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Reduction of bank lending rate: Some unsavoury implications

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The decision of the Bangladesh Association of Banks (BAB) to bring down the interest rate on lending to 9.0 per cent and that on deposit to 6.0 per cent, has become effective from July 01. But the new interest rates have yet to be universally and uniformly applied by the banks.

The BAB decision evoked diverse comments from economists, public policy analysts and the media. This article seeks to examine the likelihood of actual implementation of the decision by banks as well as its implications for flow of credit to and investment in the real economy by the private sector.

The BAB decision implies a spread of only 3.0 per cent between interest on deposits and that on advances. In reality the spread has ranged between a minimum of 4.37 per cent to as high as 4.48 per cent over the last 22 months (see attached table). In this scenario the expectation that banks will reduce their spread to 3.0 per cent appears to be patently unrealistic. This raises question as to why the lending rate as well as spread in Bangladesh is unacceptably high. An important explanation lies in ever rising non-performing loan. The percentage share of classified loan to total outstanding loan increased from 8.79 per cent in December 2015 to 10.78 per cent in March 2018. This percentage is higher than in most other Asian countries. In absolute term the amount was close to Taka 900 billion. In an earlier paper published in The Financial Express on April 03, 2018 I had identified the causes underlying such large amounts of defaulted loan. Among the causes cited were (i) the incompetence of bank personnel in valuing collateral, assessing potential of future revenues and cash flows from the projects for which loans are given; (ii) poor governance of banks leading to loans to friends, relatives or politically connected people irrespective of the merit of their loan proposals; (iii) political influence in sanctioning loans as well as their rescheduling and restructuring; (iv) ineffective judicial system reflected in huge number of pending cases either in the loan courts or superior courts; (v) the existence of too many banks which detracts from the economies of scale leading to unhealthy and aggressive lending to unworthy borrowers. Following the publication of the article, I received a letter from a very experienced and senior private bank official wherein he stated that, in general, only about 10 per cent of bank loans are granted free from intervention by some quarter or the other. Unless these problems are addressed it is doubtful that banks will be able to reduce the interest rate to the announced levels. I have also been told by a very distinguished, retired private bank chief executive that even in cases the banks ostensibly charge 9.0 per cent on lending they will exact payment from borrowers in other ways.

At this stage let us consider some of the implications when 9.0 per cent interest on lending is actually implemented. The rationale behind this decision

presumably is that the reduction of interest rate would increase the flow of credit to the private sector and thereby investment in the real sector of the economy. The reality is that the growth of credit to the private sector has been increasing for some time; rising to 17.65 per cent in April, 2018 over April, 2017 compared to 16.21 per cent in April, 2017 over April, 2016 (Bangladesh Bank, Major Economic Indicators: Monthly Update- June 2018). The growth in both April, 2017 and April, 2018 has been higher than postulated in Bangladesh Bank's Monetary Policy Statements (MPS). It is, therefore, clear that the prevailing interest rates on lending have not created demand constraint.

On the other hand, the fixation of 6.0 per cent interest on deposits is fraught with the risk of reduced deposits into the banking system. This has been happening for some time now. The growth of deposits in April, 2017 over April, 2016 was 12.43 per cent; it fell to 8.58 per cent in April, 2018 over April, 2017. There are several reasons for this ominous development. First, the real interest rate on deposits is presently nearly zero per cent or even negative. Moreover, the composition of deposits has been shifting away from demand deposit in favour of time deposit. The process of slowdown of deposit growth will get further boost from the increased differential with interest rates on savings certificates issued by the government as a result of reduction in interest rates on deposits. Banks may therefore be confronted with supply side constraints in enhancing credit to the private sector.

In the above context, in an earlier paper authored by me (published in Market Pulse, issue no- 107) I had found that the inverse relationship between the level of interest and growth of credit to the private sector operates with one-year lag. Moreover, the relationship between flow of credit and private sector investment is weakly positive. This finding is not surprising in view of many well-known constraints to private sector investment. The reduction in lending rate is thus unlikely to boost significantly private sector investment.

Table: Interest rate spread in the banks			
	All Banks		
2016-17	**Interest rate on deposits**	**Interest rate on advances**	**Spread**
July	**5.48**	10.32	4.84
August	**5.44**	10.24	4.8
September	**5.39**	10.11	4.72
October	**5.33**	10.03	4.7
November	**5.29**	9.94	4.65
December	**5.22**	9.93	4.71
January	**5.13**	9.85	4.72
February	**5.08**	9.77	4.69
March	**5.01**	9.7	4.69
April	**4.97**	9.62	4.65
May	**4.93**	9.66	4.73
June	**4.84**	9.56	4.72
2017-18			
July	**4.89**	9.51	4.62
August	**4.93**	9.46	4.53
September	**4.9**	9.45	4.55
October	**4.89**	9.39	4.5
November	**4.9**	9.3	4.4
December	**4.91**	9.35	4.44
January	**5.01**	9.42	4.41
February	**5.18**	9.55	4.37
March	**5.3**	9.7	4.4
April	**5.43**	9.89	4.46
Source: Statistics Department, Bangladesh Bank			

To conclude, my impression is that the decision regarding interest rate reduction is not based on any systematic analysis of either the causes underlying the prevailing high interest rate or an assessment of the likely impact on the economy. It has been probably motivated by a desire to demonstrate that the banks are offering some quid pro quo in exchange for the various concessions they obtained recently in respect of the number of directors from the same family, their tenure and reduction of cash reserve requirement as well as repo rate.

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