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A self-created liquidity crunch

The high lending rate has made finance costly thus hindering industrial growth. With the high revenue deficit the PLR is bound to remain steep. There should be an effort to curb the reserve ratios along with optimal use of finance, says Uttam Gupta.

IN recent years, the government has sought to justify high lending rate in terms of the prevailing high inflation rate. Now, when the latter has plummeted to below 5 per cent, the former continues to remain at a high of 16.5 per cent.

During the late 1994, when inflation was hovering a little over 10 per cent, the lending rate was 15 per cent yielding a differential of 5 per cent. On this basis and taking the present inflation rate of 5 per cent, there is a strong case for bringing down the prime lending rate to 10 per cent. Far from this, the banks are pressing for further increases in the lending rate and the policy makers respond promptly by handing out reasons to justify the same.

As part of the RBI busy season credit policy for 1994-95 the government announced deregulation of lending rates. It held out hopes that removal of control would bring an element of competition which, in turn, would lead to lowering of the rates. These were dashed in no time as what followed was a reduction of only 0.5 per cent, that too by a few banks, only to 14.5 per cent. Unfortunately, the concerned banks did not even stick to this. It goes without saying that the minimum lending rate since then has already advanced to 16.5 per cent.

Financing cost is a significant element in the total cost of production and if these costs cannot be brought down, there is not only a danger of exports getting affected, the industry may be edged out even on the home turf. Besides, the pace of investment and growth will suffer seriously.

As part of the financial sector reforms, during the early 90s, the government has gradually reduced the SLR and CRR which currently stand at 29 per cent and 14 per cent respectively. By asking the banks to maintain these ratios, the RBI impounds a portion of the net time and demand deposit liabilities.

Consequent to these reductions, it was only logical to expect that availability of credit for financing the requirements of industry and trade would increase substantially. This has not been the case. The reasons are not difficult to seek.

The revenue deficit doubled from about Rs 18,000 crore in 1990-91 to a high of Rs 33,000 crore during 1995-96. Bulk of this is being financed by market borrowings especially since 1994-95, when the government decided to put a cap on the issue of ad hoc treasury bills to the RBI. Consequently, despite lowering of SLR and CRR, the net availability of funds for industry and trade continues to be substantially short of the requirements. The situation has been aggravated by the sluggish trend in the growth of deposits.

Even as the government is adumbrating about introducing market mechanisms in the financial sector, these are hardly allowed to function freely. In fact, being the owner of the banks, it manages to corner bulk of the funds "preemptorily" thus forcing the industry and trade to contend with the residual. Even the interest rate on its borrowings is still significantly lower than the rate charged on loans to the industry.

While talking of the pool of cheap finance readily available to the government, one cannot fail to take note of the net credit from the RBI at a meagre 4 per cent by way of issue of ad hoc treasury bills.

Juxtaposing all sources of funding together, it would turn out that the banking sector is made to finance the government at the cost of others and that such financing is still heavily subsidised. The irony is that while the government blames the subsidy on loans to agriculture as the sole reason for the pressure on banks, there is not even a whisper in regard to its own role. Banks are not running charity. The cost of subsidisation has to come from somewhere. And, this is precisely what keeps the cost of lending to the industry high.

The cost of funds to the banks also needs to be carefully scrutinised. The rates offered on deposits under 2 years are below 12 per cent whereas in respect of deposits above 2 years, even after the recent liberalisation, these are in the range of 12.5-13 per cent. When the banks say that they cannot remain viable by lending at anything less than 16 per cent, this is invariably quoted as the benchmark. But, what they would not talk is the enormous cushion that is available by way of public funds in the savings account on which the banks pay a measly 5 per cent.

Although, the funds in individual accounts may be small, in the aggregate, savings deposits constitute a substantial portion of the total which drastically reduces the cost of servicing bank liabilities on a weighted average basis. Unfortunately, this benefit is not available to the borrower because of various subsidies including the subsidised funding of the government. The high overhead cost apart from losses on non performing assets and waiver of loans/interest granted at the instance of political bosses further add to the pressure on lending rates.

The government should carry the process of reducing the SLR/CRR to its logical conclusion as recommended by the Narsimham Committee. But, this alone will have little effect unless the government sheds its present practice of taking away bank funds through the backdoor. The government should, at the same time, make sincere efforts to reduce revenue deficit with the ultimate aim of converting this into surplus.

Control on inflation is of paramount importance. For this also, a tight leash on the budget with concentrated focus on reducing revenue deficit is a must. Reduced inflation will help in lowering the deposit rate without compromising on savings. Consequential lowering of the cost of funds to the banks will have a salutary effect on the lending rate. The entire exercise has to be done in a "transparent" manner.

However, to ensure that the banks fully pass on the benefit of lower cost of funds, there is need for effective competition. To facilitate this, the pace of setting up more banks especially in the private sector, should be hastened and the entire process of giving licenses has to be debureaucratised.

Last but not the least, political interference in whatever form must stop. To help this the government may seriously pursue offloading its equity holding in the banks to the public.