

Interest Rate Policy and Performance of Macro Variables: A Study of Indian Economy in the Post Reform Period

**(SUMMARY)
DISSERTATION**

Submitted To
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SUMMARY

1. INTRODUCTION

Interest rate policy is a very important tool for an economy. Reserve bank of India determines the interest rate policy of India in the pre reform period, but now any bank or institution determines the interest rate policy. In the pre reform period only RBI can change the interest rate policy. It maintains price stability and money supply in the country. Interest rate policy was administered before post reform period. In the post reform period interest rate policy is liberalized which is very affecting to the performance of macro variable. Liberalized interest rate policy started in 1990s in India. The reform did not gain momentum until mid- 1992 when rates of interest in India were gradually decontrolled in a variety of ways. In the post liberalization period, Indian economy has undergone cataclysmic policy changes with definite impacts on the way the interest rates are administered.

Interest rate affects very closely to the performance of macroeconomic variables. Macroeconomic variables is usually tries to evaluate the economic growth and development of any country. Once interest rate increases, investment, net export and consumptions decrease automatically. If interest rates increase then consumers, households are paid more money for their consumption so consumption is decrease. When consumptions decrease then also demand decrease. When interests rate increase then unemployment rate also increased. In the liberalized period interest rate determines by the market. When the prices are rising then interest to be high but not equal to price rising and when prices are falls the rate of interest to be low but not as low as it should be to compensate for the fall. An interest rate is the rate at which interest is paid by borrowers for the use of money that they borrow from lenders.

In India, the relationship between the nominal interest rates and the prices was not given much focus until the beginning of 1990s. According to classical monetary theory, the real rate of interest is determined by the force of productivity and thrift. It should not be affected in the long run by the nominal variables, such as monetary growth or inflation. A higher rate of inflation should be reflected in a higher level of nominal interest rate, leaving the real rate of interest unchanged. It has been argued that the interest rates fail to adjust fully for inflation, but would adjust gradually in the long run.

Short term interest rate determines by the central bank and long term interest rates determines by market. The administered rate of interest is a part of financial sector reforms. In the financial sector reforms introduced during the period 1992-96, interest rate emerged at the centre stage of monetary management.

High interest rate is the causes of recession. The zero interest rate policy is an important milestone in monetary policy because the central bank is no longer able to reduce nominal interest rates. Zero interest rate policy is very closely related to the problem of a liquidity trap, where nominal interest rate cannot adjust downward at a time when saving exceed investment. Under the zero interest rate policy the central bank maintains a nominal interest rate. Lower interest rates are good for barrower and lower interest rates bad for saver. Interest rates in the unorganized market for both agriculture and for industry are very considerably.

2. Objectives of the Study

The proposed research study has following objectives to fulfill.

- To examine the India's interest rate policy in the post reform period.
- To study the effects of interest rate policy on performance of macroeconomic variable in the post reform period.
- To study the effectiveness of Interest Rate Policy and make suggestions for its further improvement.

3. Hypothesis of study

The study may test the following hypothesis

- India's interest rate policy has consistently moved from administered rate of interest to liberalized rate policy in the post reform period.
- Liberalized interest rate policy in the post reform period has significantly affected to macro variables and contributed to improve their performance.
- Due to development of India's financial market effectiveness of interest policy has improved in the post reform period.

4. Research Methodology and data source

The whole study is based on the secondary data. And time period of the study is from 1991-91 to 2013-14. The study is proposed to use the annual time series data for carrying out the

empirical analysis. The secondary data have been taken from RBI bulletins, annual report of RBI, report on currency and finance, national sample survey organisation, books, journals and available literature etc. Suitable statistical and econometric techniques will be used for analyzing the casualty between interest rate policy and performance of macro variable.

The variables used in the study are interest rate, call money rate, deposits rate, prime lending rate, investment, GDP growth rate, balance of payment employment and etc. The study is used the lenear regression model.

For analyzing the impact of interest rate policy on macro-economic variables, whole period divided into three sub period, viz. 1991-92 to 1996-97, 1997-98 to 2002-02 and 2003-04 to 2013-14. For measuring the effectiveness of interest rate policy, two channel of interest rate policy has been considered. Firstly, the real variables channel which works through investment and secondly monetary channel which works through inflation. Details mechanism of both channel are as follows:



5. Significance of the Study

The present study aims to show that the effects of liberalized interest rate policy on performance of macro variables in post reform period. This study analyze that the performance of macro variables has improved or not improved in the post reform period.

6. Chapter plan

Chapter 1

Introduction

Chapter 2

Assessments of interest rate policy in post reform period

Chapter 3

Interest rate policy and performance of macro variables

Chapter 4

Effectiveness of interest rate policy in the post reform period

Chapter 5

Conclusion and policy prescription

7. Conclusion

The period of 1990s are known for the globalization and liberalization. Interest rate policy became liberalized in 1990s. The main objective of economic liberalization and globalization was to reduce the role of government in producing and give more freedom to the private sector. In 1991, when India faced the most serious economic crises after independence. India gave up state-led import substitution industrialization and the globalization and liberalization of the economy as new development plan. After independence, India's development plan was adapted towards state led import substitution industrialization. After globalization and liberalization of the economy, India has reached high economic performance. In fact, since 2003, India's growth rate has accelerated, as if proving the correctness.

The high performing Indian economy has dramatically heightened the global community's interest. India's macro- economic variables performance in post reform period has many positive features. The economy has achieved remarkable success in saving and capital formation, which is regarded as one of the driver of India's recent growth story. The gross domestic saving and gross domestic capital formation recorded as 36.5 percent and 33.7 percent of GDP in 2009-10.

However, in the decade of 1990's, Indian economy could have ensured persisted high growth rate with controlled inflation. India's new interest rate policy has played very critical role in this direction in the post reform period. New interest rate policy has helped in managing the macro economic variables in better way. Deregulated interest rate policy has contributed in achieving the contradictive objectives of macro- variables.

The whole study is based on secondary data. The secondary data has been collected from RBI, handbook of statistics on Indian economy, RBI report on currency and finance. The main of this study has to find out that the changing pattern of interest rate policy in India in post reform period.

In the early 1980s, the Indian economy reached a turning point of a high economic growth phase. This high growth is backed up by the success of green revolution. In the late 1990s, monetary policy became independent from fiscal policy. An independent monetary policy by the reserve bank of India during 2000s ensures sustainable high economic growth and stable low inflation. India's economy has continued to grow steadily without falling into a serious economic crisis since 1990s, although the Indian currency crises in the late 1990s and the international oil prices hike during the period from 2003 to the mid 2008 hit the Indian economy hard. Finally we can say that the macroeconomic performance has been successful since the 1990s in terms of economic growth, saving, investment, inflation and balance of payment.

The tightening of regulation in the late 1960s, the partial economic deregulation in the 1980s and fully liberalization and deregulation in 1990s. The Indian economy has been relatively independent from weather instability by reduction in the GDP share of the agricultural sector and improved in agriculture technologies and infrastructures. In specially, the green revolution has been contributing to stability of the inflation rate and economic growth and alleviating the balance of payment problem caused by food imports since the 1980s.

The introductory chapter reveals about the interest rate policy in India. Since from the above literatures in the introductory chapter reveals that how is India's interest rate policy in post reform period. Since independence India's interest rate policy was administered. Only RBI has can change the policy before post reform period. The present study aims to show that the effects of liberalized interest rate policy on performance of macro variables in post reform period. This study analyze that the performance of macro variables has improved or not improved in post reform period.

The second chapter of the present study is "Assessment of interest rate policy in post reform period". The chapter analyzes the many types and pattern of interest rate in India in post reform period. This chapter evaluated the rate of interest.

The chapter shows that the interest rates were administered before post reform period which is became deregulated now. This chapter analyzes that the deregulation of interest rate policy and phases of interest rate policy in India in post reform period. Liberalized interest rate policy improves the performance of macro variables. Liberalized interest rate policy would be more supportive for increasing the efficiency of monetary policy. It shows that India's interest rate

policy has consistently moved from administered rate of interest to liberalized interest rate policy in the post reform period.

The third chapter of the study is “interest rate policy and performance of macro variables”. The chapter is based on secondary data which is collected from RBI, handbook of statistics on Indian economy, RBI reports. This chapter analyzes the performance of macro variables in post reform period. The chapter includes the macro variable is investment, saving, growth rate and inflation rate, export and import and employment. This study shows that the performance of macro variables has improved in post reform period. Saving, investment, and growth rate has significantly increased and inflation is decrease. The crises of 1991 affect the balance of payment.

In the first sub-period, from 1991-92 to 1996-97 the performance of macro variables has significantly improved. In the second sub-period, from 1997-98 to 2002-02 has less improvement in the performance of macro variables in the comparison of 1st sub period. And in the sub-period third, from 2003-04 to 2013-14 has more improvement in the performance of macro-variables. So we can conclude that the performance of macro variables has improved in the post reform. And liberalized interest rate policy in the post reform period has significantly affected the performance of macro variables.

The fourth chapter of this study is titled as “effectiveness of interest rate policy in the post reform period”. The main objective of this chapter is finding out that the effectiveness of interest rate policy in post reform period. After the deregulation of interest rate, interest rate policy has become very effective. We have seen that the lending rate is significantly affected the investment. We found that that if lending rate is increase then investment is decrease. And when lending rate is decrease then, investment is increase. Lending rate and investment works appositively. Lending rate and inflation are also significantly related. We can see that when lending rates are low then inflation rate is also low and when lending rate is high than inflation rate is also high.

In the sub period 1st and 3rd, from the 1991-92 to 1996-97 and from 2003-04 to 2013-14 lending rate is much effective. And in the sub period 2nd, from 1997-98 to 2002-03 lending rates is not more effective.

In this chapter we use the leaner regression model for measurement of effectiveness of interest rate policy. Our regression model is fit for the measurement of effectiveness of interest rate policy. Our leaner regression model shows that the interest rate policy is very effective in post reform period. In the sub period 1st and 3rd it is very effective and in the sub period 2nd it is less effective.

And the last chapter of the study is “conclusion and policy prescription”. This chapter reveals the conclusions, findings and recommendations. This chapter is the conclusion of whole study.

The study concludes that there is a shift in interest rate policy, from administered to liberalized interest rate policy in the post reform period. The rates of interest become deregulated in the post reform period. The deregulated interest rate has improved the performance of macro variables. In the sub period 1st and 3rd, much improvement reflects in the performance of macro variables, however, in the 2nd sub period performance of macro variables is comparatively less effective. Overall, we can conclude that deregulated interest rate policy has contributed in improving the performance of macro – economic variables in the post reform period.

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8. Recommendations:

1. There should be active cooperation and timely coordination between interest rate policy and macro variables for achieving the desired goal of macro -economic policies.
2. For improving the effectiveness of interest rate policy, different segments of Indian financial market need to be developed, because it works through these markets.

3. Considering its strong effect on macro -economic variables, Interest rate policy should be given an independent status like monetary and fiscal policy.

9. Limitations of the study:

The study in spite of being very thorough executed with a well defined methodology still faces certain limitations which are given as follows.

1. The time period taken for the empirical analysis is not sufficient but for having a generalized idea about the scenario we have considered the given time period.
2. In this study, only the simple regression model has been used otherwise there should have been the use of the advanced econometric techniques to carry out better analysis of this study.
3. The time duration carry out this study has also been one factor to restrict the study to confine only descriptive analysis.