Outlook

3.45 There has been a distinct downward shift in interest rates across the wide spectrum of financial instruments in the current financial year. However, the impact of this in terms of higher growth in the real sector is not yet in sight. In India, banks still constitute the most important source of finance to the commercial sector, closely followed by financial institutions, which together account for around 90 per cent of the total flow of non-food credit to the commercial sector. A close co-movement between acceleration in credit flow and higher industrial growth was observed in the 1990s, especially since 1993-94. However, the first 10 months of the calendar year 1997 and the first 9 months of the financial year 2000-01 witnessed a coexistence of high rates of growth in non-food credit with sluggish or declining rates of industrial growth.

3.46 Despite some softening of interest rates, there has been substantial decline in the flow of non-food credit to the commercial sector in the current financial year. The sanctions and disbursements by AIFIs have so far registered negative growth this year. The beneficial impact of softening of interest rate appears to have been outweighed by the negative impact of deceleration in real sector. Nevertheless, to the extent lower interest rates can contribute to greater competitive strength of Indian industry through cost reduction, the move towards a low interest rate regime augurs well for the real sector. Better prospects on the agricultural front have also brightened the future outlook. The comfortable liquidity position is expected to enable the banking system to cope with the expected increase in the demand for non-food credit .

3.47 The fall in interest rates has been lower than the fall in inflation in recent years. As a result, real interest rates continue to remain high. Compared with a real prime lending rate of 2.4 per cent in 1994-95, it is around 7.3 per cent in the current year. Higher level of non performing assets, preference of households for fixed interest rates, administered interest rates on small savings and large volume of market borrowings by the Government reduce flexibility in the downward movement of real interest rates.

3.48 The slowdown in economic activity had left its mark on banking activity in terms of significant increase in food credit and investments in Government securities, both carrying a Government guarantee. If this trend continues, there is a possibility of banks becoming risk averse, thereby impairing their ability to meet the credit and investment needs of the private sector. The recommendations of the Expert Group on Administered Interest Rates assume significance in this context, and the implementation of its recommendations is expected to pave the way for a sustainable and flexible interest rate regime.