Interest Rates: An Approach to Liberalization

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Interest rate liberalization may not produce the expected benefits if the timing, pace, and sequencing are off. These should be determined by the degree of macroeconomic stability, conditions in the banking and state enterprise sectors, and the central bank's capabilities.

IN RECENT years, many developing and transition countries have allowed market forces to play a greater role in their economies. In the financial sector, this means liberalizing interest rates so that they are allowed to be set by the market, and developing financial markets so that credit can be allocated more efficiently.

Although each country must design its own blueprint for financial reform, some general principles seem to be universally applicable, at least in countries where policymakers have some control over the liberalization process. First, policymakers need to decide when to start liberalizing interest rates and how fast to move. In making this decision, it is important to consider how far advanced the country is in reforming the state enterprise sector and in establishing a "credit culture"—that is, the extent to which banks have become accustomed to using market principles in assessing credit risks. Second, they need to determine the appropriate sequencing of liberalization—the order in which interest rates on different financial instruments can be freed without threatening the health of the country's banking system. Third, the central bank needs to develop a strategy for conducting monetary policy within the framework of a liberalized financial system. To allow market forces to determine the allocation of financial resources, countries need to develop an efficient money market. And, policymakers need to be prepared for the financial innovations that will inevitably follow liberalization.

Starting point and speed

There is growing consensus among policymakers that the speed of liberalization needs to be determined in the context of a country's overall reform program. Financial sector reforms need to be supported by structural reforms in other economic sectors. Countries with serious macroeconomic and financial imbalances, or inadequate regulatory and supervisory frameworks, or whose financial institutions are insolvent, are likely to run into serious problems if they liberalize interest rates too early or too rapidly. If liberalization is premature, controls on interest rates may need to be reintroduced, as happened in Turkey at the beginning of the 1980s and in Korea in the late 1980s. Thus, the better the fundamentals, the faster a country can go with interest rate reform.

Reform of the state-owned enterprise sector is particularly important. For interest rate liberalization to succeed, the main economic players (business enterprises and financial institutions) need to be subject to hard budget constraints so that they will avoid borrowing and lending unwisely. Otherwise, credit could be directed to so-called pathological borrowers—those who are likely to take the greatest risks and who would borrow no matter how high the cost.

Moreover, uncompetitive banking systems, inadequate regulatory frameworks, and borrowers that are insensitive to interest rates undermine the efficiency of market-based credit allocation and disrupt the transmission of monetary policy signals, with adverse consequences for macroeconomic policy. When these conditions prevail, interest rates are not likely to move to their market-clearing levels.

Rapid liberalization in a country whose enterprises and financial institutions lack experienced management could also prove counterproductive and result in an unsound financial sector.

Liberalizing too fast poses certain dangers—but too slow a pace can also defeat reform programs. Reforms may lose momentum and new distortions could emerge if liberalization takes too long. To keep interest rate liberalization on track requires close cooperation between the monetary authorities and government agencies responsible for structural reforms in the real sector. This is particularly true if temporary interest rate subsidies are used to protect certain borrowers whose access to credit is seen as a priority but who would be unable to switch immediately to borrowing on commercial terms, a common situation in many countries—even those with highly competitive and deregulated markets. Eliminating some subsidies while maintaining others presents a particular challenge for transition and developing countries, where most administered rates

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are subsidized and lower than market-clearing rates.

The distortionary effects of subsidized credit facilities can be minimized, however, through the application of certain principles. First, the allocation of subsidies must be transparent to ensure that only targeted sectors benefit from below-market interest rates. Second, relationships between commercial banks and their customers should be based on an assessment of risks, in accordance with market principles. Moreover, decisions about which interest rate subsidies to eliminate should be made by the government, not the central bank, and the costs of interest rate subsidies should also be borne by the government.

Refinancing by the central bank, which has been a source of subsidized credit in some countries, should be either at penal rates or, at the very least, at market rates to discourage excessive recourse to the central bank as lender of last resort and avoid the types of distortions that occurred in China's interbank market in the early 1990s. Chinese banks used some of the central bank's subsidized refinancing to make high-risk investments in real estate and securities rather than to finance priority sectors, and it was the interbank market that served as a channel for this speculative financing.

Sequencing

In determining the appropriate sequencing of interest liberalization, the authorities need to distinguish not only between loan and deposit transactions but also between wholesale and retail transactions. Interest rates on wholesale transactions between sophisticated entities should be liberalized first, followed by lending rates and, last, deposit rates. This gradual approach safeguards the profitability of banks while allowing time for people and firms to adjust to liberalization.

Sequencing in which interbank market rates are liberalized first, followed by lending rates, and, last, by deposit rates stems from a desire to treat financially sophisticated entities (financial institutions and government agencies) differently from those with less financial awareness (business enterprises and the general public). Because the interbank market rate does not affect the public directly, its liberalization has the least political and social exposure. Korea, Malaysia, and Turkey adopted this sequencing. China has also followed this model, to allow time for the learning process—deposit rates will be liberalized last to give the general public time to get used to a new way of setting rates.

The rationale for liberalizing lending rates before deposit rates is that this sequencing makes it possible to avoid overly fierce competition in the banking sector, which could adversely affect the profitability of financial institutions, and, thus, "buys time" for commercial banks to strengthen their operations and financial structure. During this transitional period, governments should enact legislation on collateral and bankruptcy—essential if the financial sector is to operate on a commercial basis.

A mechanism for monitoring the profit margins of financial institutions may prove to be a useful tool to gauge the impact of liberalization on bank profitability. For instance, in Thailand, the central bank and the bankers association agreed to establish a minimum retail lending rate, which links lending rates to deposit rates and provides a benchmark for small borrowers, while strengthening the latter's bargaining power. Also, during Malaysia's transition to full interest rate liberalization, all rates were anchored to each bank's declared base lending rate, which was tied to the bank's funding costs. These monitoring mechanisms can also be used to promote fair competition by providing reliable information to borrowers. They presuppose, however, the existence of standardized accounting rules for asset valuation, provisions for nonperforming loans, and the calculation of income, expenses, and profits before taxes.

To avoid unstable deposit flows between financial institutions, it is prudent not to wait until all lending rates are fully liberalized before beginning to liberalize rates on some types of deposits—large time deposits, for example, which are usually held by large companies and institutional investors, in contrast with "retail" deposits held by individuals. Early liberalization of rates on large deposits is also justified by the fact that they will increasingly be competing with money market instruments (treasury bills or repurchase agreements). Many industrial countries—including Japan, the United States, and most Western European countries—liberalized "wholesale" deposit rates at an early stage. Of the developing countries, Korea also freed interest rates on wholesale deposits, as well as on large-denomination repurchase agreements, early in its reforms.

Monetary policy

An early liberalization of interest rates on wholesale transactions is also critical for the reform of monetary policy. It facilitates the development of an interbank market and a secondary market for government securities, laying the foundation for future management of the money supply through open-market operations (outright sales or purchases of government securities by the central bank in the open market or repurchase transactions for the purpose of controlling money supply).

Money markets. The central bank has a key role to play in the development of money markets. First, any measures it adopts to enhance the soundness of commercial banks indirectly pave the way for the development of a healthy interbank market. Second, it may participate directly in the development of the interbank market.

In Turkey, for example, all interbank transactions were initially intermediated by the central bank. To cover for the credit risk, all transactions had to be backed by acceptable collateral, such as government securities. In Thailand, a repurchase market was created within the central bank with a view to further developing the fledgling money market and giving the central bank a mechanism for monitoring and, if necessary, intervening in the market. In Italy, although an over-the-counter interbank market had been operating for a long time, the central bank established a computer-based market to increase market liquidity and reduce volatility. Korea's central bank promoted the establishment of brokers and dealers of call transactions to enhance the adjustment function of the interbank market and curtail market segmentation. China's central bank, seeking to improve the flow of funds between provinces and create a forum for conducting monetary operations, followed the Italian model in setting up new arrangements for the interbank market.

As different money market instruments are introduced, the central bank needs a strategy for using them to conduct monetary policy. For instance, secondary markets in government securities can be used to conduct open-market operations. However, difficulties arise when the volume of transactions in the secondary market is small in comparison with the central bank's open-market operations. Turkey's central bank, for example, has increasingly used repurchase operations in the interbank market for its open-market operations to avoid conflicts with the Turkish treasury. Often, when the central bank was selling government securities to absorb excess liquidity, the treasury objected on the ground that the central bank's open-market operations were causing interest rates on government securities to rise. To gain greater autonomy in

the conduct of their open-market operations, central banks have increasingly been issuing their own securities.

Financial innovation. Over time, the development of financial instruments such as negotiable short-term securities and repurchase agreements results in greater instability of money demand. It becomes increasingly difficult to identify a monetary variable that is stable enough to be used to forecast the behavior of other nominal policy variables, such the GDP. Although these types of problems do not affect the soundness of quantitative monetary frameworks (as opposed to more subjective approaches), especially for countries that have not achieved a high level of financial liberalization, they do add to the complexities of policy implementation and coordination. In the United States, for example, because the velocity of money became more unstable following the financial innovations of the 1970s and 1980s, the Federal Reserve had to shift its focus a number of times, moving from the narrowest definitions of money to broader measurements of liquidity. It also increased the number of variables monitored to include a wider range of economic indicators—for example, commodity prices, exchange rates, and yield curves. Similar challenges have arisen in most countries that have liberalized their financial sectors. Ultimately, these changes have led to a more eclectic approach to frameworks for designing monetary policy, including inflation targeting.

Lessons for central banks

Very few would challenge the desirability of interest rate liberalization. However, a number of countries have adopted a gradual approach, with the risk of losing momentum, on the grounds that liberalization could be bad if it occurred at the "wrong" time, and that it should therefore be postponed until complementary reforms are in place. Others have achieved a high degree of liberalization but do not seem to be reaping the benefits.

Whether liberalization should be postponed or not has been hotly debated. In some cases, policymakers have little control over sequencing and can therefore not postpone liberalization. In others, however, gradualism is a workable option that allows a country to address the structural issues raised in this article and lay the groundwork for a smooth liberalization process. In this respect, building a sound and profitable banking system is the cornerstone of financial reforms. Liberalization will not produce the expected benefits unless the allocation of credit has improved. In addition, developing a healthy money market facilitates the reform of monetary management and the use of indirect frameworks that allow the central bank to influence underlying demand and supply by influencing the general level of interest rates through its open-market operations. F&D

This article draws on discussions at an international seminar sponsored by the IMF's Monetary and Exchange Affairs Department and the People's Bank of China and held in Beijing in August 1995. The seminar focused on lessons learned from financial reforms in Italy, Korea, Malaysia, Turkey, and the United States, and their relevance to China's liberalization program. The seminar proceedings were published in 1996 under the title Interest Rate Liberalization and Money Market Development: Selected Country Experiences *edited by Hassanali Mehran, Bernard Laurens, and Marc Quintyn (Washington: IMF).*

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