

Why Bangladesh Invests less?

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ECONOMIC theory stipulates that if a country wants to achieve higher economic growth it has to invest more.

As investment increased in recent decades, Bangladesh's growth performance also improved, from 3.2% 1980s to 5.8% in the 2000s.

Despite these gains, Bangladesh is still investing (at 24.2% of GDP) much less than what it should. As a matter

of fact, the economy cannot even invest what it saves domestically (29.2% of GDP). This column reviews the

relationship between investment and growth in China, India and Bangladesh, and tries to identify why

Bangladesh is not investing as much as it should.

Since the 1990s, China's real economic growth rate has averaged more than 9% while that of India was around

6% (Figure 1). The rapid growth in both China and India has been driven by high levels of investment (Figure 2).

The figures reveal that over the last three decades Bangladesh invested much less than the other two countries,

and the recorded growth in Bangladesh was correspondingly lower. For all three countries, the data also show

that as the rate of investment increased (India) or remained high in relation to GDP (China), so was their

performance in terms of real GDP growth. What is the secret behind China's and India's success in sustaining

high levels of investment, and what is the lesson for Bangladesh from their experience? Investment theory states that level of investment in a firm or economy is inversely related to level of interest rate. The lower the interest rate in real terms (nominal interest rate adjusted for inflation) the higher would be the level of investment. A review of the real lending rates of the three countries reveals that Bangladesh has been the highest since 1990, and the lowest in China (Figure 3). The difference is even more pronounced in the case of nominal interest rates. In nominal terms, Bangladeshi investors had to pay 15 % during 1990-2006, compared with 7% and 13%, respectively, in China and India. In real terms, Bangladeshi investors had to pay 5.3 and 2.8% age points more than their Chinese and Indian counterparts. Certainly, this higher interest burden in real terms had a punishing impact on Bangladeshi entrepreneurs and can help explain the country's low level of investment. In a recent, article Indian Reserve Bank Deputy Governor Rakesh Mohan blamed the Indian National Savings Schemes (NSS) for the relatively high interest rate structure in India. He observes that by offering very high interest rate at 8.3%, the NSS is distorting the domestic interest rate structures and creating impediments to monetary policy operations. If the Indian Reserve Bank is voicing concern about the situation in India, we should be screaming about the situation in Bangladesh. Interest rates on Bangladesh NSS instruments are about 3.5% age points higher than their Indian counterparts (currently offering 8.3% interest). Why is it important for the NSS interest rate structure to be market-based? Right now, NSS instruments offer risk-free interest rates ranging between 11.5 to 12.0%, with effectively no tax withholding and for the most part tax-free. Since commercial banks have to offer equivalent rates to be attractive to the

depositors on their time

deposits, the NSS rates effectively serve as the floor for the deposit interest rate structure in Bangladesh.

Since these rates are set administratively on an ad-hoc basis at high levels, monetary policies of Bangladesh

Bank essentially have no effect on the structure of time deposit rates. If we want to reduce lending rates in

Bangladesh, the current administrative basis for setting NSS rates must be replaced by a market-based system.

It is interesting to observe that the Indian government's successful financial sector reform has contributed to a

significant reduction in the spread between lending and deposit rates (Figure 4).

Financial sector reforms in China, on the other hand, contributed to an increase in the spread but still remained

below 4%. It is also widely believed that China's deliberate policy of keeping price of capital low and

maintaining the interest spread at a positive but moderate level has contributed to its unusually high investment

rate.

In contrast, the incomplete financial reform in Bangladesh in the 1990s widened the spread from 4% in 1990 to

the 6-8% range thereafter, which is well above the international norm.

The simple analysis presented in this piece very plainly helps identify the twin problems faced by Bangladeshi

investors: (1) persistent high interest rates; and (2) the wide spread between lending and deposit rates.

The wide spread is attributable to market inefficiencies like high operating costs, lack of competition and the

consequent high profits of the commercial banks, and relatively high loan loss and associated provisioning

resulting from asymmetric information between borrowers and lending institutions (in part reflecting inadequate

credit information and collaterals).

In addition to dismantling or replacing the NSS with market-based instruments,

comprehensive efforts/reforms

would be needed to lower the interest rate structure and spread if Bangladesh wants to achieve higher levels of

investment and growth like China and India.

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