding debt and may trigger a stock market rally. However, the sustenance of the rally is dependent upon the growth of the economy.
14. Lower interest rates give a fillip to the housing sector as a borrower can borrow more amounts with the commitment of the same equated monthly installment (EMI).

15. The fixed deposits and the bond/debenture holders are generally the sufferers in the low interest regime. They can reduce their allocation to this asset class in such a phase. However, lowering interest rates generally result in lowering yield on debt securities which results in increase of bond/ debenture prices carrying fixed coupon, which may give some respite to the bond/debenture holders.
16. Low interest rates trigger an increase in appetite of investors for precious metals and precious stones, as low deposit rates can make investors partly shift their asset allocation to this asset class.
17. Reduction of interest rates can cause pressure on the currency of the country as capital may flow out to other countries, where interest rates are higher. However, if the currency of the home country is basically strong and inflation therein is low, then the outflow of currency can get restricted, giving stability to the economy as well as the currency.

On one hand, lower interest rates may generate growth by increasing consumption and investment but on the other hand dampen the growth due to reduction in purchasing power in hands of certain sections of society and institutions, which are dependent on interest income. The final effect depends on the weightage of the respective factors prevailing in that economy.

The Indian scene

India has been struggling to cope with high interest rates prevailing in its economy for many years. One of the major reasons for the same is high inflation prevailing in its economy. In the current global scenario of very low interest rates prevailing in developed economies, this high cost of capital has been hurting Indian businesses. It has slowed down investment activity. Cost of capital being high, it has also affected the cost of production thereby eroding the cost efficiency of the Indian businesses, as compared to many developed economies, in which borrowing costs are negligible. The Government has been very much in favour of reduction of interest rates but the Reserve Bank of India (RBI) had been very cautious as it feared that the reduction may fuel demand push inflation in the economy, already suffering from inflation due to supply side constraints. Over the last few years, systematic efforts have been made to reduce the inflation in the country, especially by strengthening of the supply side, by domestic production as well as imports. The efforts have started yielding results and consumer price inflation (CPI) index has come down from 9.70% in 2008 to 5.72% in 2016 and it is expected to ease further. During the period, the RBI has reduced the benchmark interest rates in the form of Repo rates from 9% in 2008 to 6.50% now; and this is not the end of the reduction process. If the inflation remains in control, as is expected in the near future, the interest rates can further come down. Investors need to align their investment strategies to falling interest rates in the days to come.

India has recently started its journey towards low interest rates and it is likely that on the back of sustained economic growth, the country may continue its journey towards further lowering of the rates, albeit gradually. Many of the developed economies in the world have low interest rates which are sustained for long periods of time. If India continues its growth at the current rate and can control inflation, the interest rates in the economy may gradually reduce. Indian investors as well as consumers are not accustomed to low interest rates. Investors will have to adjust their investment strategies to fit in to the new environment. Senior citizens as well as institutions relying more on interest income for their sustenance will have to realign their consumption / spending patterns. Lowering of interest rates may hit hard this particular section of the society. On the flip side, the businesses will have reasons to cheer due to low interest cost and EMI paying consumers will get delighted.

Conclusion

Interest rate is one of the major tools in the monetary policy of a central bank. In the recent years, the RBI has made a calibrated use of the same inspite of pressures from various quarters. This has resulted in lowering of inflation in the economy without affecting the growth much. Lowering of interest rates over a period will give great advantage to the Indian economy as costs can go down and become more competitive. This will also support the 'Make in India' movement.

"People must come to accept private enterprise not as a necessary evil, but as an affirmative good".

- Eugene Black
Former President,
World Bank

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The Forum of Free Enterprise is a non-political and non-partisan organisation started in 1956, to educate public opinion in India on free enterprise and its close relationship with the democratic way of life. The Forum seeks to stimulate public thinking on vital economic problems through booklets, meetings, and other means as befit a democratic society.

In recent years the Forum has also been focusing on the youth with a view to developing good and well-informed citizenship. A number of youth activities including elocution contests and leadership training camps are organised every year towards this goal.

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