Demonetisation and Banks' Lending Rates*

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Spokesmen of the ruling party are busy these days spreading another falsehood, namely that, because of demonetisation which has brought in huge amounts of cash to their coffers, banks would be so keen to lend that their lending rates are going to fall, and that such a fall will act as a stimulus for the economy.

This is completely wrong, and banks' lending rates can never fall for this reason. They may of course fall because the monetary policy announced by the Reserve Bank of India is so altered as to cause such a fall. But that could happen anyway; it has nothing to do with demonetisation, and the illogical linking of the two is just false propaganda.

Let us first examine what is going to happen to the funds situation of banks. The non-bank "public" always holds its money partly in the form of cash, i.e. currency, and partly as bank deposits. The average proportion in which the two are held is called the currency-deposit ratio of the "public". What has happened at present is that the currency-deposit ratio of the "public" (a portmanteau term that covers the entire non-bank private sector including firms and households in both the "white" and the "black" economies) has been drastically lowered, in an authoritarian manner through government diktat. But once the old notes have been completely retired and new notes printed in adequate quantities to ensure that there is no scarcity of new notes and no limits on cash withdrawals from banks (whenever that happens), the currency-deposit ratio of the "public" will bounce back to the level which the "public" chooses, rather than what the government dictates.

Before examining the impact of this however we must consider another factor. A part of the cash which the "black economy" holds is supposed to get "disabled" by demonetisation, owing to the inability of the "black economy" operators to convert it to the new legal tender. This would mean so much cash just destroyed.

Now, a simple numerical example will make issues clear. Suppose the total cash in the economy is Rs.400, of which Rs.150 is held by the banks (as cash reserves), Rs.150 in the "white economy"and Rs.100 in the "black economy". If Rs.50 in the "black economy" get "disabled"; if, when "normalcy" returns, the size of the "black economy" gets back to what it was to start with (because its profitability remains high); if the "white economy" too is not to witness a contraction; and if the size of money holdings with the "public" relative to the level of total income, and the currency-deposit ratio, become what they were to start with, then cash with the banks, instead of increasing because of demonetisation, will have to shrink from Rs.150 in the initial situation toRs.100 in the final situation. In other words, if the cash with the "public" is to remain unchanged despite the "disabling" of Rs.50, then banks' holding of cash will have to fall by an exactly equivalent amount.This of course will not happen:the banks will restrict lending if their cash-holdings shrink and the level of activity in the white economy will have to contract.

But such a denouement will not come to pass, if banks get additional cash from the RBI at the prevailing interest rate to make good what has been "disabled" in the "black economy". That basically means however that the interest rate will not rise but remain unchanged.

Putting it differently, if x is the amount of cash disabled in the "black economy" by demonetisation and y the amount of voluntary reduction in cash holding in the "white economy", even if its old level of activity were to continue, then, since the "black economy" is unlikely to contract, banks' cash-holding will rise if y exceeds x, and fall if x exceeds y. In fact the change in it will equal (y-x).

Hence, even though banks have higher cash at present, whether they will have larger cash at their disposal when "normalcy" returns, i.e. when the restriction on the currency-deposit ratio with the "public" have been lifted and depositors are allowed to withdraw as much money from their accounts as they would like, remains an open question.

Let us however assume the most favourable scenario for BJP propaganda, namely that banks are left with larger amounts of cash when "normalcy" returns, i.e. in the above example y does exceed x. Or, putting it more explicitly, the amount of cash disabled in the "black economy" is small compared to the amount of cash deposited with banks, even when activity in both "white" and "black" economies has returned to "normal", owing to a voluntary change in "public" habits towards lowering their currency-deposit ratio. Even in this case however there will be no fall in the interest rate. In other words, the interest rate will not fall when $x > y$, and it also will not fall when $y > x$. It will not fall in either set of circumstances. Its fall simply has nothing to do with whether banks have more or less cash. Let us see why the interest rate will not fall even when banks have excessive cash.

The BJP spokespersons assume that when banks have a lot of cash, they can do nothing else but lend it, and for doing so they have to reduce the interest rate. This is simply wrong: they can always return the cash to the Reserve Bank and buy government securities from it which yield an income, through the "Reverse Repo" operations of the latter. In fact when India was getting a lot of financial inflows into the economy earlier this century, and the RBI, in an effort to prevent the rupee from appreciating (which would have caused domestic "de-industrialization"), held on to the incoming foreign currency and printed an equivalent amount of rupees in exchange, which in turn found their way into banks' coffers, this is exactly what the banks had done. They had bought government securities from the RBI at what is called the "Reverse Repo Rate" to a point where the RBI itself had become virtually drained of such securities. Not only can the banks do this in the present situation, but they will necessarily do this. The reason is the following.

Banks are said to reach an equilibrium in their balance sheets, when any change in it, either enlarging it through larger borrowing and lending, or shifting around a given amount of resources at the margin from one use to another, is not worth their while, i.e. does not give them any extra profit net of risk. Now, suppose they can lend to the RBI (i.e. buy government securities from it) at the rate r. On the other hand they can lend to commercial borrowers at the rate m, but since this is more risky they would need to be compensated by an amount which is n. They would reach an equilibrium when r equals (m-n).

Starting from an equilibrium, any extra commercial lending by them must entail a fall in (m-n), since it would mean either lending for slightly riskier ventures (which raises n) or lending at a slightly lower rate, which lowers m and which is what the BJP spokesmen claim will happen. But r is fixed by monetary policy. Unless monetary policy changes, r remains fixed. Therefore if banks get more funds, then at the margin they would rather buy government securities from the RBI at a fixed r than lend to the "public", which, since it would entail a decline in (m-n), would make (m-n) less than r. It follows therefore that banks would never lower their interest rate to lend more, no matter how flush with funds they may be; they would rather park the funds with the RBI in exchange for government securities, unless the RBI itself changes its monetary policy to lower the Repo and Reverse Repo rates.

But if the RBI does lower these rates, then whether the banks are flush with funds becomes immaterial; they would anyway borrow funds from the RBI to lend to commercial borrowers at interest rates that are lower than before. In other words, if r gets lowered, then they would reach a new equilibrium (where the equality r = m-n is satisfied once again) at a lower m (and higher n). And in doing so they would have lent more to commercial borrowers by borrowing more from the RBI. They do not need to be flush with funds. The question of their lending more because of being flush with funds simply does not arise.

It is significant that the RBI has raised the cash-reserve ratio of banks, i.e. the ratio of the cash reserves they hold to their total deposits, to 10 percent, in order to immobilize some of the cash that has come to them because of demonetisation. The cash that is held as reserves does not earn anything for banks; and yet, despite this, the CRR has been raised. The change in monetary policy in other words is in the direction of preventing banks from using the cash that has accumulated with them for lending to commercial borrowers. It is in a direction that is precisely the opposite of what the BJP spokespersons have been claiming.

To be sure the Reserve Bank of India may change its monetary policy tomorrow to make banks lend at cheaper rates, but that, for reasons we have already discussed, would be quite unrelated to demonetisation. For a ruling party to mislead people deliberately, instead of telling them the truth, is a fundamentally anti-democratic act. But what else can one expect from the BJP?

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