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THE PROBLEM OF HIGH INTEREST RATES: DON'T CONTROL BUT PLEASE REGULATE

by

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Summary

The persistence of high interest rates in Ghana is the collective responsibility of banks, the fiscal authorities, and the monetary authorities. High bank lending rates and large spreads are of particular concern; not only can they not be justified in terms of the costs and risks in the industry, they also reflect industry inefficiencies, low and ineffective competition, and collusive practices. The monetary authorities cannot remain aloof but must exercise their regulatory authority to correct an obvious market failure in the credit system by capping interest rate spreads at the minimum.

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The high level of interest rates in Ghana continues to be a source of concern. Even though some measure of macroeconomic stability has been achieved, interest rates have shown exceptional downward rigidity. Intractably high bank lending rates, in particular, have been a source of worry as they inhibit investment and economic growth. Further, by increasing production costs, high lending rates lead to high prices of goods and services. Finding answers to the problem should, therefore, be a policy priority. In this short paper, the reasons behind high interest rates in Ghana are highlighted and measures to address the problem are suggested.

It should be pointed out that high interest rates are the collective responsibility of banks, the fiscal authorities and the monetary authorities. These three entities are, therefore, part of the problem as well as part of the solution.

Banks' lending rates could go as high as 30 percent or more, while deposit rates remain below 10 percent. To place these rates in context, note that the Central Bank's benchmark Policy Rate (PR) has fallen to 13.5 percent and inflation is below 9 percent. Obviously, there is a disconnect between banks' lending rates and the PR, which impedes the transmission and effectiveness of monetary policy.

Meanwhile, lending-deposit rate spreads of the order of 20 percentage points are unacceptably high by industry standards. To a great extent, the high lending rates and spreads can be attributed to banks' operational inefficiencies and high costs. Here, cognisance is taken of inadequate infrastructure; including technology infrastructure, and high internal operating costs; including administrative and other overhead

costs. It must also be recognized that banks face high lending risks, such as inadequate collateral, inadequate borrower identification and generally high loan default rates. These factors lead to high non-performing loans (NPLs) on the banks' books and increase their costs. Surprisingly, the proliferation of banks in the country does not appear to have brought about increased competition and lower costs.

In fact, the rapid growth of the industry does not seem to have been matched by capacity building. This has led to excessive competition for the few skilled personnel and escalation of their wage rates. Also, the proliferation and concentration of banks in urban areas has led to excessive competition for limited depositor funds, thereby increasing the cost of such funds.

The fiscal authorities must take some of the blame for this state of events. In particular, the authorities' high direct borrowing to finance the budget deficit increases the competition for funds and drives up interest rates. Also, indirectly, the high level of payment arrears to road contractors and other suppliers of government's goods and services, lead to high borrowing by these entities, which is in reality "proxy" government borrowing. Further, unpaid government creditors who borrow from banks add to banks' non-performing loans (NPLs) and costs, which are ultimately reflected in high lending rates.

The contribution of the monetary authorities to high interest rates emanates in part from their long preoccupation with fighting inflation, which until recently, had necessitated high Policy Rates. Even the recent policy easing, in line with declining inflation, appears

to have been halted, with interest rates still too high. Also the monetary authorities use tight monetary policy -overtly or covertly-to "protect" the exchange rate by keeping interest rates at levels that would prevent excessive outflow of capital. The monetary authorities also contribute to high bank lending rates through the reserve requirement policy. This policy requires banks to deposit 9 percent of their deposits with the Central Bank. Since the deposits are unremunerated, they represent a cost to banks, who cite it, in part, to justify their high lending rates.

Since banks, the fiscal authorities and monetary authorities have a collective responsibility for the causes of high interest rates, they are also collectively responsible for addressing the problem.

For banks, there is a need to improve operational efficiencies and reduce internal operating costs in the areas enumerated above so that they can accordingly reduce lending rates and spreads. Some of the measures required in this regard may be short-term, while others may be long-term measures.

For their part, the fiscal authorities must keep borrowing within programmed and statutory limits, which will reduce pressure on interest rates and crowding out of the private sector. Clearance of domestic payment arrears will also reduce the related Government "proxy" borrowing by its creditors and thereby reduce banks' NPLs and costs.

While banks have a responsibility to reduce lending rates, any significant actions to do this, on their own volition, is unlikely any time soon. In other words, the long-tried method of moral

suation does not seem to be a viable option. Rather, there is a need for visible intervention by the monetary authorities if quick and tangible results are to be achieved. The authorities' approach so far seems to have been a hands-off one, apparently waiting for the market to resolve matters. But there are obvious market failures here that require direct interventions to address.

First, formation of the Credit Reference Bureau (CRB) was a good idea, as it would, in principle, make it easier for banks to identify borrowers and assess their credit worthiness, which could stem NPLs and banks' costs. Our understanding, however, is that banks' patronage of the CRB is low. To boost patronage, the monetary authorities may have to oblige banks to subscribe to the CRB rather than making it voluntary.

Second, it is acknowledged that the primary reserve requirement plays not only a monetary policy role but also a prudential role. The latter is important in a system lacking deposit insurance. To help banks reduce their costs, however, it is also proposed that the monetary authorities reduce the mandatory primary reserve ratio from 9 percent to 5 percent. Alternatively, they should maintain the 9 percent and pay a token interest of 2.5 percent on the reserves.

Finally, it is in the area of regulation that the monetary authorities need to play a more active role in keeping interest rates in line. While conceding that banks face exogenous lending costs and risks, these cannot be used to justify the large lending-deposit rate spreads. The banks' own inefficiencies, high internal operating costs, low competition in the

industry and collusive practices in an obviously oligopolistic industry are behind these large spreads. In any case, the banks' high profitability suggests that these spreads can be narrowed without jeopardizing their financial standing and stability. The monetary authorities should therefore intensify regulation of the industry to correct obvious market failures.

To this end, the imposition of an initial cap of 8 percentage points between lending and deposit rates is proposed. This means that, for example, if the lending rate is 20 percent, the deposit rate cannot be less than 12 percent; conversely, if the deposit rate is 15 percent, the lending rate must not exceed 23 percent. While this measure, in and of itself, may not guarantee low lending rates, it will prevent banks from benefiting from only high lending rates without appropriately compensating depositors.¹

Note here that capping interest rate spreads is in no way intended to return to the old system of

controlled interest rates, which nobody wants. The call is not for the capping of interest rate levels, which would amount to "controlling" interest rates. However, the monetary authorities are being urged to regulate interest rate spreads as they see justified by the true cost of funds as determined by them—and not by banks. Such intervention can be justified as necessary in correcting an obvious market failure in the credit system; something that is done even in the most capitalist economies. This case should be made strongly to Ghana's multilateral partners—the IMF and World Bank—who may suggest that it is a return to a system of "controls."²

It needs to be pointed out that it is not just bank lending rates that are outrageously high, but various charges and fees are equally out of line. The monetary authorities must, therefore, intensify their oversight to rein in the high cost of banking services in general.

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¹ Indeed, an additional proposition of a cap for lending rate-inflation spreads of 10 percentage points was considered. The two caps would not only reduce the lending-deposit rate spread to tolerable limits, but they would also guarantee positive real deposit rates, which is a desirable outcome. However, there is uncertainty regarding the practicability of the latter cap as it would imply that the interest would have to be reset each month that the inflation rate was announced.

² The sweeping financial legislation passed by the US Congress in response to the global financial crisis justifies policy interventions to correct pitfalls in unregulated financial markets, in particular, and market economies in general. A paper on mitigating the costs of economic liberalization policies in Ghana will soon be done.