

BB Working Paper Series: WP No. 1616

**Examining the Need for an Adjustment of the Bank Rate
and Other Policy Rates in Bangladesh**

**Md. Bayazid Sarker
Md. Shamim Mondal**



Bangladesh Bank

November 2016

Examining the Need for an Adjustment of the Bank Rate and Other Policy Rates in Bangladesh.

Md. Bayazid Sarker
Md. Shamim Mondal

Abstract

In common practice, central banks routinely monitor the signaling efficiency of its bank rate and other policy rates based on the macroeconomic situation and financial market movements. In the financial markets of Bangladesh, interest rates experienced a downward trend since 2012. Considering the market demand and supply, Bangladesh Bank has lowered its repo and reverse repo rates two times after 2012. However, the bank rate has not been revised yet. This paper argues for an in-depth study to assess what bank rate would be optimal for the economy. This work believes that a downward revision seems appropriate since inflation has dropped and other policy rates have fallen as well. It also believes that the credit market waits for lowering all policy rates including the bank rate, base rates and quasi-base rates (saving certificate rate) to improve effectiveness of the policy tools and overall market situation as long as inflation is on downturn.

JEL Classification: E43, E52

Keywords: Bank rate, central bank discount rate, monetary policy tools

The authors are Joint Director, Chief Economist's Unit and Deputy Director, Monetary Policy Department, Bangladesh Bank respectively. Views expressed in this paper are authors' own and not necessarily that of Bangladesh Bank. The authors are thankful to Biru Paksha Paul and Akhtaruzzaman for their valuable comments and suggestions that helped to improve the earlier versions of this work. Contact email: bayazid.sarker@bb.org.bd, or shamim.mondal@bb.org.bd.

1. Introduction

The bank rate is widely known as central bank lending rate to the commercial banks. It is also called as central bank discount rate. In recent practice, central bank of Bangladesh (BB) frequently uses the *repo rate* as an important policy rate to control money supply. Though bank rate is used less frequently it has a significant influence on central bank's role as a lender of last resort (LOLR) and it also plays an important role as a base rate (benchmark) for other market players and investors. Even refinance scheme usually practices of bank rate plus service charges method. Therefore, central bank routinely monitors the signaling efficiency of its bank rate in respect of macroeconomic situation and financial market movement.

Normally, current macroeconomic conditions in general and current credit market developments in particular dictate any central bank to adjust the present bank rate. In present context of Bangladesh, the credit market demands for lowering all policy rates, base rates and quasi-base rates (*the saving certificate rates*) to bring back its vibrancy. Though the bank rate has very limited use as a monetary policy instrument in Bangladesh it has an indirect but significance role in fixing policy rates and base rates for overall credit disbursement and other investments. The objective of the paper is to assess the present bank rate in line with ongoing credit market conditions as well as macroeconomic situation.

2. Literature Review

We have surveyed studies related to rationales behind the central bank's policy rates adjustment in different country cases. Singh (2011) found significant contemporaneous pass-through under deficit liquidity conditions as well as significant lagged effects in India. The study used a VAR model from March 2001 to June 2012 to estimate pass-through from the policy rate to a variety of short and long term market interest rates. A drawback of this method is that, while it estimates the effect of changes in the policy rate on other interest rates, it does not give a clear sense of the speed of transmission, which is a factor that policy makers must consider when making policy rate decisions.

Mohanty (2012) used interest rate channel, studying policy rate changes through to their effects on output and inflation. Estimating a quarterly structural VAR model, it found that policy rate increases have a negative effect on output growth with a lag of two quarters and a moderating impact on inflation with a lag of three quarters, with both effects persisting for eight to ten quarters.

Morales and Raei (2013), found a role of interest rate and exchange rate in channels in monetary policy transmission in East African Community (EAC) countries. They noted that deposit rates are more responsive to changes in discount rate in across all EAC countries in the short run. Moreover leading rate, the contemporaneous pass through of both discount and Treasury bill rate is significant only for Kenya and Tanzania.

Karagiannis et al, (2010) suggests that Money Market (MM) rate compared to the Central Bank (CB) rate is more effective as a policy vehicle variable in the Euro Zone. They used monthly data from the USA and Euro and found that not all of the change in the policy rate is transmitted to the loan rates. Their findings in the USA analysis were that CB rate increases and decreases are both transmitted to the deposit and loan rates and that MM rate is not transmitted to the retail rates which probably show that the MM does not work effectively as a policy vehicle variable in the USA.

Cheong and Boodoo, (2008) in their paper on the monetary transmission mechanism: A closer look at the interest rate channel in Trinidad and Tobago used impulse response function (IRF) and the variance decomposition of the VAR model. The authors used the analysis to provide an idea of the strength of interest rate transmission and also the time it takes on interest rate policy on target variables. The aim of the study was to determine the relative importance of the repo rate in explanation of market interest rates, the importance of interest rates on credit and finally, the

importance of credit in the explanation of movements in inflation and income. Consistent with the IRF, the variance decomposition suggest that there was weak pass through from interbank rate and Treasury bill rate to prime lending rate and that there was no strong relationship and pass through effects among the variables, particularly between short term interest rates and lending rates. The results also shows that the model suggest high liquidity in financial systems was one of the reasons for incomplete repo pass through.

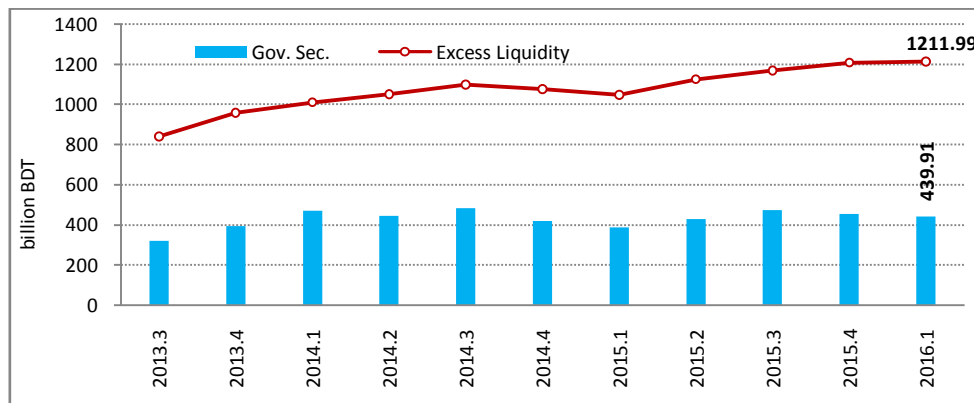
However, no study found that discusses the adjustment of bank rate in line with other policy rates, are commonly used as money market policy tools. The proposed study on Bangladesh case in fact, may help to understanding the effective use of monetary policy tools especially for developing economies.

3. Analysis

3.1 Policy rates and market rates in Bangladesh

The recent liquidity glut lessened the fund demand transmitted into all types of instruments. Liquidity in the banking system is gradually increasing over time. At the end of March 2016, excess liquidity rose to BDT 1212 billion after maintaining their required figure.

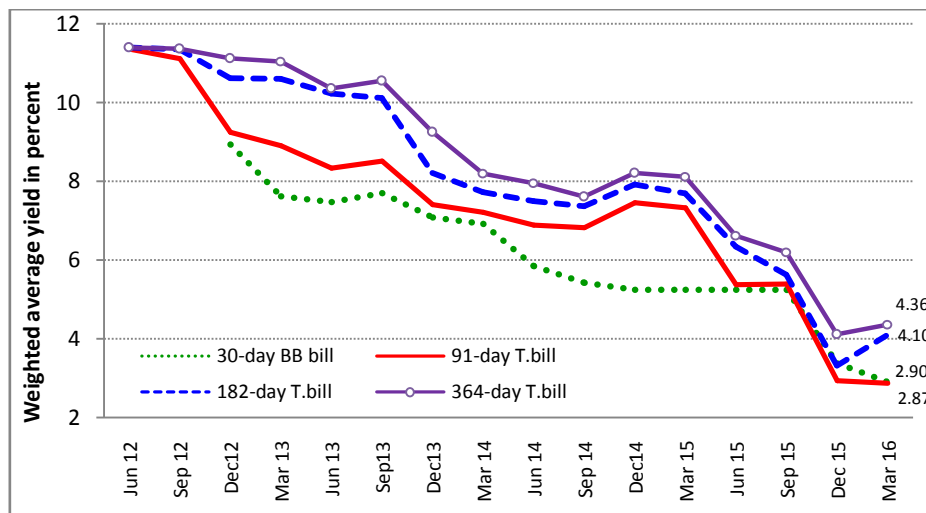
Figure 1: Excess Liquidity



Source: Major Economic Indicators, Monetary Policy Department, Bangladesh Bank, June 2016

With this excess liquidity banks invest in government securities especially in Treasury bills & bonds. Because of huge excess liquidity market interest rate was expected to fall sharply. However, market fails to response at expected level as rates were directly and indirectly sticky with base rates (*the bank rate*), quasi base rate (*the saving certificate rates*) and policy rates like the repo rate (Sarker, 2016). When saving certificate rate adjusted downward in May 2015, market interest rates started to fall despite the downward rigidity problem in the banks' credit operation. Bangladesh Bank bill rates, government bill rates and even the market fund rates fall below the bank rate. If central bank expect a true market responsive interest rate, it needs to revise it policy rates i.e., the repo rate, the reverse repo rate and even the bank rate. (See figure-1 and 2)

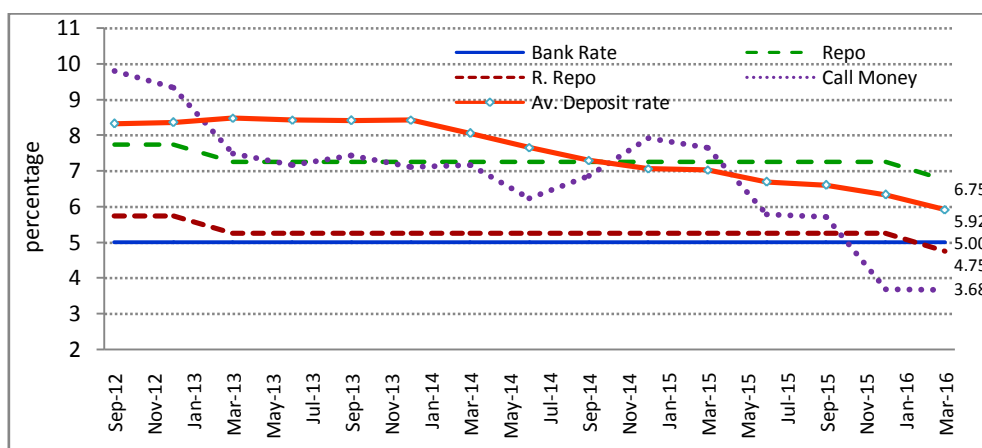
Figure 2: Yield on Bangladesh Bank Bill and Treasury Bills



Source: Major Economic Indicators, Monetary Policy Department, Bangladesh Bank, June 2016

At the end of March 2016, 91-Day Government Treasury bill rate declined to 2.87. If it is annualized, the rate would be 2.90 percent. Even 364-Day bill rate was 4.5 percent. These rates were much lower in last couple of treasury auctions in March 2016. Even 30-Day Bangladesh Bank bill touched 2.60 percent in the auction on March 03, 2016. Simultaneously, call money rate has also fallen to 3.68 percent on average at the end of March 2016 and even lowest rate was 1.00 percent, far below the bank rate. In January 2016, Bangladesh Bank revised the repo rate and the reverse repo rate to 6.75 and 4.75 percent respectively, were 50 basis points lower than the previous. Prior to this revision, market rate of bank deposit was about 350 basis points higher and call money rate was about 500 basis points higher than the bank rate. Due to downward motion of all rates, market rate of bank deposit fell to 5.92 percent at the end of March 2016. At the same time, the call money rate fell down to 3.68 percent, was also below the bank rate. (See Figure-3)

Figure 3: Policy Rates and Call Money Rate in Bangladesh



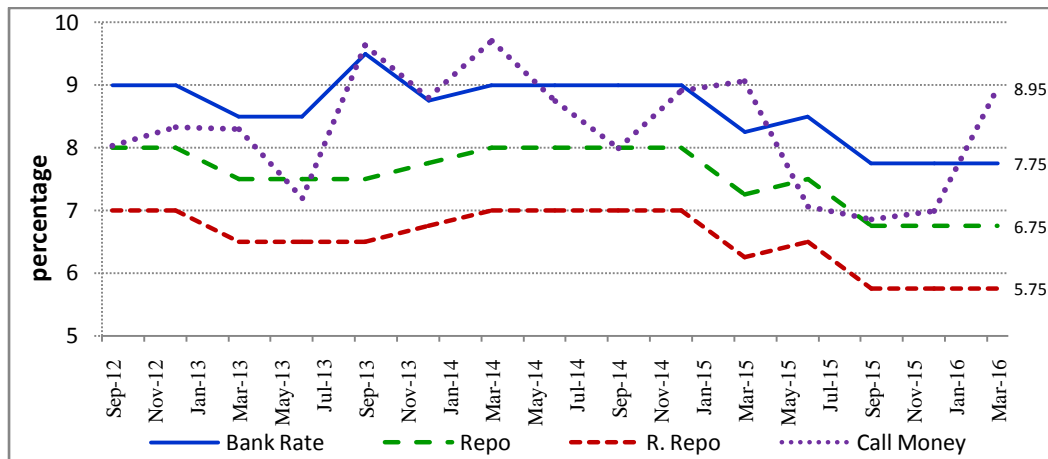
Source: Economic Trend, Bangladesh Bank, June 2016.

3.2 Policy Rates and Market Rates in Other Economies

In India, bank rate is aligned with marginal standing facility (MSF), which is commonly practiced only for banking companies. Reserve Bank of India (RBI) also keeps bank rate higher than other policy rate as they use as reference rate to penalize banks for some regulatory failures. However, RBI usually changes the bank rate in alignment with other policy rates, the repo rate and the reverse repo rate changes. In recent years, RBI revised their policy rates planning to push their excess

liquidity towards investment. During March 2014 to March 2016, RBI revised its bank rate, the repo rate, and the reverse repo rate three times and the changes were downward proportionately (See figure-4).

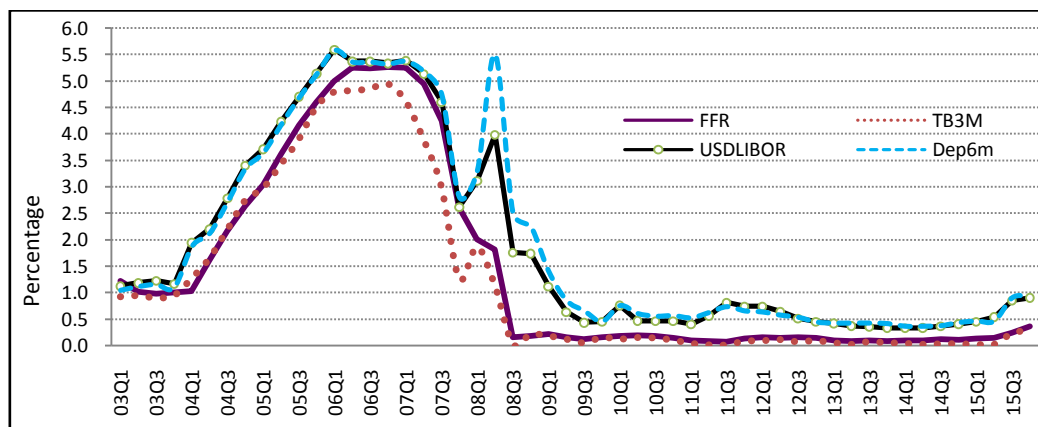
Figure-4: Policy Rates and Call Money Rate in India



Source: Database on Indian economy, Reserve Bank of India, 2016.

The USA discontinued their formal Fed discount rate in 2002 and shifted into indirect regulation by fixing upper & lower bound targeting, was 25 basis points for both targets. Considering this method *Effective Fed Funds Rate* (EFFR) can represent the bank rate, which other central banks follow. In the USA, EFFR is positively correlated with 3-Month Treasury bill rate, the government securities. The EFFR is also positively correlated with bank led market rates like 6-Month Deposit rate and 6-Month USD LIBOR rate. These market rates are mostly higher than the EFFR and traditionally these rates move almost unidirectional. After global financial crisis, these rates move more closely and EFFR is kept below the market fund rates (See figure-5).

Figure-5: Movements of Fed Funds Rate, 3M Treasury Bill Rate, 6M Deposit Rate and 6M USD LIBOR Rate



Source: Federal Reserve Economic Data, 2016

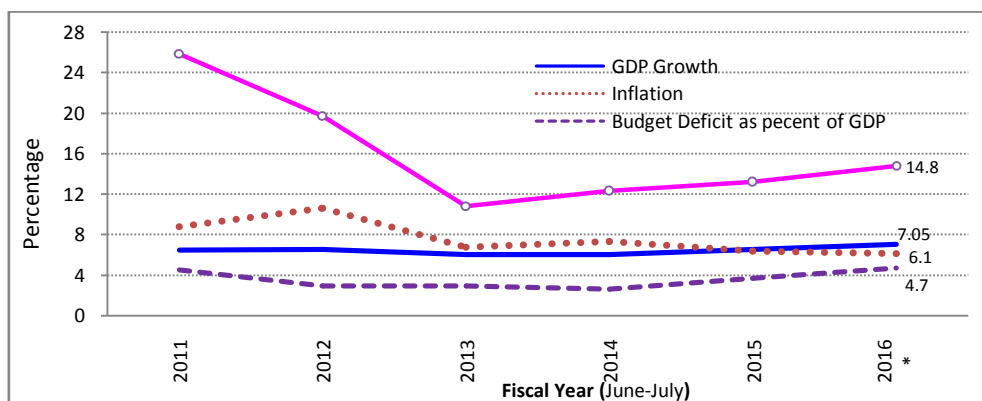
Considering those experiences from both developed and developing economies, bank rate is mostly used as an effective money market tools. Thus, the bank rate is adjusted to keep control over money market, is a common practice. Nowhere, it is static for a long time span like Bangladesh.

3.3 Macroeconomic Situation

Bangladesh economy is growing above 6 percent rates after 2010 with less volatile variation. It maintains single digit inflation rate on average during the same period and it comes close to lower single digit which was 6.1 percent at the end of March 2016. Budget deficit maintained below 5% of GDP over the decade. At the same period, current account balance of BOP was almost positive which contributed to stable local currency value. Though real, monetary, fiscal and balance of payment

position are still in positive trends, private sector credit and private investment are in a bit stagnant position that ultimately has an impact in slower economic activities. However, market responsive rate can surely boost up the domestic investment situation. Lowering the existing bank rate and repo rate can bring back the market responsive interest rate in achieving expected investment as a source of higher growth target (See figure-6).

Figure 6: Movement of Major Macroeconomic Variables in Bangladesh



* Provisional/projected

Source: BBS, 2016 and Bangladesh Bank, 2016.

4. Recommendations

In fact, the *repo rate* is widely used instead of the bank rate with a broader sense to make the banking industry more responsive to deal with market rate rather facilitative rate (the bank rate). In recent banking practice, the bank rate is used in central bank's role as a lender of last resort. However, the bank rate is used as a base rate to fixing the other central bank policy rates like the repo and the reverse repo rate. On the other hand, Bangladesh Bank is expecting to reduce the market lending rate. Though market bears excess supply of loanable fund, market lending rate is not reducing as expected to. This credit market demand-supply mismatch is originated from three points:

- i. Downward rigidity in operative cost adjustment by the banking industry
- ii. The *Quasi base rate*, the Sanchay patra rate is still seems higher
- iii. The base rate i.e., the bank rate and central bank's other policy rates are still higher than the market fund rates.

If excess liquidity persists for more than 3 years, it will bring the ultimate downward fund rates very close to the bank rate, is already seen in the market. In case of second cause, when government revised the Sanchay patra rate in May 2015, the market interest rate started lowering than the expectation. In January 2016, Bangladesh Bank has reduced the repo rate to 6.75 from 7.25 percent but it is not enough when call money rate and Treasury bill rates came down to below 3 percent.

5. Conclusion

Ideally no other rate should be offered below the bank rate or central bank discount rate. Only very few short term government securities can be offered very close to the bank rate. From the above analysis, Bangladesh Bank may revise its bank rate, repo rate, reverse repo rate and special repo rate insisting on market responsive interest rate. The present market situation also demands for a downward adjustment of the bank rate. Repo, reverse repo and special repo rates should be reduced proportionately. The proposed downward adjustment can develop a market responsive interest rate. It will help to make credit market more vibrant and ultimate increase of private investment will boost up higher economic growth. If expected situation does not prevail, central bank policy tools may not work effectively. In fact, present policy rates are not functioning well as a policy tools to regulate the money market or credit market in Bangladesh. Therefore, Bangladesh Bank can adjust its bank rate in alignment with other policy rates.

References:

- Bangladesh Bank, 2016a. *Monthly economic trend*, Statistics Department, Bangladesh Bank, July 2016.
- Bangladesh Bank, 2016b. *Major economic indicators*, Monetary policy Department, Bangladesh Bank, July 2016.
- Bangladesh Bank, 2016c. *Monetary policy statement*, Monetary policy Department, Bangladesh Bank, 2011-2016.
- Bangladesh Bank, 2016d. *Schedule bank statistics*, Statistics Department, Bangladesh Bank, Jan-March 2016.
- BBS, 2016. *National Accounts Statistics 2015-2016P*. Bangladesh Bureau of Statistics.
- Cheong, D., and Boodoo, E. 2008. "The Monetary Transmission Mechanism: A closer look at the Interest Rate Channel in Trinidad and Tobago," Research and Policy Department, Central Bank of Trinidad and Tobago, July 2008.
- FRB 2016. *Federal reserve economic data*, Federal Reserve Bank, Louisiana, USA, May 2016. Retrieved on May 25, 2016 from <https://www.quandl.com/data/FRED/>
- Golaka, C. N and Aparna, R. N. 2012. Indian money market dynamics. Retrieved on June 02, 2016 from <http://ssrn.com/abstract=262253>.
- IMF, 2015. *International Financial Statistics. May 2015*. International Monetary Fund. Washington D.C.
- Mohanty, Deepak, 2012. "Evidence of Interest Rate Channel of Monetary Policy Transmission in India," Reserve Bank of India, *Working Paper No 6*. May 2012.
- Morales, A. R., & Raei, F., 2013. Evolving Role of Interest Rate and Exchange Rate Channel in Monetary Transmission in EAC Countries. *IMF Working Paper WP/13/X*
- RBI, 2016. *Database of Indian economy*, Reserve Bank of India, India, September 2016. Retrieved on September 18, 2016 from <http://dbie.rbi.org.in/DBIE/dbie.rbi?site=home>
- Sarker, M. B., 2016. "Is private foreign borrowing worsening the credit market imperfection in Bangladesh?" *A draft working paper of Bangladesh Bank*, May 2016.
- Singh, B., 2011. "How Asymmetric is the Monetary Policy Transmission to Financial Markets in India?" Reserve Bank of India, Occasional Papers, Vol.32/2.