FINANCIAL REFORMS AND INTEREST RATE SPREADS IN THE COMMERCIAL BANKING SECTOR IN KENYA

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DECLARATION

Except for references specifically indicated in the text, and such help as I have acknowledged, this thesis is wholly my own work and has not been submitted at any other university or college for degree purposes.

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ABSTRACT

Financial reforms were a major component of structural adjustment programs deemed necessary for developing countries in the mid 1980s. These were not only meant to improve the sector, but would ultimately enhance economic growth and help in poverty alleviation. At the top of these reforms was financial liberalisation. Kenya, like many other sub-Saharan African countries, undertook financial liberalisation in 1991, one of the measures was decontrolling interest rates.

With market driven interest rates in place it was assumed that there would be increased efficiency in bank lending, as well as growth in credit availability as deposits increased. A key indicator of this improved intermediation process would be a narrowing interest rates spread, that is, the margin between the deposit and lending rate. Paradoxically, however, the expected benefits of these reforms did not accrue to Kenya's banking sector.

This study focuses on financial reforms and the spread of interest rates in Kenya's banking sector. Using a trend analysis, spanning the period before and after liberalisation, interest rates spread are shown to have escalated dramatically upwards after liberalisation. An analysis of three macroeconomic variables, namely, the exchange rate, inflation rate and economic growth offer little, or inconclusive evidence, that they were the main causes of the wide interest rate spread. In fact, the spread is closely linked to institutional/structural factors such as non-competitiveness in the banking sector, imprudent lending practices and poor and/or inadequate banking supervision. Policies for improving the institutional infrastructure and thus moderating the spreads are highlighted.

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LIST OF ACRONYMS

AERC	African Economic Research Consortium
DRC	Democratic Republic of Congo
DR	Deposit rate
EDI	Economic Development Institute
ER	Exchange Rates
Forex-Cs	Foreign Exchange Bearer Certificates
FSAC	Financial Sector Adjustment Credit
GDP	Gross Domestic Product
GDPG	Growth in Gross Domestic Product
GER	Growth in Nominal Exchange Rate
GINF	Growth in Inflation
ICPAK	Institute of Certified public accountants-Kenya
IEA	Institute of Economic Affairs
IFIs	International Financial Institutions
IMF	International Monetary Fund
INF	Inflation
IND	Interest Rate Differential
IPAR	Institute of Policy Analysis and Research
KANU	Kenya African National Union
KIPPRA	Kenya Institute for Policy Research and Analysis
Kshs	Kenya Shillings
LR	Lending Rate
NARC	National Rainbow Coalition
NBER	National Bureau of Economic Research
NBFIs	Non-Bank Financial Institutions
OECD	Organisation for Economic Co-operation and Development
SACU	Southern African Customs Union
UEMOA	Union Economique et Monetaire Ouest-Africanine
WAEMU	West African Economic Monetary Union

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DEDICATION

In loving memory of my Mum

CHAPTER ONE: INTRODUCTION

1.1 INTRODUCTION

A key indicator of financial performance and efficiency in the banking sector is the spread between the lending and deposit rates. If the spread is large, it works as an impediment to the expansion and development of financial intermediation. This is because it discourages potential savers due to low returns on deposit and thus limits financing for potential borrowers. Put differently, there is low credit availability due to depressed savings. High lending rates on the other hand would lead to a reduction in credit demand and the money supply as a result of the high cost of borrowing (Aziakpono, Wilson and Manuel, 2005:4).

Banks form an important part of the financial system and are vital for economic growth. They are the main source of credit and have a direct impact on the level of investment and expenditure in an economy. Interest rates which are described as a payment from borrowers to lenders to compensate the latter for parting with the funds for a period of time and at some risk are central for both the lending and borrowing process (Howells and Bain, 1998:45). Both high and low interest rates affect the spread and a wide spread would be negative for credit extension. The research therefore assesses the problem of high interest rate spreads within the banking sector in Kenya before and after financial reforms.

1.2 NATURE OF THE PROBLEM AND WHY IT IS WORTH ADDRESSING

Kenya's interest rates were liberalised in July 1991. In addition to the removal of controls on interest rates, liberalisation also entailed the elimination of credit controls that were previously in place. Despite the assumed benefits of financial liberalisation, available data shows that interest rates increased significantly after that. This sharp escalation was particularly in the spread. According to Ndung'u and Ngugi (2000:5), deposit rates remained low while lending rates kept moving upwards. As of December 2003, the nominal average savings deposit rate in Kenya among commercial banks was 3.51% while the nominal lending rate was 14.11%. The spread was 10.6% (see appendix A1). Compared to the 1980s and early 1990s when

the spreads remained below 4%, these wide spreads in latter years were not healthy for the economy.

According to Ndung'u and Ngugi (2000:5), the widening interest rate spreads indicated either inefficiency in the intermediation process with weak institutional infrastructure; macroeconomic instability; or a non-competitive structure in the banking sector. Indeed in Kenya, high interest rate margins were blamed for the depression in savings as well as investments. Wagacha (2001:1) observed that economic activity in the productive sectors was reduced and enterprises came under pressure where debt/equity ratios rose and net worth fell. Banking sector non-performing assets similarly slashed banks' net worth, raising problems of insolvency.

It is therefore evident that high spreads are bad for the performance of the economy and thus harmful on the welfare of the citizenry. A developing country like Kenya whose economy is heavily reliant on primary sectors like agriculture and small enterprises for economic growth badly needed an injection of investments. High interest rates as seen above depressed savings and thus lowered the available funds for investment. The potential for growth in local enterprises was greatly undermined and the high cost of borrowing also deterred foreign investment flowing into the economy. This occurred especially when financing was being sought from the local banking system. On the whole, the wide spreads not only contributed to the poor performance of the economy, but also greatly undermined any attempts at poverty reduction.

These negative effects of wide spreads on the financial sector and the rest of the economy raised major debates towards the end of 1999 onwards. According to Ndung'u and Ngugi (2000:7), the spreads were not only disadvantageous to savers and borrowers, but they were also detrimental at the macroeconomic level. This is because they contributed to inflation accelerating and the economy going into a prolonged period of recession. During 2000, Kenya proposed to reverse a policy of financial liberalisation by re-introducing regulated interest rates through the use of a Treasury-Bill benchmark on lending rates, deposit rates and other supportive measures to the commercial banking sector. The initiative is called the Donde bill after the legislator who introduced it in the Kenya Parliament (Wagacha, 2001:1).

In 2002, Kenya saw a new political dispensation with the unseating of the KANU (Kenya African National Union) regime widely blamed for Kenya's past economic ruin. The newly elected coalition government came into power with a pledge to uproot corruption among other vices in the economy. According to Market Intelligence (2003), the effect of this for the banking sector was the invoking of Section 44 of the Banking Act[1] by the Finance minister during the 2003 budget. This and stricter supervision of banking activities by the central bank has led to a decline in profits for the banking sector and a narrowing of interest rate spreads in the past year.

The issue of high interest rate spreads and how it is linked to the reform process is important. As mentioned above, Kenya's economic growth prospects were severely hampered by the high interest rate regime. The escalation of poverty and the poor performance of the financial sector during this period of high interest rate spreads are the major motivations of this research topic.

1.3 GOALS OF RESEARCH

The main goal of this research is to analyse interest rate spread patterns in Kenya, with particular emphasis on the period after liberalisation of the financial sector. Among the pertinent issues to be examined will be:

- The financial intermediation process and the impact of reforms.
- The effect of financial sector reforms on interest rate spreads in Kenya.
- Factors that may have influenced the spread and whether they are of a macroeconomic or structural nature.
- Possible ways of moderating the wide interest rates spread.

[1] The Act provides that permission must be sought by Banks from the Minister of finance before raising their charges.

1. 4 RESEARCH METHODS

The initial part of this research involves an extensive literature review. This is important in assessing the theoretical underpinnings of financial intermediation and how the efficiency of intermediation is affected by interest rates spreads. The next part of the research looks into the rationale of financial reforms. Arguments for and against financial liberalisation are covered. Thereafter the effect of financial liberalisation especially in developing countries is explored in detail.

Second, secondary data obtained from various sources including; International Financial statistics (IMF), Institute of Economic Affairs (IEA-Kenya), Kenya Institute of Public Policy Research and Analysis (KIPRA), Institute of Policy Analysis and Research (IPAR), the Central bank website and banking surveys published in the Market Intelligence 2001 and 2003 issues. These form part of the important literature and data necessary for empirical analysis in this study.

The empirical analysis involves a trend analysis, using data obtained from the above sources. This involves an assessment of interest rate spreads between 1983 and 2003. The selection of this period is based on the fact that banks had little say over spreads under a regime of controlled interest rates before 1991. It is only after 1991 that they had freedom to determine their spreads with most financial sector reforms taking place around this period. Furthermore, this was a period of relative stability in the country after some volatility in the political front in the preceding years. Tabular trend statements and simple graphs are used to track interest rate spreads over this period and offer an overview of their movement patterns.

1.5 PLAN OF THE THESIS

Chapter two of this thesis focuses on two broad issues, namely, the financial intermediation process and financial reform process. In this chapter, the critical role that financial intermediation plays in the well-functioning of any economy is illustrated. Arguments for and against the control of intermediaries and the implication on interest rate spreads is done. Other aspects of the intermediation process examined here include such aspects such as the risk and the term of interest

rates in light of their importance to spreads. The second part of the chapter deals with the financial reform process addressing financial liberalisation and financial repression. This is important since reforms affect the environment in which intermediaries operate therefore affecting spreads.

Chapter three focuses on financial reforms, deemed necessary for the economic growth in developing countries by International financial institutions (IFIs). Critics of reforms do not think that they enhance the intermediation process. Barajas, Steiner & Salazar (2000:157) for example, note that banks in developing countries typically show significantly high and persistent interest rate spreads even after financial liberalisation. This chapter therefore examines the framework under which reforms were implemented and the experience of countries that undertook financial liberalisation. The final part looks at the effect reforms had on interest rate spreads in various developing countries.

Chapter four examines interest rates spreads in Kenya in the pre-and post-liberalisation period. The background of financial sector reforms, their effect on the sector and how these developments have affected banking performance and interest rate spreads are also discussed. The chapter concludes by providing an analysis of some of the factors that may be leading to the wide interest rate spreads in Kenya. Finally, a summary of conclusions reached in previous chapters, as well as some recommendations, are presented in chapter five.

CHAPTER TWO
FINANCIAL SECTOR REFORMS AND INTEREST RATES

2.1 INTRODUCTION

The purpose of this chapter is to illustrate that first, financial intermediation is crucial for the well-functioning of any economy and second, to present some argument for and against the control of intermediaries. Both aspects have a direct bearing on efficiency and similarly on interest rate spreads. It is a fact that interest rates spreads are affected by financial institutions and the efficiency of these institutions is subject to varying degrees of government intervention.

The intermediation process, its implication on the financial sector and ultimately its impact on interest rates are introduced first. This is followed by linking it to risk and the term of interest rates, particularly in light of their importance to spreads. The second part of the chapter deals with a critical assessment of financial liberalisation and financial repression. The point is to illustrate that the control, and the economic environment in which they operate, are important aspects when considering efficiency. The next chapter deals more specifically with financial sector control and interest rate spreads in various developing countries.

2.2 FINANCIAL INTERMEDIATION

The interest rate spread, which is the difference between the lending and the deposit rate is a key indicator of financial performance and efficiency in the banking sector. If the spread is large it works as an impediment on the expansion and the development of other financial intermediation, that is, it discourages potential savers—due to low returns on deposits—ultimately limiting financing for potential borrowers. In other words, there is low credit availability due to depressed savings. It is therefore important to assess the process of intermediation and its significance within the financial system.

Intermediation in general terms would imply a position taken by a middleman, or in a broader dimension a middle-participant. Hester (1969:602) notes that "the level of middlemanness, as a measure of financial intermediation in the economy is unknown". This implies that the intermediation process is a complex process involving a wide range of participants. Within the financial sector, intermediation would generally mean middle participation in exchange for financial assets. But, to be able to understand financial intermediation more accurately the nature of the process must be described in greater detail.

2.3 FINANCIAL INTERMEDIARIES

In defining financial intermediaries, Auerbach (1988:55&65) describes them as firms that take funds from the lender (savers) and channel them to borrowers (investors). He further defines them as firms that earn their income on the spread between the yields on the financial assets they create and the financial assets they buy. Gorton & Winton (2002) in addition see financial intermediaries as central in the creation of a pool of resources needed by companies for investment. This role is of great importance for the saving/investment process necessary for economic growth (Cochran, Call & Glahe, 1999).

Underpinning the importance of financial intermediaries in economic growth, Gorton & Winton (2002:4) trace their existence to the theory of the firm. This is because financial intermediaries themselves are *firms* which stand between those who wish to lend and those who wish to borrow in the financial system[2]. They are composed of an array of competing firms: banks of different kinds, building societies, credit agencies', and so on.

In the market for loans there is often a problem of reconciling the needs of the lender and the borrower. In the absence of financial intermediation there is direct flow of funds between the lender and the borrower, through direct financing, with no

[2] Faure (2001) sees the interaction of five key elements as vital in his definition of the financial system. These are: lenders and borrowers, financial institutions, financial instruments, money creation and the institutional arrangement (financial markets).

interposition of a broker[3] (Faure, 2001). In the presence of an intermediary, however, Carter & Partington (1981:38) describe the process as follows. First, the lender does not provide funds directly to the borrower, but rather the lender places these funds with a financial intermediary. Second, the lender now has a deposit or a claim on the intermediary (if the funds are held by a bank the resulting claim on the bank is in the form of a bank deposit). Third, on receipt of the funds received from the lender the financial intermediary is capable of on-lending to the borrower. However, the borrower normally has to offer some form of security for the funds.

2.4 THE NEED FOR FINANCIAL INTERMEDIATION

The various circumstances and requirements which apply to lenders and borrowers are discussed separately in the following sub-sections.

2.4.1 Lenders

In making a decision on the various choices for saving, and in the process obtaining a claim or an asset on the financial intermediary, there are certain elements common to lenders.

First, most potential lenders would wish to minimise the risks on their lending. This risk can take a number of forms, for example: i) the risk of default, that is, the borrower is unable to repay the loan, ii) the risk that the market value of the asset held by the lender may fall and thus reduce the wealth of the individual, iii) the risk associated with inadequately diversified assets, iv) the risk that the lender may need funds before the loan is due to be repaid, that is, the term of the loan may be too long.

Second, two other aspects not unrelated to risk are convenience and liquidity. The potential lenders will examine these prior to the transaction, but usually after assessing the risk. Of more importance will be the liquidity of the investment. The term *liquidity* in this context means the ease with which an asset can be sold or converted into money at the convenience of the holder, and the certainty that the capital value of the assets will be maintained. The lender may be conscious of the

[3] The broker acts as a go-between in return for a commission.

uncertainty of his future need for funds, thus the liquidity characteristics of the investment will be very important. This may be seen in a preference, by lenders, for relatively short term lending (Carter & Partington, 1981:38).

Third, lenders usually require assets as security against risk. The main rationale for this is the existence of asymmetrical information. It is costly to examine alternative opportunities that may exist for lending. To escape from having to study the numerous data and material published by companies relating to their commercial and financial status, the lender will rather require some security.

2.4.2 Borrowers

A borrower looks for finance at the lowest price for a given period of time and at a particular point in time. In exchange for such funds, an asset as a claim against the borrower is usually provided to the lender. The claim that will induce the lender to part with funds may take various forms, for example, fixed assets like land and buildings. The form, however, must be acceptable to the lender. In fact Gambacorta & Mistrulli (2004:437) state that the claim against the borrower is the main factor taken into consideration before a loan transaction can take place.

The borrower also needs information about the market for funds. Carter & Partington, (1981:39) indicate that the purpose of this information is to avoid i) difficulties in access to funds and/or ii) higher rates of interest than are necessary. In the absence of this information, the borrower is faced with various additional risks. Key among these is the imperfect transmission of information, specifically; a potential lender exists but is unaware of a suitable borrower. This according to (Hubbard, 1997:254) increases the cost of borrowing in the financial markets. Another important risk is that the lender may wish to terminate the loan at an inconvenient time to the borrower. The borrower in turn may have to re-borrow at a higher rate, and if re-borrowing is not possible, sell off assets in order to meet the demands of the lender.

A great deal of borrowing by companies is for the purchase of capital equipment (for example; machinery, buildings etc), which normally have a long life. This will therefore require the term of the loan to be lengthy in order for the equipment to generate enough funds to cover its costs.

From the discussion above, it is clear that lenders tend to favour the short-term while borrowers the long-term in intermediation. The market may find a term-structure solution if the rate of interest on the long-term lending is allowed to adjust sufficiently upwards relative to short term lending. This change in interest rate would persuade lenders to lend long and borrowers to borrow short[4]. This is discussed in greater detail in sub-section 2.6. This change in market rates, in addition to other aspects of financial intermediation, provides a way in which the needs of both the lender and the borrower can be met. Through financial intermediation, lenders obtain information about the quality of potential borrowers at reduced information costs (Hubbard, 1997:255). The role of information and how financial intermediaries possess advantages in various aspects is explored further in the following sections.

2.5 THE PROCESS OF FINANCIAL INTERMEDIATION

Based on the fact that there are difficulties in reconciling the needs of lenders and borrowers, this section seeks to examine more closely the operations of the financial intermediary. Carter & Partington, (1981) assert that in the wider sense, the assets of financial intermediaries are less liquid than corresponding liabilities. In other words, the financial intermediary provides the ultimate lender with a more liquid asset. For example, with a deposit bank, depositors put funds into their current accounts or savings accounts. The funds are used to purchase assets. The liabilities of the bank are the deposits of which a large portion are payable to their customers on demand. For the holders, such deposits are assets, which are very liquid as they can be converted into cash on demand. Most assets[5] held by the bank are less liquid and cannot be converted easily into cash. This is because loans to customers and

[4] With interest rates on long term debt higher than short term debt, lender would prefer to lend long so as to earn more in the long term while borrowers would want to borrow for the shortest period in order to pay minimum interest on their loan.

[5] Although these assets may be sold in the market by banks, they might be reluctant to do so because stock market prices of such securities could be at an unsatisfactory low level. The decision to sell these assets might thus involve these intermediaries in the risk of capital loss.

government bond holdings normally have a time frame before maturity. Many authors [Carter & Partington (1981:41), Cochran, Call & Glahe (1999:57)] agree that this function of generating a new type of asset is vital for financial intermediaries.

2.5.1 Lenders

Though an intermediary obtains a less liquid asset from the borrower, it offers the lender a more liquid one. The lender therefore easily satisfies his/her liquidity needs and gets minimum risk associated with the loan. Through specialisation, the lender is also able to solve the problem of information since the managers of the financial intermediary will accumulate skills associated with the use of the funds and purchase of assets. The lender also has a wide range of intermediaries to choose from depending on his particular needs (Carter & Partington, 1981).

2.5.2 Borrowers

The presence of financial intermediaries is likely to lower the interest rates paid by borrowers. This is because lenders will be prepared to accept a lower rate paid to them by the financial intermediaries as part of the return they obtain in the form of the liquidity quality of the asset. The absence of financial intermediaries would mean greater risks for the individual lender and accordingly higher interest rates as compensation (Carter & Partington, 1981:42-43). According to Diamond (1996), this specialisation aspect of financial intermediaries remains one of its most important services, leading to a reduction of risks in the market for loans. The nature of specialisation and the scale of operation of the financial intermediaries translate to advantages to both borrowers and lenders. This process ensures that there is maximum availability of funds at competitive interest rates.

The success of financial intermediaries is based on various economies of specialisation and scale. For example, they apply to safekeeping of securities; enforcement of claims against issuers of direct securities; performing large amounts of accounting and paperwork, etc. However for this study, the economies of specialisation and scale as they relate to aspects of financial operations will be the main focus. Four important aspects, i) economic and financial intelligence, ii) Transaction costs iii) diversification of assets and iv) offsetting inflows and outflows are discussed below.

First, economic and financial intelligence. Most individuals are not experts in financial analysis, and even those who are find the cost of a thorough analysis burdensome. A financial intermediary is in a better position to exploit economies of specialisation and scale in the acquisition and use of information (Mishkin, 2004). It can employ experts in various branches of financial analysis, purchase financial intelligence from others, analyse and compare many different securities, and spread the cost over its large volume of assets (Carter & Partington, 1981). Through the above function, an intermediary not only ensures reliability of the information produced, it also acquires this information at the best cost (Leland & Pyle, 1977 in Gorton & Winston, 2002). This function is closely associated with an intermediary's transaction costs and diversification function.

Second, Transaction costs. These are incurred in acquiring, holding and selling securities. For example, a buyer must take a decision to buy, communicate with the broker or dealer, and pay a brokerage fee. The same happens when he/she wishes to sell. Some of the transaction costs are either fixed in the total amount or are a proportion of the total value of the transaction. A financial intermediary can reduce transaction costs far below the total that would be incurred if each individual supplier of the funds acquired and held his/her own portfolio of the direct securities. This is partly because the intermediary is able to buy in large lots, taking advantage of economies of scale, and thereby lowering the prices of transaction services (Mishkin, 2004:30). Using an intermediary is therefore far superior and more cost effective than dealing in the direct sale of purchase of assets without one (Diamond, 1996:52).

Third, diversification of assets. In a world of uncertainty, diversification of assets is a useful method of reducing risk and of achieving a better combination of income, safety and liquidity. Many households and entities other than financial intermediaries form their own diversified portfolios of money and direct securities. However, those with only modest amounts of funds at their disposal find it inconvenient and costly to achieve a high level of diversification without recourse to a financial intermediary. Since direct securities are not infinitely divisible, but are available only in discrete units, many individuals could buy only a few different issues even if they bought one

unit each. They would also encounter high costs of gathering and analysing information as earlier pointed out in this study, about many different issues as well as high transaction costs. A financial intermediary, with large amounts of assets, can diversify more effectively and much more economically. The success of diversification as a means of reducing risk and achieving a better combination of incomes, safety and liquidity in a portfolio, depends not only on the number of issues held but also on the extent to which the risk on the different issues held offset each other (Carter & Partington, 1981:43).

Fourth, offsetting inflows and outflows. Outflows from a financial intermediary include two major types. These are payment of interest or other income on outstanding claims and withdrawals by those who had previously entrusted funds to the intermediary. Inflows on the other hand include, proceeds from issues of new claims against the intermediary; income on the intermediary's assets; and proceeds from maturing direct securities held by the intermediary (such as maturing debt claims and monthly receipts of payments on the consumer instalment debt and amortized mortgages). All three types of inflows help an intermediary meet outflows without having to sell direct securities before they mature. It is, of course possible that an intermediary would experience large net withdrawals at some period and large net inflows in others. An intermediary bases its forecast of inflows on different types of information, for example, its own past experience, the past experience of other intermediaries of the same or similar type and knowledge of maturity schedules of its issues. Such information however does not enable an intermediary to forecast with certainty its future outflows and inflows. Thus the management of an intermediary faces some possibility that withdrawals will exceed inflows, which would decrease its total assets. If this occurs, failure to meet these obligations promptly and fully would spell disaster. A prudent management will arrange sources of liquidity equal to a fraction of its total assets, such as 5-10%. An intermediary would therefore use its sources of liquidity to cover any net outflows, that is, borrowing facilities and its holdings of money and other liquid assets (Chandler, 1979:111-117).

The above, provides both a rationale and understand of the process of financial intermediation, the importance of economies of scale and specialised financial operations. This gives an economic basis of financial intermediation.

2.6 RISK AND TERM OF INTEREST RATES

The interest rates charged on a loan will greatly depend on the risk and/or the term of interest rates. Howells & Bain (1998:45) define the interest rate on a loan as a payment to lenders to compensate the latter for parting with funds for a "period of time" and at "some risk". Together the term of a loan and the risk associated with borrowing the loan, give rise to the whole range of interest differentials or spreads. It is therefore important to focus on these two factors in some detail due to their significant impact on the spread.

2.6.1 The effect of term

As highlighted earlier, lenders generally prefer to lend for the shortest period while borrowers prefer to borrow for the longest period. With this in mind, the borrowers then have to pay the lenders a premium for the use of longer–term funds in order to induce them away from their preferred status.

Lenders' preference for short–term, in this argument, is mainly as a result of uncertainty. Although lenders may plan to have the funds available for lending for a long period, there is always the danger that they may need to have use of the funds earlier than they had planned. In such an instance, having funds tied up for a long period would then be costly; in either preventing the lenders from carrying out urgent spending, leaving them unable to pay bills according to Howells & Bain (1998:64). Short-term lending thus offers greater flexibility to the lender. If the lenders do not need to use the funds immediately, they can re-lend these at their convenience.

Borrowers' preference for long term loans according to Howells & Bain (1998:64) arise because they wish to avoid the costs associated with having to renegotiate or replace loans on maturity. This is because most investment projects carried out by the borrowers need a long time to break-even and make profits thereafter. Borrowers are

therefore willing to pay more for the long-term loans in order to avoid re-investment or rollover risks. These risks would tend to be costlier if taken on by the borrower than the higher interest rate on the loan to the borrower for a long-term loan at the onset.

A premium must therefore be paid by the borrowers to tempt lenders away from their short-term preference and as stated earlier, it is a cost that the borrowers are willing to pay in order to have guaranteed long-term use of funds. This premium is a liquidity premium increasing with the term of the loan but at a diminishing rate. "Clearly, this suggests that lenders are prepared to discriminate sharply between lending for, say, 1 to 5 years but are much less concerned about the difference for, say, 20 and 25 year loans"(Howells & Bain, 1998:65). The reason for the diminishing rate of increase in the premium lies in the practice of discounting. This term structure of interest rates thus leads lenders to lend short and borrowers to borrow long.

2.6.2 The effect of risk

In defining interest rates, it is observed that they influence behaviour involving commitment over a period of time. Loans are made for a specific period even if they can be sold in a secondary market (the original intention was a commitment for a single period). Likewise debts are entered into for a period of time. It will often be more difficult for a lender to get out of a loan contract since the funds may well have been invested in a long-term project with a long payback period. The above means that borrowers and lenders enter into contracts which involve some degree of risk. Risk in financial terms refers to the possibility that outcomes may differ from what was expected. It is usually assumed that the degree of risk can be measured and expressed as a probable statement, calculated on the basis of past outcomes. The risk attached to an individual loan, or asset, is thus an element in the size of the risk premium (Howells & Bain, 1998:65).

The price-of-risk is the price of the average, or standard, risk associated with an investment. This is determined by the difference in the rate of return on a portfolio of assets, which are representative of the whole population of risky assets, and the return on risk-free assets. More specifically, according to Howells & Bain (1998:67) this is

the market price of risk which would rise or fall with changes in the community's degree of risk aversion.

There are various forms of risks in the market. Howells & Bain (1998:67) provide some examples, namely: default risk—a case where the borrower cannot repay the principal; capital risks—when a loan has a lower nominal value when it terminates; income risk—the possibility that the flow of interest, dividends or other payments are less than were expected. Other risks associated to operations include business risk (from the nature of the activity to which the borrower intends to apply) the borrowed funds and financial risk (the general pattern of financing that the borrower chooses)

Gains are possible when assets are combined into a portfolio where risks are diversified. However, even with diversification some loans remain riskier than others by virtue of their differing exposure to market risk. In addition, Auerbach (1988:172) points out that all markets are faced with uncertain, or stochastic, events. Changes in expectations, or uncertainty about future events, could cause implied real rates in the future to incorporate what may be termed an uncertainty premium. Thus lenders require a premium over and above the risk characteristics inherent in a particular investment.

2.7 INTERMEDIATION AND FINANCIAL SECTOR CONTROL

In summary, financial intermediaries will accept deposits and make loans, paying out interest on the former and receiving interest on the latter (Fisher, 1971:218). Financial intermediaries thus interpose between the lender and the borrower. Gurley & Shaw (1960) in Auerbach (1988:66) examine the middlemaness of financial intermediaries. They assert that financial intermediaries have flourished because this intermediation function allows them to satisfy the needs of both the lender and the borrower to their mutual benefit. Lenders obtain a more liquid and less risky asset, which the ultimate borrower would wish to make available to the lender. Without the intermediary it is possible that the lender may not lend because the asset offered by the borrower in exchange for funds has unacceptable qualities, for example, it may be too risky or illiquid (Carter & Partington, 1981:49). Thus according to Fuerst

(1994:362) the intermediaries specialize in the evaluation of risky projects and enforcement of loan contracts.

The basis of successful financial intermediation is related to the scale of operation of the intermediaries. Large-scale operation allows the risk of default and other risks to be spread over a large number of investors, and also allows the intermediary to hold a more balanced mix of assets. This helps reduce the risk of losses, stemming from putting all your eggs in one basket (Carter & Partington, 1981:49). Thus in the final analysis, financial intermediaries play a crucial role in the flow of funds, and this is partly achieved due to the many comparative advantages they enjoy in their operations over direct provision of funds (Diamond, 1996).

The existence and growth of financial intermediaries aids the process of savings and investment in an economy and an efficient intermediation process would help in moderating the spread of interest rates. The well functioning of the financial sector, and likewise the benefits received from intermediation, depends on the way in which it is controlled. The control mechanisms also influence interest rate spreads and consequently economic development and growth. The next part of this chapter focuses on these aspects, namely, financial repression and liberalisation.

2.8 FINANCIAL LIBERALISATION AND COUNTER ARGUMENTS

Most developing countries at one time or another maintained some form of direct controls over interest rates and other instruments within the financial sector. However with the advent of adjustment programmes[6], financial sector reforms were introduced with a view to moving away from these controls and towards more market oriented instruments and policies.

[6] With most African economies experiencing economic crisis in the 1980s, the international financial institutions (IFIs) recommended adoption of structural adjustment programmes (SAPs) to stem this crisis. The SAPs which were part of neo-liberal school of thought, advocated the implementation of stabilisation policies and market-oriented policy reforms especially in developing countries. By the mid-1980s, these became a pre-condition to lending by the IFIs as well as other lenders. With SAPs in place, the scale of government intervention in the markets, including the financial market was greatly reduced (Brownbridge and Harvey, 1998:6).

At the heart of the financial sector reform process was the advent of financial liberalisation. In the pre-liberalisation period, financial repression, which entailed extensive government intervention within the financial sector, was prevalent in most developing countries. According to Brownbridge & Harvey (1998:1) this was particularly evident in Africa where newly independent governments believed that credit should be allocated according to the development objectives of the nation. To ensure that this happened, governments intervened in the banking sector by imposing control on interest rates, exchange rates as well as on credit extension. Liberalisation efforts were therefore aimed at reversing this through a variety of measures such as the moving away from direct controls on interest rates and exchange rates to more market oriented ones (Ndii, 1997:40).

Within the banking sector, measures establishing freedom of entry into and procedures for orderly exit from industry were put in place. In addition to the above, there was a reduction in the reserve and liquidity requirements for banks. Credit allocation directives as well as concessional interest rates to certain borrowers were abolished or minimised. Finally, credit controls in the capital account of the balance of payments were also eliminated (Wagacha, 2001: 1).

A more in-depth analysis of financial liberalisation and counter arguments is undertaken in the following sections. Each side is examined separately. Later in this study, it will be important to assess the effectiveness of liberalisation and whether there is a case for government intervention, albeit on a limited scope. It is therefore important to look at arguments on both sides of the reform process in order to analyse the efficiency and effectiveness financial intermediation process.

2.9 RATIONALE FOR FINANCIAL LIBERALISATION

Financial liberalisation, often followed long periods of financial repression, was implemented to put in place market-oriented policies expected to have positive effects on the economy. The underlying hypothesis behind financial liberalisation according to McKinnon (1973) and Shaw (1973) in their financial repression theory is that it would lead to enhanced levels of financial savings and investments in the economy.

In addition to this, it is argued that there would be improvements in resource allocation.

The above contention is based on the observation that since the theory is founded on the neoclassical school of thought which advocates competitive and free markets as the most efficient way of allocating resources; any attempt at regulation would be a *second–best* strategy. Accordingly, minimal benefits would accrue from interfering with markets. Liberalisation according to McKinnon (1973:33) would eliminate price distortions, and through increased efficiency in the bank lending, create an enlarged monetary system and alleviate financial repression. Ultimately, the economy would benefit from stimulation in production and a positive moderating effect on interest rates.

Proponents of financial liberalisation view it as a crucial element for development. The alternative, according to McKinnon (1993 and 1973) can only plunge the economy into ruin. Many arguments are advanced against repression. One such argument is that financial repression involves the governments' use of the central bank and/or large state owned banks to control credit provision for purposes of development. This according to McKinnon (1993:67) leads to an emergence of informal lending schemes in the economy, often with adverse effects.

McKinnon (1973:68) points out that finance is channelled through "money lenders, pawn brokers and cooperatives for financing the rest of the economic activities due to the sorry record of organised banking in penetrating the economic hinterland of developing countries". He further states that the main cause of the mushrooming of these schemes is due to the fact that access to credit is a preserve of certain classes, with the exclusion of rural and small borrowers, who would benefit most and make the best use of the funds. Financial repression therefore, if pervasive in developing countries, would encourage credit restrictions and a proliferation of these informal lending schemes.

With only a few state owned banks extending credit at controlled interest rates, inefficiencies associated with monopolies would set in and the uncompetitive nature of the banking sector would hinder growth in savings due to low deposit rates. Repression would seem to therefore hinder development through the inefficiencies associated with it. The growth of informal schemes would in turn further damage the formal banking sector, impacting negatively on interest rates. Liberalisation is therefore seen by McKinnon (1993:69) as the way out of this problem by bringing about a vigorous competitive market where deposits and loans would increase with the abolition of controls. A more in-depth discussion of reforms in developing countries is undertaken in the next chapter.

In addition to the above, another argument for liberalisation, and against the role of repression in development, is advanced by Shaw (1973). He argues that financial repression hinders financial deepening as a vital ingredient for development. Financial deepening, a positive externality due to the consolidation of various liberalisation measures, would ensure that the economy escapes from a situation of excess demand and interventionism prevalent under repression.

With financial deepening, sound policy focuses on the relaxation of numerous restrictions in the financial sector. This should ensure that the economy and the financial sector would perform better. Effective financial deepening would lead to an improvement in the quality of financial assets available to borrowers and financial institutions would exhibit more efficiency as a result of measures such as specialisation in operations. Additionally, there would be less dependence on government for financing capital growth.

In turn, financial deepening results in an improved financial sector would lead to less capital flight abroad and as a result, there would be growth in savings which are then re-invested locally. Ultimately, deepening would lead to a moderation of the differential between various rates. For example, between the lending rate and the deposit rate (the interest rate spread), and between rates in the organised formal

market and the curb market that form part of the informal lending schemes mentioned earlier (Shaw, 1973:7-15).

Although McKinnon (1973) and Shaw (1973) are proponents of liberalisation, Shaw explores possible reasons for the existence of financial repression before making his counter arguments. First, repression is seen to exist as a means of ensuring that civil servants are guaranteed jobs. Second, repression is important due to aversion to usury[7] especially in lagging economies. Here, interest rates rise excessively rendering it necessary to use government regulation as a remedy. This particular line of argument is advanced by Keynes, who Shaw quotes as follows "...the rate of interest is not self adjusting at the level best suited for the social advantage but constantly seems to rise too high, so that the wise government is concerned to curb it by statute and custom and even by invoking the sanction of moral law" (Keynes cited in Shaw, 1973:92).

Financial repression thus helps in curbing monopoly powers or outrageous terms that the lenders may impose on their borrowers. If producers pay a high rate of interest on loans they would most likely pass on this extra cost to consumers thus raising the price of the final product. Prohibition of high interest rates would therefore help in preventing exploitation, economic stagnation, underemployment and high inflation.

The above justifications for repression by Keynes do not, however, change Shaw's views against any attempts to control interest rates by the government. According to Shaw (1973), Keynes did not distinguish between nominal and real rates[8]of interest. Moreover, as already mentioned above, government controls on interest rate and credit provision lead to even greater exploitation of borrowers from informal lending schemes and state banks (which are often monopolistic). Instead of controls, Shaw suggested alternatives such as raising the real deposit rates through increased competition and smaller interest rate spreads. This is best achieved through financial liberalisation (Shaw, 1973:94).

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[7] Lending at excessively high rates of interest.
[8] The real interest rate factors in inflation.

Another proponent of financial liberalisation is Fry (1997). Although his views on liberalisation mirror those indicated above, he offers an alternative argument on provision of credit by banks. According to the McKinnon-Shaw model, two factors are considered by banks before advancing loans. These are the transaction costs of administering the loan and perceived default risks attached to the loan (see sections 2.5 and 2.6). Whereas these two factors are important, Fry (1997) argues that the expected productivity of investment projects is of even greater importance. His point is that a project with higher expected productivity would be able to service the loan with more ease than one with lower productivity. It is therefore deemed to be less risky and would attract a lower risk premium (Fry, 1997:755).

These views are echoed by King & Levine (1993) who stress the need for financing the most promising projects in a bid to accelerate economic growth. By using this criterion for advancing loans, factors such as, "quality of collateral, political pressure, 'name', loan size and covert benefits to loan officers" King & Levine (1993:31), all which may influence loan allocation in a repressed regime, would be of minimal importance. Such factors make the loan market seem attractive to entrepreneurs who were previously deterred from it due to projects with low potential returns.

In addition to the above, distress-borrowers with liabilities exceeding assets and unable to repay their loans would borrow in order to finance their losses. This inevitably sets up an upward spiral trend with borrowing increasing as interest rates rise. Bad-borrowing would crowd out good-borrowing, setting in motion the adverse selection problem [Stiglitz & Weiss (1981), McKinnon (1993:38-41), Fry (1995: 305-6), Rojas-Suarez & Weisbrod (1995)]. Fry (1997:755-756) therefore suggests letting interest rates achieve a competitive free-market level. This he argues would increase both savings and investments while deterring entrepreneurs from engaging in low-yielding, high-risk ventures. Interest rates would stabilise at a market related level).

It is evident from the arguments presented above that controls on interest rates and credit provision are not beneficial to the economy. Fry (1997), for example, therefore advocates the abolition of interest rates controls altogether in a bid to enhance the average efficiency of investments through financial liberalisation. This would also

ensure that interest rates achieve their own free market-based equilibrium, with moderate spreads. However financial liberalisation requires certain prerequisites to achieve the desired goals. These are discussed next.

2.10 PREREQUISITES FOR FINANCIAL LIBERALISATION

The success of financial liberalisation is tied to certain conditions being in place before its implementation. Previously, the role of financial deepening in development was stressed. This deepening can only be achieved if liberalisation is effective. But for this to occur, Fry (1997:759) points out that, based on international experience, several prerequisites are necessary. First, prudential regulation and supervision of commercial banks is crucial. In order to achieve this there is a need for adequate accounting and legal infrastructure to be put in place. Second, the importance of price stability as well as fiscal discipline is emphasised. This would come about as a result of the central bank limiting inflationary pressure in the economy, for example, through the use of contractionary monetary policy. Third, there would be a need for commercial banks to exhibit competitive, profit maximising behaviour. Finally, a tax system that is free from "discriminatory explicit or implicit taxes on financial intermediation" should adopted (Fry, 1995:454-60 in Fry, 1997).

The importance of macroeconomic stability as well as prudent supervision and regulation of the financial sector for the successful implementation of liberalisation is again emphasised by Villanueva and Mirahkor (1990). Macroeconomic instability would adversely affect investment projects increasing the possibility of defaulting on loan repayment which in turn may result in credit rationing. Poor bank supervision and regulation systems would lead banks to provide high risk loans at high lending rates, especially in the presence of deposit insurance (Fry ,1997). Complete liberalisation of interest rates in the absence of the above conditions increases the probability of "wide spreads, bankruptcy of the financial institutions and loss of monetary control" (Nannyonjo, 2002:7). Giovannini & De Melo (1993) and Agenor & Montiel (1996) stress the need for fiscal discipline before liberalisation. Since the government at times finances its deficit by borrowing from the domestic or foreign

market, fiscal discipline would reduce its dependency on debt and bring better economic prospects.

Another important factor that would determine the success of liberalisation is the "appropriate sequencing, consistency and credibility of the policy reforms" (Nannyonjo, 2002:7). This would entail decontrolling interest rates while strengthening the domestic financial institutions and markets before opening the capital account of the balance of payments. According to Agenor & Montiel (1996) the removal of controls on the capital account, with real interest rates determined in the world market above domestic levels, is likely to lead to a balance of payment crisis due to large capital outflows.

Agenor & Montiel (1996) in addition to this argue that trade reform, through the removal of restrictions on the current account, should precede opening the capital account. By the depreciation of the exchange rate, the adverse effect of cuts in tariffs on the balance of payment is offset. This stimulates exports and dampens imports, which is especially important in export oriented countries. In these countries, a removal of restrictions on the capital account would be expected to lead to an appreciation of the real exchange rate reducing the profitability of the export sector. In other words, the removal of restrictions would adversely affect the reform process and its main objective of stimulating economic growth [Edwards (1984), McKinnon (1973) and Nannyonjo (2002)]. It is therefore important to get the reform process right to ensure that there are few, or no, negative spin offs to the economy. The next sections deal with the counter argument, namely, for financial repression.

2.11 CRITIQUE OF FINANCIAL LIBERALISATION

A justification for financial repression, and thus the maintenance of controls on interest rates and other instruments in the financial sector, is the poor performance of most of the financial reform policies in developing countries. Taylor (1983:196) views financial reforms as a subtle continuation of *orthodox stabilisation* policies. These policies which include measures such as monetary contraction and devaluation of the commodity price system would be of benefit in developed economies.

However, such policies would hinder growth in developing countries since these countries have unsophisticated poorly articulated economic systems.

Another argument advanced for Taylor (1983) against liberalisation is based on the assumption that liberalisation would improve mobilisation of savings and thus increase the supply of loans. Taylor argues that the opposite would actually happen especially in developing countries. As previously argued, it is assumed that interest rates would rise with the implementation of liberalisation measures. Rising interest rates would normally act as an incentive to increase savings as people seek to take advantage of the higher deposit rates on offer. In developing countries however, Taylor (1983) argues that a rise in interest rates would not raise the rate of savings. This is because people would not shift their funds from the informal loan market[9] prevalent in developing countries to the formal banking sector as hoped. And even if savings were to rise, the funds shifted to the domestic banking system from the informal one would be subject to the reserve requirement. The net supply of loans would therefore fall[10].

The above observation when combined with reduced financial deepening would lead to lower output growth as real supply of credit to firms is reduced. This view is shared by Buffie (1984), Kohsaka (1984), van Wijnbergen (1982, 1983) and Nannyonjo (2002). Under repression however, the government would not only act as a main source of loans, but it would also ensure that the best use of funds is achieved by advancing credit to the most productive sectors.

The presence of controls on interest rates and credit allocation characterise regimes under repression. These controls have been cited for inefficiencies in the financial markets by proponents of liberalisation several times in the discussions above. Stiglitz & Weiss (1981), however, argue that the extent to which repression is responsible for inefficiency in the system is exaggerated. The voluntary credit rationing by banks, even with a removal of interest rate controls and other restrictions,

[9] In many developing countries, the informal markets are efficient and well tailored for the needs of the small borrowers. The fact that they are easily accessible and lack the normal bureaucracy and stringent requirement in loan application also works to boost their popularity.
[10] Supply of loans would only rise if foreign currency holding are better substitutes for deposits

may be a source of distortions in the markets that may breed inefficiency. Even if banks do not ration credit, the removal of controls would result in an increase in interest rates which would increase savings as well as lending. If the volume of lending increases beyond a certain point; the expected return to banks would reduce due to two reasons. First, the quality of the pool of borrowers would change adversely in favour of those with higher default risk[11]. Second, more firms are induced to undertake riskier projects with higher interest rates and higher expected profits[12]. In this view, the removal of controls does not therefore guarantee positive spin offs and repression might serve the economy better is such a case.

Nannyonjo (2002:6) concurs with Stiglitz and Weiss (1981) and states that

> "...since the bank cannot directly observe the actions of the borrowers, it sets an interest rate that maximises its expected profits, rather than one that clears the market...[it therefore attracts borrowers with a higher likelihood of making repayments to apply for loans]...Hence, even if faced with an excess demand for loans at the optimal rate, a bank will not raise the loan rate or the collateral to eliminate it; rather it will turn away loan applicants who are observationally not distinguishable[13] from those who obtain loans. In a similar way, a bank with an excess supply of loanable funds must assess the profitability of the loans that a lower interest rate will attract, and in equilibrium no bank will lower its loan rate". Nannyonjo (2002:6)

Advancing this argument further, Cho (1986 in Nannyonjo, 2002) adds that in the presence of imperfect information, financial liberalisation would not bring full allocative efficiency of capital. He recommends the use of equity finance as opposed to debt finance in the presence of such asymmetric information. Interest rates in markets with imperfect information would tend to be high to compensate for greater risk, leading to some of the adverse effects such as bad borrowers crowding out good borrowers and firms undertaking projects with higher risk.

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[11] Due to the adverse selection effect, which affects sorting of potential borrowers.
[12] Due to the incentive effect, which affects actions of borrowers.
[13] All loan applicants may possess the same risk profile, potential returns on investment and other characteristics used in assessing the viability of a loan.

Stiglitz (1993 and 1994) has emerged as one of the greatest critics of financial liberalisation. This is clearly illustrated where Stiglitz (1993:2) states that "[t]he impetus for financial liberalisation is not based on a sound economic understanding either of how financial markets work or the potential scope for government intervention. Nor is it based on an understanding of the historical events and political forces which have led governments assuming the role which it presently undertakes. Rather it is based on an ideological commitment to markets, grounded neither in economic theory or fact". Although Stiglitz acknowledges that market failure in financial markets does not in itself justify government intervention, he sees crisis in financial markets as more pervasive than in other markets, hence the need for government intervention.

The problem according to Stiglitz (1994:20) lies not in this intervention but rather the "incorrect design of government regulation". Liberalisation within financial markets prone to market failure would be worse than government intervention that would keep interest rates below market equilibrium levels. These forms of intervention would improve the performance of the economy and also lead to these markets functioning better (Stiglitz, 1994:20). Repression in this case would be beneficial in improving the financial markets and moderating interest rate spreads.

Stiglitz (1994) also explores another advantage of repression over liberalisation linked to collection and use of information by financial institutions. In a repressed regime, the central bank and state banks as intermediaries have economies of scale in collecting information as well as monitoring the use of loans. With liberalisation, banks take on this responsibility, and banks that do not have the resources or capacity to search for this costly information act as free riders [14](Stiglitz, 1994:30-38). If this information is imperfect, then the risk of default is greater.

Stiglitz (1994) also sees costly information is as the cause of additional negative externalities. For example, an important externality is related to the contagion

[14] These are person who enjoy the benefits of a good without paying for it especially when dealing with a public good.

effect[15]. Since the information in use for extending credit is shared by banks, if such information leads to one bank failure then depositors would assume that there is increased probability of other banks failing. This could result in runs and trigger bank failures. Second, externalities can be transmitted across markets. For example, the provision of a bank loan to a firm may signal that the firm is in a sound financial condition. This is because other participants expect banks to monitor the firms they are extending credit to. As a result, such firms would be in a position of raising additional equity from other sources such as the stock exchange due to the signal from the bank(s). If the information used initially by the bank(s) is imperfect, then the negative externalities from its decision would spread to the other financiers. These externalities if left unchecked would have a negative impact on the economy and interest rate spreads (Stiglitz, 1994:30-38).

Stiglitz (1994) therefore argues that repression would improve efficiency of capital allocation in the presence of imperfect information. The advantages enjoyed by the government in the collection of information would lead to among other things, an improved average pool of loan applicants. Since the government has the ability to lower interest rates in a repressed regime, firms' equity is increased as a result of lower cost of capital. In addition to the above, increased economic growth is achievable as lending to sectors is directed to sectors with higher technological spill over through directed credit programmes (Stiglitz, 1994:39-42).

Leite and Soundararajan (1993:147) like Stiglitz (1994) note that policies inclined towards repression are important not only as a means of increasing investment, but also as a way of keeping financial costs low. This would help in avoiding possible inflationary effects that may arise due to liberalisation. They note repression would bring allocative efficiency of capital among different sectors of the economy.

A theoretical model to justify financial repression is provided by Tobin (1965) in Kularatne (2002:652). Tobin specifies the existence of two forms of assets, physical capital and real money balances in the economy. The conclusion from this model is

[15] This explains a state in which failure of one bank leads to the failure of other banks.

that the existence of money in an economy may encourage the hoarding of savings in the form of real money balances with people preferring to hold more precautionary balances. Ultimately, this would limit the proportion of savings available to convert into loans. Real money holdings would therefore have a negative effect on the economy in this case. Remedies proposed to combat this hoarding are interest rate controls, high reserve requirements in the banking sector and taxation of money holdings. These are measures associated with repression.

2.12 SUMMARY OF REPRESSION AND LIBERALISATION

There is a small point of convergence on both sides of the liberalisation-repression debate. Fry (1997), for example, accepts arguments that government has advantages in situations of information imperfection, but he does not agree with Stiglitz's case for financial repression. According to Fry (1997:760), Stiglitz shows amazing faith in government's good intentions while imposing controls, by assuming it is "exemplary: disciplined, knowledgeable, long-sighted, objective. It pursues economic objectives without deviating into many side alleys of patronage and sleaze". However, he doubts this goodness on the part of government stating that given a chance, the government would misuse its powers, shocking even Stiglitz. Arestis & Demetriades (1997:20) agree with Fry (1997) on this point arguing that market failure does not necessarily imply government success. This is as close as Fry and Stiglitz seem to come to agreement, except that Stiglitz faults not government regulation but its sequencing.

2.13 CONCLUSION

This chapter has illustrated that within the financial sector, intermediation would generally mean middle participation in exchange for financial assets. This is carried out by financial intermediaries that take funds from the lender (savers) and channel them to borrowers (investors). These firms earn their income on the spread between the yields on the financial assets they create and the financial assets they buy. This role is of great importance for the saving/investment process necessary for economic growth.

In terms of individual incentives both lenders and borrowers would wish to minimise the risks and maximise their return. Specialisation aspect of financial intermediaries facilitates the reduction of risks in the market for loans. In particular banks, as financial intermediaries, play a crucial role. They channel funds from those with surplus liquidity to those lacking it, facilitating capital formation and trade. Banks also play a role of filtering information by screening borrowers and monitoring their activities in financial systems characterised by incomplete and asymmetric information.

The common elements in decision making on the various choices for saving, and in the process obtaining a claim or an asset on the financial intermediary, include economic and financial intelligence, transaction costs, diversification of assets and offsetting inflows and outflows. These provide an economic rationale for the process of financial intermediation, the importance of economies of scale and specialised financial operations. In addition, the term of a loan and the risk associated with borrowing give rise to a range of interest differentials or spreads.

The well functioning of the financial sector, and likewise the benefits received from intermediation, depends on the way it is controlled. An efficient financial system that promotes allocation and mobilisation of resources is important for the growth and development of an economy. Attempts to achieve this have led to reforms in the financial system. The reforms have been implemented through financial liberalisation. The arguments for and against financial liberalisation and financial repression were presented to throw some light on this issue. The case for liberalisation looks compelling but only under certain and specific conditions. If these institutional prerequisites, as a form of government intervention, are put in place effectively, then interest rates should settle at their best market equilibrium level. They would also achieve a reasonable spread reflecting a more efficient financial system. The experience from several developing countries is discussed in the next chapter.

CHAPTER THREE
FINANCIAL REFORMS IN DEVELOPING COUNTRIES

3.1 INTRODUCTION

Financial reforms, deemed necessary for the economic growth in most developing countries, have yielded mixed results. In most cases, the liberalisation measures prescribed by international financial institutions (IFIs) have not enhanced the financial intermediation process. According to Barajas, Steiner & Salazar (2000:157) banks in developing countries typically show significantly high and persistent interest rate spreads. These high intermediation margins persist even though most countries have taken on financial liberalisation over the past two decades. Chapter 2 provided a focus on the financial intermediation process and its importance in ensuring the effective functioning of the financial system. The role of financial reform programmes prescribed for developing countries in enhancing this intermediation was covered but in less detail.

The purpose of this chapter is to provide some background to the reform processes and the various factors that have led to the underperformance of liberalisation in some developing countries. The discussion begins by laying down the framework under which reforms were implemented. The experience of countries that undertook financial liberalisation, especially within the banking sector (which is at the heart of the intermediation) process, is examined next. In order to assess if the financial intermediation process was enhanced by liberalisation, a look into interest rate spreads under reforms is then undertaken. Finally, conclusions are drawn as to whether financial liberalisation has been beneficial or not for developing countries.

3.2 FRAMEWORK FOR FINANCIAL REFORMS IN DEVELOPING COUNTRIES

As noted earlier, financial reforms fall within the neoclassical school of thought. Competitive and free markets are seen as the most efficient way of allocating resources leading to better economic performance. In line with this, various reforms were undertaken in developing countries to try and free the economy from excessive government control. Between the 1970s and 1990s most developing countries

implemented various reforms through several aspects of the structural adjustment programmes. Among the important reforms were those in the financial sector through financial liberalisation. According to Abiad & Mody (2003) the experiences with these liberalisation measures differed from one country to another. These differences were mainly in the speed of implementation and the magnitude of the changes.

Seck & El Nil (1993:1) cites distortions created by governments in the price formation process as the main motivation for financial liberalisation. According to McKinnon (1973) and Shaw (1973), these distortions are due to attempts by the government to influence economic performance using direct instruments of monetary policy instead of indirect ones[16]. As outlined in the previous chapter, liberalisation is expected to free developing economies from some of the more severe distortions and thus enhance economic growth. However, this is not always the case.

Abiad & Mody (2003:4) use a political economy perspective to explain the timing, pace and magnitude of reforms in the financial sector. The rationale for this is that reforms would certainly be shaped by politics at some point in time, if not always. Their argument is based on the assumption that established interest groups, preferring to retain the *status quo,* seek to maintain the existing policy regime through compromise. This is partly due to the uncertainty that a change in policy would bring. Uncertainty as seen in chapter 2 has a high premium attached to it.

Three main sources of reforms associated with the political economy are identified. First, occurrence of discrete events or *shocks*, for example, i) formation of new governments, ii) changes in external influences, that is, movements in global interest rates and iii) policy changes by IFIs (Krueger, 1993:17). Second, discovery and realignment of relationships among different stake holders such as labour unions and government in a process called *learning*. Through *learning*, costs and benefits of strategic partnerships among different stake holders may be reassessed. Any impasse that may appear due to policy debates can then be resolved (Fernandez & Rodrik, 1991:1149). In addition, as countries move from local to regional or global norms in

[16] Direct instruments of monetary policy would include the use of regulatory powers such as imposing credit ceilings and interest rate controls. Indirect instruments on the other hand would include such measures like use of the repurchase agreements and reserve requirements ratio by the central bank to influence the money market conditions.

a bid to compete for international capital, domestic *learning* may be replaced by international diffusion of the *learning* process (Simmons & Elkins, 2001:33-40). Third, various institutional factors are important, for example, i) the political ideology of the ruling government (Alesina & Roubini, 1992), ii) structural features such as trade openness (Rajan & Zingales, 2003), iii) legal systems in place (La Porta et al, 1997) and iv) form of government (Persson, 2002) may all shape reforms.

The above sources of changes have different implications for the timing of liberalisation. Conclusions drawn from the above suggest that a *shock* and the institutional factors allow for rapid or immediate policy changes. *Learning* on the other hand is more gradual and would maintain a reform agenda allowing for further changes to take place, especially if such reforms are beneficial to the competing interest groups (Abiad & Mody, 2003:4).

Liberalisation is also seen to occur in regional clusters at roughly the same time and in a closely related way. According to Abiad & Mody (2003:4-9) most financial reforms in Latin America, with the exception of Chile and Argentina who reversed their policies during the debt crisis of 1982-1983, were clustered in the late 1980s and early 1990s. This illustrates that carrying out reforms is neither a straightforward nor a simple process. Experience of liberalisation in the East Asian economies was different from that in Latin America and other parts of the world.

Financial liberalisation in most countries in East Asia took a more gradual step-by-step approach. It started in the early 1980s stretching over a decade (Abiad & Mody, 2003:4-9). Even though there remains partial repression in the sector, south Asia's financial reforms occurred in the early to mid-1990s. Sri Lanka, for example, stands out as an exception having undertaken major reform efforts in 1978. On the other hand, most of the Sub-Saharan African financial sector reform took place in the mid-1980s and early 1990s (Brownbridge, 1998). They were mainly under the auspices of the adjustment programs mentioned earlier. A more detailed assessment of reforms in Africa, with specific country experiences, is discussed in the sub-sections below.

While examining the justification for liberalisation measures in developing countries, Johnston & Brekk (1993:99-100) pursue the efficiency motive. They see financial

reforms as mainly aimed at developing a financial system that promotes savings and efficient resource allocation. This would include providing a framework for effective monetary control implementation, promoting well functioning markets and a competitive financial structure. But, these have to be undertaken as part of a broader economic restructuring process. Their argument is that because well functioning markets with weak underlying pricing structures may provide a sub-optimal allocation of resources.

Brownbridge (1998:173) sees part of the rationale for financial liberalisation being the boosting of banking competition. This would stimulate improvements of service to customers as well as expand credit accessibility to small and medium-scale businesses. Accordingly, the adverse effects on interest rates by the informal lending schemes prevalent in developing countries would be moderated. Similarly, the entry of the formal banking sector into the smaller business segment would ultimately have a moderating effect on interest rates spread.

Bandiera *et al.,* (1999) in Ball & Feltestein (2001:250) further contend that reform in a developing country financial sector go further than issues affecting regulation of interest rates and credit expansion. They also involve specialised banking where the authorities use banks for channelling out loans for specific projects. The government may, for example, form specialised banks to extend loans to the agricultural sector. Often, this credit extension is not based on project profitability or probability of repayment. As pointed out in chapter 2, the result is that banks, especially in countries with smaller economies, view risk as belonging to the government. This leads to sub-optimal results. Part of the inefficiencies arise because, in an attempt to fund specific projects, the government frequently lends to a single company thereby creating a monopoly. If this monopoly were to fail, then the financial intermediation process would be greatly undermined.

The next section examines these contentions in light of the sub-Saharan African experience.

3.3 AN OVERVIEW OF SUB-SAHARAN AFRICA'S FINANCIAL SYSTEMS AND REFORM EXPERIENCE

Financial systems in Africa vary considerably from one country to another. First, Soyibo (1994) in Inanga & Ekpenyong (2002:4) describe Mozambique, Angola, Tanzania and Guinea as examples of countries with government-owned financial systems. Apart from the Central bank, they have few commercial banks. Second, Nigeria, Zimbabwe and Kenya are examples of countries which exhibit a rich variety of mixed ownership comprising the central bank, public, domestic and private foreign financial institutions. South Africa with its well developed financial system would fall in this category. But, according to Falkena *et al* (2001) in certain aspects the financial markets in South Africa draw better comparison with those in some parts of Asia and Latin America. Third, the final group comprises countries that have financial systems with mixed ownership but with limited variety. These include Malawi, Uganda, Ghana and other sub-Saharan countries (Inanga & Ekpenyong, 2002:4).

Financial interventions in most African countries have been implemented in the hope of accelerated economic development. Villanueva (1988) and El Nil (1990) in Inanga & Ekpenyong (2002) categorise financial reforms in African countries into three distinct groups. These groups are dependent on the desired objectives of the reforms.

The first broad category comprises countries like Botswana and Mauritius whose objective was to improve monetary policy. Inanga & Ekpenyong (2002:5) assert that to achieve this objective, these countries put in place measures to ensure the adequacy of monetary instruments and replaced direct controls with indirect ones.

The second category includes countries like Kenya and Zaire[17]. These countries introduced financial sector reforms with the objective of improving the mobilisation and allocation of domestic savings. Seck & El Nil (1993:1871) show that Zaire adopted measures aimed at developing and sustaining money and government securities markets. Kenya, on the other hand, was more concerned with the adequacy

[17] Zaire has since been renamed to Democratic Republic of Congo (DRC Congo).

of banking regulation and legislation, leading to the introduction of new financial institutions, instruments and measures.

The last category of countries, according to Inanga & Ekpenyong (2002:8), focused on improving the banking system as well as the level and structure of interest rates through the use of different approaches. Mauritania and Senegal used a reduction of interest rate subsidies and bad debts, while Burundi, Gambia and Sierra Leone liberalised interest rates and introduced a prime rate or a base lending system.

Although three main categorisations have been mentioned, they are by no means mutually exclusive, nor were they carried out in isolation. There are countries whose objectives spanned all three categories, for example, Nigeria (Inanga & Ekpenyong, 2002) and Uganda (Nannyonjo, 2002). Nannyonjo (2002) contends that Uganda's financial sector reform was part of a broader structural adjustment programme. In other words, it was not an exclusive financial reform package, but rather part of the larger economic reform agenda broadly aimed at restoring economic growth and stability in the country.

In addition, the unique economic and financial conditions in different countries were significant in shaping reform objectives and outcomes. Inanga & Ekpenyong (2002) list the economic conditions in various African countries during reforms.

- At the time of reforms in Kenya and Nigeria there were severe macroeconomic imbalances and financial system instability.
- Ghana and Tanzania were experiencing both macroeconomic instability and financial distress.
- Zambia and Zaire had macroeconomic instability but healthy banking systems.
- Malawi and Botswana also had healthy banking systems at the advent of reforms.
- Banks were already bankrupt at the onset of reforms in Mauritania.
- In a large section of West Africa, most countries were undergoing severe economic conditions. According to Inanga & Ekpenyong (2002:8) "...Former French West African colonies now under the West African Economic

Monetary Union - WAEMU[18], were all facing balance of payment problems, internal political crises and internally inconsistent economic policies". These countries include "Benin Republic, Niger, Senegal, Cote d'Ivoire Burkina Faso, Togo and Mali"[19].

What is clear is that financial sector reforms should be treated according to country specifics rather than as generic programmes.

3.4 BANKING SECTOR PERFORMANCE UNDER FINANCIAL REFORMS

Most of the reform measures carried out by developing countries, especially in Sub-Saharan Africa, focused largely on the banking sector. Typical reform prescriptions included "interest rate liberalisation, bank restructuring, privatisation of banks, and bank liquidation" (Inanga & Ekpenyong, 2002:6). Although the reform agenda in many developing countries was intended to bring positive outcomes, results within the banking sector were mixed. Crises were prevalent which often resulted in a total collapse of the banking sector. This section highlights various factors that influenced the financial sector performance in several African countries.

Inanga & Ekpenyong (2002) point out that although reforms in some countries led to an increase in the number and varieties of banking, and other financial institutions, the maturity structures of deposit liabilities of banks and non-banks were not improved. This led to an asset liability mismatch. Furthermore, the demand for long-term investment funds never diminished. Reforms also did not improve access to credit for small and medium–scale enterprises nor for the rural population. With initial conditions of the economy not explicitly studied, financial reforms touching on the banking sector were doomed to fail. In addition to this, the prescription of blanket reform packages for many developing countries contributed to their ineffectiveness.

The rapid implementation of liberalisation measures in the banking sector often contributed to their failure. Inanga and Ekpenyong (2002:6) describe the rush by

[18] Also known as Union Economique et Monetaire Ouest-africanine (UEMOA).
[19] Soyibo (1994), Caskey (1992), Paulson (1993), Plane (1993) cited in Inanga and Ekpenyong (2002:6).

creditors to have reforms pushed through in a take-it-or-leave-it manner contributed to their collapse. The World Bank (1994:29) seemed to endorse the rapidity of the reforms by stating that "...it was time Africa began to adjust". This serves to illustrate the rapid and haphazard way in which most liberalisation measures were implemented in most developing countries. In the banking sector, this often led to poor results and high interest rate spreads - a reflection of inefficiency in the intermediation process.

The failure for proper sequencing of the reforms is yet another factor for the non-realisation of the objectives within the banking. The negative experience of Latin American countries like Chile, Argentina and Uruguay with financial liberalisation in the presence of high real interest rates and inflation demonstrate the primary need for macroeconomic stability in a country. Financial liberalisation within an economy with inflationary pressures sends the wrong price signals resulting in adverse consequences for the economy. Adam (1994) in Inanga & Ekpenyong (2002) illustrates the case of Zambia, which pursued financial liberalisation with inflationary pressure between 1992 and 1993. The study concludes that this had direct fiscal costs on the economy. It also reduced the demand for real domestic currency balances as well as the seignorage revenue capacity of the economy due to removal of controls that supported the real monetary base.

Political, administrative and policy credibility issues also contributed significantly to the dismal performance of financial liberalisation in developing countries. According to Inanga & Ekpenyong (2002), a reversal of policies, or the lack of commitment in implementation of liberalisation policies, gave a wrong signal to *economic-agents* who might have been unwilling to commit resources in line with liberalisation objectives. A waning of policy credibility resulted. An example of policy incompatibility is the reduction of the liquidity in the banking system through the issue of stabilisation securities, by the central bank, in an effort by government to ensure macroeconomic stability. If the central bank underwrites government deficits at the same time, then there would be policy incompatibility weakening the sequencing and implementation of economic reforms (Inanga & Ekpenyong, 2002).

According to Brownbridge & Harvey (1998), under financial reforms, the incidence of bank failures in developing countries was very high. Ball & Feltenstein (2000) associate these bank failures with the inability of firms to service their debts due to interest obligations rising beyond anticipated return on capital. This would further lead to withdrawal of deposits from the banking system by the public due to a fear of default in banking assets. The optimal solution for banks in such a case would be to restrict credit to risky borrowers in an effort to partially avoid losses. However, Ball & Feltenstein (2000) point out that most banks in developing countries rarely take such action. This is because the firms in question are at times politically connected. The only tenable solution, in such a situation, is compensating the banks for withdrawals through active monetary policy.

According to Ball & Feltenstein (2000:248) a common feature in banking performance within developing countries is the lethargy in most management practices. These in the long term lead to failures in the banking system causing problems in the macroeconomic management. Whereas mismanagement is mainly in the lending process, unexpected changes in depositors' behaviour may lead to runs and a resultant collapse of the banking system. Policy prescriptions that would be recommended in such instances would include. First, the provision of discount loans and open liquidity market injections, from the reserve bank, should be used as compensation for non performing assets. Second, would be the use of fiscal instruments to reduce interest rate pressure on debtors.

The above factors give rise to intermediation problems which often manifest in large interest rate spreads. This aspect is discussed in section 3.5 below.

3.5 INTEREST RATE SPREADS IN DEVELOPING COUNTRIES DURING REFORM

High bank interest rates spread indicate weak financial intermediation. This may be due to lack of competition in banking systems among other factors. Under conditions of perfect competition, banks would have optimal performance that could be assessed on the basis of profitability only. Gelbard & Leite (1999:1) observe that the range of financial products in many sub-Saharan countries remain extremely limited, with few

alternatives for obtaining loans. With most banks in developing countries exhibiting uncompetitive and oligopolistic tendencies, the benefit accruing from greater competition and thus leading to converging interest rates spread are non existent (Fry, 1995:318).

In developed countries, adoption of market-based policies has led to increased efficiency in the intermediation process, and thus narrower interest rate spreads. One of the arguments advanced for the failure of convergence of interest rate spreads in developing countries, even after financial liberalisation, include the lack of a freedom of entry and exit from the market. Gibson & Tsakalotos (1994) note that competitive pressure resulting from conditions of free entry and competitive pricing would raise the functional efficiency of intermediation. This would be realised through the banks' role of asset-liability transformation, risk reduction through diversification, economies of large-scale operation and specialisation. As discussed in chapter 2, these intermediation processes reduce transaction costs and decrease the spread between deposit and saving rates.

In many developing countries, banks are still subject to high liquidity reserve requirements. In sub-Saharan Africa, Seck & El Nil (1993:1867) underscore the role of high reserve requirements (which act as an explicit tax) in keeping interest rates high. While the reserve requirements may be designed to protect depositors, the availability of a pool of resources as reserves allows for high fiscal deficits through the implicit financial tax. This creates an environment that can promote high inflation and persistent high intermediation spread (Mlachila & Chirwa, 2002:5). Barajas *et al.*, (2000:157-196) find evidence of a positive relationship between spreads and liquidity reserves in the Colombian banking system. Brock & Rojas-Suarez (2000:113-134), find further evidence suggesting that reserve requirements are still a tax on banks that translate into higher spread in a number of Latin American and other developing countries.

The removal of credit controls during financial liberalisation may worsen the quality of loans leading to systemic crises. This, according to Brownbridge & Kirkpatrick (2000:14) may allow those banks with moral hazards, and those not constrained by prudential regulations, to invest in risky assets in order to maintain a larger market

share. This may reduce the quality of assets leading to a higher proportion of non-performing loans and provision for bad and doubtful debts. To compensate for this, banks then tend to charge higher lending rates. These responses are likely to widen the spread between lending and deposit rates. A positive relationship between spreads and provision for bad and doubtful debts is observed by Randall (1998) in a study of Caribbean countries.

High non-financial costs are also a source of persistent and wide intermediation spreads in developing countries. These costs reflect variations in physical capital costs, employment and wage levels. Inefficiency in bank operations may lead to these costs being high particularly in imperfect markets. Demirguc-Kunt & Huizinga (1999:379-408) find evidence of a positive relationship between net interest margins and overhead costs. This is because as non-financial costs (resulting from inefficiency in banking operations) increase, banks shift these to their customers. This leads a shift of interest rates upwards. Similarly, Barajas et al (1999) and Brock & Rojas-Suarez (2000) find significant evidence of the positive relationship between spreads and wages or non-financial costs.

The capital that banks hold to cushion themselves against expected and unexpected risks may also lead to high spreads. To counter for additional credit–risk exposure, banks often hold more capital than the regulatory minimum capital requirement. Taxation renders these relatively more expensive than debts. This high capital ratio may be covered through widening the spread between the lending and the deposit rate. A positive and significant relationship is observed by Saunders & Schumacher (2000:832) between spreads and capital ratios in developing countries.

Macroeconomic instability and policy environment may also affect the pricing behaviour of banks. Spread equations include inflation, growth of output and money market control variables to capture the effect of macroeconomic and policy environment (Mlachila & Chirwa, 2002:7). Brock & Rojas-Suarez (2000) contend that there is substantial evidence in the literature that, particularly in developing countries, inflation is positively associated with intermediation spreads. A detailed assessment of the contribution of macroeconomic factors in Kenya is carried out in Chapter 4.

3.5 CONCLUSION

Financial reforms in most developing countries were implemented with the aim of boosting economic growth and bringing about efficiency in the financial sector. Discussions above have shown the mixed results of financial sector reforms especially in African countries. There is overwhelming evidence that the desired objectives in most cases were not achieved. Reasons for this include, political interference, institutional and macroeconomic factors.

The bulk of the reform measures carried out in developing countries focused largely on the banking sector. Although these should have improved efficiency in the sector, numerous crises were experienced with many banks collapsing especially in sub-Saharan Africa. Some of the reasons cited for this include: First, the rapid implementation of financial liberalisation usually with blanket prescriptions in different countries. Second, the failure for proper sequencing of these reforms especially where the underlying macroeconomic structures were unstable. Third, poor lending practices with banks extending credit to firms that are unable to service their debts due to interest obligations rising beyond anticipated return on capital. Finally, institutional factors like poor management and political interference in the sector during reforms. This contributed significantly to the lack-lustre performance of liberalisation efforts.

Although financial liberalisation efforts should enhance efficiency, their role in developing countries has not generated the desired results. Interest rate spreads have remained high, reflecting poor financial intermediation. This has necessitated the examination of the reform processes in developing countries in order to examine their flaws. In the next chapter, the focus is on interest rate spreads in the Kenyan banking sector.

CHAPTER FOUR
FINANCIAL SECTOR REFORMS AND INTEREST RATE SPREADS IN KENYA

4.1 INTRODUCTION

In this chapter, an analysis of interest rates spreads in Kenya spanning the period before and after financial reforms is undertaken. The chapter starts by assessing the background of financial sector reforms in Kenya as well as developments that have occurred in the financial sector during the post independence period.

The rest of the chapter provides a comprehensive look into Kenya's banking sector[20], and focuses on interest rate spreads over a twenty-year period. Recent developments in the banking sector, which may have an impact on banking performance and interest rate spreads, are discussed.

Finally, an assessment of the some of the factors that may be contributing to the high interest rate spreads are outlined, setting the basis for the conclusions and recommendations in the subsequent chapter.

4.2 KENYA'S FINANCIAL SECTOR REFORM PROCESS

Financial reforms were implemented gradually in Kenya, with a variety of measures intended to strengthen the institutional structure and regulatory framework of the financial system put in place during the 1980s. Some of the important reform measures carried out led to a revision of banking laws as well as improvements in bank supervision (Brownbridge & Harvey, 1998).

However, even with these measures, the financial sector still experienced considerable repression up to the mid 1980s. In the banking sector, for example, the central bank controlled interest rates, bank fees, charges related to lending and provision of credit

[20] The banking sector in this chapter will include Commercial banks (banks) and Non-Bank Financial Institutions (NBFIs). This is because, Non-Bank Financial Institutions formed an integral part of the sector in Kenya and were frequently subsidiaries of commercial banks. However when the discussion dictates that the two be treated as separate entities, then a clear distinction will be made.

(Brownbridge & Harvey, 1998:97). It is only towards the end of the 1980s that reforms took off in earnest with the World Bank financing these under its Financial Sector Adjustment Credit (FSAC). In 1989, measures like policy and institutional reforms aimed at restoring monetary control and enhancing of banking efficiency were put in place. According to Ngugi (2003:20), it was hoped that these would lead to the financial system becoming more market oriented and thus improve economic performance.

In 1990, controls over lending-related fees and charges were scrapped. Interest rates were deregulated in 1991 and credit ceiling on Banks and Non-Bank Financial Institutions abolished in 1993. Other reform measures, with an impact on the banking sector in the1990s, include the liberalisation of foreign exchange markets with banks being allowed to transact in foreign exchange and maintain *forex* retention accounts for such deposits in 1992. A flexible exchange rate which was market determined was adopted in 1993 (Brownbridge & Harvey, 1998).

As noted in chapter two, liberalisation was meant to bring about benefits to the financial markets. Key among these benefits include, first, greater mobilisation of savings with higher deposit rates. Second, better and more efficient allocation of loanable funds as lending rates rise. Third, the elimination of inefficiencies in the financial markets due to administrative controls[21] leading to greater competition. These benefits, and others, should ultimately enhance efficiency of intermediation and lead to a narrowing spread.

According to Brownbridge & Harvey (1998:99), the increased real interest rates after reforms did not have significant positive effects on mobilisation of savings. This is because customers only shifted their deposits from one institution to the next depending on which offered better interest rates. There was also little evidence empirically using macroeconomic statistics of efficiency in credit allocation.

[21] Some of the administrative controls mentioned by Brownbridge & Harvey (1998) include controls that segmented financial markets between banks and Non-Bank Financial Institutions.

Liberalisation did, however, stimulate more competition in certain segments of the banking sector. This came about because the proliferation of financial institutions brought with it more aggressive competition for deposits. Since the pool of depositors was small, only bigger banks benefited from this aggressive competition. These banks could easily outdo their smaller rivals with higher more attractive interest rates and new products like credit cards without risk to their capital base. The bigger banks were therefore able to attract more retail customers while investing in better customer service and new products.

To a large extent, most of the reforms undertaken in Kenya fell within the proposed financial reform framework[22]. However as discussed above, some of the desired effects of liberalisation were not achieved. The proposed enhancement in efficiency of intermediation through financial liberalisation was not forthcoming. Indeed from the data in appendix A1, it is evident that the interest rates spread, as a proxy for financial intermediation, at first narrowed and then hit double-digit figures from the mid 1990s. These remained at this level for the period of this study.

Ngugi (2003:22) partly attributes these negative results to certain shortcomings in the reform process. These include: First, the rapid liberalisation of interest rates before the proper operational and management structures in the banking sector were put in place. Second, the inconsistent and inadequate measures for maintaining stability within the financial sector often leading to a reversal of gains made from reforms. Third, the inappropriate relaxation of credits controls and initiation of open market operations (OMO) while there was high liquidity.

Brownbridge & Harvey (1998) additionally note that in a bid to fund fiscal deficit, the government increased its borrowing from banks contributing to a rapid increase in money supply and soaring inflation in 1992.

[22] The proposed framework for financial reforms is covered in great detail in chapter 2.

4.3 MARKET COMPOSITION AND BANKING SECTOR DEVELOPMENTS

According to Brownbridge & Harvey (1998), at independence in 1963 the financial system was made up of 9 foreign-owned banks (the larger ones being Barclays, Standard Chartered and National & Grindlays bank), a few Non-Bank Financial Institutions and Development Finance Institutions. The period after independence did not give rise to diversity in types of institutions within the financial sector and most of the financial services were provided for by banks. Non-Bank Financial Institutions, created mainly in the 1970s, offered the only alternatives to banks. Most of these were, however, wholly or partly owned by the larger banks by the 1980s.

The Nairobi Stock Exchange which offered an alternative to the above mentioned sectors was dormant for most of the 1960s to 1980s. Brownbridge & Harvey (1998) attribute this mainly to a lack of sophistication and innovations. In the 1990s however, the range within the financial sector had diversified. By this time, Popiel (1994) notes that, Kenya was ahead of other Sub-Saharan African countries in financial sector development. The financial sector was composed of commercial banks, Non-Bank Financial Institutions, Development Finance Institutions, insurance companies and a more vibrant stock exchange.

Table 4.1 illustrates that by June 2004, the banking sector had a total of 50 financial institutions, 43 of these were banks, 1 Non-bank Financial Institution, 2 mortgage finance companies and 4 building societies. In addition to these, a lifting of the moratorium on the licensing of foreign exchange bureaus in June 2003 saw their upsurge from 48 bureaus in June 2003 to 85 in June 2004 (Central Bank of Kenya, 2004:41).

Table 4.1: Commercial Banks, Non-Bank Financial Institutions and Foreign Exchange Bureaus

TYPE OF INSTITUTION /BUREAU	JUNE - 2003	JUNE - 2004
Commercial Banks		
(a) Operating	43	42
(b) Under Central Bank statutory management	0	1
Sub-total	43	43
Building Societies		
(a) Operating	4	3
(b)Under Central Bank statutory management	-	1
Sub-total	4	4
Mortgage Finance Companies		
Sub-total	2	2
Non-bank financial institutions		
Sub-total	2	2
Total	**51**	**50**
Foreign Exchange Bureaus	48	85

Source: Central Bank of Kenya (2004)

What table 4.1 clearly highlights is that Kenya's financial sector can be described as fairly diversified, although commercial banks still dominate. In order to understand this structure of Kenya's financial institutions, it is first necessary to examine the major events that occurred within the banking sector during the period of the study.

4.4 KENYA'S BANKING SECTOR CRISES

Banks have been the main source of financial intermediation since Kenya gained independence in 1963. This is as a result of their dominance of the financial sector. Distress in the banking sector is therefore of major importance as it would have a direct impact on the intermediation process and thus interest rate spreads.

The post-independence period saw significant developments within the banking sector. In addition to the few foreign owned banks, the mid 1970s to the early 1980s saw the emergence of local banks and Non-Bank Financial Institutions. However, according to Ngugi (2001), these developments did not enhance the banking sector performance. This is because from the mid 1980s the sector faced major fragility with bank failures escalating throughout this period up until the 1990s.

Ngugi (2001:12) estimated that during the mid 1980s, up to a third of the local banks and Non-bank Financial Institutions had been shut down or faced imminent closure. These were placed under statutory management by the Central Bank of Kenya. The 1990s offered no respite to the banking sector with several institutions on the brink of collapse. Ngugi (2001:12) states the major reasons as acute liquidity problems and gross violations of banking regulations. Most of the banks that were eventually closed down were technically insolvent by the time of the closure. This deep crisis within the financial sector exposed problems in the banking sector especially in a supervisory and regulatory nature.

The first spate of bank failures in Kenya was witnessed from 1984-1986. Three financial institutions namely; Rural Urban Credit Finance bank, Continental Bank and the Union Bank were affected. According Brownbridge & Harvey (1998), these three banks failed due to their inability to repay deposits from government owned institutions (parastatals).

The next incidence of banking crisis occurred from 1989-1990 when the Central Bank of Kenya took over the management of several Non-Bank Financial Institutions and building societies that had collapsed earlier. In order to salvage the situation, six of these financial institutions were merged with the Union Bank group to form the government-owned Consolidated Bank. The Consolidated Bank's main function, according to Brownbridge & Harvey (1998), was to restructure these institutions' operations and to recover bad debts. This turned out to be one of the few success stories of the Central Bank of Kenya's intervention. The Consolidated Bank ultimately is now an operationally sound bank (Kyalo, 2002).

After the formation of the Consolidated Bank, the banking sector experienced 39 additional bank failures. Two of these banks were placed under the Central Bank of Kenya's statutory management, restructured and reopened. One still remains under the Central Bank of Kenya's statutory management (Kyalo, 2002).

Like the 1980s, when failures were caused mainly by bad and doubtful debts, the major causes of banking crises in the 1990s, according to Brownbridge & Harvey (1998), were i) liquidity crisis associated with accumulation of bad debts, ii) poor

lending practices especially to politically connected people, iii) poor management, iv) inadequate capitalization and v) insider lending. Good examples are; the collapse of Pan African Bank, which was in terms of gross assets the fifth largest bank in Kenya in 1992 and the Trade Bank the ninth largest bank in Kenya. The Pan African Bank had lent more than 50% of its loan portfolios to companies connected to its chairman when it collapsed. The Trade Bank, on the other hand, went into liquidation in 1993 as a result of a large share of its non performing loans arising from shareholder companies which defaulted on repayments. Kyalo (2002) further reports that some of the banks that collapsed in 1993 were conduits of large scale fraud, for example, the Goldenberg scandal where massive sums of tax payers' money was looted from the Central Bank of Kenya under the cover of export compensation schemes.

These bank failures not only have significant implications for the welfare of bank customers, but also have a great negative impact on the economy. Bank failures damage the credibility of financial sector and raise the cost of borrowing. Most times, banks operating in this high risk environment require the maintenance of high levels of liquidity due to the fear of bank runs (Kyalo, 2002). The risk of contagion is also high since the failure of one bank may lead to failure of other banks. The above lead to large intermediation spreads as banks seek to cushion themselves against high risk.

The next section examines in closer detail the Kenyan banking performance and interest rate spreads in a twenty year period.

4.5 BANKING SECTOR PERFORMANCE AND INTEREST RATE SPREADS 1983-2003

By the fourth quarter of 2003, the savings deposit rate in Kenya's banking sector was 3.51%, while the nominal lending rate was 14.11%; the spread being 10.6 %. Despite the liberalisation of the financial sector, Kenya's interest rate spreads were among the highest in the world (IEA Bulletin, 2000:1).

This section focuses on interest rate spreads, using quarterly data for the period between 1983 and 2003 as well as banking sector performance. The main reasons for 1983 as a starting point are that Kenya's financial sector had achieved reasonable

stability after a previous round of volatility due to political events. The main causes of instability in the markets were first, a failed *coup de tat* in 1982 and several years of political uncertainty following the ascendancy of Mr. Daniel Moi to the presidency after *Mzee* Jomo Kenyatta's death in 1978. Second, quarterly data for this period was readily available with minimal gaps appearing in the early 1990s[23]. Finally, this period represents both the pre and post liberalisation years.

From the data in appendix A1 and illustrated in figure 4.1, the period before liberalisation in 1991 shows a steady and moderate movement in the spreads. The average is below the 3% level. However, large fluctuations in spreads appear after this. The third quarter of 1991 sees interest rate spreads drop to 2.55% only to rise again to 5.99% in the beginning of the following year. Another drop is experienced in the first quarter of 1993; with spreads staying between 1-2% up to the first quarter of 1994. The spread rises slowly at first and then rapidly from the third quarter hitting the double digit figures for the first time in the fourth quarter of 1994 when the spread is 10.26%. This reaches its peak of 16.67% in the fourth quarter of 1996 with the average spread between the first quarter of 1995 to the first quarter of 1997 being 15.8%. The spread drops gradually from that period maintaining the double- digit level reached at the end of 1994 with the only exception being 1998 when the spread breaks the 10% barrier marginally to settle at 9.79% in the second quarter.

[23] Data for 1991 third quarter to 1994 fourth quarter, which was unavailable from the international financial statistics, was calculated from Ndung'u & Ngugi (2000). The annual real interest rates were first changed to nominal interest rates using the formula: Nominal interest rate= (Real interest rate (1+inflation)/100) +inflation. To obtain quarterly data, the annual series was interpolated using methods as provided in E-views 5. Care was taken in the choice of appropriate interpolation method to ensure that the resultant interpolated series reflects as much as possible the pattern of the original series. After careful experimentation, the quadratic: match average was used. The assistance of Mr. M Aziakpono of Rhodes University in these calculations is gratefully acknowledged.

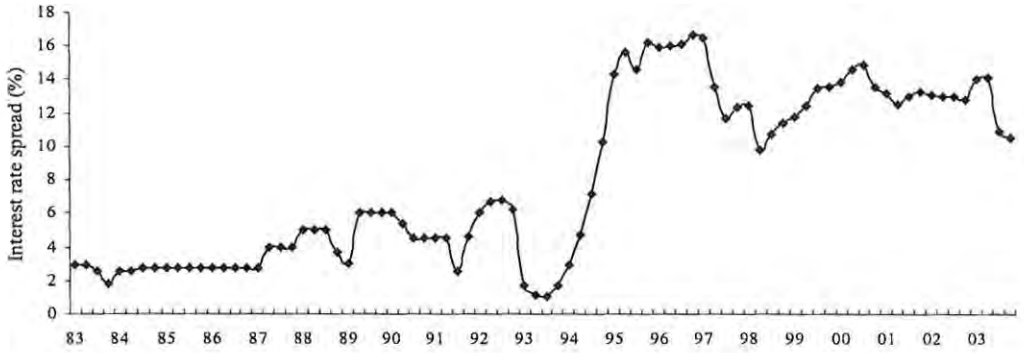

Figure 4.1: Kenya's quarterly interest rate spreads between 1983 and 2003
Source: Computed using data from IMF International Financial Statistics (1983-2003) & Ndung'u & Ngugi (2000)

This high interest rate regime, which began in mid-1991, was viewed to be a culmination of excessive monetary expansion mentioned earlier. Between 1991 and 1992, a period of political transition from a single party system of governance to multiparty democracy, Kenya experienced imprudent printing and circulation of currency. Munene & Njeru (2003b) attribute this to two major factors, first, in the wake of the first multiparty election in 1992, the government printed currency in order to finance the elections. Second in order to meet the budget-deficit occasioned by the suspension of aid from the World Bank and other donors, it expanded money supply by printing more currency.

This transition period was also characterised with poor governance. There was plunder and mismanagement in most public sectors leading to high inflation and a decline of economic growth. According to Munene & Njeru (2003b), money supply which had risen gradually from Kshs 20 billion in 1980 to Kshs 50 billion in 1990, shot up rapidly to Kshs 100 billion by January 1993. In addition to financing the elections and deficit mentioned above, the excess currency printed was also used to compensate exporters who would "...bring in foreign currency earned from exports and stabilise the exchange rates" (Munene & Njeru (2003a). It is estimated that the Central Bank of Kenya lost approximately Kshs 66 billion (US dollars1.9 billion at the exchange rate then) through the dubious export compensation schemes. According to East African Standard (2003) these schemes were paid for using Central

Bank Foreign Exchange Bearer Certificates (Forex-Cs). This led to one of Kenya's largest scams known as the *Goldenberg scandal* in 1992-1994.

The above events although not exclusive, contributed significantly to the high interest rate regime, which led to great interest rate spreads in the sector (Market Intelligence, 1998:53). The next part of this section assesses the financial performance in the banking sector and its link to high interest rate spreads.

A look at the financial results of the banking sector in a survey by Market Intelligence (2001) of Kenyan banks(see appendix A2) paints a mixed picture as far as investing in the sector is concerned. Returns declined in the sector from a pre-tax profit of Kshs[24] 15.8 billion in 1997 to Kshs 2.4 billion in 2000. This is displayed on figure 4.1 below. Profitability in the sector for the four years saw an average decline rate of 21%. While the sector was on a downward trend in 2000, the two most profitable banks had a profit before tax of over Kshs 6 billion while the net turn over for the industry was only Kshs 2.4 billion.

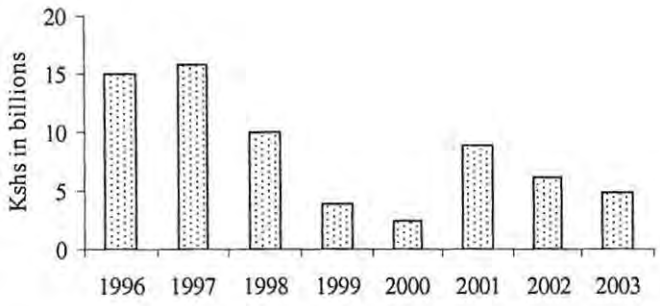

Figure 4.2: Total industry profits before tax
Source: Banking surveys conducted by Market Intelligence (2001-2003)

The decline in profits was mainly due to a number of banks reporting negative returns—10 banks make combined losses of Kshs 7.6 billion (Market Intelligence, 2001:13). By 2001, the total profits for the industry had increased to Kshs 8.8 billion only to drop by 31%, to Kshs 6.1 billion, in 2002. The main cause of this drop in profitability, according to Market Intelligence (2003), was the huge write-off undertaken by Kenya Commercial bank, the second largest bank in Kenya at the time.

[24] The average exchange rate between the rand and the shilling for the period between 1997 and 2004 was approximately SA rand 1 for Kshs 10.

In addition to the above, Co-operative Bank and National Bank of Kenya, two of the six largest banks in Kenya, reported poor performance. This declining trend in profitability seems to have stopped in 2003 with the sector posting a pre-tax profit of Kshs 6.6 billion in the second quarter, but ending the year with a average annual pre-tax profit of Kshs 4.9 billion (Market Intelligence, 2003 and Central Bank of Kenya, 2004). In 2004 the sector experienced a marginal increase in profitability over a similar period in 2003, posting a pre-tax profit of Kshs 7.1 billion in June 2004 (Central Bank of Kenya, 2004). This could be a sign that the sector might be on a recovery phase.

The biggest contribution to this bad performance in the banking sector was the high ratio of losses due to non-performing loans. These grew exponentially from an industry total of Kshs 19.9 billion in 1986 to Kshs 110 billion in 2000 (Market Intelligence, 2001:13). Although the level of non-performing loans showed a steady decline after 2000, by the beginning of 2003, commercial banks were still incurring huge losses as a result of making massive provisions of bad debts and write-offs, with non-performing losses standing at Kshs 73 billion. This figure dropped further in 2004 and by June it stood at Kshs 70.7 billion (Central Bank of Kenya, 2004).

Undoubtedly, the premium charged on loans would be higher than if the level of non-performing loans were lower because of the high default risk. Second, with the level of investment in the sector at low levels, banks are forced to charge higher premiums on their services as well as on loans to cover ground due to the low mobilisation of savings and investment. Third, banks may be forced to adapt conservative lending practices by rationing the amount of loans advanced in a bid to take on less risk.

The assets and liabilities structure of most banks during this period also indicated problems with the sector. In the same banking surveys most of the smaller banks were poorly capitalised when measured by the ratio of shareholders' funds to total liabilities. This ratio would normally be an indicator of a bank's ability to honour its customers' financial needs. In 2000, four banks had a ratio of below 7% (one bank at recorded a negative 28%), implying that it had exhausted it shareholder funds. The sector average was 13%. Averages in previous years were not much better, with 13.5% in 1996, 13.9% in 1997, 14.4% in1998, and 13.9% in 1999. The scenario has,

however, recently improved with a better capitalised sector. By 2003, most of the banks surveyed had sustained a solvency margin, with the revision of the minimum capital margin, and cash ratio of 12% by the Central Bank of Kenya (Market Intelligence, 2003).

Of course the level of capitalisation a bank should attain will depend on the nature of its assets, with some assets considered riskier than others. With the Kenyan economy in a recession after financial liberalisation, loans to the private sector were deemed riskier than investment in Treasury bills at this time of economic downturn. Loans and advances to customers reduced while investment in government securities rose (Market Intelligence 2001:23). It is only after a steady decline in returns on government securities between 2002 and 2004 that has forced banks to rethink their lending policies. In the period leading to 2004, lending to the private sector especially to retail consumers had increased rapidly amidst an environment of falling interest rates (Market Intelligence, 2003).

The banking sector seems to have experienced major crises for during the period of our study, and this has definitely had a negative impact on interest rates spread. In the next subsection as assessment of the factor that would lead to high interest rate spreads is examined.

4.6 CAUSES OF HIGH INTEREST RATE SPREADS AFTER LIBERALISATION

The set of factors identified in connection to the high interest rates spread fall into two broad groups commonly used in analysing the determinants of financial intermediation and consequently the intermediation spreads. According to Levine *et al* (2000), these are macroeconomic factors and institutional/structural factors. The first group of factors would include the economic performance, the inflation rate, and the exchange rate. The second group, which focuses on the institutional /structural environment, would reflect such factors such as capital adequacy ratio, minimum reserve requirement, non-performing loans, property rights, the legal environment,

accounting standards, transparency and taxation issues, market structure and concentration, and insider information problems

According to Ndung'u and Ngugi (2000), in addition to macroeconomic policy variables, Kenya's interest rate spreads can be seen to be influenced by various broad institutional factors. These include the level of competition in the banking sector (market power), credit risk and implicit taxes.

Whereas most of the factors mentioned above fall into the institutional/structural environment, the extent to which macroeconomic factors were connected to interest rate spreads remains unclear. The following sections are devoted to examining the how these two broad categories of factors have affected the interest-rate-spread in the Kenyan banking sector.

4.7 MACROECONOMIC VARIABLES

The effect of macroeconomic factors on the spread has been highlighted a number of times before. However, the exact nature of the relationship in the Kenyan banking sector remains unclear. To shed some light on this, three variables are compared with interest rates in a trend analysis. These variables include the economic growth (GDP), inflation, and exchange rates. To set the stage for assessing the macroeconomic variables, a brief analytical framework of these is done.

The data used in this research (see appendix A1) is derived mainly from the IMF International Financial Statistics for consistency. Where it is missing, data from the Kenya Institute for Policy Research and Analysis (KIPPRA), a government owned research centre, is used. Quarterly data from 1983 to 2003 is used because first, it is readily available and second, the period falls within the pre- and post-liberalisation periods. Kenya's economy was also entering a phase of relative stability after a turbulent political transition period mentioned earlier.

4.7.1 Economic Performance

In previous chapters, the role of economic performance has been mentioned in connection to intermediation spreads. One argument put forward is that higher level activity by financial intermediaries would stimulate economic growth. This is because higher volumes of intermediation would lead to a growth in real income. Higher real income through the multiplier effect would lead to economic growth.

In this study the nominal gross domestic product (GDP) for 20 years is used as a proxy for economic performance over the period. The growth in GDP (GDPG) is computed (see appendix A1) and compared with the spread in figure 4.3 below.

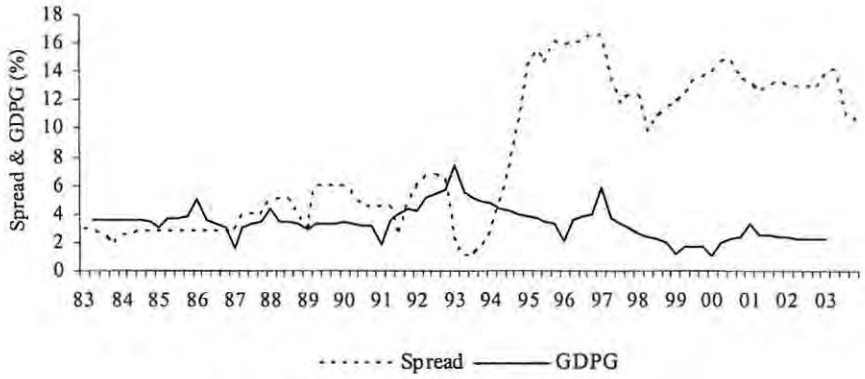

Figure 4.3: Interest rate spread and Economic growth

Source: Computed using data from IMF International Financial Statistics (1983-2003) & Ndung'u & Ngugi (2000)

From figure 4.3 above, the GDPG exhibits the normal business cycle. It is periodic with phases of upswings reflecting expansion in economic activity and downswings for recession in the economy. These cycles are however irregular through the twenty year period. The spread for most of the period also exhibits irregularity, with this being more pronounced in the post 1993 period.

Starting with the early 1980s, the spread is well below the 4%. It is narrow and actually falls below the 2% level in 1984. The low spread continues throughout most of the 1980s and early 1990s, remaining close to the GDPG for this pre-liberalisation period. The widest the spread goes is 6%, and this is just before the advent of reforms in 1991.

In the pre-liberalisation period, GDPG exhibits a normal business cycle with a slight recession, in 1985. This recession may be a lagged reaction to the slight widening of spread after a dip earlier. Between 1985 and 1987, the spread remains constant and at low levels and GDPG experiences an upswing in 1986. This positive economic performance may be due to stability in the spread which is low and narrow.

With the implementation of financial liberalisation in 1991, the spread initially narrows to 3% between 1991 and 1992, then widen slightly. The advent of reforms at first seems to dampen the level of economic activity, leading to a recession with GDPG dropping to 2%. However when the spread drops below the 2% in early 1993, GDPG rises to highest level yet at 7.43%. This would seem to suggest that in the early phase of reforms, the efficiency of intermediation is enhanced, evident from the narrow spread. This as discussed earlier generates higher economic activity.

In early 1994, the above scenario changes drastically. The spread assumes a rising trend maintaining the two digit level thereafter. The GDPG during this period is mostly in recession experiencing 3 troughs and 2 peaks, probably as a result of shocks in the economy due to wide and volatile spread.

It is clear in figure 4.3 that the 1980s illustrate an expansion in economic activity when the spread remained constant. The three peaks in GDPG that appear in 1986, 1988 and 1990 all coincide with constant spread. The trough in 1985, 1987 and 1989 all coincide with or are preceded by fluctuation upwards or downwards in spread. This trend of GDPG and spread moving in tandem is however less prominent in the 1990s. Although the GDPG follows a business cycle in the 1990s, the swings are more extreme in the 1990s compared to the 1980s. The spread on the other hand is wide in the post-liberalisation period, mostly dampening economic activity. However, the relationship between the spread and GDPG is however weak and inconsistent.

4.7.2 Exchange rate

Both exchange rates and interest rates were liberalised in the early 1990s. It is therefore important to assess the link between the exchange rates (ER) and spread before and after liberalisation. A comparison between spread and growth in nominal exchange rate (GER) as illustrated in Figure 4.4 overleaf is undertaken.

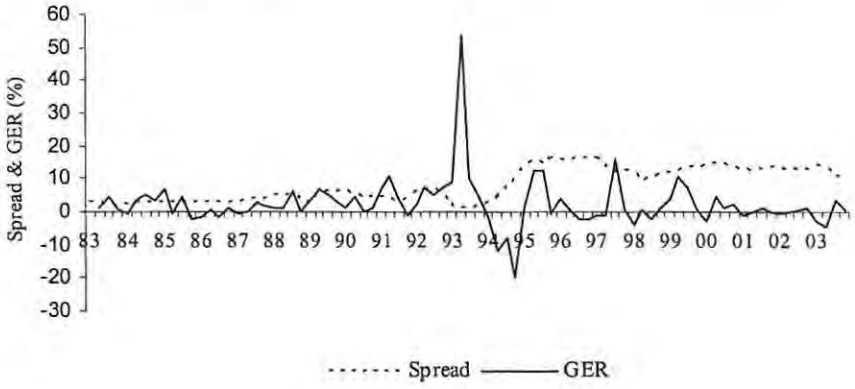

Figure 4.4: Interest rate spread and Growth in Exchange rate

Source: Computed using data from IMF International Financial Statistics (1983-2003) & Ndung'u & Ngugi (2000)

From figure 4.4 above, it is clear that the spread and GER move in tandem during the 1980s. While the spread remain almost constant from 1983 to the early 1990s, the GER fluctuates gradually within a 10% range. This only change in the early 1990s when in early 1993, GER escalate sharply upward beyond the 50% level peaking at 53.74%. The spread at this same time, contracts to it lowest level of 1.08%. Financial reforms at this period which lead to a relaxation of foreign exchange controls as well as interest rate liberalisation would explain these sharp fluctuations observed.

The rapid rise in GER in 1993 does not last long. The trend reverses sharply, and between 1994 and 1995, the GER dips to negative levels, with an all time low of -19.67% at the end of 1994. The spread by this time assumes a rising trend and attain the double digit level mentioned previously. After 1995, the GER fluctuates a lot, and only to maintains a constant trend between 2000 and early 2003. However these fluctuations seem to be independent of spreads.

From figure 4.4, it is evident that the pre-liberalisation period in the 1980s is characterised by the variables in question moving closer together and with gentler fluctuations. However, the advent of liberalisation in the 1990s seems to change this trend. The relationship between the variables is minimal with each variable moving more independently.

4.7.3 Inflation

The macroeconomic stability is generally measured by the volatility in the inflation rate. According to Rother (2001) in Aziakpono (2004:117), it is generally argued that macroeconomic instability would have negative effects on financial intermediation. The main reason for this is that increasing inflation is a disincentive to savers who expect a fall in their real wealth. The level of savings and consequently investments would therefore fall. Borrowers on the other hand demand more credit since they expect to pay less in future. Banks to cover for inflation increase their lending rates, thus limiting credit. This cycle would have a negative effect on the intermediation process.

In assessing the relationship between growth in inflation (GINF) on the spread, the consumer price index figures for the 20 year period are computed and compared to the spread. Figure 4.5 illustrates this relationship.

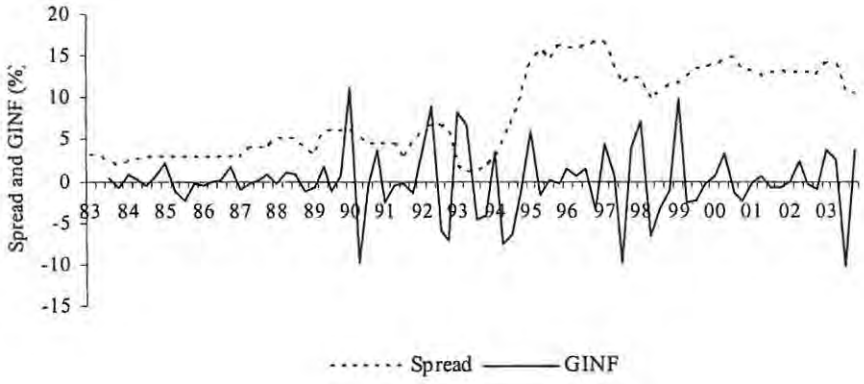

Figure 4.5: Interest rate spread and Growth in inflation

Source: Computed using data from IMF International Financial Statistics (1983-2003) & Ndung'u & Ngugi (2000)

As with the Economic growth and the Exchange rate, a closer relationship and less volatility in the inflation rate is seen during the 1980s. However the 1990s bring forth more fluctuations as well as inconsistency in the previously observed relationship.

From figure 4.5, the GINF is relatively low and moves very closely with the spread between 1980 and 1990. However from 1990, this picture changes dramatically with GINF exhibiting great fluctuations up to 1998. The fluctuations are, during this time, less dramatic. The most vivid movement in the GINF is between 1990 and 2000. This represents the post-liberalisation period when the spread is also very wide.

Figure 4.5 also illustrates a closer relationship between inflation and spreads than the other two variables examined. The 1990s which exhibit a wide spread also have the greatest fluctuations in GINF. This seems to suggest that great volatility in GINF is closely related to wide spreads. One explanation is that, because the wide spread that appear in the early 1990s are preceded by volatility in GINF. However, the extent and strength of this relationship is not clear.

4.8 INSTITUTIONAL FACTORS

Having assessed the extent to which macroeconomic factors are linked to wide spreads, a discussion of the other broad factors associated with them is provided. These are institutional/structural factors.

4.8.1 Market Composition

Although Kenya's financial sector can be described as being relatively diversified in terms of the number of financial institutions, according to Ndung'u & Ngugi (2000:10), banking services continue to dominate the sector with a 50% growth from 1981 to the early 1990s. In the banking sector itself, organisational concentration and competition exists. Five banks control nearly 60% of the total banking assets, while many small banks compete holding the balance of 40% (Wagacha, 2001:13). This level of competitiveness, even though existent, is not positive as it tends to restrict

entry into the market. The dominant banks have market power, and use oligopolistic tendencies to maintain the large spread in order to maximise profits.

4.8.2 Credit risk

Loans continued to dominate the asset portfolios of the commercial banks. However, the lending practices have been poor. With the government still owning or having interests in the banking industry, it wields considerable influence. Some of the banks have been lending to individuals and corporations without taking adequate security for the loans. When the loans are defaulted on, the banks have no recourse but to let the funds pass as bad debts.

In the early 1990s, 36% of the loans issued by banking institutions were non-performing. This practice of poor lending precipitated by government owned banks often involves bank executives who lack the independence to reject politically influential people who apply for the loans. When these people default the bank is unable to recover the funds because the loans were unsecured (IEA, 2000:3). In order to protect themselves against this risk, banks are forced to increase their premium and thus widening the spread.

4.8.3 Implicit Taxes

Reserve and liquidity requirements as well as mandatory investment and interest controls are categorised as implicit taxes. A reserve requirement with no interest tends to have a high opportunity cost as it squeezes the excess reserve available for banks to advance credit, reducing the scope of banks' income-earning assets (Ndung'u and Ngugi, 2000:19). Banking regulations require commercial banks to maintain a cash ratio of up to 10% of their total deposits with the Central Bank. This means that while banks must pay interest on the deposits, they only keep 90% of the deposits for their operations because the Central Bank does not pay interest on the 10% deposited (IEA, 2000:2). This therefore leads the banks to make up the short-fall by having large spread in their interest rates.

4.8.4 Legal and regulatory framework

In order to achieve functional efficiency in the banking sector, Ndung'u and Ngugi (2000:17) emphasise the importance of having a proper legal and regulatory framework in place. This would not only enhance the liberalisation measures by enhancing financial stability as discussed in chapter 2. The efficiency of the intermediation process would be enhanced, leading to narrower interest rate spread.

By creating a strong regulatory framework, Ndung'u & Ngugi (2000) assert that this would improve the lending practices, especially where information asymmetry exists. This would go hand-in-hand with adequate supervision which would enhance credit provision with fewer incidents of bad-debts.

Under conditions of proper legal and regulatory framework all banking institution, whether formal or informal, would have adequate and proper rules of operation and improving the intermediation process. Additionally, to ensure adequate supervision, the skill level of management would have to be improved, for example, through the employment of compliance officers.

The lack of a proper legal and regulatory framework is a major contributor to high interest rate spreads in the Kenyan baking sector. With inadequate regulator and legal structures in place, the default on repayment of loan is very high, and as earlier noted, the premium attached to high risk loans contributes significantly to spreads.

4.9 CONCLUSION

The gradual implementation of financial reforms through the World Bank's Financial Sector Adjustment Credit (FSAC) was aimed at improving the financial sector in Kenya. Some of the initial liberalisation measures aimed at improving the policy and institutional set for banking efficiency were put in place in 1989. In 1991 interest rates were deregulated and credit ceilings in the banking sector abolished in 1993.

In spite of the great hope that these measures would lead to a better market oriented financial system and improved economic performance, the desired results were not forthcoming. The lack of proper operational & management structures within banking, and inadequate regulatory measures for maintaining stability in the financial sector, often led to a reversal of gains made from reforms.

The 1980s to the 1990s saw major banking crises. These were mainly due to accumulation of bad debts, imprudent lending practices, poor management and inadequate capitalisation. All these are closely linked to a lack of the structures mentioned above. Since banks are the main players in Kenya's financial sector, their underperformance has greatly undermined the intermediation process. This has led to wide interest rate spreads.

Two major groups of factors are associated to the high interest rates. These are macroeconomic factors and institutional/structural factors. However a closer examination of three macroeconomic variables against spreads generated mixed results. In the pre-liberalisation period, the variables seem to be more closely linked than the post-liberalisation period where the variables follow independent patterns with little influence on each other.

The conclusion arrived at in this chapter is that institutional factors affect spread to a greater extent than macroeconomic factors. In the next and final chapter, a summary of the study is undertaken with recommendations for moderating spreads outlined.

CHAPTER 5: CONCLUSIONS

5.1 INTRODUCTION

The purpose of this chapter is to outline the conclusions arrived at with regards to financial reforms and their effect on interest rate spreads in the Kenyan banking sector. One of the main reasons for financial reforms in Kenya was the enhancement of efficiency in the financial sector. By looking at the discussions in previous chapters, conclusions are arrived at as to whether this was achieved or not.

To set the stage, an assessment of the effects of financial reforms and how these affected the financial intermediation process was done. Efficiency in the financial sector is directly linked to an improvement in the intermediation process. An enhanced intermediation process, especially within the banking sector, occurs when interest rates converge leading to narrower spreads. It is therefore important to examine the conclusions drawn with regards to the intermediation process under financial reforms.

Next, the chapter examines conclusions on the impact of reforms with specific focus on developing countries. This sheds more light as to the nature and effects of reforms in these countries. Thereafter, Kenya's experience under reforms is examined, with keen attention on banking performance and interest rate spreads. Of major significance are the factors that have led to the high spreads, especially after financial liberalisation. The final part of this chapter outlines recommendations on strategies of improving the banking sector and thus leading to moderate spreads.

5.2 FINANCIAL INTERMEDIATION UNDER REFORMS

Financial intermediaries are firms that earn their income on the spread between the yields on the financial assets they create and the financial assets they buy. This role is of great importance for the saving/investment process which necessary for economic growth. A mark of an enhanced financial intermediation process would be a convergence of these spreads. Since banks form the biggest part of these firms within

the financial sector, a narrow interest rate spread would show enhanced intermediation.

Banks in their normal cause of business would wish to minimise risks and maximise returns on funds. They achieve this by specialising in channelling funds from those with surplus liquidity to those lacking it. Banks also filter information by screening borrowers and monitoring their activities in financial systems characterised by incomplete and asymmetric information. In carrying out this role, banks are compelled to charge a premium for this services bringing rise to interest rates spreads.

The financial sector, would benefit if the above intermediation process is enhanced. This would lead to a more efficient financial system that promotes allocation and mobilisation of resources, important for the growth and development of an economy. Attempts to achieve this have led to financial reforms through various liberalisation measures, especially in the banking sector. These measures it is assumed would enhance the efficiency in the financial sector, by curbing financial repression which interferes with free markets.

Whereas arguments for liberalisation are compelling, it is only after looking at experiences with these reforms that conclusion can be draw as to their suitability. This is done by examining the performance of liberalisation in developing countries.

5.3 FINANCIAL REFORMS EXPERIENCES IN DEVELOPING COUNTRIES

The main aim of the implementation of financial reforms in most developing was to boost economic growth through enhanced efficiency in the financial sector. Conclusions drawn from chapter three show mixed results at best. This is especially the case in African countries where there is overwhelming evidence that the desired objectives in most cases were not achieved. The factors responsible for this dismal performance are of either of a macroeconomic or structural nature.

Most reform measures in these countries centred on the banking sector. Enhanced efficiency in the banking sector was critical if the financial sector was to enjoy

positive results. Conclusions from chapter three show that numerous sub-Saharan countries experienced severe distress in the banking sector with numerous instances of bank collapses during reforms. This was especially severe where blanket reforms were prescribed for countries, ignoring the unique circumstance in different countries. Some countries were experiencing macroeconomic imbalances, while others had political and other institutional fragility. Reforms should therefore have been implemented after looking at specific country needs in order to see which reform processes would be most adequate. There is also a need for certain prerequisites to be in put place to ensure that the unintended consequences of reforms do not occur. If these do occur, they should have a negligible negative impact on the economy. In order to avoid shocks to the economy, reforms should be implemented gradually and in the proper sequence. This would ensure more success for reforms and consequently lead to narrower spreads and a more efficient financial sector.

Since the above has not been the case in most developing countries, the interest rate spreads have remained relatively wide reflecting poor financial intermediation under reforms. The Kenyan banking sector is a classic example of this

5.4 THE KENYAN EXPERIENCE

Kenya implemented financial reforms in the banking sector under the broad structural adjustment programmes. The initial phase of these reforms started in the late 1980s. However, interest rates were only deregulated in 1991 and credit ceilings abolished in 1993.

Like most other developing countries, these reforms did not accrue positive results. The lack of proper underlying institutional structures, especially those dealing with the management and operations, as well as regulation of banking sector, undermined liberalisation efforts. During this period of reforms, the banking sector in Kenya experienced major crises. The lack of the structures mentioned above contributed to the poor intermediation process and consequently, wide interest rate spreads.

Although institutional factors have been mentioned several times in connection with the wide spreads after liberalisation, it was also important to assess the role that

macroeconomic factors played in this regard. Three variables were examined against interest rate spreads for the pre-and post-liberalisation period. Results from these were mainly inconclusive. The variables were closely linked in the pre- as opposed to post-liberalisation period, where the followed independent trends. This provides a good area for further research. Conclusions drawn from this research suggest that institutional factors affect spreads to a greater extent than macroeconomic factors. This is quite evident in the discussions throughout this research where various institutional factors have been highlighted as the main hindrance to an efficient intermediation process.

It is therefore important to give recommendations on ways of moderating interest rate spreads, with particular emphasis on the institutional setup.

5.5 RECOMMENDATIONS

Some of the solutions to moderate the margin in interest rate spreads will include the government reducing domestic debt and ensuring fiscal discipline. This according to Wagacha (2000) will help in the lowering of the core lending rates and narrow the spread. The reason is that because with less government debt there will be better economic prospects and some of the risks in lending will be reduced.

Reduction of the cash and reserve ratio will also help in the moderation of interest rates. In the year 2000, the central bank reduced the cash ratio from 10% to 9% with a possibility of further downward reduction to 5% by the end of the year (Wagacha, 2000). This and other Central Bank initiatives, like the reduction of the *lending window* facilities to commercial banks, will have a positive impact on the banking sector and lead to moderation of interest rates margins.

Speeding up the judicial process in order to reduce the backlog of cases dealing with loan defaulters will also be positive for the banking sector. Recovery of loans by defaulters has been a slow and lengthy process, especially for the individual perceived to be politically well connected. Action has started in this direction by setting up

commercial courts and the appointment of more judges. However, more is needed to increase the credibility and speed of this initiative.

Finally, the banking sector will have to improve management skills and increase competition. Downsizing of unskilled staff, using better technology in service provision, amalgamation of branches are a few suggestion in this direction. Banks should also seek to stick to their core business of banking reducing such investments in areas such as agriculture and real estate. Mergers between the smaller banks with low asset bases, so as to compete with the larger more established banks will also help in increasing efficiency in the sector and ultimately assist in the lowering and moderation of interest rate spreads.

APPENDICES

Appendix A1

Interest rate Spreads and Macroeconomic Variables

Year	DR	LR	Spread	ER	GER	INF	GINF	GDPG
1983-Q1	13.04	16	2.96	12.874				
1983-Q2	13.04	16	2.96	13.05	1.37	2.4		3.54
1983-Q3	13.5	16	2.5	13.635	4.48	2.7	0.3	3.54
1983-Q4	13.5	15.33	1.83	13.686	0.37	1.9	-0.8	3.54
1984-Q1	12.5	15	2.5	13.614	-0.53	2.6	0.7	3.54
1984-Q2	12.08	14.67	2.59	14.06	3.28	2.7	0.1	3.53
1984-Q3	11.25	14	2.75	14.74	4.84	2.1	-0.6	3.52
1984-Q4	11.25	14	2.75	15.242	3.41	2.8	0.7	3.50
1985-Q1	11.25	14	2.75	16.262	6.69	4.9	2.1	3.08
1985-Q2	11.25	14	2.75	16.127	-0.83	3.7	-1.3	3.64
1985-Q3	11.25	14	2.75	16.85	4.48	1.4	-2.3	3.76
1985-Q4	11.25	14	2.75	16.49	-2.14	1.0	-0.4	3.86
1986-Q1	11.25	14	2.75	16.217	-1.66	0.4	-0.6	4.99
1986-Q2	11.25	14	2.75	16.348	0.81	0.4	0.0	3.59
1986-Q3	11.25	14	2.75	16.097	-1.54	0.6	0.2	3.30
1986-Q4	11.25	14	2.75	16.241	0.89	2.2	1.6	3.03
1987-Q1	11.25	14	2.75	16.152	-0.55	**1.2**	-1.0	1.58
1987-Q2	10	14	4	16.176	0.15	0.9	-0.3	3.05
1987-Q3	10	14	4	16.598	2.61	1.0	0.1	3.27
1987-Q4	10	14	4	16.892	1.77	1.8	0.8	3.46
1988-Q1	10	15	5	17.068	1.04	1.6	-0.2	4.31
1988-Q2	10	15	5	17.286	1.28	2.7	1.1	3.50
1988-Q3	10	15	5	18.328	6.03	3.4	0.7	3.40
1988-Q4	11.33	15	3.67	18.306	-0.12	2.2	-1.3	3.30
1989-Q1	12	15	3	18.936	3.44	1.5	-0.7	2.90
1989-Q2	12	18	6	20.233	6.85	3.2	1.7	3.26
1989-Q3	12	18	6	21.284	5.19	2.0	-1.2	3.29
1989-Q4	12	18	6	21.837	2.60	2.5	0.5	3.31
1990-Q1	12	18	6	22.091	1.16	13.8	11.3	3.48
1990-Q2	13.67	19	5.33	23.091	4.53	4.0	-9.8	3.27
1990-Q3	14.5	19	4.5	23.129	0.16	3.4	-0.7	3.23
1990-Q4	14.5	19	4.5	23.348	0.95	7.2	3.8	3.18
1991-Q1	14.5	19	4.5	25.03	7.20	4.7	-2.5	1.90
1991-Q2	14.5	19	4.5	27.702	10.68	4.2	-0.5	3.62
1991-Q3	19.08	21.63	2.55	28.824	4.05	3.9	-0.3	4.01
1991-Q4	19.45	24.05	4.60	28.475	-1.21	2.4	-1.5	4.36
1992-Q1	20.43	26.42	5.99	29.165	2.42	6.0	3.6	4.19
1992-Q2	22.03	28.75	6.72	31.375	7.58	14.8	8.8	5.10
1992-Q3	24.25	31.03	6.78	32.989	5.14	8.8	-6.0	5.46
1992-Q4	27.08	33.27	6.19	35.339	7.12	1.7	-7.2	5.75
1993-Q1	35.23	36.96	1.74	38.635	9.33	9.9	8.2	7.43
1993-Q2	37.41	38.51	1.10	59.398	53.74	16.5	6.6	5.54
1993-Q3	38.33	39.41	1.08	65.517	10.30	12.0	-4.5	5.22
1993-Q4	37.99	39.67	1.68	68.456	4.49	7.7	-4.3	4.93

1994-Q1	36.39	39.28	2.90	67.127	-1.94	11.2	3.5	4.70
1994-Q2	33.52	38.25	4.73	58.999	-12.11	3.8	-7.4	4.43
1994-Q3	29.39	36.57	7.19	54.387	-7.82	-2.7	-6.4	4.20
1994-Q4	23.99	34.25	10.26	43.689	-19.67	-3.4	-0.7	4.00
1995-Q1	14.21	28.5	14.29	44.363	1.54	2.6	6.0	3.80
1995-Q2	11.61	27.26	15.65	49.831	12.33	0.8	-1.8	3.65
1995-Q3	13.11	27.75	14.64	55.908	12.20	0.9	0.1	3.50
1995-Q4	15.47	31.67	16.2	55.617	-0.52	0.7	-0.2	3.35
1996-Q1	17.09	33.03	15.94	57.807	3.94	2.2	1.5	2.16
1996-Q2	17.65	33.69	16.04	58.199	0.68	2.9	0.7	3.55
1996-Q3	17.75	33.89	16.14	56.91	-2.21	4.3	1.4	3.80
1996-Q4	17.87	34.54	16.67	55.544	-2.40	0.9	-3.4	4.03
1997-Q1	17.94	34.46	16.52	54.853	-1.24	5.4	4.5	5.76
1997-Q2	16.2	29.75	13.55	54.121	-1.33	6.1	0.6	3.74
1997-Q3	15.46	27.18	11.72	62.748	15.94	-3.7	-9.7	3.37
1997-Q4	17.28	29.58	12.3	63.206	0.73	0.3	4.0	3.02
1998-Q1	17.55	29.97	12.42	60.602	-4.12	7.6	7.2	2.65
1998-Q2	20.68	30.47	9.79	60.912	0.51	0.8	-6.7	2.44
1998-Q3	19.02	29.74	10.72	59.573	-2.20	-2.3	-3.2	2.19
1998-Q4	16.35	27.78	11.43	60.38	1.35	-3.6	-1.3	1.95
1999-Q1	10.87	22.62	11.75	62.781	3.98	6.3	9.9	1.19
1999-Q2	8.34	20.82	12.48	69.358	10.48	3.6	-2.6	1.74
1999-Q3	8.32	21.83	13.51	74.398	7.27	1.2	-2.4	1.74
1999-Q4	10.67	24.25	13.58	74.768	0.50	1.0	-0.2	1.73
2000-Q1	10.88	24.77	13.89	72.777	-2.66	1.6	0.6	1.12
2000-Q2	8.68	23.32	14.64	75.96	4.37	4.9	3.3	1.99
2000-Q3	6.51	21.4	14.89	77.017	1.39	3.5	-1.4	2.21
2000-Q4	6.32	19.87	13.55	78.949	2.51	1.1	-2.4	2.43
2001-Q1	7.02	20.2	13.18	78.203	-0.94	0.7	-0.4	3.25
2001-Q2	6.77	19.34	12.57	78.22	0.02	1.3	0.6	2.54
2001-Q3	6.51	19.56	13.05	78.959	0.94	0.6	-0.8	2.48
2001-Q4	6.26	19.57	13.31	78.871	-0.11	-0.2	-0.8	2.42
2002-Q1	6.02	19.11	13.09	78.301	-0.72	-0.4	-0.2	2.37
2002-Q2	5.58	18.54	12.96	78.417	0.15	1.9	2.4	2.31
2002-Q3	5.14	18.14	13	78.804	0.49	1.7	-0.2	2.26
2002-Q4	5.21	18.02	12.81	79.474	0.85	0.7	-1.0	2.21
2003-Q1	4.71	18.78	14.07	77.047	-3.05	4.5	3.7	2.21
2003-Q2	4.31	18.45	14.14	73.662	-4.39	7.1	2.6	
2003-Q3	4.01	14.95	10.94	76.204	3.45	-3.3	-10.4	
2003-Q4	3.51	14.11	10.6	76.829	0.82	0.5	3.8	

Source: **Computed using data from IMF International Financial Statistics (1983-2003)**

Appendix A2

Total Industry Profits before Tax (in Billions)

Year	Kshs
1996	15
1997	15.8
1998	10
1999	3.9
2000	2.4
2001	8.8
2002	6.1
2003	4.9

Source: **Banking surveys conducted by Market Intelligence (1996-2003)**

Appendix A3

Interest rate Spreads and Economic Growth

Year	Spread	GDPG
83	2.96	
1983-Q2	2.96	3.54
1983-Q3	2.5	3.54
1983-Q4	1.83	3.54
84	2.5	3.54
1984-Q2	2.59	3.53
1984-Q3	2.75	3.52
1984-Q4	2.75	3.50
85	2.75	3.08
1985-Q2	2.75	3.64
1985-Q3	2.75	3.76
1985-Q4	2.75	3.86
86	2.75	4.99
1986-Q2	2.75	3.59
1986-Q3	2.75	3.30
1986-Q4	2.75	3.03
87	2.75	1.58
1987-Q2	4	3.05
1987-Q3	4	3.27
1987-Q4	4	3.46
88	5	4.31
1988-Q2	5	3.50
1988-Q3	5	3.40
1988-Q4	3.67	3.30
89	3	2.90
1989-Q2	6	3.26
1989-Q3	6	3.29
1989-Q4	6	3.31
90	6	3.48
1990-Q2	5.33	3.27
1990-Q3	4.5	3.23
1990-Q4	4.5	3.18
91	4.5	1.90
1991-Q2	4.5	3.62
1991-Q3	2.55	4.01
1991-Q4	4.60	4.36
92	5.99	4.19
1992-Q2	6.72	5.10
1992-Q3	6.78	5.46
1992-Q4	6.19	5.75
93	1.74	7.43
1993-Q2	1.10	5.54
1993-Q3	1.08	5.22
1993-Q4	1.68	4.93
94	2.90	4.70
1994-Q2	4.73	4.43

1994-Q3	7.19	4.20
1994-Q4	10.26	4.00
95	14.29	3.80
1995-Q2	15.65	3.65
1995-Q3	14.64	3.50
1995-Q4	16.2	3.35
96	15.94	2.16
1996-Q2	16.04	3.55
1996-Q3	16.14	3.80
1996-Q4	16.67	4.03
97	16.52	5.76
1997-Q2	13.55	3.74
1997-Q3	11.72	3.37
1997-Q4	12.3	3.02
98	12.42	2.65
1998-Q2	9.79	2.44
1998-Q3	10.72	2.19
1998-Q4	11.43	1.95
99	11.75	1.19
1999-Q2	12.48	1.74
1999-Q3	13.51	1.74
1999-Q4	13.58	1.73
00	13.89	1.12
2000-Q2	14.64	1.99
2000-Q3	14.89	2.21
2000-Q4	13.55	2.43
01	13.18	3.25
2001-Q2	12.57	2.54
2001-Q3	13.05	2.48
2001-Q4	13.31	2.42
02	13.09	2.37
2002-Q2	12.96	2.31
2002-Q3	13	2.26
2002-Q4	12.81	2.21
03	14.07	2.21
2003-Q2	14.14	
2003-Q3	10.94	
2003-Q4	10.6	

Source: **Computed using data from IMF International Financial Statistics (1983-2003)**

Appendix A4

Interest rate Spreads and Exchange rates

Year	IND	GER
83	2.96	
1983-Q2	2.96	1.37
1983-Q3	2.5	4.48
1983-Q4	1.83	0.37
84	2.5	-0.53
1984-Q2	2.59	3.28
1984-Q3	2.75	4.84
1984-Q4	2.75	3.41
85	2.75	6.69
1985-Q2	2.75	-0.83
1985-Q3	2.75	4.48
1985-Q4	2.75	-2.14
86	2.75	-1.66
1986-Q2	2.75	0.81
1986-Q3	2.75	-1.54
1986-Q4	2.75	0.89
87	2.75	-0.55
1987-Q2	4	0.15
1987-Q3	4	2.61
1987-Q4	4	1.77
88	5	1.04
1988-Q2	5	1.28
1988-Q3	5	6.03
1988-Q4	3.67	-0.12
89	3	3.44
1989-Q2	6	6.85
1989-Q3	6	5.19
1989-Q4	6	2.60
90	6	1.16
1990-Q2	5.33	4.53
1990-Q3	4.5	0.16
1990-Q4	4.5	0.95
91	4.5	7.20
1991-Q2	4.5	10.68
1991-Q3	2.55	4.05
1991-Q4	4.60	-1.21
92	5.99	2.42
1992-Q2	6.72	7.58
1992-Q3	6.78	5.14
1992-Q4	6.19	7.12
93	1.74	9.33
1993-Q2	1.10	53.74
1993-Q3	1.08	10.30
1993-Q4	1.68	4.49
94	2.90	-1.94
1994-Q2	4.73	-12.11

1994-Q3	7.19	-7.82
1994-Q4	10.26	-19.67
95	14.29	1.54
1995-Q2	15.65	12.33
1995-Q3	14.64	12.20
1995-Q4	16.2	-0.52
96	15.94	3.94
1996-Q2	16.04	0.68
1996-Q3	16.14	-2.21
1996-Q4	16.67	-2.40
97	16.52	-1.24
1997-Q2	13.55	-1.33
1997-Q3	11.72	15.94
1997-Q4	12.3	0.73
98	12.42	-4.12
1998-Q2	9.79	0.51
1998-Q3	10.72	-2.20
1998-Q4	11.43	1.35
99	11.75	3.98
1999-Q2	12.48	10.48
1999-Q3	13.51	7.27
1999-Q4	13.58	0.50
00	13.89	-2.66
2000-Q2	14.64	4.37
2000-Q3	14.89	1.39
2000-Q4	13.55	2.51
01	13.18	-0.94
2001-Q2	12.57	0.02
2001-Q3	13.05	0.94
2001-Q4	13.31	-0.11
02	13.09	-0.72
2002-Q2	12.96	0.15
2002-Q3	13	0.49
2002-Q4	12.81	0.85
03	14.07	-3.05
2003-Q2	14.14	-4.39
2003-Q3	10.94	3.45
2003-Q4	10.6	0.82

Source: **Computed using data from IMF International Financial Statistics (1983-2003)**

Appendix A5

Interest rate Spreads and Growth in Inflation

Year	Spread	GINF
83	2.96	
1983-Q2	2.96	
1983-Q3	2.5	0.3
1983-Q4	1.83	-0.8
84	2.5	0.7
1984-Q2	2.59	0.1
1984-Q3	2.75	-0.6
1984-Q4	2.75	0.7
85	2.75	2.1
1985-Q2	2.75	-1.3
1985-Q3	2.75	-2.3
1985-Q4	2.75	-0.4
86	2.75	-0.6
1986-Q2	2.75	0.0
1986-Q3	2.75	0.2
1986-Q4	2.75	1.6
87	2.75	-1.0
1987-Q2	4	-0.3
1987-Q3	4	0.1
1987-Q4	4	0.8
88	5	-0.2
1988-Q2	5	1.1
1988-Q3	5	0.7
1988-Q4	3.67	-1.3
89	3	-0.7
1989-Q2	6	1.7
1989-Q3	6	-1.2
1989-Q4	6	0.5
90	6	11.3
1990-Q2	5.33	-9.8
1990-Q3	4.5	-0.7
1990-Q4	4.5	3.8
91	4.5	-2.5
1991-Q2	4.5	-0.5
1991-Q3	2.55	-0.3
1991-Q4	4.60	-1.5
92	5.99	3.6
1992-Q2	6.72	8.8
1992-Q3	6.78	-6.0
1992-Q4	6.19	-7.2
93	1.74	8.2
1993-Q2	1.10	6.6
1993-Q3	1.08	-4.5
1993-Q4	1.68	-4.3
94	2.90	3.5
1994-Q2	4.73	-7.4

1994-Q3	7.19	-6.4
1994-Q4	10.26	-0.7
95	14.29	6.0
1995-Q2	15.65	-1.8
1995-Q3	14.64	0.1
1995-Q4	16.2	-0.2
96	15.94	1.5
1996-Q2	16.04	0.7
1996-Q3	16.14	1.4
1996-Q4	16.67	-3.4
97	16.52	4.5
1997-Q2	13.55	0.6
1997-Q3	11.72	-9.7
1997-Q4	12.3	4.0
98	12.42	7.2
1998-Q2	9.79	-6.7
1998-Q3	10.72	-3.2
1998-Q4	11.43	-1.3
99	11.75	9.9
1999-Q2	12.48	-2.6
1999-Q3	13.51	-2.4
1999-Q4	13.58	-0.2
00	13.89	0.6
2000-Q2	14.64	3.3
2000-Q3	14.89	-1.4
2000-Q4	13.55	-2.4
01	13.18	-0.4
2001-Q2	12.57	0.6
2001-Q3	13.05	-0.8
2001-Q4	13.31	-0.8
02	13.09	-0.2
2002-Q2	12.96	2.4
2002-Q3	13	-0.2
2002-Q4	12.81	-1.0
03	14.07	3.7
2003-Q2	14.14	2.6
2003-Q3	10.94	-10.4
2003-Q4	10.6	3.8

Source: **Computed using data from IMF International Financial Statistics (1983-2003)**

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