Rates of return on national savings certificates — which way to follow?

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By *Dr. Ahsan H. Mansur*

Following the recent announcement about reduction of rates or return on most National Savings Schemes (NSS) by about 2.0 percentage points, various quarters have voiced concerns about the potential adverse implications of this measure on fixed income earners and on incentives for savings by households in Bangladesh.

As a proponent of this round of cut in rate of return, I also received queries from some very learned friends regarding its appropriateness, and received phone calls from very well-known former senior civil servants and many of my own relatives expressing concerns about its negative impact on their retirement income. More recently, during the Parliamentary debate on the proposed budget for the fiscal year (FY), 2015-16, Minister of Agriculture Mrs. Motia Chowdhury also voiced her opposition to the recent cuts in the structure of rates of return on NSS instruments.

Certainly these concerns are genuine, and while empathizing with them and having no intention of undermining the same, I would like to argue whether rates of return on NSS instruments at levels higher than what is justified by the market, would be the proper policy response to address these concerns. In this piece of analysis I would also briefly highlight the important market development issues which need to be taken into account while determining the structure of rates of return on the NSS instruments.

First we need to review what has happened to the spread between the deposit rate of banks and the rates of return on NSS instruments in recent months. In view of the recent downward trend in deposit rates of banks, the spread between the interest rates offered by banks and the rates of return on NSS instruments has widened from 2.2 percentage points in FY13 to 4.5 percentage points in April 2015. Interest rates offered by banks on term deposits of various maturities are primarily market-based and have been coming down due to various reasons: inflation rate coming down to less than 6.5 per cent level targeted under the Monetary Programme of Bangladesh Bank; banks are reducing their lending rates faced with increasing competition from private sector borrowing in foreign currency from abroad due to liberalisation of such borrowing by Bangladesh Bank in order to create a more competitive environment in the domestic banking system; and domestic banking system is flushed with excess liquidity due to slower demand for credit by the private sector. Credit to the private sector has been hovering at around 12 per cent-13 per cent range in recent months compared to historically healthy growth rates of about 18 per cent-19 per cent.

The reduction in the interest rate structure (both deposit and lending rates) in the banking system is a welcome development. Among the countries experiencing continued macroeconomic stability over a long time, Bangladesh has very high bank interest rates-both on deposits and lending. For a country with remarkable degree of stability in economic growth (hovering around 6.0 per cent plus over the last 13 years) and the exchange rate virtually fixed against the US dollar in recent years, there is no reason for the domestic interest rates to be so high in nominal and real terms. Such high interest rates are detrimental to private investment and economic growth and must come down if Bangladesh seriously wants to move to a high growth trajectory. The outcome must be market-based and not administratively engineered.

Not moving the rates of return on NSS instruments has serious distortionary impact on the money market in several ways. For example, the growth rate of bank deposits (month on month) has come down to only 12.1 per cent in April 2015, which is an all-time low level of deposit growth since 1998 (Figure 1). The sharp drop in the growth rate of bank deposits was primarily attributable to the fact that savers rushed to NSS instruments that offer higher rates of return compared to those of the banking system. The low growth level in bank deposits has not been an issue this year as demand for domestic credit from the private sector has been low due to political turmoil and lower domestic economic activity.

However, if real economic growth reaches the 7.0 per cent level as envisaged in FY16 budget, this very low level of deposit growth will seriously constrain credit expansion to the private sector from the domestic banking system. For a healthy financial system, bank deposits must grow at least by historical average level of about 17.7 per cent (from FY2000 to FY2014) in the coming years.

Figure 1: Growth of bank deposits have been falling steadily since FY11

The sharp slowdown in bank deposit growth is primarily attributable to the diversion of household financial savings to the NSS instruments, lured by the higher rates of return. One positive attribute of financial assets is that it generally comes back to the banking system as deposits of some other economic agent even when such assets are used by the primary holder for transactions related to real economic activity or purchase of real assets like land or apartments. However, when the households divert their financial savings for purchasing NSS instruments, the money permanently disappears from the deposit base of the banking system and undermines the growth potential of the banking system because without a healthy growth in the deposit base, there cannot be a corresponding healthy growth in lending activity.

The excess borrowing through the NSS instruments has prevented Bangladesh Bank from continuing with the scheduled Treasury bill auctions, undermining bond market development and banking sector profitability. Banks typically invest over 90 per cent of their idle funds in government bonds/treasury bills which generally yield between 8.4 per cent to 11.97 per cent return depending on maturity structure of bonds/bills. However, Bangladesh Bank has kept the auction of treasury bonds on hold since the first week of May after it determined that the government had Tk. 110 billion (11,000 crore) in excess funds, accumulated primarily by selling high-cost NSS instruments to the general public. Interest rates in the inter-bank market call money market have also declined to just 5.25 per cent, as most banks have excess liquidity, making that window less attractive/profitable for banks. Banking system’s profitability has been thus hard hit and the bond market has become virtually inactive through this process.

Interest rate transmission mechanism cannot work when the rates of return on NSS instruments are not linked to money market developments. Rates of return on NSS certificates are not market based and administratively determined. It also operates on a “Open Tap” basis which means that sales are always open to any eligible person interested in buying these instruments at the prevailing interest rates.

Only when volume of sales vastly exceeds or falls short of the budgeted/planned amounts, the government reacts by lowering or increasing the rates of return. At the same time because of its potential large volume effect, it serves as a benchmark, which bankers must take into consideration if they are to attract deposits in the banking system and thus bank interest rates cannot deviate significantly from the NSS rates under normal circumstances. The sharp decline in deposit growth in FY15 was a direct manifestation of this effect since banks were forced to reduce interest rates ignoring the higher rates offered by NSS instruments.

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E-mail: ahsanmansur@gmail.com]

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