Interest Rate Hike for Small Savings Schemes

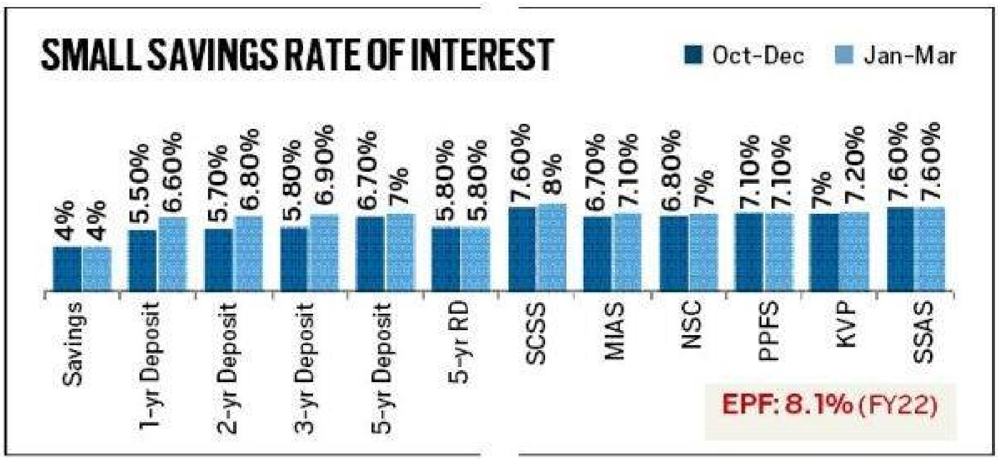
Why in news?

Amid rising yields on government securities, the Finance Ministry hiked interest rates on eight of the 12 small savings schemes by 20 to 110 basis points for the January to March 2023 quarter.

> *While the hike will serve as protection against high inflation and interest rates, the small savings rates are still below desired levels.*

What about the hikes done in small savings rates?

- This is the second successive quarter that the government has effected selective hikes in small savings rates.
- In October-December, the Finance Ministry had hiked interest rates by 10-30 basis points on some of the small savings schemes, like 2-year and 3-year time deposits, the senior citizens scheme and Kisan Vikas Patra.
- For January-March, interest rates have been kept unchanged for a 5-year recurring deposit the Public Provident Fund scheme and Sukanya Samriddhi scheme, but it has been hiked for the following schemes
    - Rates for 1-year, 2-year, 3-year and 5-year time deposits and
    - Senior citizens savings scheme.



What is the need for a hike?

- Coming amid a higher inflation rate and a rising interest rate cycle, hike in small

savings rate is necessary to protect savers, especially senior citizens.
- The view within the ministry is to balance the interests of senior citizens and persons saving in instruments without tax benefits.
- The ministry also wants to keep the interest rate for small savings in check as it essentially translates into a higher interest cost for the government when it borrows against the National Small Saving Fund.

How are the level of rates fixed?

- Interest rates on small saving schemes are **reset quarterly**, in line with the movement in benchmark government bonds of similar maturity.
- Typically, the small saving rates are linked to yields on benchmark government bonds.
- But despite the movement in G-sec yields, the interest rate changes have not strictly matched the yield movements over the past two years.

Are the hikes enough?

- Savers are concerned about the real rate of return on their investments in small savings schemes.
- If both inflation and interest rates are high, savers have a low real rate of return.
- Retail inflation rate has remained above 6% most of the year 2022, easing only a bit in November to 5.88%.
- Meanwhile, the Reserve Bank of India has hiked the key policy rate by 225 basis points, with the repo rate now at 6.25%.
- Most small savings schemes, till the beginning of the previous quarter, were fetching less than 6% interest rate.

> *The RBI in its Monetary Policy Report (September 2023) had noted that with government bond yields increasing, the revised small savings rates were 44-77 basis points below the formula implied rates.*

What does it mean for savers?

- Young investors can go to equity markets through mutual funds for their wealth creation.
- But, conservative investors and those who have retired or are nearing retirement rely mostly on small savings schemes, monthly income schemes or fixed deposits.
- Some increase in rates on certain instruments is good news for investors of small saving instruments.
- However, all small saving schemes except Sukanya Samriddhi Yojana, PPF and senior citizens' savings scheme, are currently fetching negative real returns.
- Considering that the retail inflation is around 6%, the post-tax return on most of the small savings instruments will not even cover inflation for those in the highest tax bracket.
- For investors who invest in these schemes for wealth creation, over a period of time, most of these instruments won't serve the purpose.

What can investors do?

- As inflation and interest rates go down, it will provide a boost to equities.
- Those who are comfortable with equities should look to them when it comes to saving for retirement.
- Individuals in the highest tax bracket can go for high-rated debt papers and invest in debt mutual funds, which are also more tax-efficient.
- However, for protection against inflation, equities remain the best bet.

Reference

1. The Hindu | Most small savings plans to yield more in new quarter
2. Indian Express | Interest rate hike for small savings schemes: Implications, concerns