Bank Interest Rate Reduction and its Impact on Channelling of Funds in Sri Lanka

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This study examines how far the recent bank interest rate reduction is consistent with the financial market reforms carried out from 1977 onwards, and whether its expected results have been achieved. Prior to reforms, a policy of administered rate of interest was followed, but, high inflation in this era made real interest rates negative, creating a shallow financial market, channeling even the meager funds to sub-optimal projects in the public sector at the cost of the optimal projects elsewhere. This was identified as a cause for economic stagnation prior to 1977. But with the financial reforms, bank rates were increased to make real interest rates positive to have a deeper financial market to channel more funds to the optimal projects. However, until the recent past high inflation in the economy forced to keep nominal interest rates higher for maintaining positive rates of real interest to attract more funds to banks. This, however, generated a huge discontent among investors complaining that cost of funds was unbearable. Consequently, the Central Bank has substantially reduced bank rates starting from 2007 onwards. Although this reduction made savers unhappy, it was expected that it would be welcome by investors. However, since these changes are not yet researched, this study, based on the McKinnon-Shaw Hypothesis of financial reforms and carrying out a survey of a selected bank customers, examined to what extent investors have responded to interest rate reduction. Accordingly, it found that although the recent bank interest rates reduction is not contrary to the financial reforms so far carried out, bank lending, irrespective of investors long agitation for such a reduction, has only moderately increased.

Keywords: Financial Reforms; Inflation; McKinnon-Shaw Hypothesis; Real Interest Rates; Funds Channeling