UNIT 4 : INTEREST RATES

UNIT STRUCTURE

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4.1 LEARNING OBJECTIVES

After going through this unit you will be able to:

- explain the meaning and importance of Interest rates
- describe different types of interest rates
- explain the features of administered interest rates
- analyze the rationale of deregulation of interest rates
- explain the concepts of Bill rates, Bond rates and Deposit rates etc.

4.2 INTRODUCTION

You may have noticed that everybody who lend or invest or hold securities expects a return out of it. When this return is of a fixed nature and expressed in percentage term per annum, it is known as rate of interest. There are varieties of interest rates in financial markets of any economy. The structure of the interest rates is also different from country to country.

In this unit we will discuss the meaning, importance and various types of interest rates with their features.

4.3 MEANING AND IMPORTANCE OF INTEREST RATE

When you borrow money you will pay interest. What is this 'interest'? It is the difference between 'the total amount you pay to the lender' and 'the amount you have borrowed'. In other words, it is the price the borrowers must pay to lenders to obtain the use of money for a period of time. When bank lends, the borrower is required to pay a price for the use of that money he has received from the bank. Similarly, when a company raises its funds by selling securities to investors, it has to pay interest to the investors. This is because the company uses investors' money for a fixed period. This price is called interest. On the other hand, when bank accepts deposits from the public, the bank's position becomes a borrower and the depositors' position become of a lender. In this case, bank has to pay a price for the funds it gathered from the public. This is also called interest. Hence, interest means the consideration paid by one party to other for using money. The rate of interest as per Keynes is the reward offered to people to induce to hold securities instead of cash. This means that people generally tend to hold cash because holding cash entails no risk of deterioration or capital loss while holding securities have the risk of fluctuation in the value. Interest is the reward given to the holder of securities for holding them instead of holding liquid cash. As we know that all the prices are determined in different markets, the equilibrium rate of interest is also determined by the market forces (supply and demand) in the financial market.

As per classical theory offered by Ricardo, Hume, Fishar, interest rate is reward for sacrifice or abstinence or waiting involved in the act of supplying savings. It means it is a price for preference of future over present.

Importance of interest rate

Interest rates are very significant to the economy of the country. The following points will help you to understand the significance in a better way:

- Interest rate has a close relationship with the general price level. They

are positively co-related. Hence, adjustment and re-adjustment of interest rates is very significant for the economy as a whole.

- There is positive relationship between interest rate and money supply too. Keynes opined that an increase in money stock may tend to lower the interest rates and vice verse. Open market purchase by the monetary authority tends to raise security price and lower their yields.
- In countries like India there are a number of interest rates apart from the general level of interest rates which are conversional known as "differential interest rates". These interest differentials policies are adopted by the authority with a view to achieve the goal of social welfare. Hence, the interest rates are very significant for the large chunk of the economy like small industries, exports, agriculture, small borrowers, backward areas, food procurements and other priority sectors.
- Interest rate is also a tool for controlling inflation and low interest rate policy can favorable conditions for further inflation.
- The rate and composition of savings is affected by the interest rate. High interest rates in deposits encourage savings which is desirable is a capital scoring economy like India whereas low interest will work as a disincentive to save. Hence, there is a significant relationship between interest rates and total savings, financial savings, household savings, and corporate savings.
- Interest rates influence the level of investment in an economy. Low interest rates encourage investment, help fight recession, revive the economy and accelerate the rate economy growth. However, some time low interest rates also cause distortion effects in terms of a) siphoning off resources into uneconomic projects, b) increasing speculative activities in foreign exchange market, money and stock markets and c) increasing volatility in interest rates.
- Interest rates structure influence the degree of social and mass welfare of an economy. A reduction interest rates on bank deposits, small savings, provided fund and other debt instruments harm the interests of low income group, old, weak, poor, disadvantaged who are in need

of social help.



CHECK YOUR PROGRESS

Q 1: What is interest rate?

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Q 2: State two importance of interest rate.

(i) .....

(ii) .....



ACTIVITY 1

Visit two branches of commercial banks and list out the rates of interest they charge from the borrowers.

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4.4 VARIOUS TYPES OF INTEREST RATES

A variety of short term, medium term and long term interest rates exists in the financial markets. There are also various concepts like the ceiling rate of interest, coupon rate, yields.

Ceiling rate: The ceiling rate refers to the maximum rate of interest fixed by the authorities on different financial claims. In India, the government and the RBI fixes ceilings on a number of interest rates.

Coupon rate: The coupon rate, also known as the 'bond rate' is the rate of interest stated and paid on the face value (i.e. per value) of the bond or debenture.

Yield: The term 'yield' represents the rate of interest which equals the present value of the future cash flows generated by an investment. Running yield on bond (also known as income yield, market yield, current yield) is an annual interest payment as a proportion of the market price of the bond. 'Yield to maturity or redemption yield is the annual interest payment

plus average appreciation or depreciation as a proportion of the redemption value of the bond. Dividend yield and earnings yield are concepts usually in evaluating investment in ordinary share.

4.5 MEANING AND FEATURES OF ADMINISTERED INTEREST RATES

When the interest rates are determined and controlled by the government, is called administered interest rates. Many times governments of developing countries administer the interest rates and keep them low because low interest rates had been regarded desirable in order to induce a higher rate of fixed capital formation. Controlling interest rates helps government to improve the distribution of finance, income and availability.

Deposit and lending rates of banks are controlled by the government for following reasons:-

a) To avoid unhealthy competition for borrowing and deposits
b) To maintain uniformity of interest rates on deposit accounts of all the banks.
c) To keep deposit rates in alignment with the lending rates of banks and with other rates of interest.
d) To aid deposit mobilization
e) To lengthen the maturity structure of deposits.
f) To enable the authorities to avoid frequent changes in the bank rate

Administered rates enable the government to direct the monetary transactions to desired directions and ensuring effectiveness in monetary measured.

Features of Administered Interest Rate

From the following Indian case you will be able to understand the regime of administered interest rate.

- The deposit and lending rates of commercial and cooperative banks were fixed by the authorities. Deposit rates first came to be regulated in 1966 through inter-bank agreements. Since 1969 they were fixed by the Reserve bank of India (RBI). It had also been fixing the maximum and minimum lending rates of commercial banks since 1964 and 1969,

respectively. The RBI fixed different deposit rates and lending rates for different types of banks, viz. large banks, smaller banks, cooperative banks, and regional banks.

- The Indian Banks Association had been fixing the ceiling on call rates since 1973 until October 1988 when the call rate was freed from the ceiling.
- The Government fixed the rates on treasury bills and long-term government securities.
- The Government had a great say in the fixation of interest rates on long term loans of term financing institutions.
- The RBI fixed different interest rates on loans to different categories of borrowers and on loans for different purposes.
- It fixed interest rates on different financial instruments such as commercial bills.
- Cooperative societies were required to accept deposits at higher rates and to lend at lower rates than the rates of commercial banks.



LET US KNOW

The Controller of Capital Issues (CCI) administered control over capital issues according to the Capital Issues (Control) Act, 1947. The Act aimed at healthy growth of capital market and for this purpose empowered the CCI to control the capital issues of companies. Companies had to obtain approval from the CCI for any change in their capital structure. In 1992, the Capital Issues (Control) Act was repealed and CCI was replaced by Securities and Exchange Board of India.



CHECK YOUR PROGRESS

Q 3: What is cupon rate?

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Q 4: State whether following statements are true or false.

a. The deregulated system of interest rates involves greater

uncertainty, risk and variability of interest rates.

b. Treasury bill rate is an example of deregulated interest rate.

c. The administered system of interest rates had been adopted with a view to maintain interest rate stable and at low level.

4.6 MEANING AND FEATURES OF DEREGULATED INTEREST RATES

Deregulated interest rates means the interest rates determined by the market force i.e. demand and supply. These rates are market-determined, market-related and flexible. The control of government is absent in this types of interest rates system. The process of interest rates liberation began in the middle of 1980s. However, freeing, deregulation, flexibility of interest rates has differed from instruments to instrument such as bank credit, bank deposit, government securities, small savings, and so on.

Features of the Deregulated System

- The interest rates are fixed by the respective banks as Financial Institutions individually in view of the demand for and supply of money.
- There is no government interference in fixing the interest rates.
- Interest rates may differ from banks to banks and instrument to instrument and will be fixed on competitive market condition.
- Interest rates in deregulated market changes frequently because of change of money supply and demand and competition among the institutions.
- The deregulated system of interest rates involves greater uncertainty, risk and variability of interest rates.

  The deregulated system of interest rates is expected to ensure better promotion of savings, efficiency of financial system, efficiency of investment, efficiency of monetary policy and efficiency and equity in government finance.



ACTIVITY 2

Distinguish between administered interest rates and deregulated interest rates.

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4.7 INTEREST RATE STRUCTURE IN INDIA

- Till 1985 India was having the administered system of interest rates.
- During late years of 1980s the interest rates system has undergone a change and at present it is a mixed system. Both the deregulated and administered system is applicable for instruments and institutions.
- Certain important interest rates in the economy like interest rates on small savings, provident Fund and Non-Resident Indians (NRIs) deposits are controlled by the government. These interest rates are, therefore, called administered interest-rates. Similarly, interest rates on savings accounts with commercial and co-operative banks also continue to be persevered by the RBI. The RBI also governs the lending interest rates for bank advances to the priority sectors.
- The RBI has introduced the following measures to bring in deregulation to the interest rates and to impart greater flexibility to level and structure of interest rates in the country-
  - To encourage banks to introduce a flexible interest rates option for depositors.
  - To urge banks to review and announce the maximum speed over their PLR and
  - To ask banks to provide information a deposits rate for various maturities, the effective annualized return to depositors, and the maximum and minimum interest rates charged to their borrowers.

Phases of Interest Rates Policy

The period since 1951 can be divided into the following five phases of interest rates policy (system) in India:

(i) 1951-52 to 1960-61: Flexible interest rates system

(ii) 1961-62 to 1985-86: The system of administered, regulated, and repressed or suppressed (low) interest rates.

(iii) 1986-87 to 1990-97: The beginning of liberalization or the system with inclination or intent towards liberalization and flexibility, or a semi-administered system with the inching up of interest rates.

(iv) 1991-92 to 1996-97: The system of progressive deregulation and flexibility, and a significant increase in and unprecedentally high interest rates, or the phase of deregulation and dear money.

(v) 1997-98 to 2003-2004: The system of managed flexibility with nearly complete deregulation, and one of the lowest levels of interest rates in India, or the phase of deregulation and cheap money.



CHECK YOUR PROGRESS

Q 5: What is deregulated interest rate?

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Q 6: Mention two features of deregulated interest rate.

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4.8 BILL RATES

Interest rates in bills can be discussed categorizing them in to two types – Government bills (Treasury bills) and Commercial bills. A treasury bill is a finance bill or a promissory note issued by the government. The basic features of these bills are that the interest rate of these instruments are fixed and administered by the government. However, during recent past

an auction system of trading of these bills introduced a long-standing practice of fixed yield was replaced by a flexible yield system. This was done with a view to move towards market-related interest rates on Government securities. The rate of interest at which treasury bills are sold by the RBI is called as Treasury bill rate. The effective return on treasury bills is the discount at which they are sold and is based on the difference between the price at which they are sold and their redemption value. It used to be an administered rate till 1993 and has become market determined with effect from January 1 1993.

Commercial bills, popularly known as bill of exchange is a credit instrument or re-discounting facilities. Bill rates are the cost of bills finance. Various bill rates are determined by the- A) Bank Rate b) SBI *hundi* rate c) *bazaar* bill rate d) Commercial banks bill finance rate and e) SEBI discount rate the bank rate is the rate at which the RBI rediscounts eligible bills from commercial banks. The SBI *hundi* rate is the rate at which the SBI used to discount *hundies* of indigenous bankers. The *bazaar* bill rate was the rate at which *shroffs* used to discount bills of small traders. The commercial banks bill finance rate is the minimum rate fixed by the RBI at which commercial banks can discount bills. The discount rate is the rate which SBI discount first class commercial usance bills.

The rates which can be used to indicate the cost of bill finance in India are the SBI discount rate and Discounting and Finance House of India (DHFI)'s discount rate for commercial bills. In addition to these rates, the RBI from time to time, prescribe a ceiling on the rate of discount at which bills could be discounted by banks with other commercial banks. However, this ceiling has been withdrawn by now.



LET US KNOW

DFHI was set up in March, 1988 by the Reserve Bank of India jointly with public sector banks and all India financial institutions. It deals in money market instruments like; call money, commercial bills, treasury bills etc. It mobilizes funds from commercial banks, co- operative banks, other financial institutions, companies etc. and lent in the money market

4.9 DEPOSIT RATES

The interest rates offered on deposits to the public is called deposit rates. The rates of interest on public deposits with different companies vary on the basis of maturity, over a wide range. Generally, interest rates offered by the companies to the public on deposits used to be higher than the rates on loan from the banks. Interests on deposits on government securities, deposits on post office savings bank account and other small savings schemes are administered. Governments deliberately decide to offer relatively more attractive rates on these assets in order to canalize household savings to the exchequer. On the other hand, public deposits of companies are deregulated and determined by market forces. Interest rates on bank deposits have been deregularised but due to understanding or agreement among the banks the interest rates are almost stable. Public deposit interest rates offered by the companies are well above the bank deposits because of risk factor associated with thereon. However, governments fix ceilings on the maximum interest rates offered on public deposits to ensure safety to the funds.

4.10 BOND RATES

Rates of consideration paid for the deposits made in bonds called bond rates. Government issue, from time to time, bonds generally long term for mobilization of funds for development activities. On the other hand, for short and medium term, government issue treasury bills to control money supply or to direct money as per the monetary policy. However, during 1990s, the interest rates on Treasury bills and Government bonds have been brought in alignment with market rates of interest.



Bond: A debt security whereby the issuer owes a debt and compelled to repay the principal and interest to its holder.

Apart from Government, institutional and corporate houses also issue bonds with a fixed rate of interest for fixed maturity period secured by tangible physical assets of the company. Although bonds are usually issued with a fixed coupon rate of interest, a number of modification have emerged in recent time. Bonds may be issued without specifying periodic interest payments but issued at discounted price. Such bonds are called 'zero-

coupon bond' or 'deep discount bonds'. There are certain types of bonds where interest rates are not fixed and vary with the market interest rates. Such rates are called floating interest rates. In addition to the private sector corporate bonds and Govt. bonds, the public sector bonds became popular since 1985. These bonds are redeemable not before of seven years and carry fixed interest rates determined by the Union Financed Ministry.



CHECK YOUR PROGRESS

Q 7: State whether following statements are true or false.

a. Interest rates on treasury bills are not administered by government.

b. Commercial bills are credit instruments.

c. Treasury bills are issued by government to control money supply.



4.11 LET US SUM UP

The following points have been discussed in this unit -

- Interest is the price the borrowers must pay to the lenders for the use of money for a period of time. In general market phenomenon the rate of interest is determined by the majority of developing country the rate of interest is determined by the Government; while is called administered interest rates.
- A variety of short term, medium term and long term interest rates exists in the financial market any economy. The general structure of interest rates of an economy is influenced by factors like default risk, call risk, marketability or liquidity and tax status.
- Administered or regulated interest rates are predominantly existed in India like US, UK, Japan and Australia. During last couple of decades, deregulated interest rates has exercised; however majority of interest rates are still controlled by the government.

- Treasury bill rate, deposit rates of post office savings bank public provident fund and other government securities like National Savings Certificate (NSC), Kishan Vikash Patra (KVP) etc. are classic examples of administered interest rates. Commercial bank term deposit rates are the examples of deregulated interest rate in India.
- Indian structure of interest rate may be named as 'soft interest rate policy' as because even after deregulation, the interest rate structure is titled towards the socio-economic-political dimensions.



4.12 FURTHER READINGS

1) Pathak, Bharati V (2006). The Indian Financial System : Markets, institutions and services. New Delhi, Pearson Education Ltd.

2) Batra G.S. (2002). Financial services and markets. New Delhi, Deep and Deep Publication Pvt. Ltd.



4.13 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: It is the price paid by the borrower for using money to the lender for a fixed period of time.

Ans to Q No 2: i) It helps in controlling inflation.
ii) It influences the level of investment in an economy.

Ans to Q No 3: It is the rate of interest paid on the face value of the bond.

Ans to Q No 4: i) True ii) False iii) True

Ans to Q No 5: The interest rate which is determined by market forces of demand and supply is called deregulated interest rate.

Ans to Q No 6: i) There is no government interference in fixing interest rates.

ii) It differs from bank to bank and instrument to instrument.

Ans to Q No 7: a. False b. True c. True



4.14 MODEL QUESTIONS

Q 1: Explain the meaning and important characteristics of administered interest rates.

Q 2: What is interest rate? Explain briefly different interest rates of India in practice.

Q 3: Write short notes on-

a) Bank rate

b) Features of deregulated interest rates

c) Bill rate

d) Process of deregulation of interest rates in India

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