

## DIRECTED INTEREST RATE REDUCTION

# Will it be counterproductive?

AHSAN HABIB MANSUR and ABDULLAH SHIBLI

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,

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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:

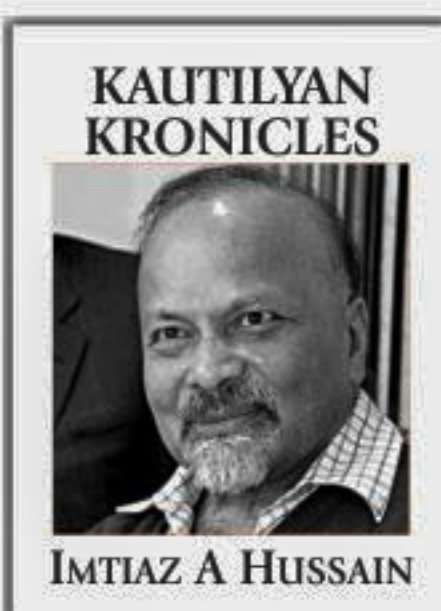
1) Lower the interest rates offered for the National Savings Directorate (NSD) instruments, which serve as anchors for the deposit rates in the banking system. As long as the NSD rates remain well above the deposit rates in the banking system, deposit growth will remain subdued leading to upward pressures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

Dr Ahsan H Mansur is the Executive Director of Policy Research Institute, Dhaka. Dr Abdullah Shibli is Senior Research Fellow at International Sustainable Development Institute (ISDI), Boston, USA.

# Mexican polls: The other soul



IMTIAZ A HUSSAIN

DEMOCRACY is, by far, the most acclaimed historical form of government. It not only allows representation of all groups, but also permits every adult to exercise complete sovereignty at the polling booth. There might be nuances and variances here or there, particularly in the preceding campaigns and subsequent outcomes, but we have, by and large, managed to live with our differences, converse with adversaries, and bite the bullet so democracy strengthens itself.

Twenty-first century elections have been breaking that model. We now see democratic elections so dividing countries that consensus, or any form of civil conversation, has been thrown out the window. Too much media attention to Donald J Trump's presidential victory constrains me from using his election to illustrate, but talking about Turkey's election last month, Nathan Gardels, editor of *The Washington Post*, made a relevant observation (June 29, 2018): "majoritarian democracy is not a friend of liberal values." Recep Tayyip Erdogan's Islamist Justice and Development Party (AKP) meant, to him, "the return of the repressed from Turkey's military-enforced secular past," with "[t]he other half of society... essentially [being] disenfranchised even though they voted."

Mexico may be precisely in such a plight after its July 1 election. Andrés Manuel López Obrador (AMLO), the leftist leader of the newly-formed Morena Party, might justifiably call it third-time lucky. Once a popular, progressive mayor of one of the world's largest cities (2000-05), AMLO's two previous defeats were highlighted by him holding that city hostage to his loss: camping with his die-hard fans right smack in the middle of Mexico City, which is notorious for its traffic bottlenecks,

he vigorously complained of being "robbed" of the 2006 election victory in a country famous for its shady and under-the-table deals, and even formed a "shadow government" on the streets. One would have thought his civil disobedience 12 years ago would have undone his political future today, as in 2012. Clearly, his opponents believed so.

Not so, and not by a long shot. Rallying behind him, Mexicans destroyed in one fell swoop the major vestiges of institutionalised political power: both dominant political parties were blown into smithereens in a country where they were fraying for almost all of this century; and with them, the bastions of local power, the governors of 32 "states" (provinces), who had previously served as king-makers, were also blown asunder in domino effect. His Morena Party (Movimiento Regeneración Nacional, or National Regeneration Movement; he had previously run as a candidate for the leftist Partido Revolucionario Democrática, PRD) irreparably damaged extant political strongholds. In power for seven straight decades until 2000, the dominant PRI (Partido Revolucionario Institucional) Party had established themselves, counting on "governors" to deliver in polls. Peruvian Nobel Laureate poet Mario Llosa Vargas even called the party "the perfect dictatorship".

There then followed a comedy of errors. As Mexico became one of the most vibrant democracies in this century, both PAN and PRI simply failed to deliver what they campaigned for. Narcotics-trade, corruption, and spiralling insecurity cannot be blamed exclusively upon them, endemic as they are, but that these ran out of control under their administration demands they be held as culpable as any other.

At least the public felt so this time, aided by another secular development. Mexico's neoliberal embrace from 1983 (the Baker Plan of debt-relief), which culminated in the 1993 eye-raising North American Free Trade Agreement (NAFTA, the first regional arrange-



Newly elected Mexico's President Andres Manuel Lopez Obrador cheers his supporters at the Zocalo Square after winning general elections, in Mexico City, on July 1, 2018.

ment in which a less-developed country partnered a developed counterpart), resulted in an income-disparity gap, particularly in the countryside, that could no longer be whitewashed. Fuming for years, furiously at that, voters rallied behind this populist, opportunist, and law-breaking (as his 2006 Mexico City tantrums exposed) politician who won his stripes as a PRI member before drifting increasingly left with every adversity. Clearly, his will not be the "left" as is defined and described in political literatures and dictionaries, but neither can the public support that made him Mexico's first "left" president be ignored or dismissed.

AMLO's campaign slogans summarise what was at stake. His calls for "good people" to "throw the bums out" and reference to a "mafia of power" show how seriously Mexicans were taking corruption and inequalities. In return, the 53 percent of votes he tallied (ironically, the same proportion as

Erdogan received), was more than what Ricardo Anaya, the joint PRD-PAN (Partido de Acción Nacional) candidate, and PRI's José Antonio Meade, got collectively (22 percent and 16 percent). Not only that, Morena swept the congressional elections (500 deputies). It was a dramatic rebuke of the country's elites in one of the most violent elections held in living memory (130+ party candidates or workers being killed), amid the most insecure moment in recent Mexican history (25,000+ violent homicides in 2017 alone).

Mexico needs a tough leader to face these domestic crises, which the last three presidents failed to be: Vicente Fox Quesada (PAN, 2000-06), Felipe Calderón (PAN, 2006-12), and Enrique Peña Nieto (PRI, 2012-18) entered with grand plans (respectively, fuller economic integration with the United States; eliminating drug-traffickers and cut taxes to boost investment; not returning to patronage, promoting transparency, and quelling vio-

lence), but failed miserably to control the underlying problems, with the same consequence, of the public slowly and completely losing faith. The simultaneous advent of a populist and hostile US president also means Mexico cannot blink: it has to stand up to convey the public anger over the imprisonment of emigrants, particularly their children, by the United States, and the distasteful construction of a border wall. No other Mexican leader took up this challenge more ferociously than AMLO.

AMLO might not be the perfect political leader, but he is just what Mexico needs at this moment. That does not mean he will deliver: for a politician as spotty as he has been, most likely he will not, since that has also been the fate of almost all recent Mexican presidents, with the exception of Ernesto Zedillo Ponce de León (1994-2000), who inherited the country's deliberately contrived peso crisis, but left office with head held high as no other politician has been able to (before joining Yale University).

Most of all is AMLO's greatest constraint: a divided Mexico. He is not the one who can bring the country together. Nobel Laureate Ohran Pamuk once mentioned how "a country can have two souls," but also how "[h]aving two souls is a good thing" because both "are continuously in dialogue with each other, sparring with each other and changing each other." AMLO may have awakened Mexico's hitherto deprived "soul", but in a country economically, socially, and racially divided so sharply historically, quenching the inherent thirst will be uphill. His six-year tenure will just not be enough to pull it off even in the best-case scenario. Though Gardels's pessimism about that "two soul" conversation in Turkey seems set to echo in Mexico, on the other hand, AMLO deserves the chance the public want him to have, not the vile of Mexico's dominant "soul".

Dr Imtiaz A Hussain is the head of Global Studies & Governance Program at Independent University, Bangladesh (IUB).

## A WORD A DAY



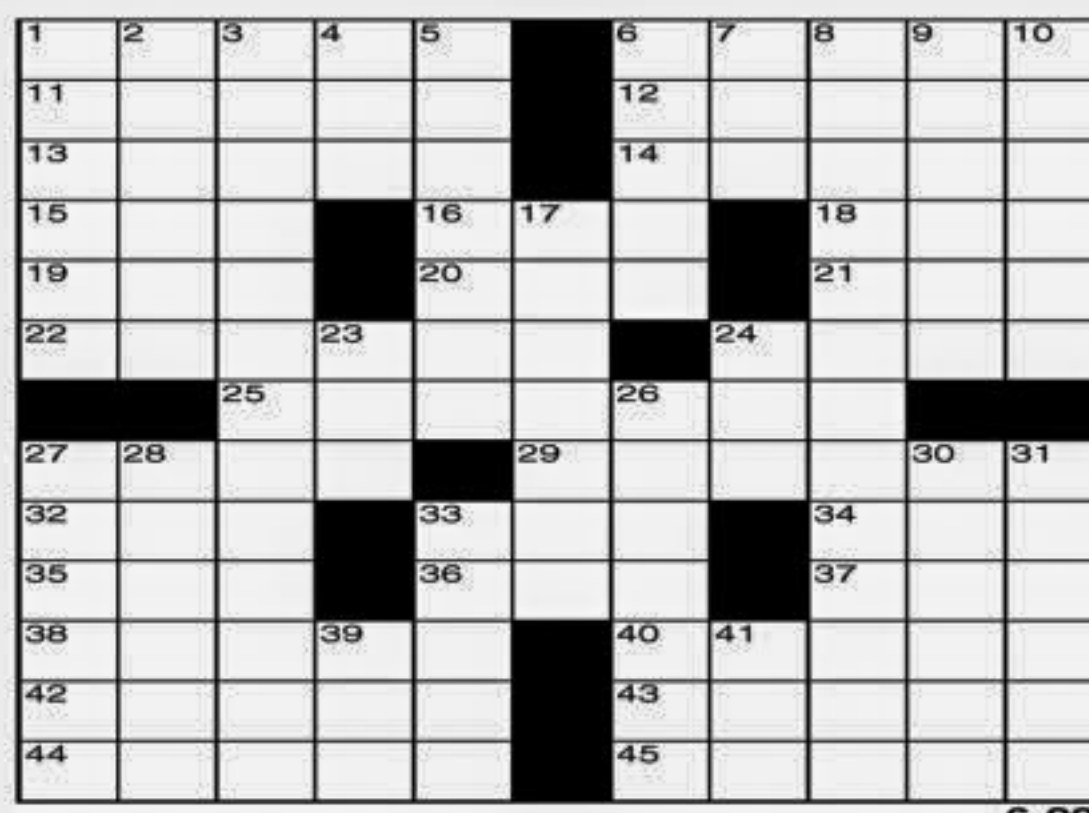
**INJUNCTION**  
NOUN

*A judicial remedy to prohibit a party from doing something*

## CROSSWORD BY THOMAS JOSEPH

- |                           |                          |                                |
|---------------------------|--------------------------|--------------------------------|
| <b>ACROSS</b>             | 29 Metal bars            | 4 That ship                    |
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| 25 More delirious         | 3 Henry Fonda film       | 39 Low number                  |
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## YESTERDAY'S ANSWER

NEWER SPIES  
 ELOPE NADAL  
 TIRED IVORY  
 DERIDE  
 SAGONE HOT  
 CAUSE COPE  
 SUMMER GAMES  
 STEP ROBERT  
 YES JOT GAS  
 EUROPA  
 ASWAN SUMAC  
 SHARK ELECT  
 PENNY APSES

## BEETLE BAILEY



## BABY BLUES

