

# Interest Rate and Its Place in Economic Decision Making

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## INTRODUCTION

In managing and promoting an economy, the government, in Nepal and elsewhere, has been using its deliberate influences (in the form of policy effects) generated through monetary, fiscal and other macro as well as micro attempts. It is the healthy but equitable socio-economic order that a nation wants to attain it. An order becomes healthy and equitable when the economy experiences a balanced distribution of growth enhancing developmental forces, and the fruits of development among regions and sectors. This eventually affects the level of household income, saving, consumption and asset—both tangible and intangible— which also covers up the employment and job opportunities, or the engagement of productive labour.

The aim of this paper is to describe the nature, structure and the role of interest rate in economic expansion, regulation, evaluation, and to narrate its position in economic theory and policy making, exposing the rate structure in use so far conceived as a central focus of monetary policy having many dimensions. The Nepalese style of handling the rate as such, however, is examined in brief.

## INTEREST RATE AS THE RIGHT HAND OF MONETARY POLICY

Almost for more than half a century beginning from the great depression of 1930s, which promoted a Keynesian led world fiscal order, different from the classical one which presumed a dichotomy between real and monetary forces, there existed an intensive debate on the alternative uses of monetary vis-a-vis fiscal policies for economic stabilisation, growth and income distribution. After all, Keynes made a heroic attempt in integrating the real and monetary forces via the liquidity or interest rate effect and laid the foundation for monetary economics. Keynes conceived that monetary effects are dominant but conditional, i.e. money used does matter but only indirectly, through substitution effect. As opposed to the prevailing (pro-Keynesian) commodity market effect under the only *active balance hypothesis regime* of the increased supply of money, Keynes saw a strong possibility of holding idle money which has a substitution in financial market as well, behaviour of which is significantly affected by the monetary policy, change of which is reflected into the change in prices of long-term bond, and hence the rate of interest.

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Rate of interest, of course, is both the reward for saving and the cost of borrowing. It is, therefore, used for deriving the discount factor that evaluates the economic costs and benefits of any project using fund which has opportunity cost (the forgone benefit when the fund is used otherway).

Injection of more money makes the economy responding via the dominant asset effect leaning more towards lower interest rate, which when compared with the marginal efficiency of investment, determines the level of investment spending, the second component of aggregate demand. Keynes' economic structure is, thus, demand determined. The supply effect of aggregate demand: the investment is automatic for there prevails a highly elastic short-run aggregate supply function. The long-run supply effect of investment, moreover, is found in Harrod-Domar growth model.

Monetary policy for Keynes, however, is not absolute for it has limited use in making interest rate lower enough. *Liquidity Trap* is the net outcome of monetary speculation which leads to the total absorption of an increase in money supply in assessed demand but at the interest rate which is lower enough. There is no policy option except to replace monetary policy by fiscal policy.

Post Keynesian development of monetary theory is rather an expansion of Keynesian demand framework re-structured in the light of neo-classical market adjustment process, with least possible government interference. This newly set economic philosophy, often known as the *monetarism*, is popular in the name of Milton Friedman. It advocates for the consumer oriented growth process and the economic structure with strong international integration. Domestic economic policy under this system is pursued in the light of policies adopted by other nations. There is little room for promoting the indigenous resource and technology for self reliance. Shocks of any kind move into and cut off the weak and strong economies respectively. The present Nepalese approach of privatisation and liberalisation to economic adjustment, is, of course, of this kind.

In fact, one may argue on behalf of monetarists that money very much matters in affecting the choice of an asset made by a wealth holder. In an effect to avoid the risk of loss from holding a particular asset, the chooser makes his portfolio reshuffled. Very few are risk lovers, even if not so they are likely to trade off this risk with the return such as maximisation of utility. Money, thus, has a substitution in all the markets alike: real as well as financial. At an extreme, it competes even with human and other physical assets in the portfolio of a wealth holder. As opposed to Keynes' indirect effect, the economy experiences the direct wealth effect when the monetary policy is tightened and loosened. The interest rate effect of money supply (monetary policy) is, thus, weakened with this broader framework of monetary adjustment. It is the commodity market effect, or the direct real balance effect (post-Keynesian development) which is more dominant in bringing changes in real sector. The economic structure again is demand determined, and it is the stock decision which plays a pivotal role in this beautiful game.

Turning to the problem of monetary policy and thus the interest rate policy of the low income countries, McKinnon and Shaw, who have dealt at length in this field.

identified the problem: how to make money, and the rate of interest as the decisive factor in the process of growth and change in low income countries.

At the outset, they begin with an argument that money complements with the physical assets, the capital goods, when it raises investment to income ratio. It is a dominant financial asset for capital accumulation in the absence of a sophisticated financial market. Injection of more money implies greater opportunity available for investment. This is completely against the neo-classical premises which put stress on substitution relationship between money and physical capital, and hold money as the part of disposable income. Both of the stock and flow decisions are widely affected by an increase in money supply.

In addition McKinnon and Shaw also differentiate the needs of the developed and the developing economies. While the need of the former is to make money less attractive for capital deepening, the latter has an urgency for monetary deepening as a headway towards an increased investment ratio. The role of interest is quite different for both of these economies. The low rate of interest for reducing cost of borrowing is the policy need of the developed country, the high rate of it helping to increase the reward for scarce saving, striving for capital deepening, is the need of the developing country. For this, both of them argue for financial liberalisation which is against active interest rate policy followed by many nations till early 1980s.

### THE TERM STRUCTURE OF INTEREST RATE

In an economy without the government regulation of the financial structure, interest rate is endogenously determined and serves as an indicator of monetary policy. Quite often, mention is made at the theoretical level of the short and long rates of interest and their relationship. It is so done in order to describe money and capital markets behaviours, and their interactions. While concern of the money market is with the short rate on assets including credit (debit) or investment with less than one year maturity; the long rate is the one which the market pays for, or receives from the use of financial fund made for the long run deal. These assets, loan and investment, however, converge into their liquid form near maturity and, therefore, become perfect substitution for cash. In this sense all assets compete with each other, and the degree of their competence becomes quite high at some point of time under the financial deal.

Likewise, as the financial fund has both the demand and supply sides and when banks or financial institutions borrow for the purpose of making loan, a margin of profit emerges as the difference between lending and borrowing rates. Individuals or households supply fund which is made of savings and are residuals as a creation of the postponement of current consumption for future gain. The rate of interest serves as the reward for the exact burden borne in this game. The trade off between present sacrifice, and the future gain also depends on the expected rate of inflation which erodes the purchasing power of both the capital value of the financial assets, and the rate of return from them. It is for this reason that monetarists showed a lesser concern for only nominal rate when talking about the rate of interest and its economic equilibrium value. This problem does not arise for Keynes, because he took it for granted that goods

prices are given, as wage rates set at the institutional level are assumed as the only source of prices.

By all account, the rate of interest has comprehensive structure, and behaves to show a complicated picture of an economy represented by numerous sectors' activities, and their inter-connections. An economy allowed to have an integrated move with outside world gets even more complicated when rates here and abroad are interlinked through financial flows across the globe as a whole.

The long run tendency in the absence of any restrictions, moreover, is to reach a point when all the rates are equated by market forces. Therefore, it may be very comfortably written in equation form as:

$$i = i_k^* = i_k^l = i_k^e = rk$$

The satisfaction of this condition keeps all fund-markets in equilibrium. Here, all the rates are in real terms (that is, the nominal rate of interest adjusted for inflation rate). Here 'i' is the global rate and \*, l, e, r, stand for equilibrium rate, long rate, expected rate and the rate of return on physical assets, respectively on all k categories.

This is true for all the rates on assets (uses, sources of fund) which compete each other. This, of course, represents an ideal situation in which a highly sensitive economy follows a *golden rule* within the perfectly competitive market framework linking this economy regularly with the rest of the world economy. This economy is completely liberalised with no restriction imposed on the flow of funds within and outside the border.

## INTEREST RATE IN NEPAL

A confusing state of the structure of the rate of interest in Nepal appears when this rate partly made as an indicator of monetary policy and mostly the instrument for discrimination among sectors and activities while lending by financial institutions. The purpose of being selective and discriminative while extending loan to various sectors and activities is the balanced distribution of credit opportunity leading to the equitable social order, positive balance of payments, minimum regional disparity, enhancement of the efficiency of the indigenous resource and technological capability into higher sectoral growth rate, stability of prices, curtailment of conspicuous consumption, increase in sectoral reinvestment quotient, etc.

Nepal, indeed, was guided since 1956 and especially after 1964 by this universal philosophy of the productive use of credits, and deposits collected from innumerable households that are active in mobilising both intermediate and primary inputs for output, income and asset generation. This active interest rate policy, however, was gradually abandoned since mid 1980s when the country, under the influence of World Bank structural adjustment programme, experienced a major shift in monetary and fiscal policies which afterwards was founded on the concept of financial liberalisation. Today, financial institutions are given more extensive role in making their own interest rate policy, however, not completely made independent. This trend in financial market

together with the course of exchange rate liberalisation has made this economy more suffocated in the absence of an ability to handle sensitive equipment of free but the competitive market computer. Results have been the distortions in market behaviour by abnormal feeling generated by high profit motive, higher inflationary expectation and organised move of financial dealers for the outflow of financial fund caused by low attraction for investment (real as well as financial) at home. Even if the nation experiences a comfortable foreign exchange position, it is not with the support of current account balance and the interest rate effect on capital account balance. This means, we have been managing the economy not with the efficiency of market forces, but by official borrowing from abroad. The question arises, therefore, whether Nepal has a deep consideration on the following interest rate related issues :

- That whether the structure of nominal rate of interest on saving includes the adequate premium for: (i) the expected rate of inflation that makes the value of return on investment (deposit, equity, bond, cash, physical asset, etc.) eroded; and (ii) the rate of real sacrifice that needs to be compensated when present consumption is curtailed.
- That whether the structure of nominal rate of interest on lending by financial institutions covers the actual cost of borrowing and the premium for : (i) expected risk and uncertainty caused by fluctuation in market rate of return on the portfolio of asset; (ii) expected change in price (the opportunity cost of holding financial assets; and (iii) the rate of interest prevailing across the border (another type of opportunity cost for holding domestic financial asset).

Moreover, the present structure of money and capital markets in the country appears rigid and fragmented and not to that extent organised and rigorous to extend favours to innumerable household savers. The structure of rate of interest here is leaning more towards business sector made up of only few big houses. The low pace of industrialization too is responsible for this trade, and especially the foreign trade, dominated economic structure. The self sufficiency ratio for manufactured articles in the country, therefore, is as low as 37 percent and the trade concentration ratio for same is as high as 85 percent (Sharma, 1990). This, of course, is not a rosy picture of our economy which needs drastic change for overcoming the deeply rooted problems of poverty, income and wealth disparity, emigration, and so on.

A brief summary of the rates of interest in Nepal is presented in Table 1. The table demonstrates that the rate of interest in Nepal is not sensitive to the rate of inflation which was around 20 percent in 1992 (USAID, 1992). In almost all the cases, the rate of interest is below or equal to the rate of inflation. Only commercial loan rate of bank exceeds the rate of inflation by one percent. This proves that Nepal has neither followed the real rate rule of *Neo-Liberal School* for which a capital scare and a financially repressed economy should pay high real rate, or at least positive real rate on deposit, nor made the rate structure in favour of production sector, say, the industry and agriculture. The rate of interest charged by Agricultural Development Bank and the Nepal Industrial Development Corporation vary between 16 to 18 and between 18 to 20 percent respectively, without discrimination in favour of productive and essential activities.

Table I  
Existing Nominal Rates of Interest in Nepal  
(range in percentage)

Head/Development Bank	Commercial Bank	Nepal Industrial Development Corporation	Agricultural Development Bank	Interest Rate on Government Security
<b>Bank Deposit</b>				
Saving	9-10			
Time Deposit	10-13.5	-	-	-
<b>Bank Loan</b>				
Industry	-	16-18	-	-
Agriculture	-	-	18-20	-
Agriculture Service	16-18	-	-	-
Export Bill	15-17	-	-	-
Commercial Purpose	21	-	-	-
<b>Security</b>				
National Saving Certificate	-	-	-	12.5-15.5
Treasury Bill	-	-	-	12-13
Development Bond	-	-	-	8-10

Note : The Bank Rate for all purposes is 13 percent.

Source : Nepal Rastra Bank.

## CONCLUSION

In a market regulated economy as of today, rate of interest should indicate the profit, or the productivity levels across sectors and activities. As its height is governed by the efficiency of the fund invested in each sector, Nepal's economic performance measured in terms of the inverse of the sectoral ICOR's (See National Planning Commission, 1992 and Sharma 1989) should not be that disappointing. But since the profit rate, or the productivity growth is affected by so many other risk and uncertainty factors with their domestic as well as foreign origin and when the profit or the productivity rate is not explained by capital efficiency alone, it is quite difficult to reach a definite conclusion on the built-in-economic nature and the structure of the natural rate and the effect of it on investment decision. The size of the influence on the rate, on the other hand, from outside the economy and of the long run and expectancy consideration is further unknown in the absence of information generated through research exercises. Still, we may conclude that the structure, height, behaviour and the co-existence of the rates are quite enough in indicating the stages of economic development known popularly as backward and advanced ones. From this point of view Nepal, obviously, belongs to the former category.

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