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An Analysis of Negative Interest Rates in India

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Abstract

The Covid-19 pandemic has plunged the global economy into economic disarray. We observe unprecedented phenomena both socially and economically as we see the laws and rules governing economies falling flat. Theoretical economic ideas such as negative interest rates have become a reality for almost a third of the world's financial institutions. More countries like the US and New Zealand are considering it.

India finds itself in the middle of this ferment facing difficult policy choices. There is no similar precedent in the history of modern economies where such a situation has been addressed. The monetary and fiscal decisions of the RBI and the government can pave the path to prosperity or reverse the hard-earned progress of the past 70 years of progress. This paper aims to identify critical factors that can quantitatively determine whether India should follow one such recent policy of negative interest rates (nominal). This is based on comparative case studies of the few countries that have implemented them based on the limited understanding developed about them. The paper also explores qualitative arguments both in favour of and against this policy and comments on its predictable outcomes and any possible alternatives.

Key Words: *Negative interest rates, Monetary decisions, Covid-19*

1.0 Introduction

The global economy, particularly the advanced economies, is experiencing a phase of low-interest rates and inflation along with a slow output growth rate since the financial crisis of 2008. An increasingly ageing population in first-world countries is acting as a catalyst to this economic anomaly. Macroeconomic theory suggests that the central bank can lift an economy out of recession by pushing down the interest rates to negative. However, till recently, this was nothing more than theoretical ideation. However, in the face of a crisis caused by the ferment of the issues mentioned above, central banks of Denmark, Switzerland, Sweden (as well as some other small countries in the Eurozone), and Japan became the early adopters of negative interest rate policy on bank reserves. The results of such unprecedented measures have captured academic and policy makers' attention at the global level for well over a decade.

These financial institutions account for a third of the global first world market and because many other countries have been observed empirically to follow the above in the same trajectory. In light of the Covid-19 pandemic, the situation became even direr as national lockdowns caused

economies to contract, production to fall, and inflation to plummet. This has resulted in countries like New Zealand, India, and the USA considering negative interest rates. The US Federal Reserve's recent reduction of rates has also brought US dollar interest rates close to zero, and they could go negative. A rush for safe bonds in the current covid crisis has seen their yields turn negative in the West. Real interest rates are already ranging in the negative territory in India. This has led to economists deliberating the possibility of the global financial system shifting towards negative interest rates and completely changing the dynamics of trade, competitive firms, and financial institutions as we know it. This would strongly affect investments, growth, and international relations in unpredictable ways and alter long-term investments such as pensions that can derail plans and entire ways of life.

2.0 Review of Literature

Varathan, head of economics and strategy at Japanese bank Mizuho (2020), wrote that "negative rates are not that positive." While all interest rate cuts benefit borrowers to the detriment of savers, negative rates severely erode pensions. Such a policy may incite a chase for returns with reckless abandon, which may be the cause of the next financial crisis.
Ingves, the governor of the Swedish Riksbank, described the use of negative interest rates as an "experiment" never tried before (Dagens Industri 2017). The policy ended in 2019 as interest rates came back to zero. The costs of negative interest rates to Sweden seem to exceed the benefits. Negative rates were the outcome of a narrow focus on consumer inflation and the Phillips curve's flattening. Riksbank felt cornered to take extreme measures to increase consumer inflation. However, though housing markets and financial markets responded quickly, consumer inflation remained largely unaffected.

Research from ROGOFF (2017, pp. 119-196) also gives an interesting narrative on the topic. The negative interest rate policy can pave the way to instability in prices and financial markets, resulting in a departure from rule-based monetary policy. According to a fixed rule, Rogoff mentions that Friedman's alternative of limited monetary expansion would not work. Friedman believed that a fixed relationship existed between prices and the quantity of money, but

this has not always been true. Rogoff argues that the ideal monetary system is the one that balances flexibility and commitment. If central banks did not have restrictions on setting interest rates to negative levels, they would have had more scope to push the economy out of a deflationary spiral quickly and counteract credit contraction effects after a systemic financial crisis. Therefore, to achieve monetary policy goals, it is necessary to enhance the likely effectiveness of a negative rate policy by discouraging cash holdings through the implementation of various legal, tax, and institutional changes.

Marques and Gelos, IMFBlog (2021). Evidently, negative interest rate policies have succeeded in easing financial conditions without causing financial instability. Thus, central banks that adopted negative rates may be able to cut them further. Moreover, those non-adopting central banks should not rule out adding a similar policy to their toolkit—even if they may be unlikely to use it. Ultimately, given the low level of the neutral real interest rate, many central banks may be forced to consider negative interest rate policies sooner or later. This paper seeks to address present-day monetary policy decisions in response to the economic crises caused due to the nationwide lockdown in India, especially that of possible negative interest rates. Addressing this issue is crucial in the current context as India stands at a crossroads. Though there are not much concrete data available regarding its pros and cons, in the long run, it is high time to select a policy and stick with it. This strategic decision can potentially make or break the country's growth rate and its future as a global superpower, not to mention an improved future for its citizens. Based on the findings of this paper and the subsequent government decision, investors, people in business, companies and labour (unions) can begin forming rational expectations regarding the actions of the respective governments, especially in our study, India. This has a strong influence on consumption and investment patterns, thereby dictating the state of the Indian economy.

The gap we identified is that there hasn't been any study that looks at these problems from an Indian perspective, especially under the Covid scenario. Even though many economists are arguing there is not being any concrete research that has taken into account the parameters under which the remaining countries adopted this and under the kind of reasons that India is a constraint to adopt it and whether its a valuable option or not, so there is a very significant gap here and we would try to cover up a specific portion of it.

In summary, the research work aims to study the reasoning, circumstances, and commonalities among countries that have adopted negative interest rates and to draw a comparison between the above and India's current figures. Finally, it aims to assess if India will have Nominal Negative Interest Rates and its advantages and disadvantages.

2.1 Hypothesis

Null hypothesis (H0): There will be no significant difference in India's current interest rates.

The alternate hypothesis (H1): There will be a significant decrease in India's current interest rates to the effect that rational expectations for the nominal interest rates to become negative may be formed.

3.0 Research Design

The area of study considered in this paper is the concept of negative interest rates. Both its theoretical and practical need, viability, impact and duration based on a comparative study of the countries which have employed negative interest rates will be explored. This research's primary focus is to find out whether the present-day economic upheaval following the pandemic, natural slowdown of developed economies, and older financial crises will result in a shift in India's interest rate into negative numbers. This shall be done using both quantitative methods as well as qualitative arguments.

The research uses secondary data by employing various published research papers, articles, and databank information from various national and international websites to get secondary data.

The population growth rates, GDP growth rate, and inflation have been considered as the independent variables to the effect that they appear to influence interest rates strongly. The interest rates, both real and nominal for the respective countries in the study, have been taken as the dependent variables. The analysis will be conducted using line graphs to compare trends of the independent variables and determine their correlation with negative interest rates.

4.0 Analysis

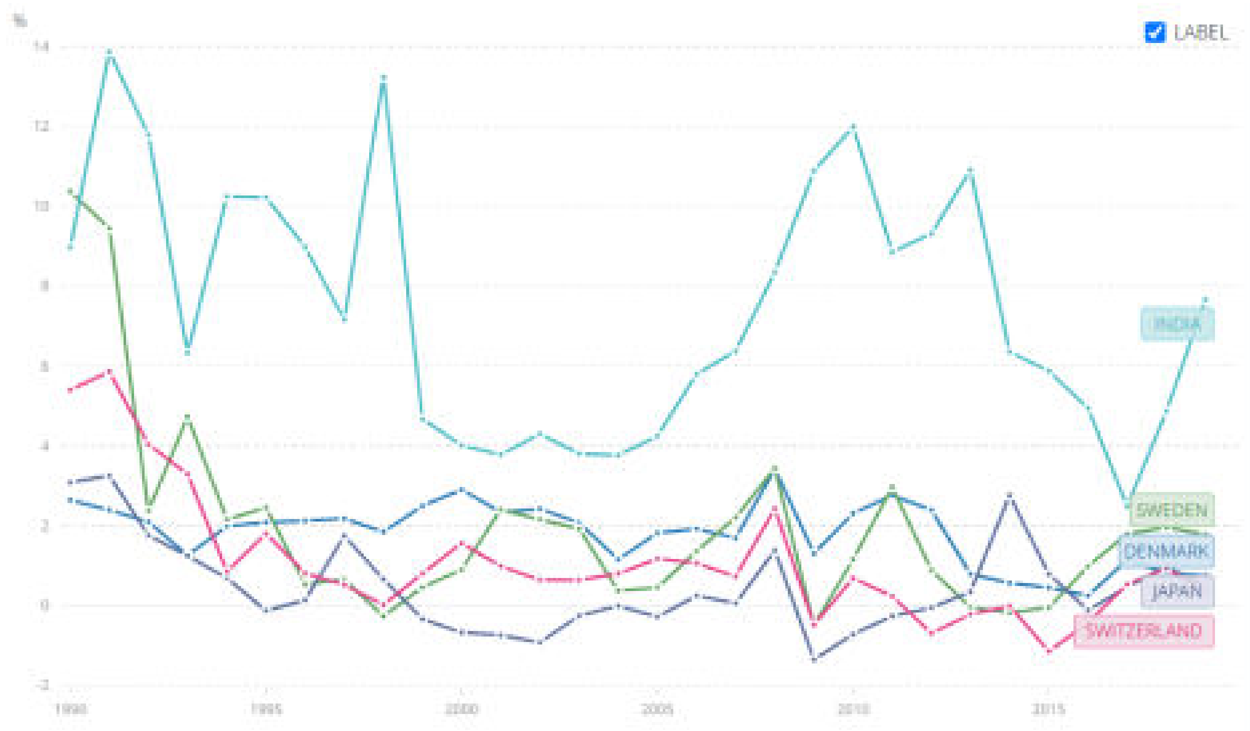

Fig 1- Inflation, consumer prices (annual %) - Denmark, Sweden, Japan, Switzerland, India

The relation between **inflation** and **interest rates** is interchanging. The countries implemented negative interest rates when the inflation rate declined and was even less than 2%. In the case of Sweden, the Negative Interest Policy was adopted in the year 2009. Within a year, there was a rise of 1.65% in the inflation rate. The other countries followed a similar trajectory.

Considering the same in India, an increase in the prevailing inflation rates will only worsen the situation as we are already heading towards an inflation rate as high as 7.66%. Any further rise will only bring more problems to the economy.

Fig 2- GDP growth (annual %) - Denmark, Sweden, Japan, Switzerland, India

India has consistently had a high GDP growth rate compared to the other countries in our study. Even during the 2008 financial crisis, that likely pushed countries like Sweden to hastily adopt mechanisms such as negative interests. Barring exceptional, unusual scenarios representing dips in the growth rate, such as the dip in growth around 2016 in India due to Demonetisation and GST implementation, the other highs and lows can be associated with boom and bust periods of a business cycle.

Most of the case study countries adopted these rates to boost GDP through increasing production and inflation. If this is implemented in India, it might be detrimental to the growth as severely heightened inflation can disincentivize investments due to risk and onset saving trends amidst uncertainty.

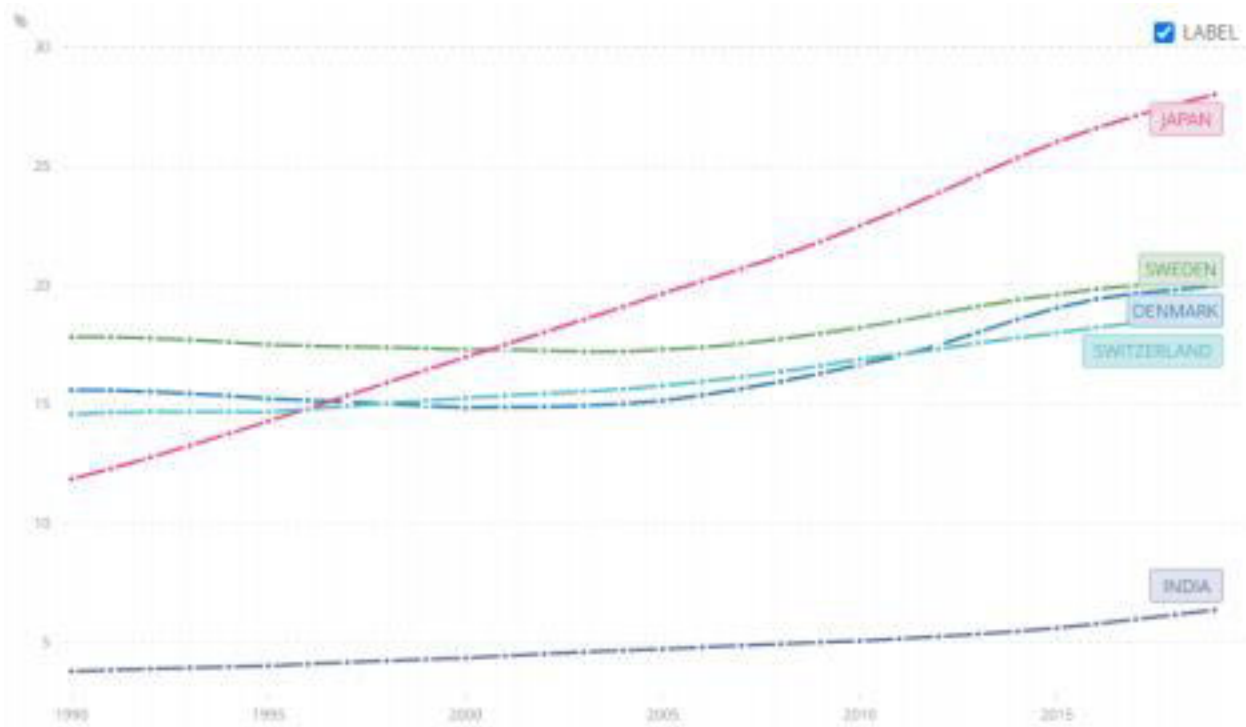

Fig 3- Population ages 65 and above (% of the total population) - Denmark, Sweden, India, Japan, Switzerland

Population demographics heavily influence the consumption and investment patterns of a country. A common trend among all the case study countries being considered is their high proportion of the aged population (>65 years here). Japan has been suffering through a recession for more than 20 years, partly because of its demography and ageing population. The effectiveness of monetary policy diminishes as the population ages because monetary policy primarily affects young workers; retired people are more likely to be removed from monetary policy.

5.0 Recommendations

The current Indian economy is not at all prepared for negative real interest rates. Rather, it is not in a position so dire as to implement negative real interest rates and face the uncertainty and repercussions of implementing a largely unprecedented policy which not even economists, much less the general population, have an understanding and acceptance towards. Compared to India's growth rates in the first decade of the 21st century, the present rates are not something to boast

about; they are certainly not poor. Consideration should be given to additional factors such as a growing global sentiment in favour of protectionism and more stringent international trade laws, and competition may be the dominant causes of this slowdown. Clubbed with domestic policies such as demonetisation and GST implementation, these factors can be cumulatively accredited to the emergence of a depressionary business cycle.

Under the above considerations, India is still on a trajectory of respectable growth and high inflation. If negative interest rates are to be implemented, it may make inflation too high and cause economic disruption and result in hyper-inflation vicious cycles. There is a possibility of many other trade-leading nations moving towards near-zero or negative interest rates, which might harm domestic companies' competitiveness in India when India already has a severely deficient capital goods export basket. However, on the flip side, greater returns on investment are likely to induce investors to borrow from abroad and invest in India to maximise returns. Simultaneously, the Indian government must carefully incentivise investors by utilising the country's strengths, such as cheap labour and low taxes.

Another important consideration is the impact of Covid-19 lockdowns and an already impending business cycle recession amidst a global economic recession. Naturally, the RBI must adopt monetary measures in its capacity to boost the economy. The current interest rates being maintained are as low as possible to incentivise financial institutions to keep operating. If not, they may delve into other riskier financial investments and cause an asset price bubble. At the same time, they may incentivise more borrowing, higher investments and greater consumption. The current policy relies on the general public's myopic view, which does not seem to adequately realise that the real interest rates are negative and incurring losses even at present.

The interest rates are perfectly balanced to achieve the objectives of economic growth as well as incentivising financial institutions, but naturally, this is not sustainable. People will slowly begin revising their expectations when interest rates will have to be pushed higher. Hopefully, the economy will be well on the path to sufficient rapid growth by that time.

6.0 Conclusion

In the present scenario, when all the advanced countries are shifting towards the policy of negative interest rates due to various factors, India can still not implement it, keeping in mind all

the repercussions it can face as a developing economy. India still does not have a dire need to implement it and can follow its current interest rates, unlike one-third of the world's countries, as most of the countries adopted it in fear of deflation or to boost their GDP. Moreover, negative interest rates could hurt depositors making them unwilling to deposit their money with financial institutions. Additionally, strategies for lowering borrowing costs can severely reduce the profit margins of the financial institutions' loaning activities by squeezing the margins between what they pay for deposits and what they earn by lending money to borrower hence disincentivizing them from giving loans and rather, promote high-risk high reward investments en masse which can destabilize the economy. This is not ideal for scarce capital economies like India. This would amount to the underutilisation of capital which has a far smaller supply as compared to demand. This would be detrimental in terms of deepening capital scarcity, too, at a stage when we are still an emerging economy.

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