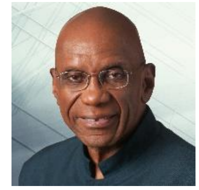

December Letter

Benefits of Removing the Minimum Saving Rate

In April of 2015 the Central Bank removed a stipulation that the minimum interest rate on savings deposits should be 2.5 percent, a rate that had been imposed on commercial banks for many years. The change has benefitted holders of saving deposits, mortgage holders and persons seeking mortgages, credit unions, mutual funds and commercial banks.

Holders of savings bonds were made aware that they have alternatives that are more remunerative than savings deposits, and given an incentive to transfer their savings. Barbados Savings Bonds yield 5.5 percent per year if held for five years. They are just as safe, convenient and liquid as bank deposits. Other alternatives that may yield more than 2.5 percent are credit union shares, deposits with credit unions, and mutual funds.

The biggest beneficiaries of the removal of the floor on interest rates are persons seeking mortgages or those who are able to refinance their mortgages. Banks have reduced mortgage rates to levels that have never been seen in Barbados, since bank mortgages were first popularised in the 1960s. As a result, potential homeowners have benefitted from substantially lower monthly payments, and homeownership is now a little more affordable.

Credit unions and mutual funds saw a noticeable uptick in business, as these institutions are able to offer better rates on funds deposited with them than the rates offered on bank deposits. The growing strength of these non-bank institutions serves to diversify and strengthen the financial system and make it more competitive. Credit unions in particular are able to operate with loan rates that are closer to the deposit rates they offer, because of their mutual ownership structure. That gives customers a better deal than commercial banks are able to offer.

Commercial banks have also benefitted from the relaxation of the savings rate stipulation. They have reduced both loan and deposit rates, but the average loan rates fell more slowly. As a result banks have increased their profitability, even as borrowers have gained from the lower loan rates. Bank profitability has been lower in Barbados and other Caribbean countries than elsewhere in the networks of Canadian banks, which has made the Caribbean unattractive to the banks concerned. The interest rate liberalisation allows banks greater freedom to improve rates of return in Barbados in line with expectations of the banks' head offices.

The liberalisation also opened the way for the Central Bank to reduce the costs of Government borrowing, through intervention in the Treasury Bill tender. However, the fact that government has not been able to eliminate the sizeable deficit on its operations means that Barbados' country risk premium has risen significantly. Government can expect to continue to pay relatively high interest rates on its borrowing, until it achieves a balance on the current account.

The full liberalisation of interest rates has already provided important benefits for savers, homeowners and potential homeowners, credit unions, mutual funds and other savings vehicles, and commercial banks. It also imposes a degree of discipline on Government, penalizing overspending by increasing the interest Government must pay because of its poor creditworthiness. Government will reap significant benefit from the liberalisation, once it reduces its cost of operations, so that current expenditures are fully covered by revenues. The Central Bank will then be in a position to intervene at the Treasury bill tender, to reduce interest rates in line with the international market, as Government's creditworthiness improves.