Interest Rates on Small Saving Schemes

Why in News

Government may reduce interest rates on small saving schemes for the July - September Quarter.

- A cut in small savings rates at this point **would further hurt households amid a surge in inflation**, according to economists.

Key Points

- **Background:**
    - Small savings rates **were slashed between 0.5% and 1.4%** on different instruments **in April 2020**, bringing the PPF (Public Provident Funds) rate to 7.1% from 7.9%.
    - The government decided to further slash interest rates for the first quarter of 2021-22 (April-June), but withdrew its decision terming it an "oversight".
- **Small Saving Schemes/Instruments:**
    - **About:**
        - They are the **major source of household savings in India and comprises 12 instruments.**
        - The **depositors get an assured interest on their money.**
        - Collections from all small savings instruments are credited to the National Small Savings Fund (NSSF)**.**
        - Small savings have **emerged as a key source of financing the** government deficit, especially after the **Covid-19 pandemic** led to a ballooning of the **government deficit**, necessitating higher need for borrowings.
    - **Classification:** Small savings instruments can be classified under three heads:
        - **Postal Deposits** (comprising savings account, recurring deposits, time deposits of varying maturities and monthly income scheme).
        - **Savings Certificates:** National Small Savings Certificate (NSC) and Kisan Vikas Patra (KVP).
        - **Social Security Schemes:** Sukanya Samriddhi Scheme, Public Provident Fund (PPF) and Senior Citizens' Savings Scheme (SCSS).
    - **Determination of Rates:**
        - Interest rates on small savings schemes are **reset on a quarterly basis, in line with the movement in benchmark government bonds** of similar maturity. The rates are reviewed periodically by **the Ministry of Finance.**
            - For the last one year, yields on benchmark government bonds have ranged between 5.7% and 6.2%. This provides the government the leeway to cut rates on small savings schemes in future.
        - The **Shyamala Gopinath panel (2010)** constituted on the Small Saving Scheme had **suggested a market-linked interest rate system** for small savings

schemes.

- **Advantage of the Rate Cut:**
    - Since the central government uses the small savings fund to finance its deficit, the **lower rates would reduce the cost of** deficit financing**.**
    - A cut in rates would mean that the **government wants people to spend and provide impetus to the economy.**
- **Disadvantage:**
    - Rate cuts would hurt **investors**, particularly **senior citizens and the middle class.**
        - Moreover, household savings have been shrinking significantly for two quarters in a row even before the second Covid-19 wave**.**
    - This would **lead to further rationalisation of fixed deposit rates** by banks going forward, and would reduce returns further.
    - A lower rate **would mean a negative real rate of return** on most debt instruments as **inflation is hovering around 5%.**

Rate of Return and Inflation

- The **rate of return is the expected or desired amount of money a person receives from an investment** in a savings account, mutual fund or bond.
- The **real rate of return is the return on investment after adjusting for the rate of inflation.** It is calculated by subtracting the inflation rate from the return on investment.
- Inflation has the power to erode a person's annual rate of return. **When the annual inflation rate exceeds the rate of return, the consumer loses money** when they invest it because of the decline in purchasing power.
- **Inflation refers to the rise in the prices of most goods and services** of daily or common use, such as food, clothing, housing, recreation, transport, consumer staples, etc. It is **indicative of the decrease in the purchasing power of a unit of a country's currency.**

Source: TH