

## THE ECONOMY

### Interest Rate Changes

The Central Bank announced a change in the bank rate in the first week of May, 1980. The rate was increased by 2 per cent. This was one of the many policy alternatives available to the Central Bank to counter the growing inflationary trends in the economy. At present the inflation rate is believed to be over 20 per cent. However, in certain sectors it is noticeable that the rate is even higher. The Central Bank interest rate operation is one of the traditional methods of restricting the excess liquidity in the economy. Two such methods are:

1. by enhancing domestic savings
2. by restricting credit creation.

### DOMESTIC SAVINGS

Popularly, interest rate manipulation is believed to be a mopping-up operation of the excess liquidity  $M^1$  and  $M^2$  and particularly  $M^3$ . ( $M^1$  is the money supply 'narrowly' defined as currency and demand deposits.  $M^2$  is the 'broad' money supply consisting of currency, demand, time and savings deposits).

However, the efficiency of interest rate policy depends to a large extent on the particular circumstances and the structural setup of the economy in which it operates. In under-developed economies, like that of Sri Lanka, the effectiveness of an interest rate policy as an instrument of savings promotion has to be looked into more closely. A savings decision if looked at as a postponement of present consumption will reveal certain factors other than that of interest which acts as its determinant. How far high rates of interest could divert funds from consumption to savings in the particular context of our economy, will depend on

1. income levels
2. distribution patterns
3. the effectiveness of the banking system
4. the market situation (price and availability of goods & services).

One important feature noticeable under inflationary conditions, particularly in our context, is the increasing tendency for "speculative consumption". Speculative buying

and hoarding are not very new under fairly acute inflationary situations. In Sri Lanka, today, decisions to save are too often postponed due to "speculative demand" for consumption. The consumer has a marked preference for immediate consumption rather than to save say Rs. 1000/- and earn Rs. 200/- at the end of one year at a 20 per cent rate of interest.

For any commodity like a bicycle or a 12" T.V. which is now available at Rs. 1000/- may later not be available at Rs. 1200/- (200 earned interest at 20%) due to possible price increases or it may not be available at all due to import restrictions that may set in as a result of foreign exchange difficulties. The increased consumer satisfaction of 'early' ownership of a commodity also adds to this decision.

The Central Bank report of 1977 mentioned that interest rate policy was tuned to catching up with the market rates. However, in Sri Lanka where there is a substantial non-formal sector it is observed the rates of interest in that sector are far above the prevalent bank rates. There are host of money dealers both in Colombo and in the out-stations whose interest rates are enormously high in the non-formal market. The people with small balances are encouraged to lend them through intermediaries like the boutique keepers, money lenders or lawyers on a very short term basis; the shortest being a 12 hour loan for which earlier Rs. 10/- was charged on every Rs. 100/- and now the charge varies between Rs. 15/- and Rs. 20/-. The rate on this type of advance remains virtually the same up to about a maximum of 6 months. It is also observed that the lending period in the non-formal sector even stretches upto medium term on which about Rs. 25/- Rs. 35/- are levied for Rs. 100/-. It becomes evident in this context that lending, small amounts through the intermediaries in the non-formal sector is more attractive than depositing in banks. However, the risk element is high for new entrants in this category but it may be surmised that the total volume of funds involved are substantial.

Earlier in January 1977, the interest rate was increased by 2 per cent to 8½ per cent. It was further increased by 1½ per cent in August

of the same year to 10 percent. The National Savings Bank put up its rates upto 8.3 percent on savings and 12 percent on 6 months deposits.

The performance of the N.S.B. and the Commercial Banking sector both in the savings and the term deposits categories over the last 2 decades shows a close co-relation between the interest rates variation and the total deposit mobilisation. The interest rates in 1965 was a mere 5 percent which had subsequently been revised to reach 12 percent in 1980.

Year	1960	1965	1968	1970	1977	1980
Interest rate	4%	5%	5½%	6½%	8½%	12%

The N.S.B. deposits from about the year 1965 shows a gradual rise in their volume. The term deposits (fixed deposits) in the N.S.B. were practically non-existent before 1971. Since 1971 there had been a gradual build up of this category of deposit in the N.S.B. too. The total of term deposits as at the end of 1978 was Rs. 1,265.4 million.

In the commercial banking sector, the savings deposits show a more even growth pattern. Perhaps the significant development is that by December 1978 the volume of total savings in this sector had overtaken that of the N.S.B. which had hitherto maintained a certain "superiority" in savings deposit collection. In the year 1965 the total savings deposits in the commercial banking sector was Rs. 223.9 million; half of that of the N.S.B. (Rs. 513.7 million). In the commercial banking sector there had been a continuous rise in the total savings

TABLE 1

SAVINGS DEPOSITS

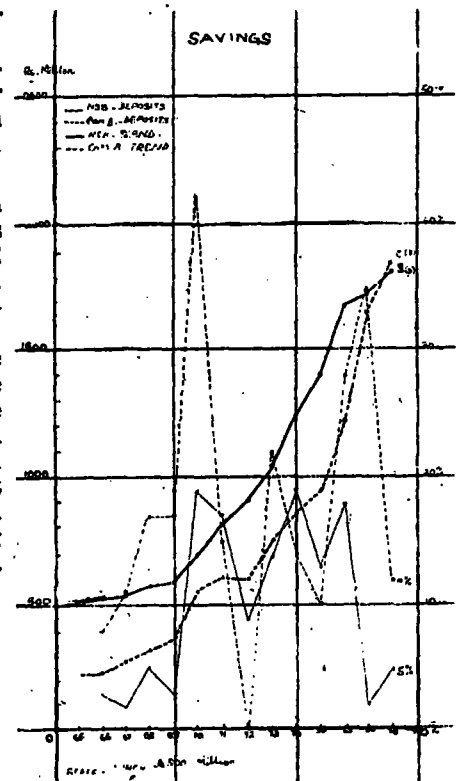
(Rupees Million)

NATIONAL SAVINGS BANK				COMMERCIAL BANKS			
Year	Deposits	Variations	Percentage	Deposits	Variation	Percentage	Total
1965	513.7	114.7	14.26	223.9	—	—	737.6
1966	529.6	15.9	3.10	243.7	19.8	8.84	773.3
1967	543.8	14.2	2.68	243.7	28.3	11.61	815.8
1968	573.5	29.7	5.46	319.9	47.9	17.61	983.4
1969	592.5	19.0	3.31	375.6	55.7	17.41	968.1
1970	707.2	114.7	19.36	534.8	159.2	42.39	1242.0
1971	831.7	124.5	17.6	615.0	80.2	15.00	1446.7
1972	913.0	81.3	9.78	610.6	4.40	.72	1523.6
1973	1043.2	130.2	14.26	749.6	139.0	22.76	1792.8
1974	1244.1	200.9	19.26	857.4	107.8	14.38	2101.5
1975	1413.7	169.6	13.63	947.4	90.0	10.57	2361.1
1976	1678.9	265.20	18.76	1216.1	268.70	28.36	2895.0
1977	1727.3	48.40	2.88	1645.1	429.00	35.28	3372.4
1978	1825.0	97.70	5.66	1846.0	200.90	12.21	3671.0

Source: Central Bank of Ceylon

deposit position, at a rate faster than that of the N.S.B. Term deposits in the commercial banking sector too show an increase in their volume. It was Rs. 3179.5 million as at end of 1978. (see tables 1 and 2).

However, the trend observed with the help of certain indicators in both the savings deposits and term deposits behaviour is not in conformity with the emerging picture shown in the total deposit position. The years 1970 and 1977 are significant in this context; in spite of the increase in rates the relative growth, which indicates the trend was negative. The savings trend in the N.S.B. shows a rise from about the year 1966; but between 1971 and 1973 this rise slows down, showing a small slump, and once again a



Above is a diagrammatic representation of the total savings, deposits and time deposits over the last two decades; in the commercial banking sector as well as with the NSB, (indicated through the thick dark line and the thick dotted line respectively). The thinner lines indicate the annual variation in growth in savings and time deposits, in the commercial banking sector and the NSB, from which the trend lines were projected and produced in the four diagrams on page 25.

TABLE 2.

FIXED DEPOSITS

(Rupees million)

NATIONAL SAVINGS BANK				COMMERCIAL BANKS			
Year	Deposits	Variations	Percentage	Deposits	Variation	Percentage	Total
1965	—	—	—	382.8	—	—	382.8
1966	—	—	—	358.9	23.9	6.24	358.9
1967	—	—	—	428.8	69.9	19.48	428.8
1968	0.1	—	—	506.3	77.5	18.07	506.4
1969	0.4	.3	300.	610.1	103.8	20.5	610.5
1970	0.5	.1	25.	633.7	23.6	3.87	634.2
1971	25.0	24.5	4900.	702.3	68.6	10.83	727.3
1972	53.2	28.2	112.8	914.4	212.1	30.2	967.6
1973	100.3	47.1	88.53	662.2	252.2	27.58	762.5
1974	167.6	67.3	67.1	803.4	141.2	21.32	971.0
1975	243.1	75.5	45.05	780.8	22.60	2.81	1023.9
1976	307.6	64.50	26.53	975.3	194.50	24.91	1282.9
1977	771.5	463.90	150.81	1796.4	821.10	45.71	2567.9
1978	1265.4	493.90	64.02	3179.5	1383.10	76.99	4444.9

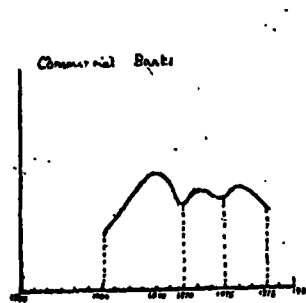
Source: Central Bank of Ceylon.

substantial rise in 1974 which was not continued in 1975 but re-emerged in 1976. From 1976 there is a fall in this trend. In the term deposits category, although the absolute total indicates a continuous growth, the trend takes an initial downward slope finally slumping by 1975 and then changing into a rising trend which reaches its highest point in 1977, from which year again there is a downward trend.

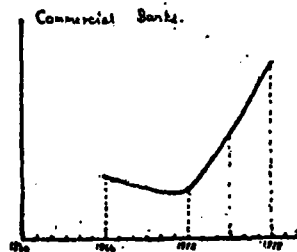
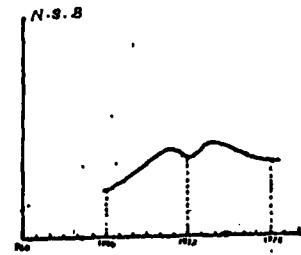
The observed trend in the commercial banking sector in the savings category is a fluctuating one; the first phase covering the year 1966-1970. From 1970 to about 1976 there is an uneven growth and from 1976 to 1978 savings show a downward trend. In the term deposit category of the commercial banks, however, a downward trend is seen upto the years 1972-75 and then from 1976 it shows a continuous upward turn.

Perhaps it is reasonable to conclude that in the context of a developing economy like that of Sri Lanka the efficiency of interest rates policy is limited. The annual report of the Central Bank commenting on the economy in 1979 gives the following example to backup this contention. The bank rate remained at 10 percent, as during the previous year. However, effective from 4th September, 1979, a progressively increasing graduated scale of penal rates ranging between 15 and 25 percent was introduced in order to discourage commercial banks from resorting to excessive Central Bank credit.

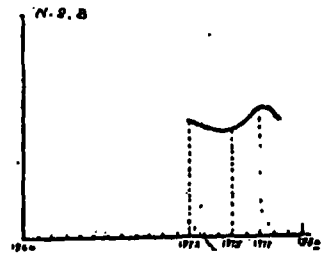
The fairly high penal rates did not directly affect the deposit and lending rates of commercial banks, but pushed up the inter-bank call loan rate from the previous levels of 7 and 9½ percent to a level between 10 and 13½ percent. Analyzed in the context of fairly heavy borrowing by banks, especially the major banks at high penal rates, this would indicate a relatively high insensitivity of major banks to current interest costs. It is undoubtedly a very useful instrument in mobilising savings deposits but perhaps other structural and administrative measures should be used simultaneously as a package to enhance its efficiency. Savings in Sri Lanka invariably is tied up with the "piggy bank" idea. In the absence of a developed money market, mobilisation of medium and large scale deposits has become rather difficult. In fact sources of potential medium and large scale deposits have yet to be



#### SAVINGS DEPOSITS



#### TERM DEPOSITS



clearly identified and measures devised to mobilise them. The savings funds, unit trusts, or building societies are some of the other sources of savings available in more developed market economies. (Since writing of this note, the Central Bank announced its scheme of issuing Bearer Bonds in Rs. 5,000/- denominations).

#### CREDIT CREATION

The interest rates changes, particularly the upward movements, have a greater bearing on the credit creation aspect of the economy. This is true particularly of a developed economy where the proportion of liquid money is less than that of "bank money". Every time the bank rates increase, credit tends to become expensive. This also has a salutary effect on the rate of inflation itself as the commercial banking sector naturally pushes its lending rates to match the bank rate. On the other hand a high interest rates policy results in a quantitative limitation in credit unless the demand for credit is matched by a similar savings mobilisation effort, because under high rates of interest the sources of re-finance available to banks would be either limited or expensive particularly in the context of developing countries where capital shortages are acute. The purpose of increasing the bank rate and thereby pushing up the interest rate levels is to limit credit expansion in the banking sector as a counter measure against inflation. However,

the efficiency of this instrument in regulating the supply of credit will depend on the total coverage of the banking system as of the economy. In Sri Lanka, in the non-formal sector, where financing is done mostly by non-institutional sources, credit is bound to be more expensive as the lending rates in this sector are much above the commercial bank rates.

Perhaps another effect of a rise in interest rates would be a dampening of the private entrepreneurship which is undoubtedly counter-productive in an economy like that of ours. As interest rates shoot up private individuals show a preference towards "indirect investment" in finance houses or banks to that of a direct entrepreneurial undertaking which carried a certain amount of risk and perhaps a lower rate of return per unit of capital.

For instance, a person with Rs. 100,000/- could earn a minimum of Rs. 20,000/- per annum by investing it in a bank, without having to face all types of organisational difficulties and risks if he had made a "direct investment".

A high interest rate on the whole discourages investment as much as it acts as a counter inflationary measure. In most parts of the world, including the United States where the interest rates have shot up tremendously, there is a growing feeling that recession is at hand. At least a few business houses in the West faced difficulties due to high cost in lending

*Continued on Page 27*