Directed Interest Rate Reduction: Will it be counterproductive?

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Recently, Bangladesh Association of Bankers (BAB), a body representing the owners of private commercial banks in Bangladesh, announced that interest rates charged by these financial institutions would be brought down to the single digits from July 1. Currently, banks and other lending agencies charge between 12-16 percent annual interest rates for various loans. The government and bankers have also indicated that the credit crunch experienced in recent months has eased, and the banks will be getting lower corporate tax rates (as announced in the budget) which should enable them to offer loans on easier terms.

While lower interest rates, even on the eve of elections, should be welcome news for all, it is worth looking at the background to this move and the possible outcome of the initiative. At the simplest level, interest rate is the cost of borrowing and returns to saving. A lower

interest rate typically stimulates investment if all other conditions are favourable. The government is gearing up for the parliamentary elections, and reduction of interest rate on lending in ad hoc manners is a much-used, and often misused, measure to boost investment and economic activity and thereby enhance the popularity of the party in power. The finance minister has lent his unqualified support to the move to cap the rate charged by banks at 9 percent, and expressed his confidence that "this would help boost investment," according to a report by The Daily Star.

As is true of any monetary policy changes, the proposed lowering of the interest rate structure would entail movements in key variables. There will be two important short-term impacts of the announced policy. The first, and most important and immediate, impact will be an expansion of demand for borrowing triggered by lower rates. Secondly, there will be a reduction of growth in bank deposits resulting from the 6 percent cap on interest rates on deposits from the current 10-11 percent rates. The combined effect will result in a significant reduction in loanable funds available to the banks while the demand for credit will increase further at a time when private-sector borrowing is already running at 18 percent, well above the target (16 percent) set in the Monetary Policy Statement of Bangladesh Bank.

At the same time, the BAB policy will further aggravate the imbalances in the money market without any market-based equilibrating mechanism because interest rate on lending is capped at 9 percent. This situation will invariably lead to rationing of credit or grabbing of credit by the powerful business houses and politically connected persons.

To understand why the policy as formulated by BAB will not work, we need to understand the sources of the current liquidity crunch. The problem was in the making for the last several years as the banking system was experiencing a declining growth in deposits, primarily because savings were diverted to purchase Shanchaypatra and other instruments which offer interest rates well above market rates. The rate of growth of bank deposits declined to only 9.5 percent in September 2017, compared with a historical growth rate of 18 percent or more. Banks were unable to meet the demand for credit, growing at 18-19 percent, in view of the much lower rate of growth of deposits. The liquidity problem was also accentuated by the increasing burden of non-performing loans, which reduced the banks' capacity to expand new credit.

In order to sustain profit growth in an environment of slower deposit growth, many banks started to push their advance-deposit ratio (ADR) rates to well above the 90 percent range, well above the rate dictated by prudence or best practice. Due to excess lending, some banks teetered on the verge of becoming illiquid and offered higher rates to attract deposits. The proposed deposit rate of 6 percent will now run counter to the forces of market. While this is done to allow banks to remain profitable, it will add to the liquidity squeeze and push them to increase lending by violating or misreporting the banking statistics. Individuals and institutions will shy away from depositing their savings at 6 percent rate and divert funds to instruments offered by the National Savings Directorate (NSD) at a lucrative 11.5 percent rate and subject to only 5 percent final tax at source.

At the BAB-proposed lower deposit rate, which is almost the same as the inflation rate, savers will shy away from parking their money in banks and, in the process, further dry up banks that are in dire need of liquidity.

The current imbalance in the money market is also being reinforced by a growing imbalance in our balance of payments (BOP). In the preceding five-year period up to FY17, the banking system liquidity increased by Tk 1.8 billion through the increases in the net foreign assets (NFA) of the banking system due to the surplus positions in BOP and the consequent reserve build-up by Bangladesh Bank. The situation has completely changed since FY17 as liquidity injection through NFA has virtually stopped. The external current account deficit is projected to exceed USD 10 billion in FY18. To stabilise the exchange rate of Taka against Dollar, Bangladesh Bank has intervened by selling USD 2.3 billion in the interbank market. In the process, Bangladesh Bank has already withdrawn the equivalent Tk 190 billion in liquidity from the banking system, adding to the liquidity crunch. To protect the stability of Taka in the exchange market, Bangladesh needs higher interest rates in order to make Taka-denominated assets more attractive. But BAB-proposal will do exactly the opposite.

To sum up, a possible scenario that will emerge from the BAB-proposal will entail: rationing of credit; crowding out of the SME and new investors by the established and connected business houses; further concentration of credit among the large borrowers; a much slower expansion of the balance sheet of the banking system due to slower deposit growth; banks tempting to violate macroprudential conditions leading to enhanced systemic risk to sustain their profitability (as happened in early 2018); much deeper depreciation of Taka in the exchange

market; and the banking system reverting back to the quantitative controls of 1970s and 1980s.

Looking ahead, the government should dissuade BAB from this risky course of action and consider the following policy measures to manage the dual problem of banks' liquidity and the imbalance in the BOP:

1) Lower the interest rates offered for the National Savings Directorate (NSD) instruments, which serve as anchors for the deposit rates in the banking system. As long as the NSD rates remain well above the deposit rates in the banking system, deposit growth will remain subdued leading to upward pressures on deposit rates.

2) Monetary policy needs to maintain a balance between quantitative easing and measures to attract deposits and enhance the attractiveness for holding Taka assets. In this respect, some degree of depreciation of Taka against the USD is unavoidable, but this process ought to be managed through close monitoring and appropriate policy adjustments as needed to avoid any sharp downward slide of Taka.

3) It would also be smart for the government to contain domestic demand pressure by keeping a tight lid on self-funded large projects that do not have counterpart foreign financing. Some form of belt-tightening may be necessary, and while this might be politically difficult during an election year, some of this may happen through managed depreciation of the exchange rate which discourages imports and encourages exports.