

Financial Institutions and Market: Does borrowing from local banking system to finance deficit budget badly affect the economy?¹

The finance minister has presented budget for FY 2011-12. An important element of this budget is the size of the budget deficit which is estimated to be Tk. 45,204 crores or 5% of GDP. Domestic borrowing from commercial banks is estimated to be Tk. 18,957 crores approximately 42% of the total deficit. Many economists have expressed concerns about the government's reliance on the banking system to finance budget deficit. These concerns are predicated on the following presumptions-

- (A) Government borrowing fuels inflation
- (B) It raises interest rate and thus adds to the cost of business
- (C) It crowds out credit to the private sector.

Budget deficit

In the FY 2010-11, the actual budget deficit was Tk. 34,51 of which collection from the local banking system was estimated to be Tk. 15,680 crores. In the fiscal year 2009-10, the budget deficit was Tk. 27,297 crores of which local banking system provided Tk. 16,755 crores. On the other hand, actual deficit for FY 2008-09 was Tk.21,843 crores of which domestic borrowings from the banking system was tk.13,793 crores. Deficit budget was also the common practice in the FY 2007-08 and 2006-07 when the budget deficit was tk.25,581 and 14,690 crores respectively. Collection from the local banking system was Tk. 7253 and Tk. 5434 crores respectively.

Inflation

It is observed that in several years government borrowing from the banking system moved in the opposite direction of inflation i.e. lower level of borrowing as per cent of GDP was followed by higher level of inflation or and the vice-versa. The causes of inflation in Bangladesh seem to lie elsewhere. Perhaps the two most important causes are domestic

¹ This case was prepared by Dr. Md. Dulal Miah solely for the purpose of classroom use. It does not intend to justify in favor of or against the monetary policy of Bangladesh.

production of food-grains (with food price weight being well above 50% in consumer price inflation) and the international price level which influences consumer prices directly and also causes cost-push inflation through impact on the prices of raw materials and intermediate goods.

Table 1: Scenario of GDP

	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10
GDP at current market price (in billion tk.)	3005.8	3329.6	3707.1	4157.3	4724.8	5458.2	6148.0	6923.8
Growth (1996=100)	5.3%	6.3%	5.9%	6.6%	6.4%	6.2%	5.7%	5.8%

Interest rate

In this case, there have been even more cases of movements in the opposite direction. Of the ten year-to-year changes, there were some years in which government borrowing from the banking system fell, but interest rates rose. The financial market in Bangladesh is by no means competitive. The commercial banks, particularly the private banks, determine lending rate through a cartel type of arrangement, leading to considerable rigidity in the interest rate structure. Government borrowing appears to exert practically no influence on the determination of interest rates.

Table 2: CPI Inflation (in %)

	FY06	FY07	FY08	FY09	FY10
General (12-month point to point)	60.13	11.59	6.03	8.51	8.70

Table 3: Interest rate developments (in %)

	FY06	FY07	FY08	FY09	FY10
T-bills 91-day	7.52	7.63	7.91	2.3	2.42
SOBs	10.84	10.88	8.92	8.51	8.67
PCBs	14.07	13.89	13.61	12.43	12.18
FCBs	12.89	13.88	14.58	13.07	12.38

Crowding out

The issue of crowding out can be interpreted in two different ways. One interpretation would be that higher growth of borrowing by the government would cause a fall in the growth of credit to the private sector. The implicit assumption is one of a zero sum game on the supply side and ignores demand side of the picture. Based on data of a sizable number of years, it is observed that growth rate of credit to the private sector rose throughout. The crowding out hypothesis in the sense noted above, therefore, does not hold.

Table 4: Trends in private sector credit (in Billion Taka)

	FY 04	FY05	FY06	FY07	FY08	FY09	FY10
Bank	946.4	1107.4	1309.7	1507.7	1901.0	2159.1	2707.6
Non-Bank	40.2	51.5	63.0	76.6	94.7	119.2	147.4
MFIs	53	62.5	81.3	101.3	121.5	125.9	149.61

Another interpretation of crowding out could be that government borrowing prevents the banks from meeting the credit needs of the private sector. The "need" is not easy to define. However, it is observed from data that in every single year credit growth to the private sector well exceeded the growth of GDP at current market prices. It can, therefore, be inferred that legitimate needs of the private sector were adequately met.

In conclusion, it can be stated that the alleged ill effects of government borrowing from the banking system cannot be statistically substantiated in Bangladesh. That does not mean that the government should resort to unbridled borrowing. The trade-offs involved need to be closely monitored and carefully assessed.

Questions:

- (A) What are the sectors that supply money in the economy?
- (B) How does fiscal budget affect the money supply?
- (C) "Government borrowing fuels inflation" how far this statement is true in terms of Bangladesh?
- (D) "Deficit budget raise interest rate" is it true for Bangladesh? Justify your answer with sufficient data
- (E) "If budget deficit is financed from the local financial systems, it crowds out the private borrowers" Do you support this statement? If so, justify your position; if not why?