



# Deregulation and Management of Interest Rates

## What are the Options?

### 1. Introduction

The post-liberalisation period was characterised by high interest rates and widening interest spread, which denied the economy the expected benefits of flexible interest rate policy such as increasing financial savings and reducing cost of capital. The interest rate structure was characterised by high domestic borrowing by government, inflationary pressure, weak monetary policy, and financial instability, which raised questions on the design and implementation of the financial reform process. In response to the prevailing market conditions, the *Donde bill* was proposed in an effort to address what seemed to be sluggish response or market failure. The main message of the proposed bill was that for successful management of liberalised interest rates, policy framework and institutional infrastructure must be adequate.

It is important to note that liberalised interest rates are managed by indirect monetary policy. However, the monetary policy tools for management depend on the level of development of the money market. For example, market interest rates such as the repurchase order (REPO) rate and bank rate are used in a fully developed money market. Where money market is still at infancy stage, Treasury bill rate is used in Open-Market-Type-Operations (OMTO). The effectiveness of the indirect monetary policy tools in management of interest rates however, depends on the efficiency of the monetary transmission mechanism. Sluggish responses of interest rates to mon-

etary policy actions characterise an uncompetitive banking sector, weak regulatory and legal infrastructure, fiscal pressure, and the level of financial depression. Thus, to ensure an effective flexible interest rate policy, liberalization process must be accompanied by: restructuring of the banking institutions to ensure competitiveness; strengthening of the legal and regulatory framework to enhance confidence; attaining fiscal discipline to reduce market distortions; and developing adequate indirect monetary policy tools to enhance monetary authority. Without an effective monetary transmission channel, the response of the banking interest rates is slow and this can frustrate the efforts of policy makers.

The study therefore analyses the financial reform process to find out whether it mirrors the proposed financial sector reform implementation framework for successful liberalisation of interest rates. It also examines the monetary policy and fiscal policy operations in relation to interest rates. Further, the structure of the banking sector is analysed to understand its implications on interest rates.

### 2. Findings

#### 2.1 Financial Reform Process

While the implementation process of the financial reforms depicts the hypothesized framework, the failure to attain competitiveness in the banking sector, and to sustain bank and macroeconomic stability and

fiscal discipline, has continued to keep interest rates high. For example, financial reform process was characterised by fragile banking institutions with low quality assets and high domestic debt. Indeed, banking institutions' participation in the reform process was passive. However, with the proposed bill, some banks responded by undertaking to enhance their operational efficiency by reducing operational costs through rationalisation of branches and tightening the loan assessment units. Whether such efforts have achieved their targeted outcome is something that needs further investigation.

## **2.2 Monetary Policy Operations**

Although monetary authority has made a substantial step in the shift to indirect monetary policy, development of money market is still at infancy stage. Consequently, monetary authority relies on OMTO and reserve requirements for liquidity management. OMTO sufficiently manages interest rates if the monetary policy framework is geared towards meeting monetary policy objectives. Auctioning of Treasury bills is determined by the monetary policy authority based on economic conditions and monetary policy targets while accommodating fiscal demands. Treasury bill interest rate is left to be determined by the market, which is dominated by banking institutions, resulting to disintermediation. Results show sluggish response of both the lending and deposit rates to the monetary policy actions either because the banking sector is inefficient or the signals given are not reflective of monetary policy objective. Further, it is demonstrated that high costs of liquidity management are punitive to banking institutions and, as such, sustain high interest rates and wide interest spread as banks target to meet their profit maximisation.

## **2.3 Fiscal Policy**

When government instruments are used in monetary policy operations, a balance must be kept between the monetary policy and fiscal policy target. It is evidenced that when the proportion of Treasury bills in total domestic debt is high and such debt is serviced by high interest rates, it tends to create loss of confidence on monetary authority.

## **2.4 Banking Structure**

The structure of the banking sector influences interest rates especially because banking institutions have a profit motivation in setting interest levels and also because the structure affects the efficiency of the transmission mechanism. Results show that the banking sector is dominated by a few commercial banks in both the loans and deposits market. First, it is evidenced that enhanced competitiveness in the banking sector facilitates reduction of interest rates. Second, the quality of bank assets is imperative in achieving effective management of interest rates. Third, bank ownership plays a major role in defining the interest rate structure. For example, locally controlled banks are less competitive in deposits and loans market and therefore, tend to offer higher deposit rates to attract funds, and high lending rates due to high credit risks. Fourth, size of the banking institutions has a significant impact on interest rates such that small banks have a higher interest spread compared to large banks as they face higher credit risks. Fifth, banks keep a high interest spread to ensure that their profit margin is maintained.

### 3. Recommendations

#### 3.1 Fiscal Discipline

As the government continues to borrow domestically, the structure of domestic debt must be sustainable. The present efforts to shift to long-term debt are desirable, but the risk preference of the market participants must be rightly weighed to avoid frequent reversals between short and long-term debt instruments. It is also important that the government does not crowd-out the private sector in the debt market. Thus, as the bonds market expands, participation of private sector must be encouraged to maintain competitiveness.

#### 3.2 Appropriate Benchmarking Interest Rate

As growth of the money market solidifies, monetary authority should define a most appropriate benchmarking rate for effective interest management. It is important that the benchmarking interest rate is stable to sustain public confidence with the monetary authority, and to allow for long-term planning. The benchmarking interest rate must also adequately embrace operations of banking institutions and monetary policy objectives for timely responses.

#### 3.3 Strengthening the Monetary Policy Framework

The *Donde bill* proposed setting an external monetary policy committee (MPC). However, this study proposes strengthening of the existing MPC by enhancing its capacity to facilitate the setting up of a comprehensive and objective monetary policy programme. The programme should not only reflect on macroeconomic trends, but also it should be geared towards meeting the monetary policy objective while sustaining fiscal demands. It is also important to have

a consultative forum with the interest groups to reduce uncertainty and consequently, enhance public confidence.

#### 3.4 Enhancing Stability of the Banking Institutions

Stability of the banking sector is important in achieving an efficient monetary transmission mechanism. This is achievable through tightening and having incentive-based prudential regulations that allow competitiveness in the sector. Stability is also achievable through cleaning up bank balance sheets with tight supervision to check insider lending, setting up an institution to deal with the non-performing loans (NPLs), and encouraging banks to invest in information capital.

#### 3.5 Macroeconomic Stability

Monetary authority is instrumental in maintaining macroeconomic stability especially because it is charged with the responsibility of maintaining stable prices. To achieve this, monetary authority must adopt an appropriate monetary policy rule.

For detailed discussion of the issues contained in this Brief, refer to IPAR Discussion Paper No. 038/2003: ***Deregulation and Management of Interest Rates: What are the Options?*** by Rose W. Ngugi. ISBN 9966-948-39-2.

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