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Effect of Interest Rates on Economic Growth in Bangladesh

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Abstract

The interest rate is the amount of interest paid by a borrower to a lender and is set by the central bank of a certain country. Interest rate is regarded as a key variable affecting savings and investment. The interest rate which is set by the central bank is called the base rate. The base rate affects the aggregate output. Thus, the study examined the effect of interest rates on economic growth in Bangladesh. The study did a literature review to have an overview of what others found regarding the effect of interest rates on economic growth. Based on the findings of the study, it was revealed that interest rates affect economic growth. The reduction of interest rates increases economic growth. If the interest rate is good, it keeps output growth high. The study discovered that low rates of interest help the economy grow since people can get more money to make purchases and invests in businesses, thus spurring economic growth. Access to loans from financial institutions depends on interest rates. A country cannot grow if the cost of borrowing is very high and this is significantly influenced by the interest rates. The study also noted that when the base rate increase, the interest rates from the financial institution also increases. Hence, interest rates affect the economic growth in Bangladesh. High rates tend to reduce the pace of economic development. The research concluded that interest rates should be made at a reasonable rate to spur economic growth. The study recommended that the central bank in Bangladesh, Bangladesh Bank, should develop policies and frameworks that will ensure the interest rates are key as low as possible. The government needs to embrace policies that will aid Bangladesh control interest rates and raise money circulation in the economy.

Keywords: *Interest Rates, Economic Growth, Bangladesh*

1.0 Introduction

The interest rate is regarded as a key variable affecting savings and investment (Brand, Bielecki & Penalver, 2018). It is typically noted that the interest rate usually has a crucial effect on a nation's saving and investment. The interest rate is defined as the cost of borrowing or gain on lending. Usually, an increase in the rates of interest urges individuals to save more. Nevertheless, a rise in the interest rate additionally elevates the cost of capital, causing a decrease in investment in a particular nation. When interest rates are increasing, both companies and consumers will cut down on spending (Blanchard, 2019). This will certainly lead to dropping of earnings and stock prices to fall. When interest rates have actually dropped, consumers and companies will raise spending, leading to increase in stock prices. Low rates of interest have a tendency to help the economy grow since people can get more money to make purchases and businesses may get more capital to widen their operations. High rates tend to reduce the pace of economic development.

Increasing interest rate is a significant concern in Bangladesh over the last few years. The prices of key products have risen; continuous fall of the stock market and so is the cost of living. The nation's high number of poor and jobless residents is going through tough economic time to survive. Interest rate is the amount of interest paid by a borrower to a lender and is set by the Central Bank of a certain country (Ferrari, Masetti & Ren, 2018). In general, as interest rates are decreased, many people are able to borrow more funds. The outcome is that people have more funds to invest or spend, triggering the economy to grow and inflation to increase. As interest rates are increased, consumers have a tendency to have much less cash to invest or spend. With less spending and investing, the economy slows and inflation reduces.

According to Palley (2019) low interest rates make it less expensive to borrow. In turn it encourages spending and investment. This brings about higher aggregate demand (AD) and economic growth. This rise in AD can also trigger inflationary incidents. It may also; minimize the incentive to save that motivates consumers to spend as opposed to keeping money. Low interest rates make the cost of borrowing more affordable. It will motivate consumers and businesses to obtain loans to fund higher spending and investment. A decrease in rate of interest will certainly lower the monthly cost of house mortgage repayments. These will leave people with more disposable income and will lead to increase in consumer spending. Low interest rates make it more appealing to acquire assets like housing which tends to raise asset price (Miles & Monro, 2021). If the Bangladesh Bank decreases rate of interest, it makes it reasonably less attractive to save money in Bangladesh due to the fact that one can obtain a better rate of return in another nation. Hence there will be less demand for the BDT leading to a reduction in its value which will make exports more competitive and imports more costly for Bangladesh.

In Bangladesh rates of interest are set by the Bangladesh Bank (BB) (Ahamed, 2021). This is referred to as the base rate. If BB is concerned that rising cost of living is most likely to increase, then they can decide to raise interest rates to lower demand and slow down the rate of economic development. Individuals who already have loans will have less disposable income since they spend more on interest payments. Hence various other sectors of consumption will reduce. Interest payments on variable mortgages will certainly rise. These will have a high effect on consumer spending. High interest rate makes it much more attractive to save in bank due to the interest obtained (Eggertsson, Juelsrud, Summers & Wold, 2019). Higher interest rate raise the value BDT which makes exports less competitive and helps to lower exports and rise imports. This has the impact of lowering aggregate demand in the country. Increasing interest rates influences both consumers and companies. For that reason the country is most likely to experience reductions in consumption and investment. Higher interest rates raise the cost of government interest payments. This can bring about higher taxes in the future. Interest rates have an impact on consumer and company confidence. Sharpe and Suarez (2021) reported that an increase in interest rates prevents investment; it makes companies and consumers less willing to venture in high risky investments and purchases. Hence, higher interest rates will often tend to lower consumer spending and investment. This will result in a reduction in AD.

The interest rate which is set by the central bank called base rate have effect on aggregate output (Williamson, 2018). If interest rate is good it keeps output growth high. Subsequently, low interest rate decreases output growth in many instances by creating economic recession. Joblessness and the rate of interest are typically inversely associated. Implying that when unemployment is high the Central Bank usually decides to maintain interest rates low, hence people will find the accessibility of low-interest funds as an incentive to invest in businesses, therefore rising the number of available jobs and reduce joblessness. On the other hand, when the joblessness rate is low, the Central Bank might move to raise interest rates to prevent inflation (Sartipi, 2021). Changes in interest rates may reflect the fundamental scenario of the operation of macro economy; it additionally impacts all the macroeconomic variables like GDP, price level, the level of employment, global balance of payments, the rate of economic development, and so on. It is obvious that the interest rate is a key economic variable which plays a crucial role in both macro and micro economy of a country (Mayer & Schnabl, 2021).

2.0 Literature Review

Mohsen, Sadat and Haidery (2021) noted that interest rates affect economic growth. The reduction of interest rates increases economic growth. Low rates of interest help the economy grow since people can get more money to make purchases and invests in businesses, thus spurring economic growth. A country cannot grow if the cost of borrowing is very high and this is significantly influenced by the interest rates. The study also noted that when the base rate increase, the interest rates from the financial institution also increases. High rates tend to reduce the pace of economic development. When unemployment is high the Central Bank usually decides to maintain interest rates low, hence people will find the accessibility of low-interest funds as an incentive to invest in businesses, therefore rising the number of available jobs and reducing joblessness. When the joblessness rate is low, the Central Bank might move to raise interest rates to prevent inflation. The reduction of interest rates is key to increasing businesses and this positively increases economic growth. The research concluded that interest rates should be made at a reasonable rate to spur economic growth. The interest rate is an essential component of saving and investment. A small change in interest rate can have a big effect on consumers and works as a stimulant of economic development and execution of economic policies of the government

According to Brand, Bielecki and Penalver (2018) saving and investment are some of the vital tools for economic development. The rate of interest has constantly been regarded as an essential factor of saving and investment. Furthermore, as per Islamic teachings, income from rate of interest on saving or investment is illegal, and therefore, most Muslims attempt to avoid gaining income from the rates of interest. Thus, the goal of the research is to evaluate the impacts of this spiritual guideline on the financial decisions of an Islamic nation's and its influence on saving and investment. We used the random impact and system generalized technique of moments design differently to data of 20 non-Islamic and 20 Islamic nations through 2008 - 2015. The findings recommend that individuals in Islamic nations are not related regarding the rate of interest on saving, however in non-Islamic nations, the interest rate, per capita income, and rising cost of living have considerable positive effects, and nationwide expenditure has a substantial unfavorable effect on saving. Nevertheless, in Islamic nations, remittances obtained and nationwide expenditure has adverse considerable effects, and per capita income has a positive substantial effect on saving. In the scenario of investment, rate of interest and inflation reveal an adverse impact on investment while trade influences investment favorably in Islamic and non-Islamic nations. Additionally, domestic credit given by financial institutions has a negative substantial impact on investment in non-Islamic nations, while in Islamic nations; compensations reveal a favorable substantial influence on investment. The governments and policy makers of Islamic nations must not copy the financial measures of non-Islamic nations since spiritual aspects play an essential duty in the rates of interest-saving association. Rather, they need to enhance per capita income by increasing employment problems and by decreasing compensations obtained and national expense. Plans on saving should not enable gaining interest. Moreover, to raise investment, efforts need to be made to decrease the rates of interest and inflation, and to improve remittances obtained and trade. These policies will rise saving and investment in Islamic nations, inevitably leading to increased economic growth.

Kholodilin and Netšunajev (2019) examined the role of the interest and exchange rates in maintaining economic development which has been a largely studied topic. As a result, the research investigates the impact of the monetary policy rates of interest, the real exchange rate and business environment in the Euro region on the economic development in Italy. For that reason, we have used a pre-test for structural breaks to discover the presence of structural breaks, adhered by the traditional unit root examinations and the unit root examinations with structural breaks to notify the stationarity of the variables. The outcomes of the Bound cointegration examination brought about the autoregressive dispersed lag short-term design which evaluates the short-term effect of the rates of interest, exchange rate and the business environment in the Euro region on the economic development of Italy. The results reveal that in the short-term, the economic development is adversely affected by the rates of interest, and favorably by the exchange rate. It is additionally suggested that business environment in the Euro region has combined impacts on the economic development. Lastly, taking into consideration the expanding connection between the inner and outside (European) business environment, the outcomes are very substantial for taking care of the interest and exchange rate in sustaining economic development.

Hoang, Thi and Minh (2020) conducted research is to investigate the influence of rates of interest on economic growth in Vietnam through 2000 to 2015. The study findings indicated that access to loans from financial institutions depends on interest rates. A country cannot grow if the cost of borrowing is very high and this is significantly influenced by the interest rates. The study also

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noted that when the base rate increase, the interest rates from the financial institution also increases. High rates tend to reduce the pace of economic development. The empirical proof suggests that there is no short-term relationship between the development of the Vietnam economy and rate of interest but there is a long term association that ranges from actual rate of interest and actual exchange rate to GDP. According to the results, the study advises government through the Ministry of Finance and Economic Affairs to wisely take care of the Vietnam's budget by preventing unnecessary expenditures which may lead to budget deficits. These budget deficits are essential drivers that trigger rates of interest to increase, that subsequently are hostile to economic development.

Ginting, Hutasoit and Peranginangin (2021) performed study to determine the mechanisms, directions and level to which rates of interest may influence economic growth. The researcher assess theoretical theories and global economic methods in high-interest-rate environments to justify that high nominal and genuine rate of interest might not dampen economic development if there are methods like low inflation assumptions, economy's attractiveness to international investors, the technological transfer impact, the build-up of domestic savings. By utilizing a structural vector autoregression (VAR) to examine econometrically the efficiency of the rate of interest channel of bank of Russia's monetary policy transmission method, the study gives proof to recommend that interest rate policy is partially effective after the worldwide economic crisis.

A study by Dutta and Saikia (2022) determined the influence of rate of interest on economic growth in Asian Nations. The study is carried out on 10 nations in Asia from 2006 to 2015. The Target population of the research is 38 nations while the sample of 15 firms was chosen making use of convenience sampling strategy. The independent variable utilized in the study is Rates of interest and dependent variables are GDP, FDI and Inflation. The study utilized descriptive analysis, correlation analysis and regression evaluation utilizing E-view software. The results of the research reveals that rate of interest has a negative substantial effect on GDP and rising cost of living while have negative insignificant influence on FDI. Additionally, it is advised that future researchers are urged to carry out an examination on various nations in Asia with the same structure to identify the influence of rates of interest that may be different because the difference in the context. Future researchers also may develop one more structure making use of other variable like exchange rate, export and savings to see more aligned outcomes. The research estimated to be valuable for other researchers and academics as the cornerstone for theory growth. In addition, government might create policies that may be utilized to stable economy accomplishments. The research will boost the economic researcher's understanding and positioned in higher education institution's library. The research will additionally pave way for many researchers out there to perform some arguing in an area not covered by the research in issues of rates of interest.

Latsos and Schnabl (2021) conducted study to take a look at the impact of interest rates on Japan's economic performance where time-series data from Central Bank of Japan through 1995-2015 is used. The methodology utilized in the study consists of the descriptive statistics, correlation and regression evaluation to check out the impact. The study establishes theoretical structures drawn from economic associated theories, fisher's concept and Keynes liquidity concept to design a fundamental structure for descriptive examination to the particular case of rates of interest and economic performance. The descriptive findings indicates that there has been a really high

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volatility in both rate of interest and rising cost of living from 2000 and 2010 specifically with interest rate hitting as low as 11.61% and as high as 29.57% while rising cost of living striking as slow as 2.15% to as high as 20.45%. GDP growth struck the lowest point of -3.45% and the highest of 5.51. Correlation coefficient strategy is utilized to develop the strength and direction of the partnership in between interest rate and economic performance. The findings from regression analysis indicates that rates of interest has an adverse effect on economic performance in Japan at 5 percent level ($r=-0.854$, $Beta=0.578$, $t=2.45$, $p<0.05$). Additionally, the study discovers that the degree of responsiveness of GDP to changes in the rates of interest is large. The study suggests that there is demand for the government to regulate the nation's interest rate as it is discovered that it adversely influences the economic performance of the nation.

According to Feldkircher, Huber, Punzi and Chantapacdepong (2021) research examined the interest rate effect on investment in Salzburg, Austria. Salzburg has the biggest quantity of investment in Austria. For long term, nexus Johansen Co-integration test is used. Whereas, vector error correlation design (VECM) is employed to discover short-term relationship through 2000-2010. The outcome shows that there is a long lasting association between variables. It has unfavorable connection in the long-term but favorable short-term. The study also creates recommendations which will certainly aid in terms of rate of interest policy along with increasing investment that encourages economic development in Salzburg. According to Palley (2019) low interest rates make it less expensive to borrow. In turn it encourages spending and investment. This brings about higher aggregate demand (AD) and economic growth. This rise in AD can also trigger inflationary incidents. It may also; minimize the incentive to save that motivates consumers to spend as opposed to keeping money. Low interest rates make the cost of borrowing more affordable. It will motivate consumers and businesses to obtain loans to fund higher spending and investment.

Talha, Sohail, Tariq and Ahmad (2021) discovered that globally the use of interest rate as a policy tool has a long tradition. Moreover, its effect on economic development is undetermined. There are 2 major hairs of literature; first Keynesian view, that higher rate of interest reduces investment and therefore development and the second Mackinnon-Shaw theory that postulates that rise in rate of interest enhances the effectiveness of investment and speed up economic growth. Nonetheless, despite the nature of association, instructions of causality are additionally undetermined. It might be as a result of utilizing different data period, nations and most notably using standard asymptotic concept based econometric strategies such as testing for possible unit root and/or cointegration, and so on. To conquer these issues, the study makes use of state of art 'optimal entropy bootstrap (meboot)' strategy to check out the causal link in between interest rate and economic development. This strategy doesn't need any information transformation (like differencing etc.) and hence retains all the attributes of the information (such as trend, structural breaks, and so on), while offering a robust picture of the causal nexus between rate of interest and economic development. The empirical evaluation is anchored on the yearly data for Pakistan through 1970 to 2015. The research concludes that there exists a unidirectional causal connection from economic development to interest rate. Therefore, state bank of Pakistan should be aware when using rates of interest as a policy tool to speed up economic growth.

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3.0 Research Findings

The study found that interest rates affect economic growth. The reduction of interest rates increases economic growth. If the interest rate is good, it keeps output growth high. The study discovered that low rates of interest help the economy grow since people can get more money to make purchases and invests in businesses, thus spurring economic growth. Access to loans from financial institutions depends on interest rates. A country cannot grow if the cost of borrowing is very high and this is significantly influenced by the interest rates. The study also noted that when the base rate increase, the interest rates from the financial institution also increases. High rates tend to reduce the pace of economic development. When unemployment is high the Central Bank usually decides to maintain interest rates low, hence people will find the accessibility of low-interest funds as an incentive to invest in businesses, therefore rising the number of available jobs and reducing joblessness. When the joblessness rate is low, the Central Bank might move to raise interest rates to prevent inflation. The reduction of interest rates is key to increasing businesses and this positively increases economic growth.

4.0 Conclusion

The research concluded that interest rates should be made at a reasonable rate to spur economic growth. The interest rate is an essential component of saving and investment. A small change in interest rate can have a big effect on consumers and works as a stimulant of economic development and execution of economic policies of the government. A country cannot progress significantly if the cost of borrowing is high. The interest rates determine the extent to which people are going to access loans from financial institutions to do business. Hence, the interest rates affect the economic growth in Bangladesh.

5.0 Recommendations

The study recommended that the central bank in Bangladesh, Bangladesh Bank, should develop policies and frameworks that will ensure the interest rates are key as low as possible. The government needs to embrace policies that will aid Bangladesh control interest rates and raising money circulation in the economy. It is suggested that the government through the Ministry of Finance and Economic Affairs in Bangladesh keenly regulate the nation's budget in different ways. By regulating unnecessary expenses or by expanding its revenue sources in the long-term and therefore avoiding running budget deficits, since those shortages put upward pressure on interest rates, which consequently adversely affects economic development in Bangladesh. The study suggests that there is a need for the government to regulate the nation's interest rate as it is discovered that it adversely influences the economic performance of the nation. The investors in businesses ought to make proper decisions to conform to the change in interest rate. The government of Bangladesh should make adaptable investment policies and pay more attention to interest-sensitive markets. The government should consider the aspect of the interest rates as one of the key determinants of economic growth and thus more should be focused on the way that will make the interest rates stable without numerous fluctuations.

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