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Interest Rate Policies in West Africa

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I. Introduction

It is by now generally recognized that the existence of externalities and other market imperfections justify government intervention. Since in most developing countries the financial system can be broadly characterized as being both underdeveloped and oligopolistic, it is not surprising to find that government intervention in the financial markets of these countries is pervasive. The relevant question to ask in such situations is not whether government intervention should be eliminated altogether, but how these intervention policies, imperative as they are, can be made less "distortion-accentuating" or more "distortion-attenuating". Taking the case of credit market imperfections, which is the concern of this paper, it has been found that government intervention has often tended to be "distortion-accentuating" in nature [McKinnon (1981), Galbis (1981)]. There are two main reasons for this. For one thing, in LDCs which are afflicted by low income and investment, low interest rates are considered to be investment-inducing and hence justified. For another, deliberate decisions to maintain low and stable interest rates are taken to countervail the perceived baneful effects of the very high interest rates prevailing in the unorganized credit market. However, it is little realized that, in the face of inflationary pressures, low interest rates in nominal terms often culminate in negative real interest rates. Thus, the financial markets, imperfect as they are to begin with, are distorted further, affecting the efficiency and pace of the growth of the economy [McKinnon (1973), Shaw (1973), Khatkhate (1980)]. The important issue is, therefore, how to prevent government intervention from being "distortion-accentuating."

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For this reason it seems essential to evolve rational criteria by recourse to which the authorities can determine the level and structure of money interest rates in the imperfect credit markets of LDCs. It is true that there cannot be one single criterion but many alternatives, depending upon the short and long-term objectives of economic policy at any given point of time, the current phase of the economy, and its relationship with the outside world. In the presence of multiple criteria the question of weights to be assigned to each criterion is also important. Such difficulties notwithstanding, it is still essential to search for a set of guidelines which, combined with judgmental considerations, would permit the determination of the levels of interest rates which are compatible with the macroeconomic objectives of a given country.

The purpose of this paper is to consider basic criteria for the determination of appropriate interest rate levels in the context of some selected West African countries. The countries have been chosen to provide varying institutional and policy frameworks so that the discussion on interest rate policies should assume a sufficiently general tone. The countries are: Ivory Coast and Senegal from the CFA franc area; three former British colonies which were part of the now defunct West African Currency Board--The Gambia, Ghana and Sierra Leone; two former French colonies which have abandoned the CFA franc area--Guinea and Mali; two former Portuguese colonies--Cape Verde and Guinea-Bissau; and Liberia which is sui generis as it uses a foreign currency, the U.S. dollar as legal tender. All these countries are basically agricultural and, with the exception of Ivory Coast, have a per capita income varying between SDR 107 and SDR 383.

The rest of the paper is as follows: in Section I the characteristics of the financial systems in West Africa are described; Section II discusses the interest rate policies pursued in those countries over the last decade; Section III contains some general considerations relevant for devising appropriate interest rate policies which are then applied to the interest rate structures in West Africa. The last section contains the conclusions of the paper.

II. Financial Systems in West Africa: Some Relevant Characteristics

Although the structure and the degree of sophistication of the financial systems vary considerably among the countries in this sample, some basic characteristics are common to most of them. For example, except for Liberia, government-owned financial institutions have a major role in the financial systems of West Africa. This is so even in countries such as the The Gambia and Ghana where a majority of deposit money banks are foreign owned because, in these countries, the leading bank is not only government-owned, but much larger than the other banks. In Cape Verde, Guinea, and Guinea-Bissau, the whole financial system is government-owned.

In most countries the financial system is relatively limited being typically composed of a handful of deposit money banks, a few specialized banks, a development bank, a savings institution and a postal checking accounts system. The exception here is Ivory Coast with a well developed financial system consisting, apart from the central bank, of 21 deposit money banks, of which 6 are government-controlled specialized banks and 6 foreign-owned; a national savings bank, a postal checking accounts system, 7 representative offices of foreign banks, 12 non-bank financial institutions; and a stock exchange. In contrast, both Guinea-Bissau and Cape Verde have a single bank which operates not only as a central bank but also as commercial and development bank. In all other countries the number of deposit money banks is small exceeding four only in Liberia and Senegal. Thus, the financial systems in West Africa can be generally described as both government-dominated and oligopolistic.

Another key feature in the financial markets of West Africa is the borrowing requirements of the public sector. Irrespective of the political system, the public sector tends to be by far the major borrower in the financial sector. In 1979, net claims on government exceeded 50 per cent of total credit extended by the banking system in Ghana, Guinea-Bissau and Sierra Leone (Table 1). If nonfinancial public enterprises are added to the central government, credit to the public sector also exceeded 50 per cent in Cape Verde, Guinea and Mali; it was above 40 per cent in The Gambia, Liberia and Senegal. Although the large credit to the governments in these countries is a direct consequence of the large proportion of government investment in total investment (Table 2), an important part of those funds also go to finance current budget deficits.

A further striking characteristic of the financial systems in West Africa is the importance of the central bank as a primary source of funds to the economy. In seven out of the ten countries in the sample more than 50 per cent of the credits extended by the banking system were ultimately financed by the central bank either directly (central bank net claims on government) or indirectly through advances or rediscounts to deposit money banks (Table 3). In 1979, all the remaining countries (Ivory Coast, Liberia and Senegal) had a ratio of central bank credit to total banking system credit to the economy greater than one-fourth. While in The Gambia and Mali the central bank is a major source of credit both to the government and to the deposit money banks, in Ghana, Liberia and Sierra Leone the recourse to the central bank by deposit money banks is minimal; in these countries most central bank credit goes to finance the budget deficit. In contrast, in The Gambia, Guinea, Ivory Coast, Mali and Senegal, there is substantial recourse to the central bank by deposit money banks. To the extent that these credits are seasonal in nature, such as crop financing, central bank accommodation is no doubt necessary. However, in most of these countries, nonseasonal advances by the central bank have become more and more important in recent years. In The Gambia, for example, nonseasonal credits increased from 6 per cent of total advances to commercial banks in December 1977 to 43 per cent in December 1980.

Table 1. Selected West African Countries: Net Claims on Government, 1979

(In per cent of total credit extended, end of period)

	Central Bank	Banking system	Domestic financing as per cent of budget deficit
Cape Verde	7.6	7.6	4.5
The Gambia	44.3	26.8	30.1 1/
Ghana	79.3	66.2	... 2/
Guinea 3/	... 4/	... 4/	--
Guinea-Bissau 3/	75.6	75.6	23.8
Ivory Coast	6.8	... 4/	31.3
Liberia	95.6	25.2	4.5
Mali	51.0	40.1	46.2 3/
Senegal	16.0	10.3	... 2/
Sierra Leone	100.0	77.0	68.2

Sources: IMF, International Financial Statistics and data provided by the national authorities.

1/ For fiscal year 1978/79.
2/ Foreign financing was negative in 1978/79 which made domestic financing more than one hundred per cent of the deficit.
3/ 1978 data.
4/ Net claims on government are negative.

Table 2. Selected West African Countries: Ratio of Government Investment to Total Investment, 1976-1980

(In per cent)

	1976	1977	1978	1979	1980
Cape Verde	...	92.4	79.2	82.4	...
The Gambia 1/	46.7	76.0	86.2	81.5	65.3
Ghana 2/	66.0	63.5	55.7	58.5	...
Guinea	70.7	58.0	65.6	53.4	60.7
Guinea-Bissau	37.0	47.3	72.5	73.6	...
Ivory Coast	69.8	75.7	77.9	81.2	66.7
Liberia 2/	50.0	41.2	69.4	76.1	48.0
Mali	...	...	...	...	...
Senegal	...	54.7	56.2	58.1	...
Sierra Leone 2/	51.4	43.6	33.0	...	...

Source: Data provided by the national authorities.

1/ Fiscal year ending in June.
2/ Capital expenditures for the fiscal year as a per cent of the total investment on a calendar year basis.

Table 3. Selected West African Countries: Central Bank as a Primary Source of Loanable Fund, 1979

(In per cent, end of period)

	ΔNCGCB/GDF 1/	ADRD/CEDB 2/	CECB/CEBS 3/
Cape Verde 4/	100.0	...	100.0
The Gambia	149.0	40.6	56.9
Ghana	46.3	--	75.3
Guinea	... 5/	21.7	94.3
Guinea-Bissau 4/	100.0	...	100.0
Ivory Coast	23.5	24.6	32.3
Liberia	111.6	0.8	25.1
Mali	50.0	61.9	76.6
Senegal	negative	32.2	37.0
Sierra Leone	87.7	--	54.7

Sources: IMF, International Financial Statistics and data provided by the national authorities.

1/ Change in net claims on government by the Central Bank expressed as a per cent of domestic budget financing.
2/ Central bank advances and rediscounts to the deposit money banks as a per cent of total credit extended by those banks.
3/ Central bank credits to the economy as a per cent of total credits extended by the banking system.
4/ In Cape Verde and Guinea-Bissau the central bank also operates as the only deposit money bank.
5/ There is a budgetary surplus.

In most West African countries traditional moneylenders are an important complement to the organized financial markets. Although generally regarded with suspicion by authorities, these moneylenders provide financial services to the rural areas and to some segments of the urban population which do not have access to the organized financial system. High administrative costs and risks associated with the handling of the small loans typically required by these sectors make them unprofitable to the organized financial sector. These informal markets charge interest rates substantially in excess of the maximum lending rates allowed on loans by the organized markets. For example, in Sierra Leone unorganized market interest rates on small loans have been reported to be, on occasion, between 20 and 25 per cent per month, which is far in excess of even annual rates charged by deposit money banks.

In a large number of West African countries where foreign participation in the financial system is important, there is a tendency for the government-owned bank to cater to the nonfinancial public enterprises while the foreign-owned banks deal with the foreign-owned firms. These foreign-owned banks also tend to concentrate their activities in the financing of export-import operations while showing only marginal interest in financing other ventures. The reason for this preference is partly historical as most of these banks were established specially for this purpose, but partly also because these operations tend to carry much less risk than other types of financing. Besides, these operations permit higher effective yields even in the presence of interest rate ceilings because fees can be charged on the opening of letters of credit, foreign exchange conversions, etc.

Finally, domestic savings in general, but financial savings in particular, which are already low, have been declining in most countries in recent years. Although the available data is scanty and not very reliable, gross domestic savings is believed to be negative in Cape Verde, The Gambia and Guinea-Bissau. It is also below 10 per cent in Ghana, Mali, Senegal and Sierra Leone. Data on financial savings, defined as change in broad money (M2) are provided in Table 4. During the period 1975-79 the average ratio of financial savings to GDP varied between a minimum of 2 per cent for Liberia and a maximum of 17 per cent for Cape Verde, with 50 per cent of the countries below 4 per cent. 1/

III. Interest rate policies in West Africa

The objectives of the low interest rate policies followed by many developing countries, and in particular by the West African countries studied here, although seldom stated clearly, tend to be linked to

1/ The extremely low ratio of financial savings to GDP in Liberia might be partly due to an underestimation of the U.S. bank notes circulating in the country. However, even correcting for that, the ratio of financial savings to GDP would undoubtedly remain low.

Table 4. Selected West African Countries: Ratio of Financial Savings to GDP, 1975-79

(In per cent)

	1975	1976	1977	1978	1979
Cape Verde	14.1	18.1	26.5	12.8	13.5
The Gambia 1/	6.8	6.0	4.5	5.1	-0.5
Ghana	7.2	7.9	9.9	10.5	2.9
Guinea	...	-1.1	-6.7	-0.8	3.8
Guinea-Bissau	4.6	3.5	5.2	8.5	3.6
Ivory Coast	2.6	9.4	11.4	3.2	2.4
Liberia	-0.1	5.5	2.0	3.4	0.9
Mali	4.1	2.7	3.3	5.1	...
Senegal	1.9	6.1	3.5	5.5	1.9
Sierra Leone	0.6	1.9	3.5	4.8	4.8

Source: IMF, International Financial Statistics.

1/ Year ending in June.

three considerations: (a) their desire to increase the level of investment; (b) their desire to improve the allocation of investment among sectors; (c) their desire to keep financial costs down so as to avoid possible effects of inflation. Before analyzing the interest rate structures which resulted from the interest rate policies followed by the West African countries over the last decade, it might be useful to examine whether, on theoretical grounds, one should expect these objectives to be compatible with the policies employed.

The belief that low interest rates stimulate investment and growth has been vigorously attacked in the economic literature [McKinnon (1973), Shaw (1973)]. It has been shown that if real interest rates are reduced below market equilibrium levels, demand for investment will no doubt increase, but actual investment will, in fact, decrease, as at low interest rates not enough savings will be generated to finance these investments. Moreover, the excess demand for investment will require the rationing of the available funds among all competing investors who are willing to borrow at the depressed rate. In the presence of rationing and controlled lending rates, it is unlikely that financial intermediaries will choose to provide funds according to a ranking of rates of return on investment. Most likely other factors such as

capacity to provide collateral, political influence, etc., will also play an important part in the financial intermediaries' decisions. Consequently, a policy of low interest rates will not only inhibit investment, but will also reduce the average rate of return on investment to levels below the maximum attainable rate.

Attempts to improve the allocation of resources are also an important factor behind the interest rate policies followed in West Africa. A large proportion of the credit extended to the private sector in West African countries represents import financing, while only a small portion goes to finance the expansion of the productive capacity of the country. The desire to change the allocation of credit among sectors of the economy has resulted in the introduction of selective credit controls in almost all West African countries (Table 5). Since these allocative changes have been implemented, for the most part, by reducing interest rates charged on loans to preferred sectors, they tended to reduce average lending rates and culminated in the same type of problems associated with financial repression. In many cases lowered lending rates were made acceptable to the deposit money banks by providing special refinancing at the central bank, which led to money creation and therefore inflation. Moreover, as lending rates were kept stable for extended periods, all real lending rates were reduced below optimal levels by price increases. This is not to imply that the case for the use of interest rate differentials as a means to influence resource allocation is always weak. However, widespread use of this policy might not be advisable, especially because of the difficulties created by the fungibility of money in ensuring that the funds are in fact used for their original purposes [Johnson (1975), Khatkhate and Villanueva (1978)].

Table 5. Selected West African Countries: Sectoral Credit Allocation Measures

	Quantitative Sectoral Limits or Guidelines	Preferential Interest Rates	Special Rediscount Facilities	Specialized Sectoral Banks
Cape Verde	No	Yes	No	No
The Gambia	No	Yes	Yes	No
Ghana	Yes	Yes	No	Yes
Guinea	No	Yes	Yes	Yes
Guinea-Bissau	No	No	No	No
Ivory Coast	No	Yes	Yes	Yes
Liberia	No	No	No	Yes
Mali	Yes	Yes	Yes	No
Senegal	No	Yes	Yes	Yes
Sierra Leone	No	No	No	No

The third objective often mentioned in defense of low interest rate policies is the cost of liberalization. There is no doubt that there will be some short-term costs involved in interest rate liberalization. However, the direction of these effects is a complex empirical issue which cannot be resolved on a priori grounds. Nevertheless, the possible inflationary effects of interest liberalization seem to have been overplayed. Available estimates of the ratio between financial costs and total production costs indicate that they seldom exceed 10 per cent. 1/ Thus, the direct effect of an increase in interest rates on production costs is likely to be small, and even this small increase cannot be expected to be completely passed on to consumers. Moreover, an increase in interest rates is likely to reduce the hoarding of goods, thus increasing aggregate supply. Finally, the long-run effect of an interest rate increase will no doubt be a reduction in inflation as it will tend to depress aggregate demand to the level of aggregate supply by eliminating the excess demand for investment.

Thus, on theoretical grounds, the low interest rate and selective credit policies presently used by a number of countries in West Africa do not seem well tailored to attain the stated objectives of the West African authorities.

In none of the West African countries selected for this study was the interest rate policy actively used as a major instrument of monetary policy. The West African countries have relied primarily on control of rediscounting (Ivory Coast, Mali and Senegal), on quantitative credit controls (Cape Verde, Ghana and Sierra Leone), or on simple moral suasion (The Gambia, Liberia) for control of the money supply. In the case of Guinea up to 1978, monetary expansion was controlled by fiscal means as the central government was generating large surpluses which were deposited at the central bank.

Because in the majority of West African countries the public sector was a major borrower during most of the last decade, monetary policies have in general been accommodating and have only become more restrictive under the pressures from external imbalances and inflationary tendencies which required stabilization programs in several of these countries.

In many West African countries the need to provide for the credit requirements of the public sector while at the same time curtailing, to the greatest extent possible, the increase in the money supply has forced the authorities to crowd out the private sector through the use of selective rediscounting, qualitative credit controls or moral suasion. This type of crowding out was very clear in Ghana where, during the period 1970-79, real credit to the private sector declined by about 66 per cent. It has also taken place in other West African

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1/ World Bank (1976). See also Villanueva (1980) for data on Morocco and Tunisia. Similar results have also been reported for Brazil [Ness and Rebello da Silva (1979)] and Korea (The Korean Development Bank, 1980).

countries as net claims on the public sector have tended to grow more rapidly than domestic credit. Interest rate increases were not used to provide more incentives to the holding of government debt chiefly because this would imply increases in the servicing of the debt which most governments felt they could ill afford.

At the beginning of the decade interest rates were controlled in all countries in the sample, although in a number of them the regulations were not effective either because market rates were below the ceiling or because the limits were being circumvented by the commercial banks. Changes in interest rate regulations were infrequent, generally not more than twice during the decade; only in Sierra Leone were the changes more frequent. Moreover, interest changes were always modest in size and often would take place only after the stabilization of the economy had become the overriding concern of the authorities. It is interesting to note that, as a rule, interest rate changes, when introduced, seldom had as their primary objective the correction of possible misallocation of resources or the increase in the average return on investment. Instead, interest rate increases were normally used as an additional measure of monetary control.

Mali, Guinea and The Gambia had a single interest rate change. Mali altered its interest rates in 1977 in order to bring them more in line with the rates prevailing in the BCEAO. This was viewed as a preparatory step for a possible return of Mali to the BCEAO. Although lending rates became comparable to the prevailing rates in the BCEAO, both rediscount and deposit rates remained below BCEAO levels. Moreover, since 1977 the BCEAO rates increased while Malian rates have remained unchanged.

Guinea revised its interest rates in 1978 with the stated objective of using them to control credit and to increase the efficiency of the economy. However, rates are still so low that the objectives of the authorities could not have been accomplished in any significant way. For example, the rediscount rate is only 2.5 per cent and in a few instances in the recent past the Banque Guinéenne du Commerce Extérieur has borrowed from its correspondents at rates ranging from 12-14 per cent to on-lend to parastatals at no more than 7.5 per cent.

In The Gambia the primary objective of the 1980 interest rate increase was the need to control credit expansion for balance of payments reasons. However, another important consideration was the existence of large amounts of CFA francs circulating in the economy side by side with the domestic currency, the dalasi. By increasing deposit rates, the authorities also hoped to expand the volume of CFA francs converted in dalasis through the banking system, thus strengthening their control over domestic liquidity and the balance of payments.

Interest rate policies in the BCEAO countries have the added complexity that they have to be identical for all countries in the West Africa Monetary Union lest there be a substantial switch of funds in

response to interest arbitrage among the member countries. This could create problems because different countries might feel differently about the objectives and effects of an interest rate change. This means that the BCEAO could respond through interest rate adjustments only when there were large interest rate differentials between France and the BCEAO which affected all member countries.

Interest rates were increased in the BCEAO in 1975 and again in 1980. The 1975 reform included not only interest rate increases but also the establishment of an interbank call market. The main objective of this reform was to prevent excessive interest rate differentials from pulling funds out of the BCEAO area and to provide profitable employment for the banks' surplus funds, which had been previously invested abroad. Even after the 1975 increase, the interest rate differential vis-a-vis France was still significant. In Ivory Coast, both in 1976 and in 1977, the operations of the deposit money banks had resulted in net outflows of funds from the country. Efforts by the BCEAO to limit refinancing resulted in some pressure on the commercial banks at the end of 1978 and again in 1979. In order to meet their prior commitments to their customers some banks were forced to borrow abroad. However, due to the interest rate differential, this borrowing abroad had a negative effect on the banks' profit margins and foreign borrowing by commercial banks was significantly reduced in 1980 exerting pressure on the liquidity position of several banks. The 1980 increase in interest rates was partly to alleviate this problem and partly in response to further interest increases in the world markets, particularly in France. On the other hand, in Senegal, despite the interest rate differentials, the deposit money banks as a whole had tended to be net borrowers from abroad during the entire 1975-80 period. A possible explanation for the different behavior of banks in Ivory Coast and Senegal was the fact that inflation rates in Senegal had been sufficiently low to produce positive real deposit rates in some years and positive real lending rates in all years. Also, the financial system of Ivory Coast, being more developed than that of Senegal, might react more swiftly to economic signals.

In Liberia, given the use of the U.S. dollar as currency, there is very little scope for monetary policy and even less for an independent interest rate policy. Prior to December 1978, attempts by the Liberian authorities to maintain ceilings on lending rates have, for the most part, just reinforced the already strong risk-averse behavior of the deposit money banks providing them with an additional incentive to place their funds abroad. Despite these ceilings, Liberian lending rates tended to move in tandem with New York rates, sometimes in defiance of legal limits. Thus, during the whole 1976-80 period, Liberian overdraft rates remained 3-4 percentage points above the New York prime rate. Since 1978, balance of payments problems have forced the Liberian authorities to take measures to increase the inflow of funds. In December 1978, ceilings on lending rates were lifted completely and floors on deposit rates were increased above the levels prevailing in New York. Moreover, the charge on outward remittances

on account of commercial banks was also increased. Finally, in January 1979, the Liberian authorities introduced a credit guarantee scheme under which the National Bank guarantees two thirds of the amount of each eligible loan by financal institutions. These measures contributed to a decline in the net foreign asset position of the commercial banks from $21 million in December 1976 to minus $32 million in December 1980.

Ghana also changed its interest rates twice: in 1975 and in 1980. The stated objectives of Ghanaian monetary policy in 1975 were to improve the allocation of financial resources, to strengthen the balance of payments and to mitigate domestic inflation. However, this was to be achieved basically through quantitative credit limits. Thus, the 1975 interest rate change was just a secondary measure taken in the context of a package of monetary measures introduced with the 1975/76 budget. Moreover, since quantitative credit ceilings were also tightened at that time creating excess liquidity in the banking system, some banks took steps discouraging large time deposits and, thus, reducing the positive effects of the interest rate increase on savings mobilization. As inflation rates continued to increase in the following years real interest rates remained substantially negative despite the 1975 adjustment. The combination of a sentiment that the 1975 interest change had failed to produce beneficial results and the large financing needs of the public sector became an effective deterrent to further interest changes until 1978. Given the highly negative interest rates and the commercial banks' continued reluctance to accept interest-bearing deposits during the period 1975-1978, the public increasingly shifted from holding financial assets to holding real assets, especially staple commodities. Partly to reverse this trend and partly as a secondary measure of credit control, the interest rates in Ghana were again raised in September 1978, with results similar to the previous increase. Excess liquidity continued to be important not only because of quantitative credit ceilings but also because the maximum interest rate permitted by law still did not seem to compensate the banking system for the risks involved in expanding its lending operations. As a result, the commercial banks continued to discourage savings deposits by not paying interest on deposits above ₵10,000 and refusing to open new time and savings deposit accounts.

Among West African countries, Sierra Leone is the only one where interest rate changes have occurred with some frequency. This is somewhat surprising as the monetary policy of the Bank of Sierra Leone was basically passive up to 1979 using mostly moral suasion to attain its objectives. The 1975 and 1976 interest rate increases seemed to have been directed partly at savings mobilization and partly at providing incentives to the commercial banks to borrow abroad and to help redress a deteriorating external situation. However, these adjustments were too small, especially because interest rates in the London market had also increased substantially in 1975-76. Thus, real financial savings, defined as changes in M2 deflated by the consumer price index, remained depressed returning to the 1973 level only by the end of 1977. Also,

the commercial banks continued to place their surplus funds abroad increasing their net foreign assets from minus Le 1.3 million in December 1974 to Le 11.9 million in December 1978. Faced with a deteriorating balance of payments situation and increasing inflation rates, the monetary policies of Sierra Leone became stricter in late 1977. Each bank was given quarterly ceilings on credit expansion and the minimum liquidity ratio was raised to 40 per cent. Despite this high liquidity requirement, the banking system continued to have excess liquidity for two reasons: (1) a large portion of commercial bank credit to the private sector went for the financing of imports. Lack of foreign exchange caused payment arrears, which both decreased the use of import financing and left the banks with large deposits which corresponded to the domestic counterpart of foreign import payments; (2) to the extent that commercial banks were not able to increase their lending to the private sector owing to quantitative credit ceilings, they were forced to purchase treasury bills to invest their surplus funds. Since, these bills were counted as liquid assets, they increased the liquidity of the banking system. The interest rate adjustment of 1979, as those in Ghana, was basically a second line of defense against credit expansion and not an attempt to correct financial repression. The same could not be said of the 1980 adjustment which finally freed domestic lending rates from all regulations and made deposit rates just barely negative. The effects of this policy will have to be evaluated in the following years to see whether the oligopolistic structure of the banking system in Sierra Leone is forcing an excessive spread between borrowing and lending rates.

Finally, in Cape Verde and Guinea-Bissau no interest rate adjustment has taken place since independence. In both these countries the fact that the public sector is by far the major borrower has inhibited the use of interest rate policies.

IV. Some Analytical Considerations Relevant to the Interest Rate Policies in West Africa

The real interest rate is the reward for the sacrifice involved in the holding of wealth instead of its consumption. If individuals optimize a stream of real consumption over time, and assuming the existence of only two periods, "future" and "present," the real interest rate can be defined as the relative price between future and present real consumption. In the absence of externalities, market imperfections and government intervention, these relative prices will be determined in the financial markets as a function of time-preferences, the real rate of return over costs and the level of real income. Moreover, this equilibrium rate would be Pareto optimal. Consequently, policies aimed at creating a wedge between the prevailing real rate and the equilibrium market rate can only be justified as a means to correct divergences from socially optimum rates arising from the existence of externalities, market imperfections, etc.

Somewhat different considerations should apply to nominal interest rates. In many countries open market operations are conducted in such a way as to fix the nominal interest rate with the objective of attaining given targets of monetary expansion, and through changes in the growth of the money supply, to influence output, prices and balance of payments. This type of intervention is typically geared to short-term fine tuning of the economy. However, it generally results in temporary differentials between the prevailing real interest rates and the long-run equilibrium rate as prices adjust gradually to changes in the money supply. Thus, the macroeconomic objectives of interest rate policies can be long or short term. While long-term objectives could include correcting the market interest rates for the existence of externalities and market imperfections, the short-term objectives relate to changes in economic activity and inflation, as well as control of capital flows.

In fully competitive financial markets with no externalities or distortions the market interest rate ensures the optimality of the allocation of resources. However, in LDCs, such markets are seldom found and in consequence government intervention to guide interest rates to socially optimal levels is both justifiable and necessary, as long as the intervention is of the "distortion-attenuating" type. In LDCs the financial market distortions are often accentuated by intervention policies directed toward keeping the nominal interest rates unduly low and by the enlargement of government budget deficits financed by recourse to the banking system. As for the latter, the central bank either accommodates the government's credit needs directly, or special incentives, such as tax incentives, are given to holders of government debt; at times, demand for government debt is created through the imposition of liquidity requirements on the financial institutions. If the central bank provides the required credit accommodation, there is a redistribution of the purchasing power in favor of the government which, added to the concomitant increase in prices, tends to crowd out the private sector. This is even more so when quantitative credit limits on private sector borrowing are simultaneously imposed to contain existing inflationary tendencies. 1/

Thus, the government should aim at reducing the imbalances resulting from recurrent operations and gradually move to limit its borrowing in financial markets to the financing of projects with rates of return greater or equal to the economywise social rate of return. To obtain these funds the government should use instruments providing yields which are slightly lower than the economywise social rate of return. Though this basic rule is conceptually unambiguous, it has a limited practical relevance as the authorities do not normally know what the socially optimum interest rate is. It has been suggested that since

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1/ Nevertheless, to the extent that the resources provided to the government finance expenditures with higher social rates of return than the crowded out private sector expenditures, the substitution is clearly beneficial to the economy.

the economywise social rate of return is unknown, one should proceed to estimate the internal (social) rate of return on each proposed project hoping that, over the years, the accumulated experience of comparing the internal rates of return on investments, and having to choose among them, will slowly evolve into a basic agreement among policymakers regarding the level of the cut-off internal rate of return [Dasgupta, Sen and Marglin (1972)]. This rate, when a consensus is finally developed, would be indicative of the socially optimum interest rate.

In the meantime, the government should gradually reduce its borrowings to a level that would permit it to borrow directly from the financial markets in competition with the private sector. Morever, the government should ensure that the projects financed by these resources have rates of return at least comparable to those obtained on projects in the private sector.

Although the optimality of a given set of interest rates is difficult to determine, it is possible to assess whether these interest rates are clearly inadequate by the use of a set of indicators. These indicators are given below together with their relevance for selected West African countries.

1. Positive real rates

A useful benchmark to evaluate the adequacy of a given level of interest rates is to check whether these rates are positive in real terms [Chandavarkar (1971), Khatkhate (1972), Galbis (1977)]. In equilibrium under perfect competition one should expect the real interest rate on savings instruments to be positive; otherwise there would be a strong tendency to substitute the hoarding of goods and self-investment for financial savings. 1/ Clearly not all real interest rates on financial instruments need to be positive. In most countries demand deposits (and currency holdings) do not pay interest. However, up to a point, the services and convenience resulting from the use of these deposits make the subjective return on these assets positive. Nevertheless, in all cases, and specifically in hyperinflation situations, it is highly unlikely that the average real rate of return on savings instruments will remain negative. Thus, if the average real rate of return on savings instruments is negative it creates a *prima facie* evidence of financial retrogression. This is even more so when real lending rates are negative.

During the last decade negative interest rates were by and large prevalent in West Africa (Tables 6, 7, 8) and despite the recent interest

1/ Throughout this paper real interest rates were obtained by subtracting the inflation rate, as given by the consumer price index, from the nominal interest rate. However, the relevant real rate is the one obtained by using expected inflation rates. The implicit hypothesis used here is that the discrepancies between them are minor.

rate increases, they continue to be so. Only Senegal, in certain years, shows positive real rates for savings deposits and central bank discounts. Positive real lending rates are more common but they tend to occur only in certain years and for particular types of loans. For example, real lending rates on loans to nonpriority sectors in Senegal were positive during the whole period 1976-80. However, interest on credits for crop and export financing, as well as for the storage of agricultural products were negative in 1977 and 1979. Given the stability of the nominal rates, real rates have tended to fluctuate with inflation. Countries with high inflation rates, such as Ghana, Guinea-Bissau and Mali, have had the most negative real rates. It is necessary, however, to add a caveat in deriving the real rates on the basis of price deflator, whether it be the consumer price index, wholesale price index, or the GDP deflator. For one thing, the consumer price index, which is used here, tends to rise slower than the wholesale price index because in most of the West African countries, the prices of the basic staples are government-controlled, thereby leading to underestimation of real interest rates. For example, in Sierra Leone where a wholesale price is available, real interest rates would be substantially more negative if the wholesale instead of consumer price index were used. For another, none of the normally used price indices can give the theoretically correct measure of real interest rates [Brown and Santoni (1981)]. Since there is no available alternative, the real interest rates derived on the basis of consumer price index are to be taken as broadly reflecting the real situation.

Table 6. Selected West African Countries: Real Central Bank Discount Rate, 1976-1980

(In per cent, end of year)

	1976	1977	1978	1979	1980
Cape Verde	-1.8	-5.2	-7.3	-0.9	-4.0
The Gambia	-11.1	-6.4	-2.8	-0.1	-0.7
Ghana	-48.1	-108.4	-59.6	-40.9	-36.6
Guinea 1/	...	...	...	...	...
Guinea-Bissau	5.5	-11.5	-17.4	-22.5	...
Ivory Coast	-4.1	-19.4	-5.0	-8.6	-4.1
Liberia	...	...	...	...	...
Mali	-4.6	-19.0	-27.2	...	...
Senegal	6.9	-3.3	4.5	-1.6	1.7
Sierra Leone	-9.2	-0.4	-2.9	-11.2	0.9

Source: Data provided by the national authorities.

1/ There is no price data for Guinea. However the national discount rate is very low (2.5 per cent).

Table 7. Selected West African Countries: Real Savings Deposit Rate, 1976-1980

(In per cent, end of period)

	1976	1977	1978	1979	1980
Cape Verde 1/	-1.3	-4.7	-6.8	-0.4	-3.5
The Gambia	-13.8	-8.9	-5.2	-2.6	-1.8
Ghana	-48.6	-108.9	-61.1	-42.4	-38.1
Guinea	...	...	...	...	...
Guinea-Bissau	...	...	...	...	...
Ivory Coast	-6.6	-21.9	-7.5	-11.1	-7.1
Liberia	-0.6	-1.3	-0.3	-3.6	-5.8
Mali	-4.8	-21.0	-29.2	...	...
Senegal	4.4	-5.8	2.0	-4.1	-1.3
Sierra Leone	-10.2	-1.4	-3.9	-13.2	-1.1

Source: Data provided by the national authorities.
1/ Time deposits; more than 12-months.

Table 8. Selected West African Countries: Real Lending Rates, 1976-1980

(In per cent, end of period)

	1976	1977	1978	1979	1980
Cape Verde 1/	-1.8	-5.2	-7.3	-0.9	-4.0
The Gambia 2/	-8.8	-3.6	0.4	3.2	4.8
Ghana	-43.6	-103.9	-54.6	-35.9	-31.6
Guinea	...	...	...	...	...
Guinea-Bissau	5.5	-11.5	-17.4	-22.5	...
Ivory Coast 3/	0.9	-14.4	--	-3.6	-1.6
Liberia 4/	5.4	3.4	...	4.9	4.6
Mali 5/	4.9	-10.0	-18.2	...	...
Senegal 3/	11.9	1.7	9.5	3.4	6.7
Sierra Leone 6/	-2.2	6.6	4.1	-5.2	...

Source: Data provided by the national authorities.
1/ Basic rate.
2/ Average lending rate.
3/ Non-priority sector (maximum).
4/ Overdrafts.
5/ Private enterprise, non-priority sector.
6/ Maximum.

However, positive real rates suggest only a floor for nominal rates; so other indicators will have to be used to decide the level of the positive real interest rates.

2. World interest rates

It is often argued that interest rates should be higher in the developing countries than in the developed countries, as the latter have a more abundant supply of capital. Thus, interest rates in developing countries should be at least as high as those in the world markets. Unfortunately, the link between real interest rates and capital scarcity is much more complex than is implicit in this argument. For one thing, real interest rates in the developed countries have failed to show a secular downward trend as a result of the growth of their capital stock. Second, "whatever empirical evidence there is does not bear out that the rate of return to capital in LDCs is higher on average than in developed countries" [Khatkhate (1980)].

Even if real interest rates in developing countries cannot be expected to exceed always those in developed countries, it is true that some consideration has to be given to world interest rates when assessing the appropriateness of interest levels in a given country. Although most developing countries have some form of control on capital movements, these capital controls are not always effective, resulting in different degrees of openness to capital movements. Consequently a country's freedom to impose any given interest rate becomes somewhat limited as the failure to take foreign interest rates into account is likely to result in destabilizing capital movements. The seriousness of this limitation varies with the degree of openness of the economy and with the type of exchange rate regimes followed by the authorities. Attention should be given to international flows of funds if (a) there are no capital controls, or if they are ineffective; (b) the currency is freely convertible; (c) the currency is widely accepted outside the country; (d) there is a thriving black market for foreign exchange; (e) foreign firms have a large role in the domestic economy. The existence of any one of these factors or a combination thereof indicates a substantial degree of de facto openness in the economy. In these cases the interest rate differential, after allowance is made for exchange rate expectations, should not be too large so as to avoid destabilizing capital movements. For this purpose the relevant "world" interest rates are those of the countries to and from which capital movements are more likely to take place or with whom the country concerned has close banking connections. Note also that if a country is hoping to attract foreign private capital flows, domestic rates should exceed world rates, in order to compensate foreign financial investors for the increased risks of international lending.

A number of the West African countries chosen in this study are open economies. This is clearly the case in Ivory Coast, Mali, Liberia and Senegal where the institutional framework is such as to reduce substantially the effectiveness of capital controls. However, to a lesser

extent, the same is true in other West African countries. In The Gambia, for example, close trade links with neighboring countries make it possible for large amounts of CFA francs to circulate side by side with the domestic currency, the dalasi. Since the CFA franc is widely accepted internationally owing to its link to the French franc, this allows for a considerable degree of openness in the Gambian economy even in the presence of capital controls.

In the case of Liberia, the interest rate differential vis-a-vis New York seems to have been maintained relatively constant despite attempts by the Liberian authorities to place ceilings on lending rates. Given that since 1978 lending rates were freed while deposit rates were raised above the New York rates, interest rate differentials have now been neutralized as a source of capital outflows.

In contrast, both in the BCEAO countries, and even more seriously in Mali, interest rate differentials vis-a-vis France point to the fact that West African interest rates remain excessively low. International comparisons of interest rates are difficult not only because of exchange rate expectations but also because it is not easy to find comparable rates in different countries. However, since the BCEAO countries have their exchange rates firmly pegged to the French franc, and since there is freedom of capital movement in the French franc area, a rough comparison of interest rates is presented in Table 9. The available evidence indicates that not only is there an interest rate differential against the BCEAO countries (and Mali) but this differential has tended to widen in 1979, requiring an adjustment in 1980. It is also important to note that in countries like Ivory Coast, which have a large expatriate population, the interest rate differentials affect the timing of salary transfers. Although a substantial part of these transfers will sooner or later take place irrespective of the interest rate differential, it might be advantageous to the exporting country to retain these "foreign savings" for as long as possible. The fact that the BCEAO savings rate has tended to lag behind the French rate has contributed to undesirable early remittances.

3. Rates of return on investments

Rates of return on realized investments, if they are outside-financed, are generally expected to exceed the lending rate. Thus, these rates of return can be used as a guide to determine the adequacy of the interest rate levels. The difficulty with this approach is that since in most countries there is not perfect mobility of factors of production and there are special constraints on new entries in the high return sectors, there is not one "economywise" rate of return on investment but a spectrum of rates of return. Moreover, to the extent that there has been financial repression--real interest rates below equilibrium levels under perfect competition--some of the projects undertaken, although having rates of return above the actual lending rate, have rates of return below the competitive equilibrium rate. These facts have led to the suggestion that the lending interest rate

Table 9. Interest Rate Comparisons, 1976-1980

(In per cent, end of period)

	1976	1977	1978	1979	1980
Lending rate 1/					
BCEAO	7.0	7.0	7.0	7.0	9.5
France	9.6	9.3	8.8	11.5	12.3
Mali	5.0	7.5	7.5	...	...
Central bank discount rate					
BCEAO	8.0	8.0	8.0	8.0	10.5
France	10.5	9.5	9.5	9.5	9.5
Mali	3.5	6.0	6.0	...	...
Savings rate					
BCEAO	5.5	5.5	5.5	5.5	7.5
France	6.5	6.5	6.5	7.5	7.5
Mali	2.9	4.0	4.0	...	...

Sources: OECD, Financial Statistics and data provided by the national authorities.

1/ For BCEAO and Mali crop financing rate; for France, prime lending rate.

be guided by the rate of return on the "modern" sector of the economy [Khatkhate (1980)]. The problem with this approach is the definition of "modern" sector. The only definition consistent with the objective of setting real interest rates at levels close to socially optimum rates is one that defines a sector as being "modern" if the rate of return on investments in this sector exceeds the socially optimum rate which is itself not known. Nevertheless, some guidance can be obtained by ranking the rates of return of different sectors and trying to infer which lending rate would cut off all clearly inefficient investment projects. This is equivalent to the procedure suggested for the government and can be used to help the authorities in their judgment of the socially optimum cut-off rate. 1/ Perhaps more interesting is to compare the

1/ However, one should be careful to take into account short-term difficulties in given sectors which might temporarily depress the rates of return, even of the more efficient sectors.

rate of return on potential investments with the lending rate. If lack of financial resources seems to hamper the chances of the project being implemented even if its rate of return substantially exceeds the prevailing lending rate, one should suspect that the lending rate is artificially low and is resulting in credit rationing. This is especially so if the rate of return on these potential projects also exceeds the rates of return on a number of the realized projects.

Comprehensive and well ordered data on the rate of return on investment in West African countries is lacking, though there is some stray information for a few countries. In countries like The Gambia, Mali and Senegal, rates of return on investment appear to be substantially higher than the maximum lending rates. Livestock, which is a traditional form of wealth-holding in West Africa, is estimated to yield a return on capital in the 10-12 per cent range. Investment on real estate is also said to have high yields. Table 10 provides a few representative rates of return in The Gambia. As these rates tend to exceed lending rates, moderate increases in lending rates are not likely to curtail investment but to lead to a shift from lower-yielding to higher-yielding projects. However, given the limited nature of the statistical information on internal rates of return on projects in West Africa, it is not possible to rely heavily on money rates of return on investment as a guide to the appropriate interest levels.

Table 10. The Gambia: Representative Rates of Return, 1979

(In per cent)

Agriculture	16-19
Airport	12-15
Banjul-Serrekunda highway	40
Barrage	8
Distributive trade	20-30
Fisheries	18-20
Hotels	18-20
River wharfs	25
Average lending rate	9.3

Source: Khatkhate and Leite (1979).

4. Borrowing and lending rates

In perfect competition equilibrium, the spread between lending rates and the average cost of loanable funds (that is, funds obtained by the financial intermediaries to on-lend) should be just enough to cover costs, risks, and "normal" profits. Large spreads, common in many developing countries, indicate lack of competitiveness or government

intervention in the financial markets. Assuming no government intervention, the perfect equilibrium rate will be somewhere between the borrowing and the lending rate. Government intervention in financial markets include not only direct interest rate regulations but all regulations that affect the operating costs of the financial intermediaries such as liquidity ratios, reserve requirements, access to rediscount window, etc. These regulations may cause marked divergences between borrowing and lending rates far in excess of those which would have prevailed under a less regulated environment [Galbis (1981), McKinnon (1981)]. However, this is not to say that all regulations should be abolished altogether. Some of these regulations fulfill perfectly legitimate objectives such as avoiding failures of financial intermediaries. Nevertheless, the cost of regulations to the financial intermediaries is likely to be reflected in a larger spread between borrowing and lending rates, and therefore should be allowed for when assessing the appropriateness of a given interest rate regime.

Despite interest rate regulations, spreads between average costs of funds and average lending rates are high in West Africa. For example, in The Gambia, the difference between the average lending rate and the average deposit rate is between 6 and 8 per cent. Even in Guinea-Bissau where lending rates are as low as 6.5 per cent, the bank spread is large because no interest is paid on deposits. These large spreads are partly due to the oligopolistic structure of the banking system. However, it also reflects the fact that interest rate regulation in West Africa favors large spreads because of the relative inefficiency of the domestic banks which to a certain extent is a consequence of the need to fill the vacuum created by the risk-averse behavior of the foreign-owned banks. Thus, oligopolistic profits by the foreign banks are tolerated to permit "normal" profits by the domestic banks. In all likelihood straight liberalization, with the possible exception of Ivory Coast, is not likely to generate enough competition in the banking industry to force a narrowing down of the spreads. Thus, regulation of the spread between borrowing and lending rates is likely to be necessary to avoid bank-induced financial repression, as opposed to government-induced financial repression. Except for Liberia since 1978 and Sierra Leone since 1980, both lending and borrowing rates have been controlled in West African countries and thus the interest rate spread cannot be used to gauge the adequacy of interest rates. In the case of Liberia, although the spread is large and bank profits high, the existing institutional setup precludes corrective actions by the authorities as they are bound to increase the incentives for the banks to invest abroad defeating the basic objective of developing the domestic financial market. In Sierra Leone, it is still too early to know whether simple interest rate liberalization provides an acceptable structure of interest rates or if corrective measures will be necessary to control the borrowing-lending spread.

5. Interest rates in "informal" markets

In many countries interest rates in informal markets are substantially in excess of the rates prevalent in the organized financial system. It is sometimes suggested that this indicates the existence of financial repression and that as a consequence lending rates in the organized markets should be raised. It is doubtful, however, that interest rates prevailing in the informal markets could be used as a guide for the determination of the interest level in the organized market. Although by their intrinsic nature informal markets are unregulated, there is no evidence that they are more competitive than the organized market. Also, informal markets do handle high-risk loans and consequently require a higher premium to cover their expected losses by default [Tun Wai (1957), Bottomley (1963), and Bhaduri (1977)]. The fact that borrowers can be found at these high rates might mean that there are investment opportunities with high rates of return which have been rationed out by the organized financial system. However, it might also mean that rates of time preference in certain sectors of the population are extremely high, resulting in a strong credit demand for consumption purposes. This second hypothesis is not an unlikely event in countries where income is very low and uncertain. For all these reasons, interest rates in informal markets would be an inappropriate indicator for fixing interest rates in the organized market.

If it is found on the basis of the criteria, referred to in the foregoing, that in any particular country the prevailing level of interest rates is inappropriate, then the question is how to attain the right level of interest rates. Freeing the financial markets from all regulations is obviously not justified in the presence of externalities and oligopolistic banking structure. It has been suggested that the savings deposit rate be used as the minimum basic rate and that all other rates be tied to it. The Government would then intervene in the financial market by increasing the saving deposit rate while assessing its effects on the basis of criteria similar to those mentioned above [Galbis (1981)]. However, the appropriateness of this, and other possible management rules would depend on the institutional characteristics of each country. 1/

1/ An alternative, more market-oriented approach, is for the government to fix the maximum spread between the average cost of funds to the financial intermediaries and their average earnings, while allowing them to set both lending and deposit rates. If the spread allowed by the authorities takes into account "normal" intermediation costs, risks, and profits (but not excessive monopolistic profits), the optimizing behavior of the financial intermediaries, even in the presence of oligopolistic structures, would tend to ensure an interest rate structure similar to the equilibrium rates under perfect competition. In principle, international comparisons could provide an initial idea of "normal" spreads. However, one should be careful when doing international comparisons as reserve requirements, portfolio regulation, etc. may vary from country to country and should be taken into account in the comparisons. Also, as Alain Coune pointed out to me in a personal conversation, there may be some practical difficulties from the point of view of bank supervision in implementing a spread-control system.

For the purposes of this paper, it is enough to state that the results of whatever management rule that is chosen should be judged on the basis of the same guidelines mentioned above.

IV. Some Broad Conclusions

Although definitive conclusions in any single West African country should await a specific study of that country, it is clear from the foregoing general overview of a sample of ten countries that the prevailing policies of low and stable interest rates have resulted in an inappropriate structure of interest rates. Both in market and in centrally planned economies it is extremely important to avoid distortions of relative prices if only to ensure optimum allocation of resources. For this, the interest rate reform will have to constitute an important component of any package of policy measures aimed at improving the performance of these economies. First, it should be well understood that lower money interest rates do not provide any incentive for investment unless domestic savings are forthcoming. Second, real interest rates can hardly remain at negative levels, if unproductive hoarding of goods is to be avoided. Third, interest rates, after allowing for exchange rate expectations, should not be set without due consideration for interest rate differentials vis-a-vis world financial markets. Fourth, whenever public sector dependence on the financial market is largely due to fiscal imbalance, the servicing requirements of the government debt become a major stumbling block in the path of interest rate reform. Thus, interest liberalization will have to go hand-in-hand with an improvement in the financial position of the government. Only after its borrowing requirements are reduced to manageable levels will the government be able to engage in a meaningful interest rate policy. This is especially so because of inflationary pressures that tend to result from fiscal imbalances. Fifth, in centrally planned economies as well as in countries where the public sector is a major borrower, it is important that government projects funded by recourse to financial markets are made to pay interest rates commensurate with the social rates of return. In these countries, the calculation of internal rates of return in each project seems to be imperative if the policymakers are to make rational choices among competing projects. In market economies, the socially optimum rate might be assumed, as first approximation, to be equal to perfect competition equilibrium rate. However, given the oligopolistic structure of the banking system in most West African countries, one should not expect that simple liberalization of interest rates would produce optimum rates. Thus, interest rates will have to be managed in such a way as to reduce the spread between borrowing and lending rates to "normal" levels, while producing positive real interest rates.

Finally, external shocks as well as internal developments affect the conditions in which the economy is operating. This is particularly so in agricultural countries such as the West African countries where climatic factors might be the main determinant of economic activity. Under those circumstances and given that foreign interest rates also

fluctuate considerably, it is desirable that interest rate management techniques be kept flexible. This means that the authorities will have to follow the economic situation closely and be ready to revise their interest rates at much shorter intervals than in the past. Recent interest adjustments indicate that the authorities in West Africa are becoming more conscious of this problem and are acting accordingly, although perhaps not as forcefully as it is warranted.

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