0440

IMF WORKING PAPER

WP/91/121

INTERNATIONAL MONETARY FUND

African Department

Interest Rate Liberalization: Some Lessons from Africa

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December 1991

Abstract

This paper undertakes a survey of theoretical considerations and an analysis of the experience of five African countries with interest rate liberalization. Despite substantial progress in monetary policy reforms, liberalization has only partially affected the level and variability of interest rates. Several factors --macroeconomic instability, oligopolistic financial markets, the absence of developed capital markets, as well as the sequencing of the liberalization programs and the asymmetric availability of information-- explain the increase in the spread between lending and deposit rates as well as the rather inflexible pattern of interest rates during the transition to a market-based financial system.

JEL Classification Numbers:
E43, E44, G28, O16

1/ This paper was prepared during a summer internship at the Fund. A discussion with Abbas Mirakhor in the early stages of this paper was helpful. I am indebted to Ishan Kapur, Joaquin Pujol, Reinold van Til, Michael Hadjimichael, Paul Hilbers, and Thomas Rumbaugh for very helpful comments. I thank Ronald Hicks, Menachem Katz, and Philip Young for locating information as well as for making numerous useful comments, and Janet Bungay for editorial advice. All remaining errors are mine.

Contents

Summary

This paper reviews the experience of The Gambia, Ghana, Kenya, Malawi, and Nigeria in liberalizing interest rates. Since the mid-1980s these countries have put in place programs for structural reform of their financial sectors. Substantial progress has been made in developing market-oriented instruments of monetary control and in strengthening prudential bank supervision. Financial liberalization, however, has only partially affected the level and variability of interest rates. Lending rates were affected least, while deposit rates moved downward in some cases after the liberalization, leading to an increase in the spread between lending and deposit rates.

An analysis of the experience of these five countries shows that macroeconomic and financial instability, oligopolistic financial markets, the absence of well-developed bond and equity markets, the sequencing of the financial liberalization programs, and asymmetric information available to lenders and borrowers contributed to this behavior of interest rates.

Macroeconomic instability at the end of the 1970s and the first half of the 1980s rendered a large part of the commercial banks' assets nonperforming and required precautionary reserves to make up for loan losses. Moreover, it led to the breakdown of the market for long-term credit and deposits. The problem of nonperforming assets induced banks to widen the spread between deposit and lending rates to generate profits. They did not, however, increase the lending rates, for several reasons. First, an increase in the lending rates would deter well-established borrowers. In that case, banks would have had to attract new borrowers, whose creditworthiness was virtually unknown. Second, despite an official policy of interest rate liberalization, there was often implicit government pressure not to raise lending rates since this would increase the cost of financing government deficits.

Moreover, the absence of well-developed bond and equity markets gives the banking sector a monopoly in attracting deposits. Under the system of administered interest rates and credit ceilings, the absence of profitable investment opportunities led to excess liquidity in the banking sector, thereby reducing the need for deposits.

The sequencing of the financial liberalization programs and the oligopolistic structure of the banking sector contributed to this evolution of interest rates. Except for Kenya, interest rates were liberalized early in the financial liberalization programs to send a strong signal about the government's commitment to the creation of a market-based financial system. Indirect monetary instruments were developed at the same time, and the governments were implementing a stronger regulatory framework for the financial sector. Until this became fully effective, interest rates were not completely determined by (competitive) market forces.

I. Introduction

Since the beginning of the 1970s, attention has increasingly been paid to the adverse effects of financial repression in a number of developing countries. McKinnon (1973, 1988), who coined the phrase, has stated that an economy is financially repressed whenever "governments tax and otherwise distort their domestic capital markets.", as a result of which savings and investment are constrained and the growth of the economy is hampered, contrary to the then conventional view.

Starting in the late 1970s, a number of developing countries --primarily in Asia and Latin America-- embarked on a course of financial liberalization, with widely varying outcomes. In Chile and Argentina, an abrupt removal of ceilings on credit and interest rates led to exorbitantly high real interest rates, which, in the face of adverse real shocks and insufficient bank supervision, required substantial government intervention to restore the health of the financial system. In Malaysia and Korea, financial liberalization has been more successful. Firms and financial institutions adjusted more smoothly to the deregulated, but still closely monitored, environment. The reasons for these differing outcomes have been extensively documented (Cho and Khatkhate (1989), Corbo and de Melo (1985), and Luders (1985), among others).

In the last half of the 1980s, several African countries also sought to liberalize their financial systems, including interest rates, and their experience with such reforms is examined and analyzed in this paper. The analysis is restricted to five sub-Saharan, non CFA franc zone African countries that undertook a program of interest rate liberalization in the late 1980s: The Gambia, Ghana, Kenya, Malawi, and Nigeria. Supported by the International Monetary Fund (IMF), these countries liberalized interest rates, developed or reactivated indirect monetary instruments, strengthened the regulatory framework, and spurred competition in the financial sector with a view to increasing the efficiency of credit allocation in the economy. The initial effect of interest rate liberalization on the level and variability of lending rates was rather limited. In particular, these rates were only partially responsive to changes in inflation. Deposit rates, on the other hand, tended to decrease after their liberalization. This led to an increase in the spread between lending and deposit rates.

This paper is organized as follows. Section II discusses some basic relationships and gives a short review of the McKinnon-Shaw argument for financial liberalization and the ways it has been expanded and amended in recent years. Section III reviews the experience of five sub-saharan African countries in the light of these theoretical developments. Section IV summarizes the main results.

II. Theoretical Considerations

1. Some basic relationships

Theoretically, the relation between savings, investment, and economic growth on the one hand and interest rates on the other hand is not entirely clear. 1/

On the relation between savings and interest rates, there are two opposing effects. First, an increase in real interest rates will shift the balance between consumption and savings in favor of the latter. Postponing consumption now in order to consume later becomes less costly (substitution effect). However, an increase in real interest rates raises income, which will increase consumption (income effect). Thus the net effect of increased interest rates on savings, both financial and nonfinancial, is ambiguous. A switch from negative to positive real deposit rates, however, will affect the composition of savings. With consistently negative interest rates, households will hedge against inflation by investing in real estate, consumer durables, or foreign assets. In that case, an interest rate liberalization, which generates positive real interest rates, can have important effects on financial savings (IMF 1983). It is important to note that institutional factors may dampen the impact of increases in interest rates on savings, particularly when the bulk of savings are in the form of mandatory contributions to pension funds or social security contributions.

Interest rates influence both the volume and productivity of investment. There is obviously a link between the volume of savings and investment. More savings imply more loanable funds and thus more investment. If a low interest rate policy results in capital outflows, domestic investment is constrained by the availability of savings. As for the demand for loanable funds, there are some theoretical arguments for an inverse relation between interest rates and investment. First, looking at the net present value of investment suggests that higher interest rates imply a higher discount rate for the expected payoff of the investment project, and therefore reduce the profitability of investments. Second, higher interest rates raise the financing cost of investment projects above their expected rate of return. However, these arguments do not take into account that the expected rates of return are affected by the macroeconomic environment (IMF 1983). Changes in interest rates also affect the composition of investment, and thus the productivity of investment projects. When real interest rates are negative, firms have an incentive to borrow for their own inflation hedges, such as inventories and imports. If the supply of loanable funds is limited, this type of investment will crowd out more productive investments in plant and equipment.

The relation between real interest rates and economic growth is theoretically not well established either. If the substitution effect

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1/ For a detailed analysis, see International Monetary Fund (1983).

dominates the income effect, an increase in real interest rates will increase savings. If economic growth is constrained by a shortage of loanable funds, this increase in savings would boost investment and hence economic growth. The immediate link is through savings. However, as noted above, it is not clear whether the substitution effect does in fact dominate the income effect when real interest rates increase.

On the empirical side, most studies do not find clear effects of interest rates on savings in industrialized countries. In some developing countries, higher interest rates, associated with a financial liberalization program, seem to have had a positive effect on financial savings. However, as noted above, this does not necessarily reflect an increase in total savings but a switch from investments in nonfinancial assets to financial savings. If the financial liberalization is part of an overall macroeconomic program, than other influences, such as a reduction in the budget deficit, might explain the rise in savings. If the exchange rate is stabilized at the same time, the rise in domestic savings might merely reflect a portfolio shift from foreign to domestic assets, which is not directly related to the rise in interest rates. Moreover, financial liberalization can induce an inflow of savings from the unofficial market into the official banking system, as the banking sector becomes more competitive relative to the unofficial markets. 1/

2. Financial repression paradigm

Despite these theoretical and empirical ambiguities, a marked change in attitude toward interest rate policies occurred in the early 1970s. In 1973, both McKinnon and Shaw characterized the environment of low interest rates and heavy government intervention, which was present in most developing countries, as a situation of financial repression. In their view, low interest rates might have increased the desired level of investment but they also reduced the actual level of investment, owing to the reduction in savings. Interest rates were often administered at negative levels in real terms, discouraging financial savings, hampering the development of the financial sector, and promoting capital flight.

McKinnon (1973) stressed the importance of self-finance, given the absence of well-developed financial markets or the limited access to these markets for most investors. This led him to his central proposition that physical capital and money are complements. Owing to the lumpiness of physical capital, investors save first in financial assets until they are able to invest in physical assets. Low interest rates have an adverse effect on this process of self-finance. If real interest rates are negative, the accumulation of monetary assets becomes more difficult and less profitable than other inflation hedges.

1/ For an empirical analysis of these and related issues, see Giovannini (1985).

Shaw (1973), on the other hand, emphasized external finance for investment and growth. In his view, the development of the financial sector increases savings and investment, and thus economic growth, thanks to risk-pooling, economies of scale, lower information costs, and accommodation of the difference in liquidity preference between lenders and borrowers. He underscored the detrimental effect of low and negative interest rates on the development of the financial sector. 1/

Thus, while the specific mechanisms are different in both models, the conclusion is the same. Low interest rate policies have created major distortions in the economies of most developing countries. The only way to fuel economic growth is through a program of financial deepening, which requires a liberalization of the financial sector. More specifically, all direct controls on interest rates and credit should be abolished and the authorities should refrain from imposing sectoral credit allocations. Then, the interest rate would behave as a market price and turn positive in real terms, which would enhance savings and investment.

These views were anything but generally accepted in the early 1970s. First, there was a belief that low interest rates stimulate investment and growth and improve the allocation of resources in the economy. It was recognized that low interest rates could reduce savings, but a strategy of forced savings was preferred over a more market-based system of allocating resources. Low interest rates allowed the government to extract seigniorage and reduce the cost of financing the budget deficit. 2/ A similar argument applies to investment in the private sector. Development planning models were used to target certain "priority" sectors and regions to speed up economic growth. These targeted groups had access to credit on cheaper terms, which required the existence of a system of administered loan rates. In these cases, interest rates were used more as an instrument of development and income policies than monetary policy. Second, as Shaw (1973) pointed out, there was a mistrust of the way financial institutions operate and a belief that they extract monopoly rents. In the eyes of policy makers, this market distortion justified government intervention in the financial sector through the use of ceilings on credit and interest rates. Third, Shaw (1973) also mentioned the ineffective control that the authorities have over monetary growth as a rationale for financial

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1/ For an extensive discussion of the McKinnon-Shaw framework, see Fry (1988).

2/ Giovannini and de Melo (1991) picked up this line of thought and analyzed financial repression from this public finance perspective. They calculated the revenue from this financial-repression tax in a set of 24 developing countries and found that it can be quite substantial. They concluded that, from this perspective, financial repression can be an efficient way for the government to raise revenue if there are constraints on other types of taxation. They also argued that a financial liberalization program might require a concurrent fiscal reform to make up for the lost revenue from financial liberalization.

repression. Both McKinnon and Shaw stressed that monetary discipline is necessary for an effective strategy of financial deepening. In many developing countries, the machinery of indirect monetary instruments to control liquidity and inflation was not in place, justifying the use of direct instruments, mainly credit and interest rate ceilings. Finally, even in the cases when the authorities were convinced of a more market-based approach, they often kept credit and interest rate ceilings in place, fearing the inflationary impact of financial liberalization.

As mentioned earlier, not all countries had a successful experience with financial liberalization. Although the failure of some of these financial liberalization programs in the late 1970s and early 1980s did not provoke a return to the old framework of comprehensive government intervention in the financial sector, subsequent research has highlighted the importance of institutional impediments, macroeconomic instability, asymmetric information availability to borrowers and lenders, and the sequencing of the liberalization program. The following section summarizes the main findings of this research and demonstrate the importance of these factors for the determination of interest rates.

3. Recent theoretical developments

a. Structure of the financial sector

In the absence of transaction costs, market distortions and informational problems, no government intervention is necessary to achieve allocative efficiency. In this case, as Fry (1988) points out, institutions would be irrelevant. In such a financial sector, interest rates would be optimal allocators of credit in the economy. Financial institutions generate their revenue through the spread between lending and deposit rates and the fees they charge to their customers. In a competitive market, this revenue is sufficient to cover operating expenses, such as administrative and default costs. Although financial markets all over the world are distorted, these distortions tend to be more severe in developing countries. Thin and small markets, high transaction costs stemming from managerial inefficiency, and government regulation all affect each other and distort the level and structure of interest rates.

In most developing countries, financial markets are little developed and there are only a few financial institutions. This creates a monopoly or implicit collusion in the financial sector, and financial institutions can extract rent by increasing the fees and the spread between deposit and lending rates. Whenever interest rates are administered, they will raise their fees or, when these are included in the ceilings, they can ask for higher collateral, which borrowers have to deposit at a low interest rate. Since banks generate their revenue from the spread between lending and deposit rates, limited competition as such does not push the level of interest rates in any particular direction. When banks are free to determine their interest rates, limited competition will result in a higher spread than in a competitive market. 1/

Transaction costs are another determinant of the spread between lending and deposit rates. These are typically covered by the spread between deposit and lending rates and the fees that financial institutions charge. Transaction costs include the costs of administering the payments system and default costs. In developing countries, these costs tend to be higher than in the industrialized world. Payments systems are still developing and have not reached the level of efficiency attained in developed countries. Macroeconomic instability, weak prudential bank supervision, and lack of technical expertise in the financial sector are widespread in developing countries and increase the default costs significantly. Moreover, legal means to recover bad loans are in general less effective in developing countries. These problems tend to increase the spread between lending and deposit rates substantially.

Equally important are government policies regarding the financial sector. Coming from a highly regulated environment, financial markets are generally cartelized in developing countries at the time of financial liberalization. Credit ceilings and selective credit policies often tend to favor well-established institutions and to preserve the market shares of these institutions, de facto excluding newcomers in the market. Moreover, governments of developing countries have a tradition of setting up special development banks to finance specific activities or regions in the economy. Often, these institutions have monopoly power for the services they provide. The resulting market segmentation increases the ability of these institutions to extract rent by raising lending rates and/or lowering deposit rates.

These three structural impediments --small and thin markets, managerial inefficiency, and selective government regulation-- not only

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1/ Besides its effect on interest rates, Cho (1986) stresses that not only the structure of the banking sector, but also the structure of the financial market as a whole is important to the efficiency of a financial liberalization program. He emphasizes that, with imperfect information, "a substantial liberalization of the equity market is a necessary condition for complete financial liberalization." He constructs a model in which banks group the borrowers in classes depending on the average return on their projects. However, they cannot observe the riskiness of the different borrowers within the different classes. After showing that the variance of the projects enters the profit function of the banks, he demonstrates that this might lead to situations where banks refuse to lend to a certain class of borrowers that has a higher average return than another. If the equity market is little or not developed, government intervention through selective credit policies might improve the allocation of capital in the economy. This conclusion only holds under rather stringent conditions, such as the government having the same information on borrowers that the banks have.

affect interest rates directly but reinforce each other. Selective government intervention erects walls in the already small financial landscape, reinforcing oligopolistic tendencies. The resulting lack of competition gives little incentive to innovation and rewards managerial inefficiency. The development of strong banking skills, such as analyzing the credit worthiness of borrowers, is not stimulated since the market shares are more or less fixed in a system of direct credit and interest rate controls.

b. Macroeconomic and financial stability

Throughout the discussion on interest rate management in developing countries, the importance of stable macroeconomic and financial conditions has been stressed. McKinnon (1973, p. 79) put it as follows:

> "This preferred strategy of high real rates of interest--where real finance is plentiful at those rates--may be nearly impossible in an economy with high and unstable inflation. Uncertainty and the desire to avoid risk may make nominal rates of interest that incorporate the expected future price inflation look too high to borrowers and too low to depositors."

Fry (1988) quotes Hanson and Neal (1985, p. xiii) who state that "the success of financial liberalization programs depends on appropriate domestic fiscal, monetary, exchange rate, commercial and trade policies." Fry himself considers "price stability, fiscal discipline, and policy credibility as the three key factors explaining Asian successes and Latin American failures in financial reforms over the past three decades." (Fry 1988, p. 326).

Although the importance of macroeconomic and financial stability has always been recognized as a necessary condition for the success of a program of financial liberalization, there are recent theoretical contributions on the adverse effects of financial liberalization in the absence of macroeconomic and financial stability.

Dornbusch and Reynoso (1989) highlight the potentially destabilizing mix of high and unstable inflation, a steeply depreciating exchange rate, and financial liberalization. They note that a high and unstable inflation quite often increases the demand for financial liberalization. They argue, however, that this might result in a further increase in inflation if the government runs a budget deficit and if the exchange rate is depreciating rapidly. Whenever the government has to service its foreign debt, a depreciating exchange rate raises the cost in terms of domestic currency. When the government resorts to money creation to finance its deficit, the higher interest rates resulting from a financial liberalization might very well reduce the government revenue from money creation. With a given budget, this induces an even higher rate of inflation. 1/

Mirakhor and Villanueva (1990) link macroeconomic instability to imperfect information, risk sharing, and moral hazard to explain the success or failure of financial liberalization in some developing countries. They employ the Stiglitz-Weiss argument on credit rationing to demonstrate that financial liberalization might lead to lower-than-expected lending rates in the case of imperfect information, even if there is perfect competition in the financial sector. Stiglitz and Weiss (1981) develop a model in which interest rates serve a double function: they not only clear the market for loanable funds but also assume the role of a selection device to affect the quality of the borrowers. Too high an interest rate would attract riskier borrowers (adverse selection) and would give the current pool of borrowers incentives to choose riskier projects (adverse incentive) to cover the higher financing costs. Macroeconomic instability can worsen this situation because it forces the banks to hold more reserves since there are more defaults. However, Mirakhor and Villanueva stress that there is a more detrimental effect from macroeconomic instability, namely, that it does not allow banks and borrowers to predict reasonably well the cost of loanable funds in the future. As long as the borrowers are more risk-averse than the bank, risk-sharing contracts will ensure that the interest rate charged by the bank is less variable than the opportunity cost of money. However, this type of contract is very vulnerable to macroeconomic shocks.

Both these arguments underscore the influence of macroeconomic instability on interest rates. Lack of fiscal and monetary discipline and sharply depreciating exchange rates all spur inflation, which in turn affects interest rates. More specifically, high and erratic inflation prevents the development of long-term markets --and thus long-term interest rates-- and depresses the level of short-term deposit rates. The development of long-term markets suffers most from unstable inflation rates. If the idea of indexed loans is absent, financial intermediaries will refuse to take on long-term loans. 2/ In these cases, the real cost of loanable funds cannot be predicted within reasonable bounds, implicit contracts will break down, and banks will be destroyed, ruined by adverse

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1/ A depreciating exchange rate also affects the effectiveness of credit ceilings whenever the latter are formulated as percentage of deposits. A depreciating exchange rate increases the domestic currency value of deposits denominated in foreign currency, which gives the banks more room to extend credit. Concerned about high inflation, the Nigerian authorities forbade banks to extend credit based on these foreign-denominated assets in April 1989.

2/ Indexed loans can be absent for very good reasons. As Mirakhor & Villanueva (1990) point out the fates of the financial institutions and borrowers are intertwined. Indexed loans put the entire burden of inflation on the firms. If they cannot carry this burden, the financial intermediaries are threatened too.

macroeconomic shocks if they extend long-term loans. Thus, there will be no interest rates for long-term deposits since there will be no market at all. Even the interest rates on short-term loans will be affected. Macroeconomic instability forces the financial institutions to keep higher reserve levels. This jeopardizes their profitability, forcing them to keep a larger spread between lending and deposit rates.

A distinct, but closely related problem is instability in the financial sector. Macroeconomic instability, government pressure to extend loans to public enterprises, and lack of managerial skills often lead to the buildup of nonperforming assets in the balance sheets of commercial banks. These nonperforming assets diminish the profitability of the banks and force them to generate a higher yield on new loans to compensate for the incurred losses. This increases the spread between lending and deposit rates significantly. 1/ Excess liquidity is another source of instability in the banking sector. In most developing countries, the combination of credit ceilings, administered interest rates, and loose monetary and fiscal policies leads to the buildup of excess liquidity in the financial sector. This problem is reflected in the balance sheets of commercial banks by a level of actual reserves that is significantly above the required reserves. Since these reserves yield very little or no remuneration, they have a depressing effect on the profitability of the banks. In cases where the excess liquidity is not removed before the liberalization of interest rates, it is likely to depress deposit rates as long as banks are constrained on the lending side. Furthermore, banks will first extend credit based on these excess reserves before actively attracting new deposits.

c. Sequencing of financial liberalization

The sequencing of financial liberalization programs is not only vital for its overall success but is crucially important for the determination of interest rates after they are liberalized. Mirakhor and Villanueva (1990) suggest a sequencing based on their model that highlights the impact of macroeconomic instability, imperfect information, and moral hazard on financial liberalization. Wong (1991) addresses the problem of the switch to a market-based system of monetary control and suggests a sequencing based on country experiences. Leite and Sundararajan (1990) take a similar approach. As Wong (1991) points out, these sequencing issues depend very much on country-specific circumstances, such as the existing institutions and the speed with which the legal framework can be altered. The

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1/ Greene (1989) notes a potentially favorable effect of high inflation on the balance sheets of commercial banks when part of the assets are nonperforming. High inflation enables the banks to "inflate away" the impact of these nonperforming assets on their profitability. While this is undoubtedly true, high inflation can induce more defaults on new loans and also works on the liability side of the balance sheet. If depositors demand positive real interest rates or if high inflation leads to disintermediation, the banks can face a double profit squeeze.

comprehensive insight afforded by these studies make it possible to outline below the steps to be taken for financial liberalization in countries with weak bank supervision and an unstable macroeconomy. 1/

As seen in Section II.3.b., macroeconomic stability is crucially important for the success of any financial liberalization program, which underscore the importance of moderate inflation, an appropriate exchange rate, and sustainable budget and current account deficits. Therefore, the first step should be to stabilize the economy. Besides the theoretical arguments of section II.3.b., there are unfortunate examples of what can happen when the financial sector is liberalized too quickly during a period of macroeconomic instability. Corbo and de Melo (1985) and Mirakhor and Villanueva (1990) recall the experience of Chile, Argentina, and Uruguay, where financial liberalization occurred at a time of severe macroeconomic imbalances. The rate of inflation in each of these countries was high, the current account deficit was substantial, the exchange rate was depreciating rapidly, and economic growth was lagging; the combination of macroeconomic instability and financial liberalization along with weak bank supervision led to weakness and uncertainty in the financial system, including "distress borrowing" 2/ which in turn led to high interest rates in real terms and eventually to an accumulation of nonperforming assets. Government intervention was required to restore the health of the financial system. 3/ While macroeconomic imbalances are being redressed, proper attention should be paid to strengthening weak financial institutions. Since the restructuring of financial institutions is likely to take several years, it is important to start this process at the beginning of the financial liberalization program.

With the stabilization of the economy under way, the authorities can start Step 2. A successful financial liberalization program involves both the development of indirect monetary instruments, such as treasury bills and securities issued by the monetary authorities, and the strengthening of the regulatory framework and prudential bank supervision. As for the development of indirect monetary instruments, auctioning schemes for these new instruments can be organized. This implies that the interest rates on these new instruments reflect market conditions and that monetary authorities set (ranges for) deposit and lending rates based on these key interest rates. This partial liberalization of interest rates also sends a

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1/ For the sequencing of financial liberalization in countries with different initial conditions, see Mirakhor and Villanueva (1990).

2/ "Distress borrowing" occurs when firms borrow to pay off previous loans, regardless of how high the interest rate may be.

3/ Velasco (1985) stresses the importance of inflationary expectations. In the case of Chile, the government was not able to reduce these expectations, which made it more difficult to implement the liberalization program. He also shows how the liberalization program contributed to the breakdown of the financial system in 1981-83 and how this in turn aggravated the macroeconomic imbalances in Chile in the early 1980s.

BOX 1
FEASIBLE SEQUENCING OF A FINANCIAL LIBERALIZATION PROGRAM

STEP 1
Restoration of Macroeconomic and Financial Stability

Reduce fiscal deficits
Tighten monetary and credit policies
Stabilize balance of payments and restore appropriate exchange rates
Restructure or liquidate defunct financial institutions

STEP 2

Development of Indirect Monetary Instruments	Strengthening of the Regulatory Environment and Bank Supervision
Introduce or reactivate indirect monetary instruments Liberalize interest rates on these instruments Set up auctioning procedures Introduce central bank refinancing facilities	Establish rules and guidelines for loan classification, provisioning for bad debts, interest rate capitalization, capital adequacy, and limits on loan concentration.

STEP 3
Enhancement of Competition Among Banks

Extend more bank licenses
Allow foreign banks
Allow nonbank financial institutions to compete with banks
Privatize banks

STEP 4
Removal of Direct Controls

Fully liberalize lending and deposit rates
Abolish direct credit ceilings

Sources: Partially based on Mirakhor and Villanueva (1990), Wong (1991), and Leite and Sundararajan (1990).

strong signal about the commitment of the government to move to a market-based financial system. Outright liberalization might not be advisable at this point if bank supervision is still too weak or if some banks have not recovered sufficiently from non-performing assets; a flexible implementation of interest rate ceilings is required.

The new indirect instruments allow the authorities to mop up excess liquidity in the financial sector and the market participants to gain experience with them, which facilitates the removal of direct controls later on. The strengthening of the regulatory framework and bank supervision should be implemented simultaneously with the introduction of indirect monetary instruments. The monetary authorities can specify rules on how to provide for bad debt. In order to avoid the recurrence of this problem, it is important to ensure careful regulations of loan classification and interest capitalization, and to place limits on loan concentration, which will give the central bank the necessary instruments to assess the riskiness of commercial banks' portfolios and to take corrective action at an early stage.

After having taken these steps, the authorities can then enhance competition in the financial sector. It is essential to have effective bank regulation and indirect monetary instruments in place. Coming from a tightly regulated environment, banks are adapting to competition and hence proper government intervention is necessary to avoid any excesses that might threaten the overall system. Short-term and long-term financial markets can be further developed and should be regulated and monitored properly. The central bank should control liquidity in the financial system and regulate the operations and responsibilities of market participants. At the same time, the authorities can make the markets more transparent by continuously disseminating information. Besides these measures, competition among financial institutions can be encouraged in a more direct manner. Among other things, entry barriers ought to be removed, the regulatory framework for different types of financial institutions should be unified, all selective credit controls should be abolished, and state-owned banks should be put up for sale.

Finally, all direct controls on interest rates and credit ceilings should be lifted. At this stage, the key interest rates on treasury bills and other bills issued by the monetary authorities are already market determined, and other interest rates are being administered flexibly around these key rates. Their liberalization will therefore only confirm the prevailing interest rate structure. Credit ceilings can be abolished at this point. With a stabilized economy, banks will be able to attract long-term deposits and extend long-term loans. Competition from other banks and bond and equity markets will force them to cut down on intermediation costs. Effective bank supervision will prevent instability in the system. If any doubts remain with regards to the effectiveness of the new indirect monetary instruments or the bank supervision measures, it might be wise to keep the credit ceilings temporarily in place --at a nonbinding level-- as a safety net, as the system adapts to the new environment.

How do interest rates behave when freed at an earlier stage on in the liberalization program? As already mentioned, the liberalization of interest rates before some macroeconomic stability has been achieved is likely to increase the spread between deposit and lending rates. Moreover, as the experience of some countries has shown, distress borrowing can lead to exorbitantly high real lending rates. Excess liquidity, nonperforming assets, and monopoly or collusion in the financial sector reinforce the tendency to increase the spread between lending and deposit rates. Whenever banks are constrained in raising their lending rates, this could result in a lowering of the deposit rates.

III. The Experience with Financial Liberalization in Selected African Countries

The Gambia, Ghana, Kenya, Nigeria, and Malawi are all recovering from the macroeconomic imbalances that emerged in the beginning of the 1980s. Adverse external shocks and inappropriate policies had hurt their economies rather significantly. In the context of a strategy of macroeconomic stabilization and structural reform, these countries started financial liberalization programs in the second half of the 1980s. As part of these programs, they removed ceilings on interest rates. In some cases, credit ceilings were also removed several years after the introduction of the financial liberalization program (Table 1).

Table 2 describes the behavior of deposit and lending rates and inflation during 1983-90. In Ghana, both lending and deposit rates increased significantly over time in real terms, with lending rates becoming positive in 1989. The high variability of inflation in the first part of the decade induced large swings in the level of real interest rates. A significant reduction in inflation from the high levels attained in the beginning of the 1980s pushed up real interest rates significantly. Lending rates were more or less constant during 1987-90, while the minimum savings deposit rate showed a downward trend during the same period. This led to a widening of the spread between lending and deposit rates by 2.1 percentage points from 1987 to 1990. In 1991, however, both lending and deposit rates increased sharply, while the spread declined to 7.9 percentage points.

The Gambia has been successful in attaining positive real interest rates since the interest rate liberalization in 1987. Interest rates rose sharply in 1984-86 in nominal terms, but could not keep up with the sudden surge in inflation. After the deceleration in inflation in 1987, commercial bank lending rates were adjusted downward, albeit slowly. Although the rate of inflation remained near 10 percent from 1987 onward, these lending rates exceeded 25 percent. Deposit rates fell from some 18 percent in 1986 to about 13.5 percent in 1991. Hence, the spread between deposit and lending rates increased from 9.0 percentage points in 1986 to 13.0 percentage points in 1991.

Table 1. Interest Rate Liberalization in Selected African Countries

	Date of removal of ceilings on lending rates	Date of removal of credit ceilings
Ghana	September 1987	Scheduled for 1992
The Gambia	July 1986	November 1990
Kenya	July 1991	---
Nigeria	July 1987	---
Malawi	April 1988	January 1991

Source(s): Data provided by the national monetary authorities.

Table 2. Interest Rates and Inflation, 1983-91

(Interest rates in percent per annum unless otherwise indicated; spread in percentage points; and inflation in percent per annum)

	1983	1984	1985	1986	1987	1988	1989	1990	1991 11/
					Ghana				
Lending rate 1/	19.0	21.2	21.2	20.0	25.5	25.6	26.0	26.0	29.5
Deposit rate 2/	11.5	15.0	15.8	17.0	17.6	16.5	15.5	15.2	21.6
Spread	7.5	6.2	5.4	3.0	7.9	9.1	10.5	9.8	7.9
Inflation	122.8	39.6	10.4	24.6	39.8	31.4	25.2	37.2	20.0
					The Gambia				
Lending rate 3/	18.0	18.0	27.0	27.0	27.0	28.5	26.5	26.5	26.5
Deposit rate 4/	7.5	7.0	15.5	18.0	15.0	15.0	13.0	13.0	13.5
Spread	10.5	11.0	11.5	9.0	12.0	13.5	13.5	13.5	13.0
Inflation	15.6	21.8	35.0	46.2	12.4	10.8	10.2	9.1	...
					Kenya				
Lending rate 5/	15.0	14.0	14.0	14.0	14.0	15.0	18.0	18.0	25.0
Deposit rate 6/	13.0	12.0	12.0	12.0	10.0	13.0	13.0	15.8	19.0
Spread	2.0	2.0	2.0	2.0	4.0	2.0	5.0	2.2	6.0
Inflation	11.5	10.3	13.0	3.9	5.2	8.3	9.8	11.7	...
					Nigeria				
Lending rate 7/	13.0	13.0	13.0	15.0	15.0	18.4	29.8	29.0	...
Deposit rate 8/	7.5	9.5	9.5	9.5	11.0	12.4	16.5	17.8	...
Spread	5.5	3.5	3.5	5.5	4.0	6.0	13.3	11.2	...
Inflation	23.2	39.6	5.5	5.7	11.3	54.5	50.5	7.5	...
					Malawi				
Lending rate 9/	16.50	16.50	19.00	19.00	19.50	23.00	23.00	20.00	...
Deposit rate 10/	12.75	12.75	14.25	14.25	17.25	13.25	13.25	13.75	...
Spread	3.75	3.75	4.75	4.75	2.25	9.75	9.75	6.25	...
Inflation	12.4	12.4	14.9	14.8	28.4	30.6	14.5	11.7	...

Sources: International Financial Statistics, various issues; Kapur et al. (1991); Reserve Bank of Malawi, Financial and Economic Review.

Given the different levels of sophistication of the financial markets in these countries, a uniform definition of the interest rates for all countries did not seem appropriate. Instead, the most representative deposit and lending rate was chosen in each country. Note, however, that with financial liberalization, this "reference rates" can change over time. In the notes below, detailed information for each country is given.

1/ Rate on unsecured loans for 1983-88; average lending rates for 1989-91.
2/ Rate on three month time deposits.
3/ Commercial bank lending rates.
4/ Minimum deposit rates on three month time deposits.
5/ Commercial banks' maximum lending rates.
6/ Minimum deposit rate on 9-12 month time deposits.
7/ Maximum lending rate, end-of-period.
8/ Savings deposit rate at commercial banks, end-of-period.
9/ Maximum rate on unsecured loans of commercial banks.
10/ Annual rate on 12-month time deposits with commercial banks.
11/ Latest available figures.

In Kenya, nominal interest rates were generally responsive to the evolution in inflation. Interest rates became positive in real terms from 1983 onward. Nominal interest rates fell from 1983 until 1987, after which they increased, reflecting the evolution of inflation. Since 1987 interest rates have been falling in real terms. The spread between deposit and lending rates widened from 2.0 percentage points in 1983 to 6.0 percentage points in 1991.

The inflation pattern dominated the evolution of real interest rates in Nigeria. After the sharp deceleration in inflation in 1985, interest rates were positive in real terms until 1988. A surge in inflation in 1988-89 caused interest rates to turn negative again in real terms. In nominal terms, deposit rates responded moderately to these inflationary swings, while lending rates rose sharply.

In Malawi, lending rates were positive in real terms since 1983. Real deposit rates, on the other hand, were negative from 1985 until 1989. A surge in inflation in 1984 and 1988 did not induce a surge in nominal deposit rates, making them negative in real terms. Following the decline in inflation after 1988, nominal lending rates were lowered at the beginning of 1990. The spread between lending and deposit rates peaked at 9.75 percentage points in 1988-89 but narrowed to 6.25 percentage points in 1990.

In all countries in our sample, movements in real interest rates were generally determined by changes in inflation. Substantial progress was made in five countries in the 1980s with reducing inflation and thereby increasing real interest rates. Nominal interest rates responded to these swings in inflation, albeit rather slowly. At the same time, lending and deposit rates generally did not react symmetrically to changes in inflation, especially after they had been liberalized. Changes in lending rates appeared to lag relative to deposit rate adjustments when inflation decelerated, whereas the opposite tended to happen when the rate of inflation accelerated. This resulted in a significant increase in the spread between lending and deposit rates.

1. Institutional developments

As mentioned in the previous section, institutional factors are an important concern in a financial liberalization program and constitute a key determinant of interest rates. Here we look at the evidence in our sample, which includes widely varying financial sector structures. After outlining the basic structure of the financial sector, we look at the profitability of the banks. The concentration and ownership structure in the financial sector and legal restrictions are also discussed (Table 3). 1/

In Ghana, the banking sector is relatively diverse, with 11 fully licensed commercial and secondary banks. In 1990 2 additional banks--both privately owned--opened, reflecting the favorable prospects for banking that resulted from financial sector and monetary policy reform. There are around 20 insurance companies in the nonbank financial sector, which is not regulated by the banking law. This sector also comprises the Social Security National Insurance Trust (SSNIT). The SSNIT administers the social security system in Ghana and is a major buyer of treasury bills and government stock. A stock exchange was set up in November 1990. The trading volumes were large at first but have since been small, and only 11 companies have been listed so far. Concerning the concentration in the banking sector, the 3 largest banks accounted for around 73 percent of deposits in the banking sector at the end of 1990. The Government and the Social Security National Insurance Trust have a majority stake in 8 out of 13 banks. Until recently, profitability of most banks was very low, owing to the large stock of nonperforming assets. Inadequate banking expertise and bank supervision exacerbated this evolution. Since 1988, however, efforts to upgrade the financial system have improved the overall outlook. Since 1989, nonperforming assets have been gradually removed from the balance sheets of the banks. As a result of the replacement of nonperforming assets, the profitability of most banks could be restored. For those banks still experiencing financial difficulties, individual restructuring plans are being implemented.

In The Gambia, the licensing of a new commercial bank in 1991 increased the number of licensed banks to four and spurred competition. Besides these commercial banks, there is a postal savings bank, 2 insurance companies and the Social Security and Housing Finance Corporation. There is no significant equity market in The Gambia. Concerning the legal framework within which financial institutions operate, it is worth mentioning that only commercial banks can take deposits and the postal savings bank is governed by a separate act. Evidence suggests that banks have generated substantial profits recently, reflecting efforts taken since 1988 to restore the health of the financial system. As could be expected from the small size of the financial sector in The Gambia, most of the financial activities are concentrated in a few banks. The largest government-owned commercial bank controls 44 percent of the deposits, while the rest is evenly split between the remaining two privately owned commercial banks. After a

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1/ The lack of precise information on the profitability of banks prevents a careful analysis of their cost structure before the liberalization of interest rates. If the spread between lending and deposit rates was implicitly suppressed through sectoral credit allocations and interest rate ceilings, an increase in the spread after the interest rate liberalization might reflect an attempt by the banks to revert to a pattern of operating losses.

Table 3. Concentration of Deposits in the Banking Sector 1/

	Percentage share of the three largest banks in total deposits
Ghana	73
The Gambia	100
Kenya	...
Nigeria	37
Malawi	100

Sources: Data provided by the national authorities.

1/ As of end-1990 for Ghana, The Gambia, and Nigeria, and 1989 for Malawi. Given the existence of credit ceilings in all these countries up to end-1990, these deposit shares did not change very much over time.

restructuring of its activities, however, the government-owned bank was put up for sale in mid-1991.

In Kenya there is a diverse and competitive banking sector with 88 banks. In addition, there are numerous nonbank financial institutions. The stock exchange in Kenya has a long tradition but is of relatively minor importance in terms of volume and value. Concerning their profitability, commercial banks are generally profitable, but the nonbank financial institutions are in a weaker position. Recently, the government set up a new state-owned commercial bank through the amalgation of 5 ailing nonbank financial institutions. Detailed information on the ownership structure in the financial sector is not available but the largest commercial bank is government-owned. Legal requirements for entry are different for banks and nonbank financial institutions, as is the prudential supervision. Although the nonbank financial institutions can attract deposits, there seems to be a separate market for banks and for nonbank financial institutions. The implementation of the Banking (Amendment) Act of 1985 has to some extent rationalized the dichotomy in regulations and supervision between banks and nonbanks. The Deposit Protection Fund, set up in September 1986, was introduced to protect deposits with any commercial bank, financial institution, or any other eligible deposit-taking institution in Kenya. In 1987, the Building Societies Act was passed to regulate building societies.

Nigeria has a competitive banking sector with 109 banks at end-1990. The number of commercial banks and merchant banks increased from 29 to 42 and from 12 to 24, respectively, after the interest rate liberalization. However, this process was already going on before the interest rate liberalization and is only partially related to it, reflecting the access to foreign exchange that a banking license provides. The stock exchange in Nigeria is an important means for a number of firms to raise capital, although this is still rather small in value compared with the amount of capital raised through the banking system. Concerning the profitability of these institutions, the private and foreign-owned banks seem to be profitable, although the performance of the government-owned banks is rather poor. There is some concentration in the financial sector with the top three banks accounting for 37 percent of total deposits and the top five banks for 47 percent. Government ownership is substantial with the Federal Government and the different states together controlling more than 40 percent of the number of commercial banks, and about 10 percent of the merchant banks. The difference in regulation between banks and nonbank financial institutions seems to induce large portfolio shifts between the two sectors. 1/

The financial market in Malawi is relatively small. It comprises 2 commercial banks and only a few nonbank financial institutions. In

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1/ In June 1991, the nonbank financial institutions were brought under the direct supervisory control of the central bank. This will ultimately result in a more uniform regulatory structure.

addition, the equity market is very shallow. Sketchy evidence suggests that these 2 banks have generated substantial profits, providing some evidence of collusion between the two commercial banks. The largest, government-owned commercial bank controls 66 percent of all deposits while the Government or government-related organizations also have a controlling stake in the second commercial bank. Legal restrictions on the operations of financial institutions, on top of tacit agreements among the financial institutions, have segmented the financial landscape to a considerable extent. The two commercial banks, the Leasing and Finance Company of Malawi, and the Mercantile Credit Ltd., are governed by the Banking Act, the latter two being licensed as nonbank financial institutions. The Post Office Savings Bank has its own separate legislation, the New Building Society is ruled by the Building Societies Act, and the cooperatives operate under the Cooperatives Act. This legal differentiation among financial institutions affects the competitive nature of the Malawian financial sector negatively.

There are clearly institutional impediments that prevent the interest rate liberalization from having full effect. 1/ In all the countries in our sample, the absence of well-developed bond and equity markets puts the banking sector as a whole in a monopoly position for the domestic financing of government deficits and the private sector. 2/ In the banking sector, this oligopolistic setting is almost certainly an explanatory factor behind the increase in the spread between lending and deposit rates after the interest rate liberalization. Excess liquidity in the banking system and government influence over the banking sector explain why this was achieved through the lowering of deposit rates rather than through increases in lending rates. During the course of the financial liberalization programs, the authorities took three basic steps to encourage competition in the financial sector: they licensed more banks; they actively sought foreign banks to set up branches in their countries; and they opened markets for financial instruments for the nonbank public. These measures, most of them taken in 1990-91, spurred competition significantly in a number of the sample countries.

1/ In the countries in this sample, there exists an informal financial sector, interacting with the formal financial system. Limited availability of information on the relative importance of informal financial markets prevents a closer look at this subject.

2/ The absence of well-developed bond markets makes the government highly dependent on the banking sector to finance its budget deficit. This can create serious moral hazard problems since the banks know that the government will bail them out in case of financial distress. It also gives the government incentives to use moral suasion on the banks not to raise lending rates too much despite the official policy of interest rate liberalization. At the same time, banks do not have to fear the competition of the government when attracting deposits from the public.

2. Macroeconomic and financial conditions

As emphasized in Section II.3.b, macroeconomic and financial stability are of utmost importance for the success of financial liberalization programs. In this section, the progress that has been made in stabilizing the economies of the five sample countries is discussed. Table 4 summarizes the major macroeconomic developments in the 1980s.

During the course of the last decade the outlook of the Ghanaian economy improved markedly. Ghana entered the 1980s with substantial macroeconomic imbalances. The economy declined at an average rate of 6.4 percent during 1979-82. A budget deficit averaging about 6 percent of GDP during the same period led to rampant inflation, which reached a peak of over 140 percent in mid-1983. In April 1983, the Government introduced an Economic Recovery Program with support from the IMF. This program aimed at redressing these macroeconomic imbalances while at the same time implementing a structural reform of the economy. This resulted in a significant increase in economic growth. Real GDP grew on average at about 5 percent per annum during 1983-90. At the same time, savings and investment picked up markedly reaching 11.6 percent and 16.0 percent of GDP respectively in 1990. Tight fiscal and monetary policies kept the budget deficit and current account deficit in check and inflation and money growth has declined markedly since 1983. As part of the recovery program, the authorities pursued a flexible exchange policy. In 1986 they introduced a floating exchange rate system, resulting in a fast depreciation of the exchange rates and an improvement of external competitiveness. 1/

Since 1986, tight policies have been very successful in stabilizing the economy of The Gambia. By 1986, its economy was reaching a spiral of high inflation, increasing budget deficits and negative economic growth. Stricter monetary and fiscal policies reversed this trend. Economic growth picked up and averaged around 5 percent per annum in the latter half of the 1980s while savings and investment reached over 20 percent of GDP in 1990. Inflation, which peaked at more than 46 percent in 1986, declined to around 10 percent in 1989 and remained low afterwards reflecting a similar favorable evolution in money growth. The budget, including grants, has recorded a surplus since 1988 and the current account deficit has been kept in line. The exchange rate stabilized after a steep depreciation in 1986.

The growth rate of Kenya's economy has been picking up in the second half of the 1980s, while savings and investment have been high throughout the decade. Kenya continues to face problems with its current account, which worsened from 0.5 percent of GDP in 1986 to more than 7 percent in 1989. Inflation has been relatively moderate, averaging about 8 percent in 1986-90. Money growth, reaching a peak of 27.6 percent in 1986 decreased

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1/ For a review of the performance of the Ghanaian economy during 1983-91, see Kapur et al. (1991).

Table 4. Macroeconomic Performance, 1983-90 1/

(In percent of GDP)

	1983	1984	1985	1986	1987	1988	1989	1990
				Ghana				
Economic growth	-4.6	8.6	5.1	5.2	4.8	5.6	5.1	3.3
Savings	3.6	8.0	8.1	10.0	11.7	12.5	13.7	11.6
Investment	3.7	6.9	9.6	9.7	13.4	14.2	15.5	16.0
Budget position	-2.7	-2.3	-3.0	-3.3	-2.4	-2.8	-2.1	-2.4
Current account	-0.8	-1.0	-2.5	-1.5	-2.1	-1.7	-1.8	-4.5
Money	38.1	72.1	59.5	53.7	53.0	43.0	26.9	18.0
				The Gambia				
Economic growth	-0.3	3.1	-0.3	5.4	5.5	4.6	6.0	3.0
Savings	7.5	10.5	14.3	16.9	22.5	19.0	21.0	20.5
Investment	14.1	14.3	15.1	19.8	17.4	17.8	22.0	20.5
Budget position	-6.1	-8.7	-6.0	-7.1	-9.4	2.4	3.9	3.5
Current account	-6.6	-3.8	-0.8	-2.9	5.2	1.2	-1.0	--
Money	3.2	32.9	24.5	43.9	20.5	8.3	17.0	16.9
				Kenya				
Economic growth	0.2	2.1	4.1	7.4	5.9	6.1	4.4	4.5
Savings	18.3	19.3	19.1	19.2	16.2	16.4	14.9	16.0
Investment	20.9	23.2	25.8	21.8	24.3	25.1	25.2	23.7
Budget position	-3.7	-5.1	-5.4	-6.6	-4.2	-4.6	-4.2	5.6
Current account	-0.7	-1.8	-1.5	-0.5	-6.3	-5.4	-7.4	-5.3
Money	6.6	12.9	10.2	27.6	12.4	8.3	17.8	15.5
				Nigeria				
Economic growth	-5.4	-5.1	9.4	3.1	-0.5	9.9	6.3	5.1
Savings	8.9	8.6	8.8	4.6	7.4	5.4	14.6	21.2
Investment	14.8	9.6	9.0	15.1	13.7	13.5	13.9	14.6
Budget position	-11.0	-4.2	-2.6	-2.7	-9.0	-10.9	-4.4	-3.7
Current account	-6.0	-1.0	-0.2	-10.5	-6.3	-8.1	0.7	6.6
Money	13.3	13.3	10.5	2.7	22.8	33.3	11.0	40.3
				Malawi				
Economic growth	3.5	4.5	4.2	1.1	0.5	3.3	4.1	4.8
Savings	6.2	15.0	8.2	6.3	10.2	9.6	8.3	9.6
Investment	13.7	13.0	12.8	12.3	15.4	18.7	21.2	18.2
Budget position	7.5	6.3	7.5	-9.6	-7.0	-1.7	-2.2	-3.5
Current account	-8.5	0.6	-6.1	-3.5	-2.6	-2.2	-8.2	-4.2
Money	0.6	39.6	-3.3	8.8	30.3	27.4	5.5	12.3

Sources: International Financial Statistics: various country reports.

1/ Economic growth is measured as the annual percentage change of real GDP. Savings are gross national savings, as a percentage of GDP. Investment is gross investment as a percentage of GDP. The budget and current account positions are also measured as percentage of GDP, both including official grants. Money is the percentage change over previous year in money plus quasi-money. For Ghana, money is the percentage change over previous year as defined in Kapur et al. (1991), Table 13. For The Gambia, all data are from July 1. For Kenya, the budget position is for the fiscal year starting July 1.

steadily afterwards. The exchange rate versus the US dollar depreciated 37.5 percent from 1986 until 1990.

The Nigerian economy is recovering from sharp macroeconomic imbalances in the early 1980s. The economy declined 5.1 percent in 1984 while inflation peaked at 40 percent in the same year. Since then, economic growth has been increasing reaching well over 5 percent per annum in the late 1980s. Savings and investment evolved along similar lines. After a successful deceleration in inflation in Nigeria in 1984/85, the inflation rate climbed again to more than 50.5 percent in 1989, followed by a steep deceleration in 1989-90. Money growth, which had been moderate in 1983-86, was rather volatile since then, rising markedly in 1987-88 and 1990. In recent years, there have been significant improvements in the budget and the current account positions, but the Nigerian economy remains vulnerable to adverse shocks, especially in the oil market. The exchange rate versus the US dollar has depreciated markedly since 1986.

During the second half of the 1980s, the Malawian economy recovered significantly despite severe external shocks. Economic growth slowed down in the mid-1980s but gained in strength afterwards. Similar developments can be noted for savings and investment, reaching 9.6 and 18.2 percent of GDP in 1990. An improved apparatus for fiscal policy has brought down fiscal deficits, while a tight monetary policy was effective in bringing down inflation after 1988 and also reduced the growth of the money supply. Despite these positive developments the current account remains weak due to price developments in the economies of its trading partners and volatility in its exchange rate versus the South African rand. Moreover, Malawi remains vulnerable to political and economic developments in South Africa and Mozambique.

As is clear from this overview, the authorities in these countries successfully reversed the trend of negative economic growth, spiraling inflation, and unsustainable budget and current account deficits. There was a significant improvement in the monetary and fiscal management of their economies, except for a short lapse in Nigeria in 1988. Despite these positive developments, however, all these countries remain vulnerable to adverse shocks. As pointed out in Section II.3.b, Mirakhor and Villanueva mention the opportunity to forecast the cost of loanable funds within reasonable bounds as the main benefit from macroeconomic stability. In such a case, implicit contracts between borrowers and lenders can develop. It is safe to say that none of these contracts survived the problematic macroeconomic experience of the late 1970s and early 1980s. This led financial institutions not to lend in the long term and to restrict their clientele to well-known borrowers. In all these countries, this seriously hampered the development of long-term interest rates and led to the buildup of nonperforming assets in the banks' balance sheets, giving the banks strong incentives to widen the spread between deposit and lending rates after these were liberalized.

As essential as macroeconomic stability for the success of an interest rate liberalization policy is a stable financial environment. In this regard, two problems--excess liquidity and the existence of nonperforming assets on the balance sheets of financial institutions--are particularly important. Precise information on nonperforming assets is not available for all countries in our sample but there is evidence that this is a very serious problem in our sample. To cope with losses from these nonperforming loans, banks were forced to widen the spread between lending and deposit rates. Concerning excess liquidity, Table 5 shows that this was a substantial problem at the time of interest rate liberalization in most countries in the sample. 1/

The authorities introduced measures to drain this excess liquidity from the financial system. However, as was expected, it took time for these indirect instruments to become fully effective in mopping up this excess liquidity. The problem was most severe in Malawi, where excess liquidity amounts to over 35 percent of deposits in the period 1986-88 (Table 5).

3. Sequencing of financial reforms

As the experience of Latin American and Asian countries has shown, the sequencing of a financial liberalization program is an important determinant of its success. It may be useful here to compare the sequencing in our sample with the scheme suggested in Section II.3.6. (see Box 1). Boxes 2a-e give an overview of the most important developments in macroeconomic and financial policies since 1985 in these five African countries.

The Ghanaian authorities initiated a program to restore macroeconomic and financial stability before embarking on their financial liberalization program. They started an Economic Recovery Program in 1983 to deal with the significant macroeconomic and financial imbalances. This program was generally successful in pursuing a tight fiscal and monetary policy and allowed the exchange rate to depreciate to a more realistic level. In 1987 and early 1988 interest rates were liberalized, followed by the removal of sectoral credit allocations later in 1988. Concurrently with the liberalization of interest rates, the authorities started the development of indirect monetary instruments, and the regulatory environment for the financial sector was strengthened. Treasury bills were introduced in 1987, followed by short- and medium-term Bank of Ghana bills in 1988 and 1989, respectively. In September 1988, as part of the policy to rely more on indirect monetary instruments, the Central Bank started issuing Bank of Ghana bills and treasury bills, initially only for banks. Since November 1990, this market has also been open to the public. In 1987, the authorities started a treasury bill tender system. In 1989 the authorities adopted a comprehensive restructuring plan for the bank sector. As part of

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1/ From an economic point of view, excess cash reserves are the most relevant measure. Due to data limitations, however, the sum of cash and secondary reserves is used in Table 5.

Table 5. Excess Reserves in the Banking System 1/

(In percent)

	1983	1984	1985	1986	1987	1988	1989	1990
Ghana	...	...	...	...	27.4	12.1	...	15.0
The Gambia	...	...	...	...	12.2	22.0	15.7	22.7
Kenya	...	...	2.0	11.0	11.0	4.0	4.0	10.0
Nigeria	33.0	44.7	43.8	19.3	30.7	35.6	27.5	22.0
Malawi	2.2	13.6	19.2	35.2	42.6	32.8	8.3	...

Sources: Various country reports; author's calculations.

1/ Excess liquidity is defined as the ratio of the difference between liquid asset holdings and required holdings over total deposit liabilities. End-of-period data. For The Gambia, all data are end of June.

BOX 2a

Sequencing of a Financial Liberalization Program: Ghana

	1986
Sept.	- Introduction of a weekly foreign exchange auction
	1987
Sept.	- Decontrol of maximum lending and minimum deposit rates
Oct.	- Introduction of a weekly auction for treasury bills
Nov.	- Establishment of the Consolidated Discount House
	1988
Feb.	- Decontrol of minimum bank savings rate
	- Removal of sectoral credit controls, except for agriculture
Apr.	- Establishment of foreign exchange bureaus
Sept.	- Introduction of 90-day Bank of Ghana bills, available to banks
	1989
July	- Adoption of a comprehensive restructuring plan for banks, going on through 1991
Aug.	- Adoption of a revised Banking Law, strengthening the regulatory environment and bank supervision of the Bank of Ghana
Dec.	- Introduction of nonrediscountable medium-term Bank of Ghana securities, available to banks
	1990
Mar.	- Unification of bank cash reserve requirements on demand and time and savings deposits
Apr.	- Unification of foreign exchange markets
May	- Replacement of nonperforming bank claims on state-owned enterprises, primarily with Bank of Ghana bonds
Nov.	- Opening of a stock exchange
	- Introduction of short- and medium-term Bank of Ghana bills, as well as five-year government stock
	- Widening of access to Bank of Ghana medium-term instruments to the nonbank sector
	- Abolition of the requirement for lending to agricultural sector
	- Decontrol of all bank charges and fees
Dec.	- Replacement of revaluation losses of the Bank of Ghana by long-term government bonds
	- Replacement of nonperforming claims on the private sector by the financially distressed banks, primarily with Bank of Ghana bonds
	- Introduction of a first compliance test based on new capital adequacy requirements
	1991
Mar.	- Replacement of nonperforming claims on the private sector by the four sound banks, primarily with Bank of Ghana bonds
June	- Opening of a second discount house

BOX 2b

Sequencing of a Financial Liberalization Program: The Gambia

	1985
	- Start of the restructuring of the Gambian Commercial and Development Bank, continuing through 1990
July	- Adoption of the Economic Recovery Program
Sept.	- Amendment of the Central Bank Act to empower the Central Bank of The Gambia to prescribe both minimum and maximum rates on deposits
	- Removal of ceilings on lending rates
	1986
	- Introduction of a requirement of weekly reporting of commercial bank balance sheets and closer monitoring of their developments
Jan.	- Introduction of a flexible exchange rate system
	- Removal of all existing restrictions on current foreign exchange transactions including import licensing
July	- Removal of all controls on interest rates
	- Introduction of a biweekly tender system for 90-day treasury bills
	1987
June	- Increase in banks' reserve requirements
	1988
	- Suspension of the Exchange Control Act of 1966
	1989
	- Liquidation of the Agricultural Development Bank
	1990
Apr.	- Establishment of foreign exchange bureaus
Sept.	- Removal of credit ceilings
	1991
	- Preparation of proposals to revise the Central Bank of The Gambia Act and the Financial Institutions Act
July	- Offering for sale of the Gambian Commercial and Development Bank

BOX 2c
Sequencing of a Financial Liberalization Program: Kenya

	Before 1985
	- Establishment of minimum liquid assets ratio for all financial institutions
	- Establishment of credit ceilings
	- Rediscounting by the Central Bank of treasury bills and other government securities with a maturity of 3 months or less
	- Offering for tender on a weekly basis of 2 billion shillings of 90-day treasury bills
	1985
	- Implementation of the Banking Act
	1986
Sept.	- Establishment of the Deposit Protection Fund
Dec.	- Introduction of a cash ratio for commercial banks
	1987
	- Adoption of the Building Societies Act
	1988
	- Start of a major restructuring program of the financial sector
	1989
Apr.	- Revision of the Banking Bill
	1990
	- Introduction of a monthly auction for medium-term bearer bonds
	- Establishment of a Capital Market Development Authority
June	- Removal of fees and charges from interest rate ceilings
Nov.	- Restructuring of the treasury bill auction
	1991
June	- Removal of the ceiling on lending rates

BOX 2d
Sequencing of a Financial Liberalization Program: Nigeria

1985

- Elimination of minimum credit allocation requirement to indigenous borrowers
- Establishment of Second-Tier Securities Market for small companies
- Implementation of third phase of the rural banking program

1986

- Modification of credit ceilings for merchant banks, giving them more flexibility
- Gradual abolition of selective credit allocations

1987

- Establishment of unified foreign exchange market
- Removal of the controls on minimum and maximum interest rates

1988

- Adoption of a new Securities and Exchange Commission Decree
- Establishment of the Nigerian Deposit Insurance Corporation
- Introduction of significant institutional changes at the Central Bank of Nigeria
- Unification of the credit ceiling requirement for commercial and merchant banks

1989

- Unification of the official and autonomous segments of the Foreign Exchange Markets
- Establishment of a foreign exchange bureau
- Adoption of a Privatization and Commercialization Program
- Eliminiation of the practice allowing commercial banks to extend credit based on their foreign currency deposits held abroad
- Introduction of a treasury bill and treasury certificate auction
- Signing of accord between banks and the Central Bank to limit spreads between interest rates

1990

- Introduction of a cash requirement for merchant banks
- All banks are required to report on the activities of their subsidiaries offering financial services
- Introduction of a minimum capital requirement
- Issuance by Central Bank of nontransferable and nonnegotiable stabilization securities to mop up excess liquidity
- Introduction of new accounting guidelines for all financial institutions

1991

- Readministration of interest rates
- No new bank licenses

BOX 2e

Sequencing of a Financial Liberalization Program: Malawi

	1988
Apr.	- Removal of interest rate ceilings
	1989
May	- Initiation of steps to set up discounting and financing facilities
June	- Introduction of a statutory reserve requirement of 10 percent of total bank deposits
	1990
	- Provision for Investment and Development Bank of Malawi, previously not a deposit-taking institution, can now accept corporate deposits
May	- Introduction of a bank rate, linked to an official auction rate for bills
Oct.	- Granting of permission to two parastatals to switch their deposits from the Reserve Bank of Malawi to commercial banks
Nov	- Introduction of a monthly auction of reserve Bank of Malawi bills, open for commercial banks
	1991
Jan.	- Removal of credit ceilings

this program the authorities, supported by the World Bank, worked out a solution to the problem of nonperforming assets on the banks' balance sheets. In May 1990 nonperforming claims on state-owned enterprises were replaced in the balance sheets of the banks, mainly with Bank of Ghana bonds. A similar replacement occurred in December 1990 and March 1991 for nonperforming claims on the private sector. A new Non Performing Assets Recovery Trust will try to recover as many of these claims as possible. With this effort well under way, competition was enhanced through the widening of access to medium-term Bank of Ghana bills to the nonbank sector. The removal of direct credit ceilings is scheduled for 1992.

In The Gambia, macroeconomic stabilization took place simultaneously with financial liberalization. The authorities undertook an Economic Recovery Program in July 1985. Interest rates were liberalized by July 1986 and a system of treasury bills was introduced. As mentioned earlier, the economy of The Gambia was more or less stabilized by 1988. Restructuring of the most important commercial bank, the Gambian Commercial and Development Bank, initiated in 1985, has culminated in the bank being offered for sale in 1991. Prudential reform was undertaken, although on a rather limited scale, with the introduction in 1986 of a requirement of weekly reporting of commercial banks' balance sheets. Direct credit ceilings were removed in September 1990. Although financial markets have developed relatively slowly, competition in the financial sector has been stimulated through the planned sale of the Gambian Commercial and Development Bank and the licensing of a new commercial bank in 1991.

Macroeconomic imbalances have been fairly moderate in Kenya in the last decade. Indirect monetary instruments --such as liquid asset ratios and refinancing facilities-- which were already in place in Kenya in the 1970s, have been reactivated. A treasury bill market had existed previously but the accepted rate had been only marginally different from that of the preceding week. Every month, the Central Bank also offers bearer bonds with a maturity of one year, two years, or five years. In addition, a cash reserve requirement was introduced in 1986. Since 1986, the authorities have been working on the improvement of the prudential supervision of all financial institutions and on the development of capital markets. In 1990, the Capital Market Development Authority was established, aiming at a further development of bond and equity markets. During the last decade interest rates were administered flexibly in order to reflect changes in inflation, and direct controls on lending rates were removed in July 1991. In the meantime, direct credit controls are still in place.

Vulnerable to the oil market shifts, Nigeria has experienced some difficulty in acquiring financial stability since it liberalized its interest rates in 1987. As already noted, the rate of inflation decelerated in 1990 after a short lapse in Nigeria's monetary policy in 1988-89. Selective credit allocations were abolished in 1985-86, and interest rates were liberalized in 1987. Since 1985, the authorities have actively implemented structural reform in the financial sector. A securities market for small companies was instituted in 1985 and in the following year a unified foreign exchange market was established. A Nigerian Deposit Insurance Corporation was founded in 1988. In the same year institutional changes were introduced at the Central Bank of Nigeria, and it became legally independent in 1991. Financial markets and indirect monetary instruments were already in place before the interest rate liberalization started, but they had to be reactivated. A treasury bill and treasury certificate auction was introduced in 1989 and a cash requirement for merchant banks was introduced in 1990. During the course of this liberalization program, the Nigerian authorities reacted flexibly to undesirable transitional effects of the liberalization. From mid-1989, banks were no longer allowed to extend credit based on their foreign currency deposits held abroad. In the same year the Central Bank of Nigeria and the banks agreed on limiting the spread between lending and deposit rates. In 1990, banks were requested to report on the activities of all their subsidiaries offering financial services. Given the somewhat slow response of interest rates to the steep deceleration in inflation in 1990, interest rates were temporarily readministered in 1991. As for the problem of excess liquidity in the financial sector, the Central Bank started issuing nontransferable and nonnegotiable stabilization securities in 1990.

The Malawian authorities removed interest rate ceilings in April 1988. Steps have been taken --albeit slowly-- to improve prudential bank supervision, to develop indirect instruments of monetary control and financial markets, and to enhance competition in the financial sector. In 1990, the Investment and Development Bank of Malawi, previously not a deposit-taking institution, was allowed to take corporate deposits and two parastatals were permitted to switch their deposits from the Reserve Bank of Malawi to commercial banks. A monthly auction of Reserve Bank of Malawi bills for commercial banks was introduced in November 1990. Credit ceilings were removed in 1991.

All the countries in this sample are making a fairly successful transition to a market-based financial system. The sequencing of their financial liberalization has more or less followed the plan outlined in Section II.3.c. With the support of the IMF all the countries followed fiscal and monetary policies aimed at stabilizing their economies. The success of these programs has been essential for the orderly transition to a market-based financial system. Although the spreads between lending and deposit rates did widen, the monetary and fiscal policies were in general sufficiently credible to adjust inflationary expectations downward. This avoided a sudden surge in real interest rates which, as the Latin American experience showed, can require a readministering and even a bail out of the financial sector. The Nigerian authorities had some problems in stabilizing prices, which affected inflationary expectations and led to high real interest rates in late 1990. In response, the authorities stepped in and readministered the interest rates temporarily. As a second step, they started developing or reactivating indirect monetary instruments and strengthened the regulatory framework.

The problems of excess liquidity and nonperforming assets posed a harder challenge for the countries in our sample. Given the seriousness of these problems in most of the countries, it was expected that it would take some time before indirect monetary instruments would mop up the excess liquidity. Furthermore, as the Ghanaian experience shows, discrete measures might have to be taken in some of the other countries to tackle the problem of nonperforming assets effectively. While the initial steps have been taken in these African countries to enhance the development of capital markets, more time is needed for these markets to develop further. In most countries progress has been made to enhance competition in the financial sector. In the cases of Malawi and The Gambia, however, the smallness of the financial market makes this a more difficult task than in the other countries in our sample.

IV. Conclusion

All of the countries discussed in this paper have taken strong steps to restore macroeconomic stability and economic growth since the mid-1980s. These programs include wide-ranging structural reforms, including the liberalization of the financial sector. The principal conclusion of this paper is that despite the progress that has been made in restoring macroeconomic stability, the destabilizing experience of the late 1970s and early 1980s has hampered the development of medium-term and long-term credit markets making banks reluctant to attract long-term savings and extend long-term loans. This has had a negative effect on the efficient allocation of credit in the economy, and together with institutional problems such as the oligopolistic nature of the financial sector in these countries, can explain a tendency toward the rather sticky behavior of interest rates and an increase in the spread between deposit and lending rates in The Gambia, Ghana, Nigeria, and Malawi.

It is important to note that financial liberalization did not contribute to financial instability in the countries in our sample, as it did in Latin America. Given the relatively low level of development of the financial sector in these countries, fiscal policy is the most important determinant of inflation, exchange rates, and current account imbalances. Monetary policy plays a very important supportive role, but can only adjust these imbalances in the context of a tight fiscal stance. In the case of a loose fiscal policy, interest rate liberalization can reduce the effectiveness of monetary policy, if the indirect monetary instruments are not yet as effective as the interest rate ceilings, which can exacerbate existing imbalances.

As for institutional issues, the experience of these countries underlines the importance of a competitive financial sector, including all institutions providing financial services. A unified legal framework defining the role of all financial institutions is an essential part of a financial liberalization program. The experience of these African countries emphasizes the role of well-developed bond and equity markets. These markets have brought to an end the monopoly position of the banking sector for the provision of financing means to the private sector and the government. As the Ghanaian experience shows, the importance of allowing nonbank institutions and the public to participate in the newly developed treasury and securities markets is an effective way of increasing competition in the financial sector.

As for the sequencing of financial liberalization programs, some lessons can be drawn from the experience of these countries. Their experience confirms the lessons already drawn from the Asian and Latin American experience with regard to the importance of macroeconomic and financial stability. Tight fiscal and monetary policies are a sine qua non for an smooth transition to a market-based financial system. Such stability is not only important to avoid accumulation of nonperforming assets of commercial banks, but also to dampen inflationary expectations, which is especially crucial to avoid too large an increase in real interest rates. Macroeconomic stability also creates room for capital markets to develop. The timing of the interest rate liberalization within the context of the overall stabilization program is another key factor. The countries in our sample, with the exception of Kenya, liberalized interest rates early in the overall stabilization program. Given the extensive regulation in the financial sector in these countries, this early liberalization of interest rates sent a strong signal about the commitment of the government to financial sector reform. Nevertheless, several other factors --including institutional rigidities, the recent history of macroeconomic instability, the lack of competition, and the heavy burden of nonperforming assets and excess liquidity-- led to an increase in the spread between lending and deposit rates, mostly through a reduction in deposit rates. While these transitional phenomena went counter to the expectation of higher and positive real interest rates, which would spur investment and economic growth, it is anticipated that they will disappear as indirect monetary instruments and a new regulatory framework become more effective. As the case of Nigeria shows, though, this strategy of an early liberalization is not without risk and requires flexible and adequate policy responses to undesirable interest rate patterns.

Along the same line, the analysis in this paper supports the Mirakhor-Villanueva argument for a gradual reform of the financial sector. A financial reform as suggested in Section II.3.c. requires several years to implement. Given the large macroeconomic and financial imbalances that faced these countries in our sample, their stabilization programs will take time to be fully effective. It will take even longer to eradicate expectations of high inflation in the private sector. Moreover, the development of indirect instruments and bond and equity markets, the reform of the legal framework, and the privatization of financial institutions cannot be accomplished in a short time span.

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