A New Growth Consensus?

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A series of apparently contradictory trends and measures points to a dangerous new consensus on the functional role of banks in India. To start with, in his first monetary policy review after assuming office, Reserve Bank of India (RBI) governor Raghuram Rajan decided to run with the hares and hunt with the hounds. While he disappointed those who were expecting a cut in interest rates, he chose to hike the repo rate, or the rate at which banks borrow from the RBI against government securities as collateral, arguing that the battle against inflation had not been won.

On the other hand, in what appeared a minor concession to those arguing that easy and inexpensive liquidity was needed to boost demand and flagging growth, he chose to lower the interest rate on the Reserve Bank of India's marginal standing facility (MSF), established in 2011, under which banks can borrow funds at a rate linked to but set higher than the repo. Originally the MSF rate had been set at 100 basis point or 1 percentage point higher than the repo rate. This differential was hiked by a further 2 percentage points to 10.25 per cent in July 2013 in a move that seemed motivated by the need to curb speculation on the rupee. The September 2013 Mid-Quarter Review of Monetary Policy partially reversed that hike by reducing the differential between the MSF rate and repo rate by 75 basis points (bps) to 9.5 per cent. The consequent ability of the banks to obtain funds at a lower cost without collateral was seen as a measure aimed at boosting banking sector liquidity.

Thus, there appeared to be two contradictory planks to RBI policy. Keep interest rates high to curb excess borrowing in order to curb demand and fight inflation. Ease liquidity conditions so that banks can lend to genuine borrowers who would, however, have to bear the burden that a higher interest rate implied. Not surprisingly industry was not too impressed since higher borrowing costs would deter those who were planning to borrow to buy their much-desired house, automobile or consumer durable. On the other hand, the purpose of the higher base rate to combat inflation by curbing demand and debt-financed speculation seen as pushing up both commodity and asset prices appeared to be defeated. Demand would increase as a result of new debt. And those expecting higher returns such as speculators in commodity, real estate and stock markets would be willing to bear the higher interest costs.

Barely a month after this initial contradictory foray by the new governor, a set of developments that followed meetings between the Finance Minister and the RBI Governor pointed to a method behind this confusion. In early October, the RBI strengthened its liquidity enhancement measures aimed at increasing bank access to lower cost funds by: (i) further reducing the MSF rate by 50 bps to 9 per cent; (ii) conducting open market operations (OMOs) involving the purchase of government securities to the tune of Rs 9,974 crore to inject liquidity into the system; and (iii) providing "additional liquidity through term repos of 7- and 14-day tenors for a notified amount equivalent to 0.25 per cent of net demand and time liabilities (NDTL) of the banking system". Clearly, the RBI's decision to maintain high interest rates is not aimed at curbing credit and liquidity in the system.

These "accommodative" initiatives on the part of the RBI were matched by another unusual measure: this time on the part of the Finance Ministry. In early October the government announced that it would infuse capital into public sector banks in excess of the Rs. 14,000 crore provided for in the Budget, with the specific intent of enabling "them to lend to borrowers in selected sectors such as two-wheelers, consumer durables, etc at lower rates in order to stimulate demand." Clearly, measures aimed at augmenting liquidity and enhancing the banking system's capacity to create credit is being viewed as the solution to the growth slowdown. Debt financed private consumption is being seen as the appropriate stimulus for growth. Since the banking system would in principle be able to create credit that is a multiple of the sums infused by the government, every rupee spent from the government's budget could in principle generate demand that is much larger if banks "pushed" loans.

Hence, as a follow up to its enhanced capital infusion announcement the Finance Ministry has reportedly asked the banks to (i) specify by how much they would be willing to reduce the interest rates at which they lend for purchases of commodities such as two-wheelers and consumer durables; and (ii) agree to enhance lending to the chosen sectors by at least ten times the capital infused, with periodic reporting on retail lending volumes to satisfy the government. The argument seems to be that, since the government is infusing low or near-zero cost capital into the banking system, the latter should in turn provide cheaper loans in areas identified by the government.

The message is clear. Capital infusion is being seen not just as a means of recapitalising the banking system that has been recording increases in non-performing assets, but also as a means of providing an interest rate subsidy or subvention to boost demand in particular sectors. A government that limits spending for the poor because of the need to curb the fiscal deficit, is willing to subsidise a consumption spurge by the "middle class" by taking over the private sector's task of boosting sales with cheap credit in times of slack demand. A combination of liquidity infusion and interest rate reduction realised through administrative fiat that serves as the means to stimulate growth seems to be the strategy on which there is a new consensus between the RBI and the Finance Ministry. This is not the conventional shift away from dependence on the fiscal lever to a reliance on monetary and banking policy. The use of capital infusion as an additional device implies that the strategy has a fiscal component as well. But, for any given increase in the fiscal deficit, the demand generated in the first round can be much larger.

For such a strategy to be successful, the banks would have to draw into the universe of borrowers a larger number of individuals than it was willing to accommodate in the past. Reducing interest rates would partly help by serving as a teaser. But some dilution of norms with regard to assessment of creditworthiness may also be necessary to hike buyer numbers in the selected sectors. Further, once the process begins, if the government is not to appear partial in the favours it dispenses, requests from other sectors for such demand-stimulating support would have to be accepted. It did not need the subprime disaster in the US to persuade anyone that this method of spurring growth is built on a debt bubble that is fragile. As RBI Deputy Governor K. C. Chakrabarty is reported to have said after the measure was announced: "It is not a very prudent measure to increase consumption by lowering interest rates. If the rate goes up it will become NPA."

This strategy is, however, not new. With neoliberal fiscal reform requiring forbearance with respect to taxation and "fiscal consolidation" in the form of deficit reduction at levels of debt that are arbitrary and wildly different across countries, the role of tax- or debt-financed public expenditure as a stimulus to growth has significantly declined. The pressure not to resort to the fiscal route to spur growth is immense. But claims that the “animal spirits” unleashed by reform would spur sustained growth have not been realised either. Thus many countries, including India, have come to rely on debt-financed private consumption, facilitated by an easy monetary and liberal banking policy, as the principal stimulus to growth. A consequence is that growth rides on a bubble blown by debt and is therefore fragile and ephemeral.

In India, the pursuit of this strategy is reflected in three trends. The first is a sharp rise in the ratio of scheduled bank credit to GDP from around 20 per cent to more than 50 per cent during the years of high growth after 2000. The second is a significant increase in the share of retail lending in total scheduled commercial bank lending, with lending for individual housing investments, automobile purchases, purchases of consumer durables, credit card expenditures and education. The third is enhanced bank lending to infrastructure, with the ratio of such lending to total lending to industry rising sharply, despite the obvious maturity mismatches involved in using the money of depositors to fund bulky, illiquid loans to a few infrastructural projects. All of these can increase bank fragility.

The role of the government in driving these trends is clear from the fact that they apply more to public sector banks than to either domestic or foreign private banks, with a few exceptions. But that has in the past been associated with a conflict between the central bank and the Finance Ministry. The RBI has made inflation its principal concern and relied heavily on interest rate increases and monetary restrictions to combat inflation. The government on the other hand has demanded an easy monetary policy with low interest rates as the means to stimulate growth. The RBI has opposed this not only because of its focus on inflation, but also because of the implications that trajectory could have for non-performing loans in and the stability of the banking sector. This has often meant a subtle but noticeable standoff between these two arms of state.

This points to the new consensus suggested by the contrary policy developments of recent times. While the RBI is sticking with its policy of keeping interest rates high, it seems to be going along with the idea of (i) infusing liquidity into the system; (ii) persuading banks to use that additional liquidity to lend to selected sectors to stimulate demand and drive growth; and (iii) allow the government to use capital infusion as a device to get banks to reduce interest rates in order to induce consumers into borrowing (especially in the “festival season” when the pressure to spend is high). In the process the RBI seems to be ignoring the potential increase in bank fragility, which it should be concerned about. Not surprisingly, Governor Rajan had to defend the measures by saying that the MSF rate cut combined with recapitalisation would spur “certain kinds of investments”, though he grudgingly admitted, “indirectly some consumption will also get financed.”

However, it should matter to the RBI that the cheaper liquidity released through this process would undermine the use of a high repo rate to address inflation, if that were possible at all. Perhaps Rajan’s commitment to high interest rates is motivated by some other factor. One possibility is the need to keep domestic financial markets attractive to foreign investors and lenders, so as to attract capital, easily finance the current account deficit and stabilise the rupee. That too smacks of short-termism.

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