The War on Interest Rate
Does the Language Matter?

Nkunimdini Asante-Antwi
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POSITION PAPER

Authors Note
The article below was first authored and published as a position paper in The Ghanaian Banker Journal, in May 2006 by Nkunimdini Asante-Antwi. It was originally titled Markets or Control: Which Way to the Promise Land. The central argument is that, the history of market intervention in Ghana has done very little to improve efficiency in capital allocation and asset pricing on the money market. At best, interest rate is best set using tools of monetary policy to influence money supply in complement with a package of fiscal responsibility to address issues related to loan default risk and operational cost structure at the firm (bank) level.

Recently the Trade and Industry Minister, Dr. Ekow Spio-Garbrah, declared "war" on interest rates, sparking debate and controversy on policy feasibility.
The purpose of de-archiving this position paper, is to weigh in on the urgent matter of asset price responsiveness on the money market and buttress the proposition that history may be the best teacher on this particular matter.
At the macro-level, the Public Sector Borrowing Requirement (PSBR), Prime Rate and fiscal position of government may have tremendous sway on interest rate setting by the Monetary Policy Committee (MPC). At the firm level, portfolio quality (non-performing loan ratios), reserve requirements, capital adequacy and operational cost that the banks carry, also holds sway on asset prices. Any "war" effort therefore, that does not take into consideration these variables as ammunition is bound to yield vanity, desolation and wasted

effort. Sound strategy must be aligned with noble intent and clear goals. In furtherance of the ongoing debate, this position paper as first published in 2006 will be republished as a two-part series. I enjoin readers to consider the arguments as one more perspective in this very important policy debate on how to lower borrowing cost for businesses in Ghana.

Introduction

Throughout the world, no nation is known to have developed without a strong and supportive financial system which provides real credit to businesses, especially the SME sector. Such SME sector being the biggest in all economies seems to bear the full brunt of underdevelopment, by virtue of insufficient financing and other factors as well. A worldwide study conducted by World Bank, Shiffer and Weder (2000), which drew on 10,090 firms from 80 countries analyzed the nature of business obstacles facing such firms. Presentation of the results was made in order of obstacle severity facing the surveyed firms. 40% of the respondents were small firms, 40% were medium and the remaining 20%, large firms. The survey required entrepreneurs to rate the obstacles facing their business according to severity of adverse impact. One-third of all firms indicated financing as major obstacle. This figure was slightly lower for larger firms, probably because larger firms have relatively better capacity to generate free positive cash flows, internally. By and large, the conclusion for this study gives the indication the SMEs find it more difficult sourcing financing than their larger counterparts.

This phenomenon is especially compounded in the Ghanaian experience where property titles (security) are shrouded in perpetual controversy. Insufficient credit to critical sectors of the economy has engendered furore is some segments of the business community and the intellectual fraternity. Such furore, to a considerable extent, evolved into a collective clamour for a monetary policy framework whereby liberalism would yield its pathway to interventionism. Simply put" let the politicians decide where Mr. Ato Investor puts his money, regardless of risk, and adverse implication for shareholder value. To be fair, such policy propositions have always been spontaneous reactions to desperate times where a broader social good has been subordinated to the commercial objectives of private capital. There is a colossal temptation to open one's mind to the argument that, the vanguards of the financial institution, i.e. the banks, do little work for all the windfall earnings they make. Credence to this argument is not really farfetched, especially after analyzing the degree of price response of most commercial and universal banks to macro-economic improvements, competition and monetary policy reforms. Shiffer and Weder have also argued that, sometimes, interventions on behalf of SMEs may be justified, if market forces or institutional structures fail to redistribute capital to real sectors. I will argue however, with a certain degree of inclination towards such proposition, albeit retaining my policy discourse in terms of substance and degree. I unapologetically, hold the view that, any legislative instrument that seeks to regulate and control credit in favor of some sectors, in blatant disregard for risk, will constitute a strategic blunder, in our collective quest for growth. History has taught us that the policy outcome of such moves has been nothing to write mom and dad about. Consequently, this article seeks to review a phase of Ghana's financial history in order to draw lessons that

may serve as a backbone for sustainable growth model.

Financial Development Before ERP (Summary)

A basic recognition worldwide is the correlation between financial market deepening and economic growth. The study of Goldsmith (1969) demonstrated an empirical correlation between a solid financial system and economic growth. In a similar line of thought, Gertler and Rose (1994) argue that, economic growth and financial sector development are mutually dependent. In a slightly divergent presentation, Nissanke and Aryeetey (*Economic Reforms in Ghana)*, argued that, only some segments of the real sector receive credit because of institutional weakness inherent in the financial sector. Some of such weakness, they argued were high transaction cost, inadequate complementary institutions, inter alia.

Over a period of about five decades, Ghana has moved away from an interventionist monetary policy regime to a liberal one. Through it all, financial intermediation has arguably failed, to a considerable extent, to efficiently distribute credit to sectors that require it the most. In the erstwhile political dispensation, poor macro-economic performance was advanced as justification for ridiculously colossal investment in low-risk, high-yield government treasury instruments. One can confidently argue that, such reason no more cuts ice under our fiscal and monetary policy environment.

Ernest Aryeetey, Machiko Nissanke and William F. Steel (2001) argued that, it only became fashionable to advocate a policy change from liberalism to interventionism, where there was a major shift in developmental thought, which incidentally coincides with political change. In the 1970s, such advocacy became the cornerstone of monetary policy framework. An overwhelming fusillade of interventionist clamour came during 1972-1978, which coincidentally marked the interest of central government in promoting small businesses. Indeed, by benefit of hindsight, the argument that intervention was the only pragmatic response to a collective desire to see some real fruits of post-independence economic plans sounds unreasonable yet practical. To all intent, and purposes, the market structures were fledgling and too weak to bear fruits during a short gestation period. Simply put, the revolutionary results of intervention satisfies civil clamour more quickly and conveniently than the evolutionary results of free market system. It was imperative for the post-independence socialist government to redirect credit allocation to support domestic development agenda. Some of such interventions were restrictions on spreads and quota prescriptions.

A government intervention in the financial sector has been criticized as being the cause of underdevelopment and inefficiency in the financial system. McKinnon (1973), Shaw (1973) and Fry (1988) are prime advocates of this school of thought. Popiel (1994) argues that, besides shifting allocation of investible funds from markets to government, central controls implicitly taxes the financial markets and uses the banking system as a tool for budget deficit financing. It would be very interesting to see how this hypothesis plays out under the new Bank of Ghana Act, 2004. Under this new Act, deficit financing is limited to 10% of previous year's revenue stock. According to McKinnon and Shaw, repressive financial policies, particularly interest rate ceiling, retard investment and growth. They further argued that,

liberalization would stimulate greater savings mobilization and efficiency through more competitive markets. Fry's (1988) empirical findings, using pooled-time series data for seven Asian countries are presented as evidence supporting the McKinnon-Shaw proposition, that financial liberalization increases savings.

Liberalization: A Comparative Analysis

The distrust engendered between interventionist and liberalist is largely due to the fact that, in spite of liberal reforms during the ERP, the system failed to serve the promised deliverables.
Matter-of-factly, liberal reforms in Ghana emerged strongly during the 1980s as a broad policy response to a debilitated economy, which resulted from an expansionary fiscal policy pursued by the Acheampong regime. The underpinning policy objective was to promote efficiency by generating competition within a broader free market context. The initial focus of the program (on the monetary side) was to liberalize the foreign exchange markets through devaluation and elimination import licensing. The following policy initiatives also affected the nature and operation of the financial markets:

- Introduction of Treasury Bills in 1987
- Foreign Exchange auctions in 1986
- Interest rate deregulation in lending and deposits (1987)
- Sectoral credit controls (1988)
- Private foreign exchange bureaux permitted by BOG (1988)

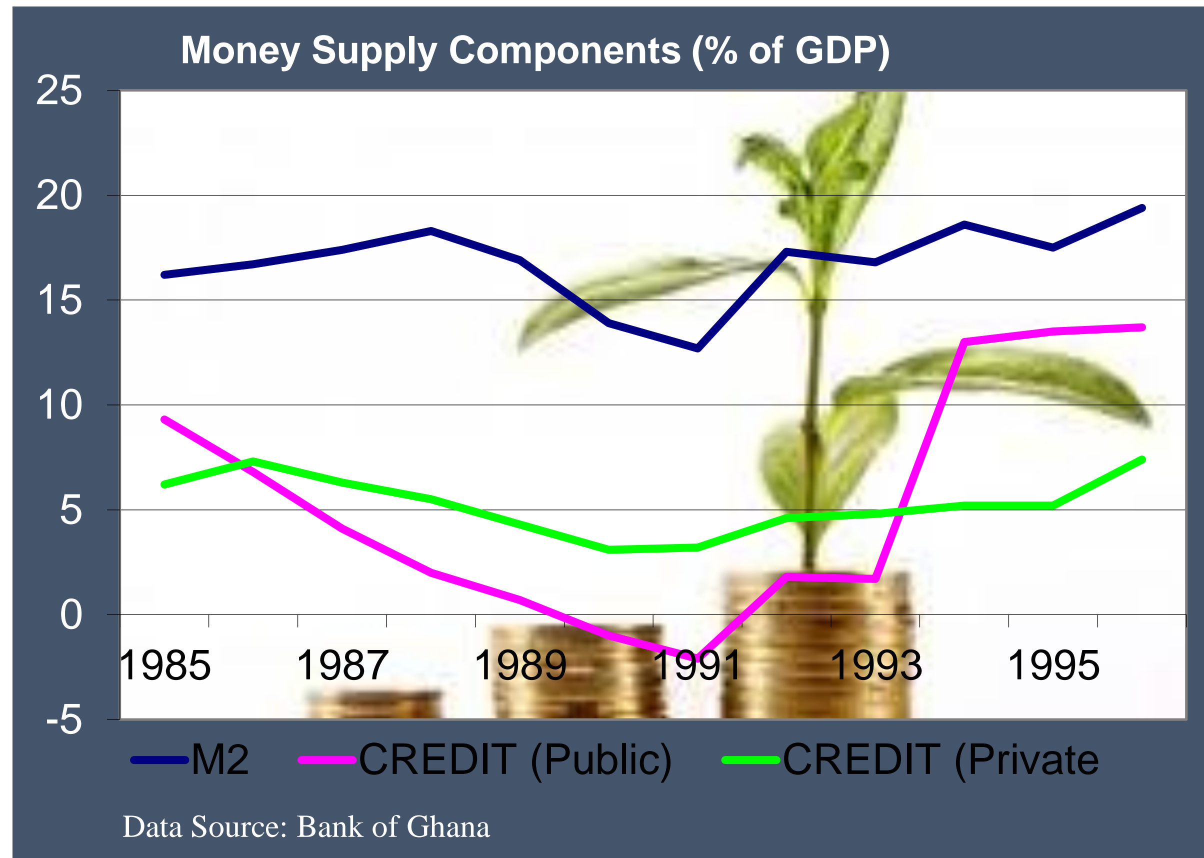
Despite these reforms, the broader objective of ensuring better allocation towards real sectors of the economy, increase in the saving/GDP and investment/GDP ratios (targets) were not realized.

Table 1. Analysis of Key Macroeconomic indicators

	Annual Ave. (1984-1991) Plan	*Annual Ave. (1984-1991) Actual*	*Deviation*
Real GDP growth (%)	5.11	4.66	-0.45
Inflation	22.30	28.30	-6.00
Domestic/GDP (%)	1990 (Plan) 15	1990 (Actual) 6.0	-9.0
Private Investment/GDP (%)	15	7.6	-7.4
Broad Govt. Deficit	Ave. (1987-9) Plan -7.3	Ave. (1987-8) Actual -5.2	+2.1

Source: World Bank, 1987b,; Sowa, 1994; Aryeetey, 1994
Credit: Harrigan and Nissanke *(Economic Reforms in Ghana)*

It is however worthy of mention that institutional support structures, like efficient commercial courts, capacity building organizations and strong regulatory framework were lacking during these times.



Data Source: Bank of Ghana

Next Issue

In part II of this series, we examine the interest rate construct and a sustainable market-based strategy to help reduce borrowing cost.

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(233) 303 935 351
(233) 202 952 658
info@metisdecisions.com