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Research Note

Thoughts on Interest Rate: A Pedagogic Note

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Interest Rate: Concept and Linkages to Other Macro Variables

Interest rate is the price that an economic agent pays or receives through an intermediary in economic transactions involving use of fund, generally known as capital. Interest may be considered as the "wage' of capital and thus productivity of capital determines interest rate. No doubt, capital has its genesis in savings, the leftover from the consumption. Any resource has alternative uses. Capital has an opportunity cost. An investor may either consume capital at the present time or may defer present consumption on expectation of higher yields in future.

The policy on interest rate may have multidimensional impacts on an economy. Interest rate is considered as a major instrument in influencing share market operation. An appreciation or depreciation of exchange rate hinges on pragmatic policy on interest rate. The most obvious impact of interest rate is on investment decision. For a well-developed capital or money market, a rise in interest rate generates demand for domestic currency that is convertible, appreciating the currency and in the process discouraging exports. As a result, trade balance may worsen because of cheaper import. Very often, abrupt or sudden change in the interest rate may result in jittery and severe shock in capital market. One of the important parameters of contagion effect is the change in performance and thus adverse transmission effect may retard growth process. interest rate that may destabilize peer

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country economy's The performance of share market is closely linked to interest rate structure. Share market performance is generally bearish when yield on alternative risk free savings instruments such as bonds, defense savings certificates or treasury bills are high. Intervention by monetary authority is a common practice in many developed economies in sipping interest rate to invigorate share market. However, interest rate policy may have little effect in stimulating investment in capital market because preference for investment in share market depends on congenial investment climate and thus higher growth in manufacturing and service sectors determines the dividend. Lack of good governance in the embodiment of corruption and extortion often frustrates investment even at a low interest rate and retard growth of the economy. Savings always seek an outlet with less risk and reasonable premium. Premiums on different savings instruments such as interest on savings or fixed deposit or long term deposit schemes such as Three Year Savings Bonds or deposit pension schemes, treasury bills is crucial in influencing decision on the probable pot where savings flows or stabilizes. The trade off between risk and reward is thus fundamental. Where risk is very low and enjoys an assured return, the proclivity of flow of funds is automatic. Saver's ventures on risky investment only when the return is very high and the alternative mode of savings instruments are not promising.

Interest Rate in Savings Mobilization

Interest rate, an elixir of savings plays an important role in resource mobilization that can be utilized in productive investment. Investor pays a price for the use of fund to an intermediate unit generally financial institutions that muster fund from scattered sources and savers receive a premium in the process for deferring current consumption. Thus, interest rate structure on the viewpoint of savers should protect the real worth of the fund they deposit in the bank. When financial institutions or financial intermediaries borrow money at high interest rate, they generally lend at higher interest rate. The difference between the borrowing rate and the lending rate determines the profit. However, profit depends on other factors such as schedule of loan in the context of time, short-term vs long term or sectoral composition and the efficiency through which financial institution functions, the extent of bad debt and on innovation in lending practices.

The difference between real rate of interest and the nominal rate of interest should be positive for effective savings mobilization. In other words, this implies that real interest rate adequately compensates for the deferred consumption and inflation does not erode the purchasing power of money. When real interest rate is high, the cost of borrowing is also high that may discourage investment and ultimately growth. A return on bond or fixed deposits or in the case of Bangladesh 3 year's savings bond or Family Savings Certificate are risk free and generally higher real or effective interest rate dissuade risk averse savers to invest in risky ventures generally in share market. Indeed, the preference prevails over those instruments that entails risk. Thus, a realistic

interest rate policy helps to stabilize macroeconomic balance by ensuring consistency in both domestic and external fronts.

Interest Rate and Fiscal Policy

Fiscal prudence also demands a well-knit interest rate policy to strike a balance between government revenue and expenditure. Government borrowing may push interest rate up at the inconvenience of the investor. Often quoted "crowding out" phenomena represents shortage of loan able fund with financial institutions when government borrows to meet revenue shortfall. Interest rate on government floated long-tenn bonds also drains resources on interest payments in each year and curtails freedom in budgetary allocation in immediate investment opportunities by diverting resources. The issue of intergenerational debt burden sharing is no less important in this borrowing episode.

Interest rate policy is again important for old age people who rely mainly on accumulated interest earnings from their savings. The lowering of interest rate may work as a catapult in subsistence when people at old age rely exclusively on earnings from accumulated savings. Senior citizen in USA is experiencing a hard time due to the low interest rate; especially certificate of deposit holders are having a tough time in the current market in USA. The rate on CD has reduced from 4.85 per cent in 2001 to 3.25 percent in 2002. Recently, the Federal Reserve Policymakers slashed key interest rates by a half percentage points to a 41 –year low of 1.25 percent in an effort to prop the ailing economy. This 50 basis point rate cut did not accompany the rate cut by European and British Central banks that precipitated the dollars latest slide. Interest rate as a policy in fiscal and monetary management is thus an important instrument from different perspective.

Interest Rate in Bangladesh: Towards a Pragmatic Interest Rate Policy

Of late, Bangladesh have adopted a market based interest rate policy. The interest rate was previously set by the Central Bank. An analysis of current interest rate structure of Bangladesh may answer many pertinent questions such as whether the current interest rate is too high or low in comparison to interest rate in neighboring countries. What may be an acceptable interest rate on the viewpoint of both savers and investors? Will it be absolute market prerogative to determine interest rate, which equates the demand and supply of loanable funds? These are the few reasonable questions that donor community, Bangladesh government, civil society and poor small savers seek to resolve. An approximation to answers all these questions may be attempted through theoretical ,analysis and on the basis of secondary data. An econometric analysis with current economic' data may shed light on proper policy guideline.

To be fair the interest rate on various savings instruments; interest on savings account as well as on fixed deposits was high before October 2001 when the present government assumed power. With an inflation rate below 4 percent, the real interest rate was positive and till today it is positive. Though timid inflationary pressure is offing, the current real interest rate is positive. The decision on slashing interest rate at different points of time in the past years may be justified on fundamental market criteria. Real interest rate is positive and macroeconomic management does not bode any omen on the loss of purchasing capacity.

Despite interest rate cut and imposition of 5 % deduction on the earnings on the various savings instruments and on fixed deposits, there is clamor for savers to invest money on those instruments. Rationale may be lack of alternative savings instruments or lack of confidence in other mode of investment, e.g., investment in share market. The status quo is reasonable but further slashing may depress the savings habit. It is true that when interest on deposit is high, the cost of borrowing is also high that work as a disincentive in investment. Any investment undertakings depend on the rate of return. Fund for investment may be borrowed at a rate of 16 percent, which assures a return of over 20 percent. The rate of return is different on different undertakings. An outright consideration that only borrowing rate works as a crucial variable in determination of probable rate of return in investment undertakings is fraught with danger and requires cautious and judicious steps before embarking on a policy that underline slashing of interest on deposit to invigorate investment climate.

Borrowing rate of interest is not the single determinant; there are other variables that influence the outcome in an investment endeavor. Besides, the borrowing rate of interest, administrative cost of fund and the leakage through extortion are two important parameters that influence rate of return. Extortion and administrative cost in the business environment substantially reduce the real rate of return on investment in Bangladesh. Empirical investigation may chart a trend in different undertakings. However, it is safe to say that from the very beginning of an undertaking when one considers the time lapse in terms of infra structural inadequacy or leakage through rent seeking at various stages from procurement to marketing, the rate of return is substantially reduced. One may logically arrive at a conclusion that in the condition of substantial leakage through extortion and other rent seeking activities, the slashing of interest rate will work only as conduit in the transfer of income from the savers to extortionist. This conclusion is valid even without any empirical support. Newspaper reporting supports this assertion and sluggish business investment and idle reserves in the financial institutions testifies to this phenomenon. Thus, slashing of deposit rate with consequent lowering of borrowing rate only enhance the return of the rent seeker in the absence of law and order and ineffective and inefficient management of loanable funds by the financial institutions.

It is to be understood that leakage in the form of extortion and rent seeking from productive activities depresses the entrepreneurial behavior of young businessmen and severely hinder the growth of a healthy investment climate. The pragmatic policy may be the creation of adequate infrastructure both physical and legal through which investors enjoys congenial environment in carrying out activities from loan application to processing and from procurement to marketing. A congenial environment may ensure a safe return on the investment even at a rate, which rewards both the savers and the borrower. Incidental non-business expenditure substantially reduces the rate of return in investment sometimes below the rate of borrowing. Therefore, problem lies not in the higher cost of borrowing but in other non-business transactions. Squeezing the scope of saving through cancellation of saving instruments or lowering the deposit rate of interest works as disincentive for savers that may allure to search for alternative illegal outlet. There are instances when poor savers were cheated in remote Bangladesh by unscrupulous money launders.

Lending practices in Bangladesh is fraught with non-economic norms, often projects are processed without due consideration of yield or rate of return. The Board with little consideration of repayment or probability of return approves projects with dubious return. Very often, the feasibility study or approval process is substituted by command and control structure and moreover perfunctorily supervision or follow up once a loan was disbursed results in accumulation of poor quality assets. Non-performing or default loans to the extent of over Tk 24,000 Crore [28 percent of the entire loan portfolio] manifest this syndrome. Huge non-performing loans create additional burden in asset management and enforce on the banking institutions to keep interest rate at a higher level and for provisioning. Expenditure-Income [EI] ratio of the Nationalized Commercialized Banks NCBs was very high, strangely exceeded 100 percent in 1999 before falling to 95 per cent by the end of 2001.

Concluding Remarks

Data on savings as a percentage of GDP in Bangladesh may be compared with savings rate of India. United Nations System of National Accounts 1993 [SNA 1993] through which GDP and other macro variables were revised during mid 2000 anchor national savings rate around 22 percent against the old estimate of 15 percent. National savings consider net factor income from abroad and net current transfer as essential ingredients. On the other hand, domestic saving that includes both public and private savings is 18 per cent in the revised estimate as compared to 9 by the previous estimate. This may be compared to 10 years average Savings data of India at 23.2 percent average [1992-93 to 2001-

02]. Investment as a ratio of GDP in Bangladesh is about 22.4 percent as per the revised estimate; old estimate put the ratio at 18.7 percent as against investment GDP ratio of 24.4 in India. The image reflects gaps in investment and savings ratio on the basis of domestic savings alone. This manifest savings propensity requires incentive and an assurance that long term inflation expectation remains within a reasonable bound through efficient management of the economy in both the monetary and fiscal front for fixed deposits of more than two to three years duration. The new rate structure to be implemented from May 1, 2002 compare favorably with rate structure on savings account and on certificate of deposits of different duration now prevails in India.

Penalization of savings through slashing of interest rate may not bring a congenial environment in investment. The strings lie elsewhere. Perception of those non-market fundamentals may work as a useful guide for any future effort on interest rate cut. Development of capital market may be an effective alternative in relieving the banking institutions as providers of long-term investment finance. Unfortunately, this is not working in Bangladesh. " New issues through private placements and public offerings in the capital market in FY 02 amounted to Tk 0.55 million, against long-term bank loan disbursement of Tk. 35.05 billion". When compared to market capitalization of listed stocks in the Dhaka Stock Exchange against outstanding long-term loans of banks, the difference is hefty; to the extent of over Tk. 100 billion. Thus, slashing of interest rate to prop up capital market may not be a viable option in the absence of transparent trading rules and decent corporate governance.

Bullish share market can make a dent in the interest rate structure on banking institutions. The reverse may not work even in a developed capital market. The recent interest rate cutting episode by FED is a manifestation that by trimming interest rates by a quarter percentage point might help to jump start the economy that is stalled despite previous six rate cuts between January and

June. The experience, however, is that rate cuts failed to help get the economy moving along again. The implication is monetary policy is not a cure for the economy and the ineffectiveness requires careful analysis in the context of other important variables such as share market performance, the elasticity of share market response with interest rate changes and also the exchange rate. The bottom line is interest rate cut may not be useful option in the absence of other parameters that includes both market and non-market fundamental.

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