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A distorted credit policy

Credit squeeze for industry is unlikely to improve even in the medium to long run, says **Uttam Gupta**

IN its credit policy announced in April 1995, the RBI has increased the maximum interest rate on deposits up to three years to 12 per cent from existing 11 per cent. A corresponding increase in the lending rate is almost a foregone conclusion as the busy season credit policy announced last in October 1994, had already allowed banks the flexibility to fix lending rates. The mood at that time, was however, different.

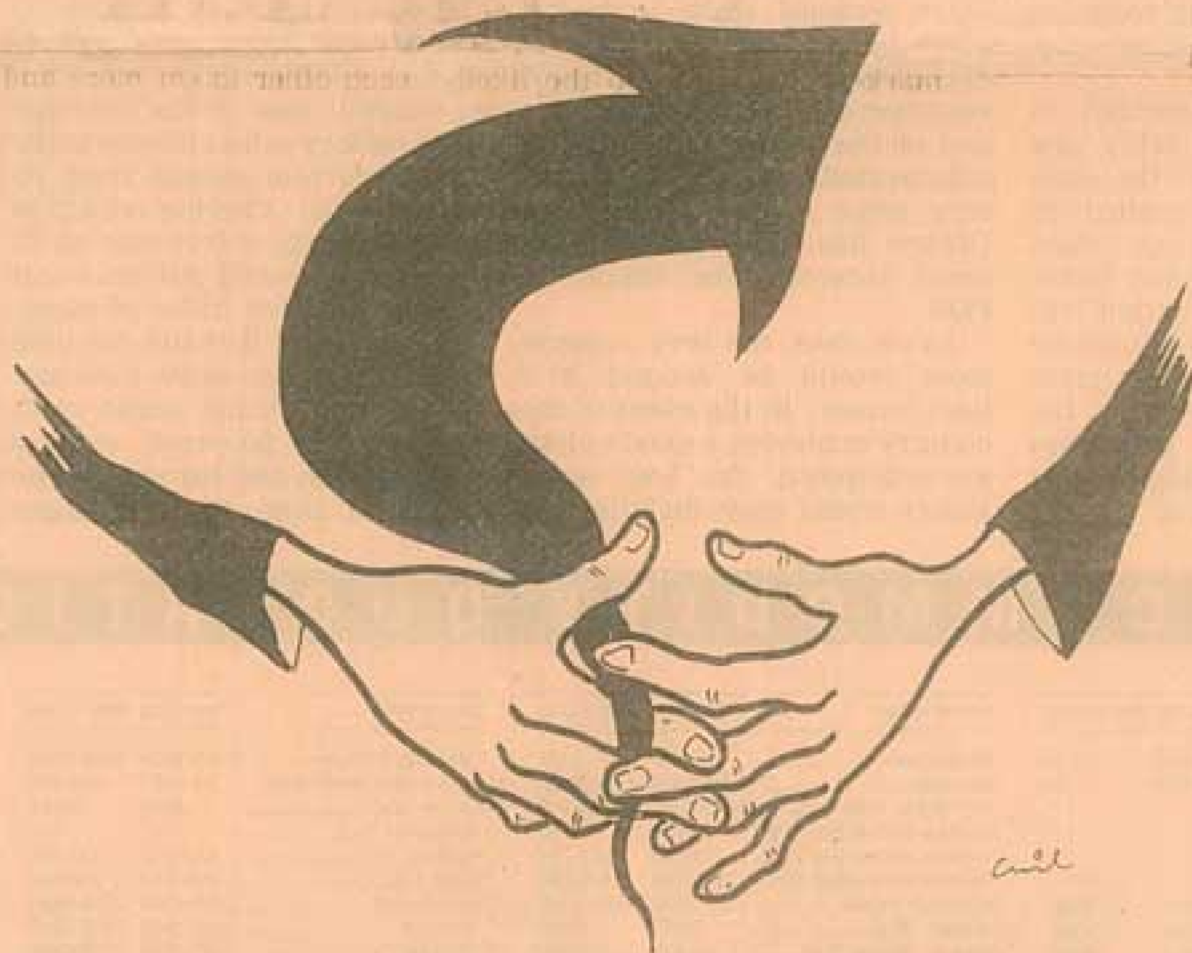
RBI's decision was meant to signal the possibility of a significant reduction in the cost of credit. Some of the banks with SBI in the lead even responded immediately by reducing the prime lending rate from 15 per cent to 14 per cent. Unfortunately, even this token gesture was short-lived.

A few months later in January 1995, these banks decided to increase the rate by 1 per cent again thus restoring the status quo ante. With a further hike of 1 per cent announced now, the banks are gearing up for another round of increase in the lending rate. It would now be a minimum of 15.5-16.0 per cent for companies with good track record; for others, the commercial banks are free to charge higher rates without any ceiling.

The message is loud and clear. Far from aspiring for any reduction to a level of about 6-7 per cent prevailing in developed countries, industry should now get ready to face an ever increasing interest rate regime. This is because even when the underlying factors i.e., the inflation rate and availability of funds were favourable during 1993-94 and the first half of 1994-95, the lending rate did not come down. Presently, with industrial recovery gathering momentum and diminishing availability of funds from the capital market route, there is increased demand for credit from the banking sector. Besides, the inflation rate has gone up. In view of these developments, it is inevitable that lending rate would increase.

The availability of bank finance for industry is unlikely to improve even in the medium to the long run. The reasons are manifold. First, the growth of deposits will be hampered notwithstanding increase in the maximum rate in nominal terms. The inhibiting factors are the continuing high rate of inflation and erosion in the overall saving potential of households. Reintroduction of tax deduction at source (TDS) would act as a further disincentive.

A second major reason is a fallout of the government's understanding with the RBI not to allow the monetisation of its deficit beyond Rs 6000 crore. This implies that the government would be borrowing heavily from the banks to support its deficit, thereby reducing available funds for lending to industry. In this backdrop, any relaxation on the CRR/SLR requirements is also unlikely to release funds for industry.



Third, due to "negligible" budgetary support and limited internal generation of resources, the PSUs also fall back on the market borrowings as a major source for funding their expansion and modernisation schemes. With private parties not too keen to lend, funds have to come mainly from the commercial banks, FIs and mutual funds owned and controlled by the government.

Fourth, the government is asking banks to divert resources to the Rural Infrastructural Development Fund (RIDF) under Nabard. During 1995-96, this would involve diversion of about Rs 3000 crore. To that extent, availability of loanable funds to industries will be reduced. Needless to mention that this is going to be a permanent feature.

Sometime back when the capital market was bouyant, it appeared that industry's dependence on banks for funds would reduce. Now, the market is no longer buoyant and consequently, chances of mobilising funds are limited. The government has allowed access to external commercial borrowing (ECB). But there is an overall ceiling; even within this, borrowings are restricted primarily to infrastructure projects.

Any respite from inflation is unlikely as all generic elements i e increasing fiscal deficit, administered prices and rising cost of food continue in full fury. This is sufficient justification for keeping interest rates high which, in turn, will feed inflation and the vicious cycle to continue.

What will then be role of the RBI? Following the understanding to cap monetisation of budget deficit, the government maintained that the RBI would be able to assert its independent role in ensuring monetary stability while simultaneously providing necessary stimulus to the economy. On money supply, more than the incremental supply, the accumulated liquidity overhang (including substantial chunk as black money), is a major worrying aspect.

The other important role is that of deciding where and to what extent, bank funds should go. Unprecedented borrowings by the government is at the cost of restricting credit to industry. This is unacceptable considering that the, unlike the latter, government borrowings do not add to the productive capacity of the economy. Such government borrowings will further aggravate the demand-supply imbalance leading to higher rate of inflation.

There is need to establish a certain degree of parity in allocation of funds. This, in turn, may require a greater say for RBI nominees on the board of directors of banks on the one hand and significant disinvestment of government's equity to enable induction of private shareholders representatives in the boards and consequently, in the decision making process.

Some check on flow of bank funds to the government would also exert an indirect pressure on the latter to manage its finances prudently and effectively. This way the RBI can help in putting a check on inflation through the fiscal route.

A reasonable restriction on borrowings by the government will also help the RBI in purposefully using the CRR and SLR instruments for regulating flow of funds to the industry and agriculture.

Guiding the monetary and credit parameters on the right path devolves on the government. It must pursue the macroeconomic stabilisation programme vigorously with main thrust on reducing the revenue expenditure. This would help both in controlling inflation and releasing funds for industries. Control on inflation will augment real rates on savings deposits which, in turn, will create conditions for lowering the lending rates with consequential favourable effects on the financing cost of the industries.

Simultaneously, reforms should be introduced in the banking sector to bring about reduction in cost of intermediation. Significant progress in regard to privatisation is also needed to generate competitive pressures with the ultimate goal of lowering cost to the borrowers and improved customer services.

Unless these changes are seriously pursued, the Indian economy will remain trapped in the vicious circle of high interest and high inflation rate which will prove deadly and disastrous for GDP growth and well being of the people.