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High interest hinders income, distribution

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Visitors walk past display stalls from technology companies during the Global Investors Meet 2015 at the Chennai Trade Centre on Wednesday. — AFP

High interest is a great disincentive to investment and hindrance to growth of Public income (GDP). While sharing income by the participants of economic chain, higher chunk goes to persons deploying capital comparing to those deploying knowledge and labour. For striking balance, the cost of capital (interest) must reduce radically. In India, inflation can't be controlled by hiking interest. For promoting savings, taxation tools are more effective than interest hike. Differential interest rate among various borrowers also needs review.

Interest rate in India is too high comparing to major economies of the world. It is indeed a big hindrance to investment, particularly in capital intensive projects like infrastructure and core sector industries. These projects become unviable and India faces shortage and high cost of the core goods and services. Its impact travels to entire economy, converting India to high cost economy. With this, we will not be competitive in global trade. Trade deficit will persist and Indian currency will keep on depreciating. Essential imports will be costlier in rupee terms. In such a situation, the growth of public income (GDP) will be inconsistent and face several hiccups.

High interest is also a hindrance to judicious **distribution of public income**. It is well known that public income is generated out of production of goods and services in the entire economic chain. It is distributed among the participants of economic chain depending upon their deployment of capital, knowledge and labour. If the cost of capital (interest) is high in any country, the participant investing capital will get larger chunk of income comparing to those who have put their knowledge and labour. Should capital get higher dividend than knowledge? We must appreciate that knowledge and human capital are the most valuable resources of any country. Capital can be generated for nation with the help of these resources only. Those must be suitably rewarded by giving its due share by decreasing the cost of capital.

With these considerations, the big question arises; why do we keep interest so high comparing to peer countries? Probably it is due to fear psychosis of inflation, which is considered to be a big monster for India. It is strongly believed by most economists that high interest is the only tool by which we can **control inflation.** A second question arises; whether this belief is rational with respect to India, unlike developed countries?

Per capita income of developed countries is too high comparing to India. Their consumption needs are mostly fulfilled with their income. So as to generate additional demand, these countries extend consumer finance in a liberal manner at low interest. Any hike of interest causes slowdown of demand and vice versa. Hence consumption demand is closely linked with interest rate. In other words, they manage demand vis-a-vis inflation through interest tool. India doesn’t need curbing of demand. Rather we must remove supply constraints and reduce cost of production and delivery. Those will be the right choices for controlling Inflation instead of depending on monetary tool.

High interest in India causes decline of investment and growth rate affecting the public income and their purchasing power as well. On the other hand, production cost of goods and services shoots up since capital is a basic input. Due to inflated cost of goods and low growth of income, any common consumer cuts consumption causing decline in demand. Thereafter, producers are compelled to sell products at distress sale price to keep the wheels running. It means, initially high interest brings inflation and then reduces purchasing power and demand and finally ends with distress on both public and producers. Prolonged high interest will bring **deflation and recession**, which is a much bigger monster. This is what we are facing today in India. This is an outcome of high interest for a long period. Why don’t we review interest policy with an open mind?

For controlling headline inflation, supply constraints must be removed and cost of energy, logistics and minerals must be brought down by suitable initiatives. Labour productivity must improve through labour reforms. Post farming, storage and distribution infrastructures must be strengthened; that will arrest food inflation at consuming end.Processing of perishable food must be promoted to arrest price volatility in fruits and vegetables. High interest is no answer to this problem.

The buck doesn’t stop here. India follows **differential interest** policy depending upon its end use. Government borrows at the lowest rate. Unfortunately, most of such borrowings are used for bridging revenue deficit that is excess of consumption expenditure. Auto loan and such consumer loan are also financed at lower rate comparing to the business loan, which is used for production of goods and services. Banks find it most easy options; since consumers loan are generally not subjected to scrutiny and it is also a part of populism.

Out of business loans, SME sector pays the highest rate; that contributes highest to GDP and public income. They are not able to get cheap funds from market or abroad. Why not we rewrite interest policy as a whole? All capital expenditures may be private or government must attract lower interest. Infrastructure, agriculture and core sector loans should be at the lowest rate. Government borrowing for consumption and other consumer loans, except housing and education, should attract higher rate. It means government must pay different rate depending upon end use. By this, ill effects of high interest will be diluted to some extent.

High interest is also opted to promote **savings** for investment needs of the nation. The question arises whether savings in India is linked with interest rate alone? In India, the taxation rules and incentives impact savings more than the interest rate. Income tax laws must be friendly, rates must be low, tax terror must end and savings linked incentives be expanded on all financial savings. This will increase savings at faster rate comparing to the hike in interest. Physical savings, particularly gold savings, must be shifted to financial savings by innovative methods. PMJDY scheme is a good step to bring rural savings to bank. By decreasing interest, corporate savings will also jump which will be reinvested in business expansion giving compounding benefits to economy.

It is high time for India to redesign interest policy which impacts growth of public income (GDP). Interest cost on productive activities must reduce comparing to consumption spending by government and public. First visible improvement will be seen in infrastructure services like energy, power and transportation. Then it will spread to entire economy. Cost of production and supply will reduce easing inflation. Exports will be competitive cutting the trade deficit. If we succeed in arresting depreciation of Rupee; foreign investment will rush and growth will take a leap jump. India must come out of the present rut and boost economy. By this, we will also do justice for income distribution which is now tilted towards rich persons having more capital resources.

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