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# A note on

# Revision of Interest Rates in Nepal

Kanhaiya Mathema

Monetary policy working through the interest rates lost its weight in the economic system of the world with the great depression of the 1930s But it reemerged as an effective instrument of economic policy during 1950s which was after the outbreak of the korean war. In this period it was taken as a package-deal approach. Persuasion of this policy is continuing even in these days in a number of countries including Nepal.

One of the expectations behind this weapon of monetary policy is to attract the flow of idle capital fund in productive activities through desirable investment channels. However, its sensetiveness in this direction lies in the widespread network of financial market and banking institutions with a major monetized sector of the economy where a marginal change in the interest rate leads to a tremendous movement of capital fund through a change in the deposites and borrowings with the commercial banks. keynes believes that the level of interest rate is a major factor in the demand function and argues that at low interest rate the demand for money would become highly elastic with respect to the interest rate.[1]

In a developing economy like Nepal, owing to the nonmonitazion of the major sector of the economy and the prenatal stage of the financial markets effect of monetary policy through interest rate manipulation is difficult, if not impossible, to findout. Moreover, due to the

Mr Mathema is Lecturer, Economics Instruction Committee, T.U. He owes much to Prof. A. L Pradhananga, Chairman and Lecturers G. N. Sharma and S. Sharma, Economics Instruction Committee, Kirtipur Campus, for their comments on this note.

1. H.B.C, Bannoh, D.E. Bond & R.A. Sheareh, Money and Banking Theory, policy nd Institutions,' Harper and Raw Publishers, London, 1975, p. 436.

dualistic nature of the economy, there are many other highly profitable lines for investment. In case of Nepal, the five hundered miles long openborder with India all the more has aided in the envolvment of huge fund in illegal activities. More than that a change in bank deposit in such an economy may be more from the security point of view than from the point of view of the return to the deposits. Besides, It may not be wrong to presume that the depositors may be indifferent to the rates of interest in a developing economy. And accordingly, fund will be used in the holding of real estates and gold and silver.

No doubt, deposit is the principle source of capital of the commercial banks. As such an attraction should be given to the depositors to make their fund deposited with the banking institutions. Besides, the increased deposits may help reduce the increasing inflationary preassure in the economy. Because the effect of the increased bank deposit may directly be reflected in the low consumption expenditure of the people. The banking institutions an increase their volume of assets only "when their lending policy would be a sound one. In this regard, the interest rate can become a true fried, philosopher and guide" of these institutions, Thus interest rate should not be excessively high in bank loans. Because increased rate of intrest in bank loans curtails investment.

The central bank being the monetary authority in any country, has the prerogative to change the rate of interest of the banking and financial institutions provide the prevailing economic situation so demands. In Nepal it is Nepal Rastra bank, the central bank of the country which if necessary, brings about a change in the overall monetary policy of which the interest rate is the one. Accordingly, in the decade of 1970 only, a change in interest rate was introduced three times so as to mobilise the potential savings of the country through the banking institutions. However, the volume of deposite and loans of commercial banks shows that both depositors and borrowers are indifferent to the change in the rates of interest of the commercial banks For instance the saving deposit of the commercial banks in july 1976 was R.s 1980 million and that of fixed deposit was of Rs. 807.7 million. In February 1977, a change in interest rate, particularly, the fiixed deposit rate, was reduced by 1 percent and 2 percent respectively in the deposit with the maturity period of 6 months, 1 year and 2 years and above. In 1975, the fixed deposit rate was highest at 16 percent and in that period the total volume of fixed deposit was Rs. 517.3 million which was less than by almost Rs. 3 million in comparision to the 1975 level However, in 1977 the volume of saving deposit increased to Rs. 224.4 million and that of the fixed deposit to Rs. 949.8 million[2]

2. Nepal Rastra Bank, Quarterly Economic Bulletin, Mid. October 1982 No. 1 Volume VI.

The following table shows the commercial bank's deposit rates for two years.

## Table 1

**Commercial Bank's Deposit Rates**
**(Percent per Annum)**

| Kinds of Deposit | Effective July 16, 1976 | Effective Feb. 12, 1977 |
|---|---|---|
| Current Savings | 8 | 8 |
| *Fixed* | | |
| 3 Months | 4 | 4 |
| 6 Months | 10 | |
| 1 Year | 14 | 12 |
| 2 Years & above | 15 | 13 |

Source; Nepal Rastra Bank, Annual Report, 1981/82

Similarly, the bank loans and investment rates are also increasing irrespective of the interest rate. One of the important reasons for the increased loans may be the high expectations on the part of the business community of further increase in market price. Thus inspite of the rise in the interest rate surpassed by the rise in the price level the borrowers might have directed the bank fund in some speculative purpose to exploit the opportunities prevailed by the rising price level. A bird's eyes view of the commercial banks' loan rates makes it clear that the volume of bank loan and advances is increasing. This increasing trend of bank loan has by-passed the manipulated rates of interest in bank loan. Given below is the commercial banks loan rate for two years.

## Table 2

### Commercial Banks' Loan Rates (Percent Per Annum)

| | Effective February 12, 1977 | Effective April 10, 1978 |
|---|---|---|
| 1. *Industrial Loan* | | |
| 1.1 For Fixed capital | 10 | 10 |
| 1.2 For working capital | 14 | 14 |
| 2. *Agricultural Loan* | | |
| a, cardamom, Horticulture, tea and cotton cultivation | 8 | 8 |
| b, Livestuck, Poultry, Fishery, Sericulture and Bee Keeping | 11 | 11 |
| c, Irrigation | 14 | 11 |
| d, other agricultural Loan | 14 | 14 |
| 3. Service sector | 14 | 14 |
| 4. Export Bills | 12 | 12 |
| 5. HMG Development Bonds | 14 | 14 |
| 6. Fixed Deposit Receipts | 2 Percent more than that of fixed deposit. | 2 Percent more than that of fixed deposit. |
| 7. other Loans | 2 Percent more than specified rates. | 2 Percent more than specified rates |

Source: Nepal Rastra Bank, Annual Report, 1981/82.

At the above given loan rates, the volume of loans and investments of the commercial banks has increased in 1978 and onwards in comparision to the previous year. in 1977, the volume of loans, advances and overdrafts of the commercial banks was Rs. 1055.2 million. It increased to Rs. 1401.1 million in 1978.

This is the simple evidence of the fact that the rate of interest has very little impact in the psychology of both depositors and borrowers in the country. But Nepal Rastra Bank has recently introduced a change in the interest rates. It raised the interest rates in banks deposits and bank loan by 0.5 percent and 1 percent respectively effective from 1st Ashad 2039 (15th June 1982). In the version of Nepal Rastra Bank, the increase in interest rate in bank deposits is to *attract more savings to be mobilised in investment activities and thereby to minimise the inflationary pressure in the economy*. On the other hand, the increment in the rate of interest in bank loans is effected with a view to balancing the increased demand for internal loan and the situation of imbalance created out of the ineffective mobilization of deposites with the commercial banks. Besides, the increase in the bank lending rate is to check the diversion of bank loans from productive to nonproductive purposes.

But looking at the past movement of bank deposit and loans and advances, one can doubt the effectiveness of this sort of marginal variation of rates of interest in bank deposits and bank loan in the near future.

In order that a marginal increase in the interest rate is effective, Nepal Rastra Bank, as the monetary authority of country, should widen the economic horizon in the country. In other words, attempt has to be made to convert the large nonmonitized sector of the economy into the monetized sector by developing banking habit at a vigorous pace for which industrialization and modernization of agriculture sector are essential things. This would create an atmosphere conducieve to the building up of sound capital market.

Instead of increasing the interest rates marginally, it has at least to be raised by 4 or 5 percent with higher level of stability so that potential fund can be attracted. For instance, the rate of interest in bank deposit in Demark Jyse Bank is 16 percent.

The borrowers should be given an adquate facility by way of simplyfing the lending procedure.

The provision of the withdrawal of any amount of saving deposit at 15–20 days notice has given little meaning to 3 or 6 months time deposit with the interest of 4 and 9 percent respectively. It permits fixed depositors to be moved to saving deposit venue which necessiates banks to hold high liquid assets.

Of the many steps, the above mentioned ones are a few measures to activise the rate of interest of the commercial banks from the point of view of strengthening the economy and correct the imbalance between demand for loan and the flow of fund in the economy.

# Book Review

**P. R. Brahmananda, The IMF Loan and India's Economic Future, Himalaya Publishin House, Bombay, 1982.** Pages 96, Price Rs 10 (IC), Statistical tables and appendices.

The book has been arranged in six chapters and also includes nine appendices which give explanations of various concepts and notions related to development problems and the relation of foreign sector with the domestic economy. Appendices also deal with recent topics such as supply side economics, exchange rate policy, the socalled oil crisis and its terms of trade effects, etc. Discussions are focused on issues related to Indian economy.

This tiny book has sought to highlight the controverey arising out of the decision of the IMF to approve the 5 billion SDR(currently epuivalent to 5.75 billion US dollars) loan to INDIA repayable in instalments.

In chapter I of the book the author talks about the credit worthiness of India, the nature of the IMF loan, and Indian government's attitude towards this loan. The IMF is no doubt the apex of the world monetary system whose main concern is with the international lipuidity problem with its long history since the time of gold standard. The outcast of gold standard by the gold exchange standard in the first quarter of the 20th centry was due to the chronic liquidity problem that the world faced and the establishment of IMF also could not solve it, for the supremacy of big powers made the system less progressive. The second amendment of the articles of the IMF in 1976 made the system much flexible by bringing a new dimension in various international measures focused on persistent payments gap and growing liquidity problem. The low income nations were the main which were much affected with the disease. The IMF is doubtlessly a friend in need of all member nations despite the fact that it has the roots on the viable economies of the great powers with notable economic influence. This multinational monetary as well as financial organization differs from other sources of liquidity and finance mainly in its very nature. A good-will approach is the best approach that it follows in dealing with subjects concerning the liquidity run and financing of difficulty caused by various sources including structural maladjustment of member nations.

With these background in mind the author says 'the approved amount of loan to India under *Extended Fund Facility* is within the limit of Indian quota and conditionality clause is general for all the borrowers'.His explicit reasoning behind the justifications is perhaps not the bias towards loan as such, but it appears that for him the loans subject to conditionality and performance clauses are nondiscriminatory, cheaper, and are lent for good purpose. Professor Brahmananda gathers the Indian government's programs and policies to fight against adverse effect, if any, with the loan as well in the context of Indian economy.

In the second portion of his 'Ramayana' about the effects of loan he describes various mechanisms in *Chapter Two* such that the adverse monetary implication of the loan on Indian economy would be not much significant except that the effect after repayment would be much different. In the same chapter he has tried to sketch the views of Indian government regarding the abverse trend in the terms of trade of the third and emerging world which has become a major concern for all including big and small powers alike. The deteriorating terms of trade has created a burning payments problem to the world including India and Professor Brahmananda is much serious in this matter. He gives the reference of the estimates made by sixth plan of India about the size of the current Account deficit in nutsell and proceeds alongwith the justifications for incuring loans for the improvement of national productivity and employment situation.

The third chapter of the book has been assigned to expose the issues related to the loan as such. The author gives the reference of the meeting organized by the West Bengal Finance Minister Dr Ashok Mitra of left wing group. As the reactions of the meeting came as the *West Bengal Document* in the form of *White Paper*, the fundamentals of it relate to the charges leading to the loss of national soverignty and independence. Different arguments were put forth in justifying that the loan is not in India's favour which might lead to the depreciation of Indian currency, the increase in money supply, the tying of India's domestic demand management policies to the decision in Washington, the hamper to the growth of Indigenous technology etcetera. The main verdict of the document shows a discontentment that 'Indian people were not taken into confidence' while making loan arrangement.

In reply to the above reactions Prof. Brahmananda becomes little biased against the *West Bengal Document* by saying that 'points in the document are not factually correct.' He overlooks the factual truth that this thing could be judged only after the loan arrangement is materialized. His furthur note that 'in terms of plan document, the gap to be bridged was rather large and it was not possible to fill the void by ordinary borrowings from the IMF' might be relevent. But he would have reacted in a mild and different way in this regard and become less ideological than the *White Plan* of Marxists as such.

While going through this chapter it appears that professor Brahmananda is completely in favour of existing central Government of India without noticing himself as the prominent scholar of India who should have to be as ideal as Yudhisthira of Mahabharata. Well, apart from others the notable real truth he has described in his analysis is 'the fund so far has not penalised any member', and this reality with the IMF is highly admirable too.

The chapter IV on 'Rethinking on Economic policy' describes the features of Indian economy it terms of the recent role of the government, growth trend, parallel economy, savings to income ratios, etc. This chapter is also designed to give a glimpse of Indian trade pattern, exchange rate policy and nature of Indian investment. The author is optimimistic that the IMF loan would help in utilizing domestic economic capacity and resources such that the notable export advantage could be enjoyed. In this regard he hopes for a dream that if it comes true *Indian Rupee* would be appreciated and national prestige would be a sure advantage of it.

The fifth part of the book is highly cautious about the existing and potential rate of inflationary rise in general level of prices. Sources are identified and monetary and financial factors are treated as the active partners in raising the level of prices. The author is visilent in allocative mechanism for assets and also suggests for some productive holdings of financial assets.

It is in the last chapter (6) of his book that the author returns back to the major issues which relate to the debate as created by the IMF loan and makes some concrete suggestion for fixing up 'priorities in the wake of IMF loan'. Priorities include oil exploration, increase in domestic fertilizer capacity, modernization and expansion of capacity in cement, paper, steel and etc. Prof. Brahmananda has also put a proposal for constituting a Central Economic Council with its headquarter in Delhi and branches every where in the country. This is his ideal plan and if executed properly the Council will efficiently look after the priority matters. Although the implementation of his program would be beneficial and expensive both, there is some chance for the academic bureucratization out of it which may or may not result in a wishful dream. It is in the same chapter that the author again puts arguments infavour of loan and concludes that the mechanism of absorption of the loan would be such that it would not result in inflation and inerease in money supply. But what is confusing in the face of it is whether the quantum of money supply is solely determined by the decision of the monetary authority and whether the reserve currency is utilized only for the purchase of imports.

If the whole amount of loan is utilized to purchase imports, the multiplier effect would not be experienced by the domestic economy. This course of adjustment depends fully

upon the way how Indian government would work over the loan period. At the some time domestic economy would be free of inflation provided two sectors-domestic and foreign-are fully decotomised. Otherwise the imports will pull prices up, as prices are mostly sticky downward, ahd linkage between them is well established. In the face of all these it will be a mistaken belief to have a simple generalization when the economy and people do not follow the normal track as economists suggest. The other way reasoning on which the author keeps mum is the effect of reserve base on credit supply through commercial banks. Increase in spending in the process of loan utilization may by whatever economic unit adds to the income stream and brings a reshuffle in the portfolio adjustment by people, for the whole of the spending is impossible to be directed to the foreign economy. Since the holding of assets is influenced by the relative rate of return on assets, domestic economy would not be deprived of the opportunity to absorb money and to keep it in various forms of assets including cash and deposits. Even though there are some underestimations of the events and economic adjustments in the analysis of loan mechanisms the treatment of the subject by him gives an academic flavour. The author has stil the worry that the loan might generate inflationary pressure and says 'conditionality clauses are extremely liberal' as against the extreme views put by marxists. The author also tells us about some probable implications of rising prices including its terms of trade effect. His way of reasoning like this and that brings a bit of confusion to readers.

While concluding this chapter prof. Brahmananda makes the ideal remark if everything is OK nothing is difficult. But the question is only of how to keep everything all right in this real and diverse world. If the case would be otherwise and fruits would rot J.M. Keynes will be correct in his belief how economists make others fool.

Besides, the notion of economic gaps, question of efficient allocation of rerources facotrs inhibiting India's economic gowth, problem of debt servicing, exchange rate policy, role of the IMF, supply side economics and terms of trade effect of oil price hike are the topics treated under appendices. The author has very interestingly explained these topics and has tried to relate the notions and concepts to the Indian economic problems.

After reading the book one gets the impression that what prof. Brahmananda seeks to explain is India's economic future entirely in terms of loan absorption and the growth of Indian economy focused on national income. But one would have a question in mind that whether the increase in national income alone would make the Indian people better off in the face of the growing inequality of income. The absorption of loan through its redistribution effect

may furthur assecentuate the income disparity and this question remains fully unanswered. At the same time the *future expectation effects* of the loan which would be generated in the Indian economy have not been explicitly discussed in the book. So it is not clear how far his way of analysis would fill the real 'gap in thinking' that his book intends to do in favour of people around 50% below poverty line.

Overall impression of the book THE IMF LOAN AND INDIA'S ECONOMIC FUTURE in the forn of monograph by prof. Brahmanananda to a reader is that it is written and subjects are being arranged in a manner that even the nonmonetarists and non-economists would be able to read it, grasp and enjoy the subject withoutloosing their temperament and patience. Besides, policy makers and students of economics would find the book as a much useful guideline to those issues which are related to the subject as such. So far as the price of the book is concerned, one should appreciate the effort to keep the price very low inspite of the heavy costs of printing and raw materials these days.

Department of Economics
Tribhuvan University, Kirtipur.

**Gunanidhi Sharma**