A Review of Policy Proposals in Bank Financial Sector Work

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This series of Economic Policy Notes is intended to bring to the attention of Bank managers interesting issues of economic policy emerging from the work undertaken in the Country Policy Department.
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I. INTRODUCTION

1. This note reviews policy recommendations in recent Bank financial sector reports and compares them with the guidelines presented in the recent financial intermediation policy paper. 1/ The note is based upon the findings of a survey of financial sector work which updates similar work undertaken by IND in 1983. 2/ It focusses on three important policy issues: interest rates, targeted credit programs and the taxation of intermediation. These three topics are not exhaustive, but they represent a sizeable portion of Bank/country dialogue. The note points out areas where discrepancies exist between current practices and the findings of the policy paper. The fact that such discrepancies exist is not surprising. Most of the sector reports reviewed here were drafted prior to the finalization of the policy paper. However, it does imply that some additional efforts in IND and CPD are needed to set the implementation guidelines for the policy paper's general recommendations.


II. INTEREST RATE POLICIES

The Importance of Interest Rates

2. Interest rates are the most important component of the Bank's policy dialogue on the financial sector. Traditional Bank advice, that they be kept positive in real terms, has gone unheeded. A recent analysis of interest rates in ten developing countries indicated that most governments continue to maintain rigid nominal rates. As a result, real rates are primarily a function of inflation. 1/ These rates were mainly negative during the seventies then started to become positive as inflation subsided in most countries in the early eighties. Unless major policy reforms are undertaken which increase the flexibility of nominal rates, real interest rates in many LDCs will become negative if inflation starts rising again. Such an occurrence would have adverse effects on the efficiency of these countries' financial systems in the mobilization and allocation of resources.

3. Bank reports distinguish between deposit and lending rates and argue that an important positive relationship exists between deposit rates and the amount of savings mobilized through the financial system. This type of saving is important, since it determines the amount of productive loans that banks and other intermediaries are able to supply to finance investment. The reports use the ratio of M2 to GNP as an indicator of the relative size of financial savings. This ratio

1/ See INDFD Report No. 5391.
is quite sensitive to changes in the real deposit rate. 1/ It has declined in cases where inflation has caused real rates to be significantly negative. On the other hand, countries which have undertaken major financial reforms, producing positive rates after a period of highly negative ones, have experienced a substantial increase in this ratio.

4. Artificially low lending rates affect the efficiency of investment; they lead to excess demand and credit rationing. As a result, instead of being channelled to the most efficient investors, credit usually goes to the safest ones — those who have the highest collateral. 2/ A decline in the overall efficiency of investment occurs. Some reports also argue that the policy leads to a suboptimal choice of technology; firms receiving cheap credit tend to use more capital intensive techniques than those which would have been chosen at lending rates reflecting the true opportunity cost of capital. 3/

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1/ Thailand (4085-TH), p.14, para. 2.24; Turkey (4459-TU), pp. 2-4, para. 1.5, 1.6; Ecuador (5270-EC), pp. 26-30, para. 2.24-2.27; Peru (4316-PE), p. 31, para. 4.11.


3/ Thailand (4085-TH), p. 55, para. 3.73; Brazil (Financial Systems Review, 1984), p. 66, para. 5.69.
Moving Towards Market-Determined Interest Rates

5. The financial intermediation policy paper recognized that there was a need for changing the Bank's advice on interest rate policies. The recommendation that interest rates be positive in real terms is frequently not adhered to, and may not always be sound. This is based on observations that at times even market determined rates are negative in real terms. Therefore, the policy paper argues for moving away from the positive interest rate target and toward a greater role for markets in interest rate determination.

6. In spite of this, most Bank reports support continued administration of interest rates. Usually two reasons are provided for why it may be unwise for countries to immediately liberalize interest rates; the monopolistic structure of financial markets and the fear of macroeconomic instability. If the financial system is monopolistic; post liberalization credit volumes will be restricted, interest rates will be too high and investment too low. In such cases, there is a reluctance to advise liberalization.

7. The notion that the Bank should advise countries not to liberalize interest rates if their financial markets are monopolistic may be

1/ Sierra Leone (4457-SL), p. 21, para. 8.7; Nigeria (4051-NI), pp. 65-66, para. 8.12; Mexico (Informal Discussion Paper, September, 1983), p. 2, para. 5; Morocco (4957-MOR) pp. 71-72, para. 5.33, 5.34; Turkey (4459-TU) p. 6, para. 1.15.
short-sighted. Most LDCs have stringent regulations pertaining to entry into the banking industry. Unless regulatory reforms allowing freer entry are undertaken, the financial markets will never be contestable, and Bank advice will continue to be that the governments should administer interest rates, rather than liberalize. The Bank should, instead, recommend measures to increase the competitiveness of financial markets in order to make liberalization feasible. In addition to reducing the regulations on domestic entrants into the market, such recommendations may include opening the system to foreign competition.

8. The effect of an interest rate liberalization on macro stability is an important concern. A liberalization can be destabilizing if undertaken simultaneously with bank deregulation, and the opening of the capital account of the balance of payments. In some recent cases of deregulation, banks have tended to assume that governments will protect them from failure by bailing them out if they face financial difficulties. This can lead to overborrowing from abroad and excessive risk taking, thus becoming self-fulfilling. Southern Cone experiences are examples of this.

9. The fear of macro instability should not lead to an offhand dismissal of liberalization efforts, however. Not all liberalizations lead to severe stability problems. Countries that liberalized interest rates without major regulatory changes did not experience the type of problems witnessed in the Southern Cone. Administered interest rates are not a preferred long-run alternative and many reports are probably too reticent in pushing for market determined interest rates, given the
potential gains which are achievable from more appropriate and flexible interest rates. If macro stability is an issue, the reports should propose measures prior to liberalization which will ensure its success. In such cases, the regime of administered rates should continue on a temporary basis until the appropriate policies are in place.

Interim Administration of Interest Rates

10. If interest rates need to be administered during a transitional period, the Bank should be able to advise countries on the levels at which to set rates. Ideally, administered rates should mimic what would have been an efficient market outcome. Since market rates fluctuate a great deal, this implies that administered rates should be flexible. Bank reports need to propose rules of thumb for setting interest rates and adjusting them as market conditions change, rather than suggesting a fixed level of positive real interest rates.

11. Developing rules for setting administered interest rates to mimic efficient market outcomes is difficult. Market determined rates are functions of a large number of domestic and international variables. Except for economies which are quite insulated from the international economy, Bank reports have suggested rules that link foreign and domestic interest rates over the long run. 1/ The rule most

1/ Ecuador (5270-EC) p. 33, para. 2.37; Indonesia (5501-IND), p. 18-19, para. 2.4; Peru (4316-PF), p. 17, para. 3.18; Nigeria (4051-INT), p. 74, para. 7.18.
often used is that domestic rates be equal to international ones plus
the expected rate of depreciation of the domestic currency. However,
there is no consensus about rules that would be generally applicable to
these countries in the short run, when stabilization is an issue and the
capital account of the balance of payments is closed.

12. **Setting interest rate floors and ceilings.** In the absence of
detailed information regarding what the market outcome would have been,
some reports suggest setting floors and ceilings for deposit and lending
rates, respectively. 1/ A usual suggestion is the setting of a minimum
base rate, preferably on a short-term saving instrument, to which the
other rates should be tied by fixed, but not unalterable, margins. 2/
The margins ought to be set with recognition of the fact that domestic
lending rates should not be below international rates for long time
periods. Authorities should then be prepared to change the base rate
frequently in order to offset changes in expectations of inflation and
devaluations.

13. **Uniform versus differential rates.** In many cases, the Bank can,
through loan conditionality, influence interest rates in some sectors
and not others. The problem faced by Bank economists in these cases is

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1/ Cameroon (6028-CM), p. 47.8 para. 4.52-4.55.

2/ Ecuador (5270-EC), pp. 33, para. 2.37; Morocco (4957-MOR), p. 69,
para. 5.27.
whether it is better to have a system of uniform interest rates that are negative in real terms, or whether they should opt for a system of differential rates where lending rates to one or more sectors are considered appropriate. This question was recently debated with respect to an agricultural loan to Nigeria. No consensus has emerged about how to handle such situations. In a financially repressed economy where credit rationing exists (i.e., producers do not equate the marginal efficiency of investment to the interest rate) one cannot argue for maintaining uniform interest rates on efficiency grounds). On the other hand, the merits of an alternative system of differential rates have never been studied. Since this question is bound to arise for other countries, more work which attempts to identify the merits and drawbacks of the two alternatives is needed.

III. TARGETED CREDIT PROGRAMS

The Nature of the Programs

14. In nearly all developing countries, the government intervenes in the allocation of credit among the various economic sectors, usually to increase sectoral production or income. The interventions include sectoral targets for the volume of credit and/or for lending rates, either of which distorts interest rates away from likely market outcomes. Bank reports indicate that most such distortions constitute a subsidy; lending rates to the affected sectors end up being below those
which would have resulted without intervention. 1/ Some reports note, however, that targeted credit programs can theoretically be beneficial if, for example, they offset other distortions such as may result from inappropriate producer prices, taxes or monopolistic practices. 2/

15. The most frequently targeted sectors are agriculture, small-scale industry and exports. In some LDCs the targeted programs are administered through commercial banks, while in others, they are administered by specialized, state financed institutions. In nearly all cases, the financial institutions involved pass at least some of the extra costs of such programs onto others, thus protecting their profit margins. This is sometimes done by rediscounting the targeted loans, at concessionary rates, to the central bank. In other instances, direct subventions from the budget cover the recurrent and/or capital costs of such programs, particularly for specialized, state institutions. Where lending rates to non-targeted sectors are completely flexible, non-priority borrowers cover some or all the costs through higher lending

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1/ Brazil (Financial Systems Review, 1984) pp. 37-40, para. 4.01, 4.06, 4.08; Turkey (4459-TU) pp. 29-30, para. 4.2, 44; Indonesia (5501-IND) p. 26, para. 2.23; Colombia (4274-CO), p. 25, para. 3.11; Thailand (4085-TH), p. (ix), para. 27.

2/ Nigeria (4051-UNI), p. 42, para. 4.01-4.02; Thailand (4085-TH), p. 56, para. 3.74; Turkey (4459-TU), pp. 29-30, para. 4.3; Indonesia (5501-IND), p. 29, para 2.29.
rates. The cost of such programs can also be absorbed by private savers if profit margins or spreads are protected by lowering deposit rates.

**Their Efficiency Effects**

16. Most Bank reports contain negative evaluations of targeted credit programs. It is believed that they provide cheap loans to relatively inefficient producers. Hence, they lead to an inefficient allocation of resources among prospective investors, and a suboptimal choice of technology by those who actually receive the credit. 1/ For example, a report on Thailand argues that subsidized credit schemes were associated with rising incremental capital output ratios — decreasing efficiency of investment. 2/

17. In spite of these objections, administered distortions or subsidies have a way of being recommended time and again as a way of offsetting existing distortions. Financial sector studies recognize this but still argue against using directed credit programs. Even if a subsidy is warranted, a directed credit program is seen as being an inefficient way of giving it, particularly in the longer run. Most reports argue that any warranted subsidies be provided through the

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1/ See the policy paper, p. 23, para. 3.29.
2/ Thailand (4085-TH), p. 20, para. 2.41.
fiscal system. 1/ Three reasons are usually given for this. First, it is believed that fiscal subsidies are more transparent than those provided through the financial system. Second, some reports argue that fiscal subsidies can be more readily adjusted to changes in macroeconomic conditions than financial ones. 2/ Third, reports argue that delinking the financing of priority sectors from the financial intermediation process would minimize the distortionary effects of targeted credit programs. 3/

18. The merits of the last two arguments are questionable. There is no a priori reason to believe that fiscal systems are more flexible than financial ones. Also, in general, the distortionary effect of a subsidy will not depend upon whether it is administered through the fiscal or financial systems. The two types of subsidies are certainly equivalent from the point of view of the priority investor. At the margin, increases in the fiscal deficit are financed by printing more money, which is a tax on the financial system. That is, in both cases priority borrowers receive low interest loans and the cost of the subsidy is shouldered by the rest of the financial system. In fact, 


2/ Indonesia (5501-IND), p. 30, para. 2.34.

administering a subsidy effectively is very difficult no matter which system is used. Also, the difficulty increases with the duration of the subsidy program since other changes in the economy alter the net impact of such subsidy attempts.

Other Problems

19. Although the efficiency argument is probably the strongest argument against targeted credit programs, Bank reports point out several other problems associated with these schemes. Mandatory credit allocations and the associated low lending rates depress bank profits. Thus, in countries like Thailand and Nigeria they have reduced the banks' ability and/or willingness to mobilize savings through higher deposit rates or more branches. 1 In a country like Ecuador where directed credit operates through the central bank's rediscount window, financial institutions concentrate on funding lending by rediscounting rather than by increasing deposits. 2 Hence, targeted credit schemes have a negative effect on savings mobilization, at least in the long run.

20. Some reports contend that the cost imposed by subsidized credit on nonpriority borrowers is unacceptably high. For example, it is

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1/ Thailand (4085-TH), p. 49, para. 3.59; Nigeria (4051-UNI), pp. 38-59, para. 5.09.

2/ Ecuador (5270-EC), p. 40, para. 3.8-3.9.
believed that the high cost of borrowing in Turkey was due to both the relative shortage of non-preferred credit and to a tax imposed on lending rates. Other reports point to the macroeconomic effects of targeted credit programs. 1/ For example, an expansion of those programs through central bank rediscounts usually leads to increases in the monetary base, and hence in the price level.

Towards Eliminating Targeted Credit Programs

21. Most reports argue for the gradual elimination of directed credit programs. However, they are usually cautious about recommending an exact timetable. There is always a fear that the elimination of these schemes will lead to short-run disruptions in the output of the priority sectors. This fear has been reiterated in the financial intermediation policy paper. 2/ In cases where the programs are designed to offset existing distortions, the problem becomes how to deal with the distortion once targeted credit is eliminated.

22. The gradualist approach to eliminating directed credit may be justified in situations where their sudden elimination leads to a drastic fall in sectoral credit, investment, output and employment. Unfortunately, most of the reports which push for gradualism fail to

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1/ Indonesia (5501-IND), p. 21, para. 2.9-2.10; Ecuador (5270-EC), p. 43, para. 3.15; Morocco (4957-MOR), p. 80, para. 6.11.

2/ See policy paper, p. 24, para. 3.32.
make the case that elimination will cause such disruptions. In many cases, particularly for long existent schemes, adjustments have occurred which reduce the impact of the targets. Thus, when credit is fungible, targeted credit may be an ineffective tool for directing investable resources. Reports for Brazil, Ecuador, Nigeria and Indonesia present data that tend to support this argument. If this is the case, then a gradualist approach is not necessary. Targeted credit schemes will not distort the allocation of investment, nor will they offset existing distortions. However, they will continue to impede financial development. Their immediate removal will not lead to any short-term disruption. It is for this reason that an analysis of the effectiveness of existing targeted credit programs in channelling resources to priority sectors is important.

23. If the programs are partially or totally effective in offsetting existing distortions, Bank reports should give more consideration to whether the distortion can be removed by more direct means; e.g., more market oriented pricing policies. The offsetting

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1/ See policy paper, p. 23, para. 3.28.

2/ Ecuador (5270-EC) p. 49, para. 3.28; Brazil (Financial Systems Review, 1984), p. 63, para. 5.60; Mexico (Informal Discussion Paper, September, 1983), p. 5-6, para. 15; Nigeria (4051-UNI), p. 45, para. 4.07.
distortion argument can be used to justify nearly all types of government interventions. As was argued earlier, the recommendation that the subsidy implied by targeted credit be administered by the fiscal system will not necessarily lead to any improvement over existing situations.

IV. TAXATION OF INTERMEDIATION

The Nature of Financial Taxation

24. LDC governments usually extract resources from the financial system by using implicit taxes on intermediation. These include excessively high reserve requirements and the requirement that commercial banks use a certain portion of deposits for the purchase of low-yielding government bonds. Implicit taxation is a significant method of financing government deficits in most LDCs.

25. This type of taxation is utilized when governments cannot rely on non-bank, domestic borrowing to cover their budgetary deficits. Instead, they extract "seigniorage", or implicit tax revenue from the financial system, by the issue of base money. This leads to the inflation tax on moneyholders. The real revenue flow accruing to the government from the issue of base money is equal to the percentage change in nominal base money times the real monetary base. This latter variable consists of currency holdings by the public and reserves held by the commercial banks. Hence, increases in reserve requirements lead to a rise in the implicit tax extracted from the financial system.
Alternatively, the government can extract greater revenues from the system by forcing banks to purchase bonds at below market yields; or, by printing more money — higher inflation.

**Its Effects**

26. The impact of changes in reserve requirements (and other implicit taxes on intermediation) on the government's ability to finance its deficit is rarely discussed in Bank financial sector reports. But, many reports analyze the effects of excessively high reserve requirements on bank profits and on interest rates. The implicit tax rate (and hence government revenue) which results from high reserve requirements and compulsory holdings of government bonds varies significantly depending, importantly, on the rate of inflation. However, Bank work in this area indicates that, even in the absence of inflation, the various types of implicit taxes have negative effects on the development of the financial system.

27. When deposit and lending rates are administratively determined, commercial banks cannot pass through the costs implied by high reserve ratios or mandatory purchases of low yielding government bonds to either savers or borrowers. These implicit taxes reduce the banks' returns from collecting marginal deposits. Hence, some reports argue, that they

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1/ Ecuador (5270-EC, April, 1985), p. 59, para. 4.08; Turkey (4459-TU), pp. 22, para. 3.16.
are an important disincentive for savings mobilization by the financial system. 1/ They limit bank expansion and lead to financial shallowing.

28. If interest rates are market determined, implicit taxes can be defined by reference to their impact on the spread between deposit and lending rates. In an undistorted financial system this spread will just cover costs and "normal" profits. Financial sector reports argue that, in such a setting, increases in bank costs due to implicit taxation will be at least partially passed through to savers and borrowers. 2/ Lending rates will rise and deposit rates will fall — implying an undesirable increase in spreads.

Bank Recommendations

29. There is agreement among many reports that reserve requirements should be set at "prudently" low levels. 3/ However, they refrain from making any specific suggestions as to what that level ought to be. It is often noted that a reduction in reserve requirements may lead to an increase in the price level. Hence, several reports state that

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1/ Thailand (40850-TH), pp. 16-17, para. 2.30; 2.33-2.34; Ecuador (5270-EC), p. 38, para. 3.6; p. 59, para. 4.08.

2/ Colombia (4274-CO), p.22, para. 3.05.

3/ Indonesia (5501-IND), p. 25, para. 2.19; Turkey (4459-TU), pp. 22-23, para. 3.18.
reductions in the monetary base and/or the amount of preferential credits must accompany decreases in reserve ratios. 1/ To avoid stabilization issues, other reports argue that increases in the interest paid on mandatory reserves, so as to reduce their opportunity costs, is preferable to drastic cuts in actual ratios. 2/ In countries where they are important, the Bank usually recommends that mandatory purchase of government bonds be discontinued; or at least that bond yields be raised to market levels. 3/

30. As was stated earlier, governments need to resort to the implicit taxation of the financial system to cover their fiscal deficits. Therefore, Bank recommendations concerning the taxation of intermediation should be linked to its position on whether the government's budget is appropriate. At present, this is not taking place. There is usually more than one combination of reserve requirements and inflation rates that would cover a given level of budget deficit. At the moment, economists have no tools that would enable them to determine a preferred combination. This implies that Bank advice to reduce reserve requirement in many cases may be a recipe for higher inflation, unless the deficit is reduced.


V. CONCLUSIONS

31. This note has indicated the need for implementation guidelines for the policy paper's general conclusions. At least three areas where such guidelines are especially needed were identified. All reports agree that appropriately high interest rates have important, positive effects on the mobilization of financial savings and the efficient allocation of investable resources. There is a consensus among economists that interest rates should be flexible and should reflect market conditions. Yet, financial sector reports rarely advocate completely liberalizing interest rates. Administered rates are not a preferred long-run solution, however, and Bank reports should not dismiss liberalization so lightly. They ought to explore policies that precede or accompany liberalization efforts to ensure their success.

32. Reports often note that the subsidy associated with targeted credit may be warranted to offset existing distortions elsewhere in the economy. But, they state that in such cases subsidies should be administered through the budget instead of directed credit. The merit of this argument is difficult to determine. Fiscal subsidies are in general just as distortionary as subsidies administered through the financial system. The offsetting distortion argument can be used to justify nearly any type of government intervention. Therefore, Bank reports ought to explore more direct means of removing such distortions.

33. Bank recommendations regarding implicit taxes on intermediation are not well developed even though these "taxes" are quite
significant. Some reports recommend a reduction in required reserve ratios and a simultaneous slowdown of the rate of growth of the monetary base to avoid changes in the price level. None of these reports suggest specific, desirable, required reserve ratios. Other reports argue that increases in the interest paid on mandatory reserves, so as to reduce their opportunity costs, is preferable to drastic cuts in actual ratios. However, the basic problem of the size of the budget deficit which gives rise to the need for "excessively high" implicit taxes on intermediation is rarely addressed in financial sector reports.