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Review article

INTEREST RATE LIBERALISATION IN WEST AFRICAN COUNTRIES: CHALLENGES AND IMPLICATIONS

This paper reviews the challenges and implications of the interest rate liberalisation policies implemented in some West African countries. The literature reviewed so far shows that, the outcomes of interest rate liberalisation, as implemented in Nigeria, Ghana and Ivory Coast, are positive. However, in some instances the implementation of the policy has led to challenges in other sectors of the economy. The paper, therefore, is of the view that, careful consideration should be given to the interest rate liberalisation policy in developing countries, especially primary commodity exporters like Nigeria, Ghana and Ivory Coast. In all three countries, the results of implementing these policies support numerous past studies that have reported positive outcomes regarding the effects of interest rate liberalisation on economic growth. The paper thus concludes that interest rate liberalisation polices, together with other real sector policies, have a positive impact on economic growth in the countries under review. However, policy makers should put in place alternative policies in order to deal with any possible challenges that may occur as a consequence of the implementation of interest rate liberalisation in these countries.

Keywords: West Africa; liberalisation; interest rate; Ghana; Nigeria and Ivory Coast.

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1. Introduction

The aim of this paper is to present the challenges and implications of the implementation of the policy of interest rate liberalisation in Nigeria, Ghana and Ivory Coast. This paper contributes to the literature on financial liberalisation by investigating whether financial sector reforms have any positive influence on economic growth. The paper uses data from the 1960 to 2008, thus covering the periods of financial repression and of interest rate liberalisation and comparing the two periods. However, the main period covered is the post-liberalisation period. The motivation for selecting Nigeria, Ghana and Ivory Coast among all the West African countries is that these three countries account over 85% of the economic output of the region and all have implemented the interest rate liberalisation policy (IMF, 2016).

In addition, most of the recent studies published on interest rate liberalisation are based on evidence mainly from South American and East Asian countries, with little or no attention devoted to West African countries. The potential weakness of this paper is that the application of the findings to any other country should come with a proviso. The paper is divided into six sections, including the introduction. In section two, the paper reviews the literature on interest rate liberalisation. This is followed by three sections on the challenges and implications of interest rate liberalisation in Nigeria, Ghana and Ivory Coast. The conclusion is in section six, followed by the references.

2. Literature Review

The McKinnon-Shaw hypothesis postulates that financial liberalisation will lead to an increase in savings, an increase in investment and hence rapid economic growth. Some proponents of the hypothesis are Kapur (1976), Mathieson (1980), Galbis (1977) and Jao (1985), among others. Mathieson (1979), for example, argues that the optimal policy is to over-depreciate the exchange rate, reduce the rate of monetary growth and increase loan and deposit rates. The increase in deposits and hence loan rates removes credit rationing, which allows output to rise. It is very important that the increase in interest rate is co-ordinated with the exchange rate policy. The deposit rate must therefore not be increased so as to generate large capital inflows. Instead, the deposit rate should be increased moderately. This will attract a flow of deposits from domestic sources as well as moderate capital inflow. The implication is that growth can remain above its steady-state level and the higher output sets the stage for a fall in the inflation rate by eliminating excess demand for goods.

The main critics of the hypothesis are Van Wijnbergen (1983) and Taylor (1983)[1]. Using Tobin's portfolio framework for households, household choice of investments includes time deposit, loans to business through the informal sector and gold or currency. They argue that in response to an increase in interest rates on deposits, households will substitute these for gold or cash and loans in the informal sector. As Lucas (1988) pointed out, economists 'badly over-stress' the role of the financial sector, thereby reinforcing the difficulties of agreeing on the link and its direction between finance and economic growth (Arestis, 2005b).

Taylor (1983) argues that the McKinnon-Shaw hypothesis may be wrong on two accounts. Firstly, an increase in the desire to save reduces aggregate demand and makes economic contraction more likely than economic growth (a Keynesian viewpoint). Secondly, bank deposits may increase following a rise in real deposit rate. Taylor argues that the impact of this on credit availability will depend on where these deposits come from. If inflow of deposits into the banks comes from the assets of the previously non-productive sector, then there will be a positive impact on credit availability, but if deposits flow from the informal sector then the total credit supply will contract. This is because banks are subjected to reserve requirements, whereas informal operators are not (Gibson and Tsakalotos, 1994). Van Wijnbergen (1983) and Taylor (1983) argue that financial liberalisation may lead to stagflation. Taylor (1983) suggests that in aiming at improving capital accumulation, developing countries should tackle the problem more directly through increasing capital utilisation and creating an atmosphere of confidence in which 'animal spirits' will encourage investment.

Other literature is related to market failure and addresses the issue of asymmetric information in credit markets. Diamond (1984), for example, argues that banks emerged as a result of information asymmetries between borrowers and savers. Proponents are of the view that in the costly state verification approach, financial intermediaries can verify the success of investment only by monitoring costs, which the financial intermediaries try to minimise. They stress that information asymmetries are a problem because they may lead to capital misallocations and high monitoring costs. In line with this, Williamson (1987) shows that high monitoring costs may cause equilibrium in credit rationing, even in the absence of other market failures.

[1] *See also Grabel (1995, 1994), Studart (1996), Dutt (1990) and Paul and Dutt (1991)*

3. Interest Rate Liberalisation in West African Countries

3.1 Nigeria

Challenges and implications of interest Rate liberalisation in Nigeria

According to Owusu and Odhiambo (2012a), Nigeria, like many other developing countries, especially those depending on a single commodity for their export revenue, has faced a number of challenges since the implementation of interest rate liberalisation as part of the Structural Adjustment Programme (SAP) in 1986. Apart from high and increasing interest rates, other challenges that Nigeria has experienced since the implementation of its financial liberalisation policy relate to mixed savings, investment and financial deepening trends; changes in the sectoral allocation of credits; low economic growth rate in relation to financial depth; the relatively wide spread between lending and deposit rates; and foreign currency deposits. These sets of challenges are discussed separately below.

Interest rate liberalisation, investments and financial deepening

Whilst in the pre-financial liberalisation period the average proportion of GDP invested was 19.6%, the proportion decreased to 15.5% after the financial liberalisation policy was implemented, reaching as low as 9.5% in 1996. However, the proportion of GDP invested by Nigeria had been increasing since 1996, reaching 33.8% in 2008. On the other hand, the savings ratio, which began on almost the same level as investments before financial liberalisation, increased to about 27.3% in 1980 then tumbled to a low of 5.0% in 1996 but recovered to 10.3% in 2001 and to 17.3% in 2008. At the same time foreign direct investments (FDI) flow into the country increased from an average of 1.3% of GDP before the policy was introduced to an average of 3.7% of GDP thereafter. One other positive outcome of financial liberalisation was the increase in capital flow and the consequent augmentation of the country's foreign exchange reserves. Previously, the stock of total reserves (minus gold) was $1,165m in 1987; this figure increased to $53,002m by the end of 2008. The increase in FDI could be attributed to several factors. One factor related to the increase in investment in the oil industry and the communications sector and the flexible exchange rate regime following the implementation of the SAP (Aryeetey, 1994).

Financial deepening, as measured by the ratio of M2 (money and quasi-money) to GDP, started to increase in 1974 from 12.5% through to 39.6% in 1986, then dropped to as low as 13.7% in 1996, but stood at 38.4% in 2008. The pre-liberalisation average stood at about 27.0% but decreased to about 24.0% after the policy was implemented. The drop of three percentage points may suggest that there has been a worsening of financial deepening after the financial liberalisation period. (Owusu Odhiambo, 2012a).

Furthermore, there has been a tremendous change in the structure of credit allocated to the various sectors by the banks after the implementation of the financial liberation policy. Previously agriculture, forestry and fishing, manufacturing, construction and trade and commerce were allocated on average 6.0%, 25.2%, 16.5% and 24.6% of the total credit respectively, while the post financial liberalisation period saw an average of 10.9%, 28.7%, 3.7% and 14.5% for agriculture, manufacturing, construction and trade and commerce respectively. The data seems to suggest that the miscellaneous sector benefited most as a result of interest rate liberalisation, from an average of 8.8% to 31.8%. The lowest was the construction sector, which fell 12.8% points. The question arises: "Does this change in the composition of the credit allocation reflect an increase in the efficiency of credit allocation?"

According to the World Bank (2002), the bulk of the credit channelled to the private sector was directed towards short-term investment. Long-term finance was very rare and only the most creditworthy had access to it. The private sector, especially small and medium enterprises (SMEs), is yet to feel the impact of the financial liberalisation policy. As Ajayi (2007) observed, the anticipated flow of funds from the banking sector to the real sector, which was one of the thrusts of the government policy, has yet to manifest in the economy, especially SMEs, with the financial sector reflecting a strong preference for large enterprises. The banks were reluctant to give loans to the private sector, especially SMEs, not because the sector was not viable, but due to the perceived risky nature and lack of government guarantee schemes (Obamuyi, 2009).

According to Obamuyi (2009), in 1992 credit to SMEs accounted for 48.8% of the total. The proportion fell drastically since then, reaching 2.7% in 2005. It fell further to a low of 0.2% in 2008. The implication is that the interest rate liberalisation policy has not generated enough funds for the development of a private sector-led economy. This means that the government objective of using the private sector as a catalyst for development may not be easily achieved.

According to Obamuyi (2009), although the majority of SMEs[2] are either very or fairly satisfied with the liquidity position of their banks, the stringent lending conditions, including various astronomical charges, have made bank financing unattractive to the private sector. About 80% and 69% of private business opera-

[2] *About 92.7%*

tors are dissatisfied with the lending conditions and high cost of funds of the banks respectively. The issue, therefore, is that the banks are liquid and ready to lend, but the private sector is reluctant to borrow because of the high transaction costs and other lending bottlenecks. This has the implication of restraining private sector investment, and ultimately retarding economic growth.

Interest rate liberalisation and economic growth

In Nigeria, the annual average GDP growth pre-liberalisation was 0.3%[3] but after the policy was implemented, the economy was growing at an average rate of 4.8%. In addition, growth rates before financial liberalisation were not steady, with a number of years recording negative growth or shrinkage. There were seven years between 1975 and 1987 when negative rates were recorded (the economy shrank), going as low as negative 13.0% in 1981, while a rate as high as 10.0% was recorded in 1985. The post policy period has seen constant positive growth rates, but no growth from 1988 through to 2008. Some recorded as low as zero, as in 1994, and some years recorded rates as high as 11.0%, as in 2004 (Owusu and Odhiambo, 2012).

The analysis also shows that, inflation has increased in the post financial liberalisation period as compared to the pre-policy period. The average rate of inflation before the introduction of the policy was 16.2%, as compared to the post-policy average of 24.8%. Based on IMF data, Nigeria recorded only one trade deficit after the implementation of the financial liberalisation policy and that was in 1998. During the pre-policy period, Nigeria recorded an average balance of trade surplus of 7.0% of GDP. The post liberalisation period has seen an increase in the average surplus of 16.4% of GDP (IMF, 2009).

Spreads between lending and deposit rates

The gap between lending and deposit rates in Nigeria has widened significantly since the introduction of the interest rate liberalisation policy in 1986. Before interest rate liberalisation, the spread between the lending and deposit rates fluctuated between 0.9% in 1987 and 4.0% in 1972, with an average for the period of 2.9%. A spread of about 3.5% was maintained between 1972 and 1981. This

[3] *This is based on the average from 1975 to 1987.*

increased to 8.4% in 1993, then to 10.6% in 1997, but dropped to 5.5% in 2004 before increasing to 7.4% in 2005. Following the implementation of the full interest rate liberalisation policy in 1986, the spread widened significantly from the previous high of 4.0% in 1972 to 5.8% in 1989. Between 1989 and 2008, the interest rate spread varied between a post- liberalisation low of 3.5% and a historic high of 10.6%, with an average spread of 6.9% for the period to 2008. Between 1997 and 2004, the interest rate spread decreased dramatically from 10.6% in 1997 to 5.5% in 2004 but then increased to 7.4% in the following year before decreasing to 3.5% in 2008 (Owusu and Odhiambo, 2012a).

Interest rate liberalisation and foreign currency deposits

Loss of confidence in the domestic currency (the Naira) has been another challenge. The implementation of the interest rate liberalisation policy has led to an increase in foreign currency deposits within the domestic banking system. The main factor behind this loss of confidence is inflationary pressures leading to a lack of budgetary discipline, combined with monetary financing and domestic debt financing. As a result of this, the private sector responded by demanding higher real interest rates on government securities as well as increasing its foreign currency holdings. Also, residents in Nigeria tended to hold part of their wealth in foreign currencies (especially US dollars) as a hedge against rampant inflation. As noted by Adebiyi (2005), the lack of harmony between fiscal and monetary policies hindered the effectiveness of monetary policies. There is a direct relationship between monetary and fiscal policies of governments. In most countries, fiscal deficit is financed through borrowing from the banking system. There are serious consequences when the proportion to be borrowed exceeds or is significant compared to what the Central Bank has accounted for. The magnitude and the pattern of government fiscal operations have been a major source of ineffective monetary control in Nigeria (Ojo, 2001)

Before interest rate liberalisation, the proportion of total savings held in foreign currencies was nil. However the post-liberalisation period has seen an increase in the proportion of foreign currency from zero to 5.1% on the average. This proportion stood at 12.2% in 2008, down from a high of 13.9% in 2005. The rapid increase in the proportion of savings held in foreign currencies is mainly due to the rapid depreciation of the Naira. Before the implementation of the interest rate liberalisation policy, the Naira depreciated by only 9.7% per annum compounded. However, it depreciated by 16.5% per annum compounded after the liberalisation period (i.e. between 1988 and 2008) against the US dollar (Owusu and Odhiambo, 2012a).

3.2 Ghana

Challenges and implications of interest rate liberalisation in Ghana

Beginning in 1986, within the context of the Economic Recovery Programme (ERP) which began in 1983, the Government of Ghana and the Central Bank of Ghana, in conjunction with the World Bank/IMF, launched a financial liberalisation package to liberalise interest rates, decontrol and unify the foreign exchange systems[4], organise a market for Treasury Bills, privatise government owned banks and ultimately, establish a capital market. As a result, the interest rate ceiling was completely deregulated in order to allow market forces to determine their levels. The deregulation of the exchange rate regime resulted in the opening of forex bureaus throughout the country. The balance sheets of the banks were cleansed, with all the non-performing assets being transferred to a special institution formed purposely to retrieve these assets from the debtors. Financial Sector Adjustment Programme (FINSAP) bonds were issued in place of these assets. Furthermore, the Banking Supervision arm of the Central Bank was strengthened and restructured to be able to perform its duties. (Bank of Ghana, 1988).

Interest rate liberalisation, investments and financial savings

In 1989, banks and other financial institutions in Ghana were allowed to determine their lending, but interest rates were not fully liberalised until 1991. According to the financial liberalisation hypothesis, removal of interest rates should lead to an increase in financial savings and investments and hence economic growth. In Ghana, total financial savings as a percentage of GDP increased from 1969 until 1983, but had started to decrease to 27.4% from the previous year's level of 70.4%. The rapid decrease in total deposits that occurred between 1982 and 1984 was caused primarily by measures taken by the Provisional National Defence Council (PNDC) government to eliminate fraud (including freezing certain banks deposits pending investigations for tax liability), withdrawal of some denominations of the domestic currency from circulation and rampant change of currency notes, leading to loss of confidence in the domestic currency and the banking system as a whole. This trend continued through to 1986, then stabilised for the following two years. From 1989, financial savings started picking up steadily through to 1995, even though the level was still low compared to the late 1970s and early 1980s. The

[4] *The official and the parallel exchange rate systems.*

trend reversed after the implementation of the full interest rate liberalisation policy in 1990. Following the introduction of the policy, financial savings increased continuously for a period of 12 years then dropped drastically from almost 188.2% of GDP in 2001 to 21.9% in 2002[5]. After this massive drop, financial savings started to improve again, increasing consistently from 2002 to 2008, due to the prevailing political and economic stability in the country. Financial savings as a percentage of GDP increased by about 11.1% points on average after the implementation of the interest rate liberalisation, compared with the pre-liberalisation period. This was mainly due to the relatively higher interest on deposits offered by the banks compared to other asset types (Owusu and Odhiambo, 2012b).

Interest rates have been on the increase since the liberalisation policy was applied. Deposit rates were 11.5% in 1978 but ended up at 16.5% in 1989, with a yearly average of 13.7%. Even the full interest rate liberalisation in 1991 could not reverse the trend. The rate rose to a high of 35.7% in 1997, then dropped to as low as 8.9% in 2006, followed by 11.3% in 2008. The average for the post-liberalisation period is therefore 20.1%. This is about 6% points over the pre-liberalisation average. Furthermore, the discount and lending rates followed the same trend as the deposit rate. For example, the lending rate started at 19.0% in 1978, but in 1988 stood at 25.6%, with a pre-liberalisation average of 20.9%. After the full interest rate liberalisation, the trend continued upwards, reaching 47.0% in 2000 but dropping to 27.3% in 2008, with an average of 31.4%, showing an increase of about 10%. Comparing the real interest rates, it was found that while the average real deposit rate before financial liberalisation was negative (-) 39.5%, it was negative (-) 1.6% after the implementation of the interest rate liberalisation policy, showing an increase of 37.9 points[6]. The real discount and lending rates followed similar trends. On average, the real lending rate before interest rate liberalisation was negative 30.0%, but the real discount rate was negative (-) 28.5% by 2008, the averages being 8.4% and 4.2% respectively. The hypothesis holds the view that the removal of interest rate ceilings will lead to an increase in real deposit rates (Owusu and Odhiambo, 2012b).

In Ghana, whilst in the pre-financial liberalisation period, the average proportion of GDP invested was 9.6%, it increased by more than two-fold to 21.9% after the financial liberalisation policy was established (this increase was not via increase in domestic savings only but also via borrowing from international organisations and donor countries) and reached 33.0% in 2006 and 2007 (World Bank, 2009). On the other hand, the savings ratio, which began on almost the same level as investments before financial liberalisation, increased to 13% in 1996 then

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[5] *This is because of capital flight resulting from political uncertainty and change in financial reporting.*

[6] *This was calculated by adjusting the average nominal interest with the average inflation.*

tumbled to a low of 3% in 2005. At the same time foreign direct investment (FDI) flow into the country, expressed as a percentage of GDP, increased from an average of 0.5% pre-liberalisation to an average of 3.3% post-liberalisation (Owusu and Odhiambo, 2012b).

Financial deepening, as measured by the ratio of M2 (money and quasi-money) to GDP, started falling in 1980 from 20.0% down to 10.0% in 1984, then rose by 4% to 14.0% in 1989. It has since been increasing, reaching a high of 29.0% in 2007. This level is the highest in the country's economic history. It is hoped that, as the financial liberalisation programme stays on course and the financial system matures together with the capital account liberalisation, financial assets such as stocks, bonds (issued by both government and firms), will appear on the financial markets and with growth in income, financial deepening will also increase. This is because with an increase in the real rate of return on financial assets, assets held previously in the form of, for example, large inventories, gold, land and livestock, will find their way into the formal financial system. It should be noted however that the main aim of financial liberalisation is to cause a shift of savings from lower productivity self-investment to higher productivity investment intermediated by the formal financial sector (Owusu and Odhiambo, 2012b).

Interest rate liberalisation and sectoral credit allocation

There has been a tremendous change in the structure of credit allocated to the various sectors by the banks before and after the removal of credit controls in 1990 and full interest rate liberalisation in 1991. While pre-liberalisation agriculture, forestry and fishing, manufacturing, construction and trade and commerce were allocated on average 22.0%, 29.3%, 11.0% and 20.0% of the total credit respectively, the post financial liberalisation situation shows agriculture at 10.2%; manufacturing 23.7% ; construction 9.8%; and trade and commerce 24.7%. Whilst the proportion of credits allocated to the agricultural sector has halved, that of trade and commerce has gone up, showing the relative profitability of the two sectors. The question is: "Does this change the composition of the credit allocation and reflect an increase in the efficiency in credit allocation resulting from the liberalisation policies?"

The allocative efficiency of credit in an economy can be measured in several ways; the best is probably to compare marginal returns on capital investment across different sectors of the economy. If the marginal returns in different sectors are equal, one may say that the economy allocates credits efficiently on the assumption that risk, uncertainty and transaction cost are kept constant. Due to a lack of data, it was difficult to obtain accurate estimates of marginal return on credits in different sectors of Ghana's economy. One option was to compare the cost of credit in different sectors on the assumption that firms, in order to maximise profit, equate their marginal cost of capital and marginal rate of return on investment. This approach has been used by Cho (1988) to study the efficiency of credit allocation after financial liberalisation in South Korea, and the same approach is taken in this paper. It is hypothesised that credit allocation in an economy has become efficient (or at least more efficient), if borrowing costs in different sectors of the economy are equalised (or differences in borrowing costs are reduced).

Following this conceptual framework, the following calculations on Ghanaian sectoral borrowing costs were made. The borrowing costs of each sector were calculated between 1980 and 2008 by dividing total interest and discount payments by the total amount of debt in each sector, which included all sources[7] of borrowing[8]. The variation in the borrowing cost reflects the differential borrowing cost for different sectors offered by the banks. The assumption is that with an increase in efficiency of credit allocation, the variance of borrowing cost of the sectors should reduce. The variance before financial liberalisation was relatively small, except in 1984 when it jumped from the previous year's figure of zero to 4.00 then dropped to 1.00 in 1985 until falling to 0.07 in 1986 and subsequently to 0.23 in 1990. The average variance for the pre-liberalisation period was therefore 0.7. The situation after financial liberalisation, however, shows a relatively steady increase from 1991, reaching 6.36 in 1998. This has been the situation since, reaching 8.13 in 2002 and 7.19 in 2007 then falling to 5.48 in 2008. The average for this period is therefore 5.08. This shows an increase in lending risk of 647% on average between the periods before and after the financial liberalisation. The results must be interpreted with caution since they are based on underlying assumptions[9]. It should also be noted that it is not clear whether a lower variance of cost of borrowing between sectors is an indication of allocative efficiency; also no adjustments for risk were made in the interest rate figures (Owusu and Odhiambo, 2012b).

However, the results provide an initial step towards in-depth research into the allocative efficiency of credits in Ghana after the financial liberalisation policy. According to Aryeetey (1994), this apparent drop in efficient allocation of credits under financial liberalisation in Ghana may be due to a number of institutional, structural and financial constraints created under a repressed regime and the ap-

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[7] *Since data on informal sector credit activities were not available, the paper uses only the formal financial sector borrowings (i.e. all the Deposit Money Bank)*

[8] *Again because of non-availability of data, the paper uses the average cost of borrowing in each sector instead of marginal cost of borrowing.*

[9] *Of course, in practice, different sectors have different risk, uncertainty, and transaction cost and therefore borrowing cost may not equalise.*

parent lack of medium-term financing, rudimentary nature of capital market and weakness in financial intermediation in general. He argues that as a consequence of these, private businesses find it difficult to contract credit, leading to an apparent lack of competition, hence less efficiency. In a total of 133 private firms surveyed by Aryeetey, Steel, et al. (1993) in Ghana, inadequate finance was the most significant constraint for about 60% of these companies. Even though it was the most important constraint for the group, it would appear that contracting credit was a serious constraint for the smaller firms (see also Adjustment in Africa: Lessons from country case studies; Ghana: Front-runner in adjustment, World Bank (1994)).

Another reason could be the deep mistrust of the private sector of a government whose policies, first in 1979 and then in 1982 to 1983 and in 1992 indicated an antagonistic attitude towards private investment. Some of the policies taken by the Armed Forces Revolutionary Council (AFRC) and the Provisional National Defence Council (PNDC) governments in 1979 and 1982 and furthermore, the National Democratic Congress (NDC) government from 1993 to 2001, strongly suggested a bias towards private wealth. These included the freezing of all individual bank accounts with balances exceeding 50,000 Cedis ($1 = 2.75 Cedis) and the confiscation of private property through the citizen's vetting committee. These may be good reasons for the absence of competition in the credit market. Furthermore, according to a survey conducted on 133 private firms[10] by Aryeetey, Steel et al. (1993), the sentiment often expressed among Ghanaian investors is that the various macroeconomic reforms are being undertaken by the government only to satisfy donor conditions so as to get assistance. Hence in the absence of such assistance the government will reverse the liberalisation policies. In reaction to this, the private sector chooses to put its capital in short-term investments and engage in sectors of the economy with fast and high turnover, such as trade and commerce; and with the relaxation in the restrictions on imports of finished goods, the private sector appears to choose trading over long-term physical investment.

Interest rate liberalisation and economic growth

Annual average GDP growth before financial liberalisation was 1.0% but after the implementation of the policy, the economy was growing at an average rate of 4.8%. The growth rates before financial liberalisation were not steady. There were years when negative rates were recorded, some as low as negative 13.4%, as in 1975, and some years recorded positive rates as high as 8.8%, as in 1984; how-

[10] *This survey included Small, Medium and Large*

ever, the post-liberalisation period has seen constant positive growth rates from 1991 through to 2008.

This is in line with the hypothesis; but it could also be argued that the growth is not only due to the financial liberalisation policy but is also associated with the increase in government borrowing from international organisations, remittance from abroad, increase in export revenue, accumulation of human capital, technological transfer and accumulation of production experience.

Even though inflation reduced on average after the financial liberalisation, the level is still high compared to other African countries[11]. The government brought its budget deficit under control just after the financial liberalisation policy was implemented but the problem appeared again in 1992 and 1993. This drastic increase in government spending triggered a rapid increase in the rate of inflation from a mere 10.1% in 1992 to about 60% as at the end of 1995. Inflation has reduced since then, falling to a low of 11.6% in 2006. On average, post liberalisation inflation has been about 22.8%. This represents about 57.1% of the pre-liberalisation levels (Owusu and Odhiambo, 2012b).

One aspect of financial liberalisation has been the increase in imported consumer goods (IMF, 2009). Even though the deficit is not only made up of consumer goods, the proportion which constitutes consumer goods has increased significantly. In 1985 the proportion was 47.1%, but at the end of 1995, it stood at 67.7% and in 2008, this figure rose to about 70%. Ghana has not recorded any trade surplus since the implementation of the financial liberalisation policy, while during the pre-liberalisation period it recorded an average balance of trade surplus of 0.3% of GDP. The post-liberalisation period has seen an average balance of trade deficit of 12.7% of GDP. This trend may not be sustainable for economic growth in the long run since these imports which are mainly consumer goods, are being financed through the inflow of foreign capital, remittance from abroad and external borrowings, rather than an increase in domestic productivity and export revenue.

Spreads between lending and deposit rates

The gap between lending and deposit rates in Ghana has widened significantly since the interest rate liberalisation policy was initiated in 1990. Previously the spread between the lending and deposit rates fluctuated between 3.0% in 1986 and 9.1% in 1988 and 1989 with an average for the period of 7.4%. A 7.5% spread

[11] *For example the average inflation of Ivory Coast for the same period has been around 4.5% per annum while that of Senegal was 3.3% (Africa Development Indicators, 2009)*

was maintained between 1978 and 1983. This was reduced to 6.2% in 1984, then to 5.4% in 1985, and then further reduced to its lowest figure of 3.0% in 1986 before increasing to 7.9% in 1987.

Between 1988 and 1990, the spread increased and remained at 9.1%. Following the implementation of the full interest rate liberalisation policy in 1991, the spread narrowed significantly from the previous high of 9.1% in 1990 to 4.2% in 1991. Between 1991 and 2008, the interest rate spread varied between a post-liberalisation low of 4.2% and a historic high of 21.4%, with an average spread of 13.5% for the period to 2008. Between 1997 and 1999, the interest rate spread increased dramatically from 9.8% in 1997 to 21.4% in 1999 and 18.4% in 2000, before decreasing to 13.1% in 2001. In 2002, the spread went up again to 19.6%, then 21.2% in 2003. However, since 2004 the interest rate spread has been stable between 15% and 16%, thus 15.2% in 2004, 15.8% in 2005, 15.4% in 2006, 15.3% in 2007 and 16.0% in 2008 (Owusu and Odhiambo, 2012b).

Interest rate liberalisation and foreign currency deposits

Although financial savings have increased since the implementation of the interest rate liberalisation policy, one aspect of this increase is the loss of confidence in the domestic currency, which has led to a significant increase in foreign currency deposits within the domestic banks. Whereas before implementation of financial liberalisation policy the proportion of total financial savings held in foreign currencies ranged between 0.5% in 1975 and 18.0% in 1989, with a yearly average of 5.4%, the post liberalisation figures have seen massive increases, ranging from 15.1% in 1992 to 60.1% in 1996, with a yearly average of 30.9%. As can be seen, the proportions have been increasing consistently from 1990 through to 2008. The rapid increase in this phenomenon is due to the following reasons: (i) the rapid depreciation of the domestic currency after the financial liberalisation policy was implemented; (ii) the high or rampant rates of inflation; (iii) the disappearance of black market dealing in foreign exchange as a result of the operations of the forex bureaus, as well as the acceptance of foreign currencies as deposits by the banks; (iv) inadequate real interest rates; (v) controls on capital markets; and (vi) excessive government expenditure. Furthermore, there was also the granting of credit in foreign currency to the private sector by the domestic banks. Since such loans are repayable in foreign currency, their repayment probability is determined not only by the domestic interest rate but also by the exchange rate. This has implications for the monetary policies of Ghana's financial authorities (Owusu and Odhiambo, 2012b).

3.3 Ivory Coast

Challenges and implications of interest rate liberalisation in Ivory Coast

In 1990, in the face of macroeconomic instability, liquidity crisis, balance of payment problems, internal political crises and internal inconsistent economic policies, Ivory Coast liberalised its preferential discount rate, followed by bank interest rate de-regulations. This was the first step to a structured liberalisation policy. However, Ivory Coast continued to have negative real interest rate after the liberalisation (Montiel, 1995). By liberalising the preferential discount rate, Ivory Coast was geared toward restructuring the financial sector, controlling inflation and then strengthening the external reserves position. According to the IMF, the Ivory Coast government objectives under this interest rate liberalisation policy were to strengthen the financial sector by increasing domestic savings and boosting the competitiveness and efficiency of banking and financial institutions by streamlining the banking supervision regime.

Interest rate liberalisation, investments and financial savings

The total financial savings expressed as a percentage of GDP with banks in Ivory Coast increased continuously from 17.4% in 1969 to 25.1% in 1978. This dropped to 15.9% in 1983 then bounced back to 23.2% in 1987 and 21.5% in 1991 before the initial liberalisation policy. However, the trend reversed from 1992 and financial savings dropping to a low of 12.8% in 1999. From 2002, financial savings as a percentage of GDP have been steady, reaching 19.9% in 2007. On average, financial savings decreased by about 2.7% points during the post-liberalisation period compared with the pre-liberalisation period.

The other side of the story is that the increase of confidence in the domestic currency, the CFA, which is shared by eight countries, led to a relative decrease in foreign currency deposits within the domestic banks. Whereas before financial liberalisation the proportion of total financial savings held in foreign currencies ranged between 9.3% in 1977 and 30.1% in 1983 with a yearly average of 18.2%, the post liberalisation figures ranged from 9.2% in 2005 and 19.6% in 1999 with a yearly average of 12.0%. This translates into a 6.2% point reduction in the proportion of deposit held in foreign currency in the post-liberalisation period as compared to the pre-liberalisation era. This decrease could be due to (in addition to the above mentioned factors) the fixation of the exchange rate of the CFA to that of the French Franc in the early years and later to the Euro, hence making the CFA a convertible currency (Owusu and Odhiambo, 2012c).

Interest rates have been on a downward slide since the interest rate liberalisation policy commenced in Ivory Coast. Deposit rates started from 3.0% in 1969 but ended up at 7.0% before the policy was introduced in 1989, with a yearly average of 5.71%. After the implementation of the policy in 1990, deposit rates went up to 7.6% in 1991 but dropped to 3.5% the following year and settled at this rate until 2008. The average for the post-liberalisation period is therefore 3.9%. This is about 1.8% points lower than the pre-liberalisation average. Furthermore, the discount and lending rates followed the same trend as the deposit rate. For example, the lending rate started at 12.0% in 1977 but in 1982 stood at 16.0%. It then dropped to 14.0% the following year. In 2008, the rate was back at 16.0%, with a pre-liberalisation average of 14.0%. After the full interest rate liberalisation was implemented, the trend continued downwards, reaching 3.9% in 2008 with an average of 6.1%, showing a reduction of about 7.9 points (Owusu and Odhiambo, 2012c).

Comparing the real interest rates, it was found that while the average real deposit rate before financial liberalisation was negative 2.9%, the figure was negative 1.1% after the implementation of the interest rate liberalisation policy, showing an increase of about 1.8 points[12] compared with the pre-liberalisation average. However, the lending rate did not follow a similar trend. The average real lending rate before interest rate liberalisation was 5.2% but reduced to 1.1% post-liberalisation. This shows a reduction of about 4.0% points. This is in consonance with the hypothesis that removal of interest rate ceilings will lead to an increase in real deposit rates and the reduction of the lending rates. The hypothesis is therefore verified in the case of Ivory Coast. Furthermore, total financial savings have increased, but with decreasing portions being held in foreign currency. The policy outcome in Ivory Coast is therefore positive on the above basis.

Related to this is the un-diminishing size of the underground market economy, as measured by the decrease in the ratio of currency outside banks to narrow money (M1). The average ratio of currency to M1 before financial liberalisation was about 86.9% and after financial liberalisation was about 85.5%. The small decrease of 1.4% may suggest the small reduction in the underground economy. Since 2003, the ratio has been reducing, reaching 74.0% in the year 2004 and then stabilising at around 82.0% between 2005 and 2008. This is probably due to the fact that with increasing inflation over the period, demand for money has increased and therefore Ivoirians chose to hold more cash rather than depositing it with the banks. Also, this may suggest that the financial policy has not been able to provide other opportunities for investment avenues in the Ivorian economy.

[12] *This was calculated by adjusting the average nominal interest with the average inflation.*

In the case of Ivory Coast, before the interest rate liberalisation period, the average proportion of GDP invested was 19.6%. This reduced by 8.7% points to 10.9% after the implementation of the interest rate liberalisation policy. The proportion of GDP invested in Ivory Coast has been reducing since 1991, reaching a low of 8.7% in 2007. However, this recovered slightly to 10.1% in 2008. In the same way, the savings ratio showed an average of 23.2% before the interest rate liberalisation period, and then tumbled to an average of 18.8% during the post interest rate liberalisation era. Conversely, at the same time foreign direct investments (FDI) flowing into the country increased from an average of 0.8% of GDP before interest rate liberalisation to an average of 1.7% of GDP in the post liberalisation period (Owusu and Odhiambo, 2012c).

One other positive outcome of financial liberalisation is the increase in the capital flow and the consequent augmentation of the country's foreign exchange reserves. Prior to interest rate liberalisation, the stock of total reserves (minus gold) was $4.0m at the end of 1990. The reserves increased to $2,252.1m by the end of 2008. The increase in FDI could be attributed to several factors. One factor related to the discovery of large quantities of crude oil deposits in the country and the subsequent investment for its extraction. Also, the increased remittances from abroad through official channels contributed to the increase in the country's foreign exchange reserves, as well as the relative stability in the prices of cocoa beans on the world market. Another factor that might be responsible for the increased FDI could be the relative political stability which has prevailed in the country since 2006 following the civil war.

Financial deepening, as measured by the ratio of M2 (money and quasi-money) to GDP increased in 1969 from 23.3% through to 31.0% in 1978, then stabilised around 28.0% until the interest rate liberalisation in 1990, with an average for the period of 27.3%. From 1990, it hovered around 28.0% then started to fall, reaching 22.6% in 2004. It has, however, started its recovery, reaching the pre-liberalisation average figures between 2007 and 2008. The figure stood at 27.8% in 2008. These levels are, however, still lower than the levels in the late 1980s and early 1990s but it is hoped that as the financial liberalisation programme stayed on course in Ivory Coast, the financial system will mature and financial assets such as stocks and bonds (issued by both government and firms), among others, will appear on the financial market with growth in income. This will provide a myriad of investment options for citizens, leading to further financial deepening. This is because with an increase in the real rate of return on financial assets, assets held previously in the form of large inventories, livestock and land will find their way into the formal financial system[13] (Owusu and Odhiambo, 2012c).

[13] *Note that the main aim of financial liberalisation as postulated by the McKinnon-Shaw hypothesis is to cause a shift of savings from lower productivity self-investment to higher productivity investment intermediated by the formal financial sector.*

Interest rate liberalisation and sectoral credit allocation

There was a tremendous change in the structure of credit allocated to the various sectors by the banks after financial liberalisation. While before the interest rate liberalisation in 1990, agriculture, mining and quarrying, construction and commerce, manufacturing and services were allocated on average 27.4%, 1.0%, 7.4%, 12.3% and 52.0% of the total credit respectively, in the post liberalisation period agriculture received 22.7%, mining and quarrying 1.0%, construction and commerce 13.96%, manufacturing with 16.5% and services 45.9%. The question that arises, as with Ghana and Nigeria is: "Does this change in the composition of the credit allocation reflect an increase in the efficiency in credit allocation in Ivory Coast?"

According to the World Bank, the bulk of the credit that was channelled to the private sector in the developing countries after the implementation of the interest rate liberalisation was mainly directed towards short-term investment. Long-term finance was very rare and only the most creditworthy had access to it (World Bank, 2002). In most countries, the private sector, especially the small and medium enterprises (SMEs) are yet to feel the impact of the financial liberalisation policy. This is the case in Ivory Coast. The implication is that the financial liberalisation policy has not generated enough funds for the development of a private sector-led economy. This means that the government objective of using the private sector as a catalyst for development may not be easily achieved. However, according to Graham (1996), claims on domestic credit shifted in favour of the private sector rather than the government in Ivory Coast after the interest rate liberalisation policy. He estimates that borrowings by the central government in Ivory Coast were down by approximately 60% on average relative to the pre-interest rate liberalisation period.

The allocative efficiency of credit in an economy can be measured in several ways; the most effective is probably to compare marginal returns on capital investment across different sectors of the economy. If the marginal returns in different sectors are equal, it can be said that the economy allocates credits efficiently on the assumption that risk, uncertainty and transaction cost are kept constant. Due to a lack of data, it was difficult to obtain accurate estimates of marginal return on credit in different sectors of the Ivorian economy. One alternative was to compare the cost of credit in different sectors on the assumption that firms, in order to maximise profit, equate their marginal cost of capital and marginal rate of return to investment. It is hypothesised that credit allocation in an economy has become efficient (or at least more efficient), if borrowing costs in different sectors of the economy are equalised or differences in borrowing costs are reduced. However, due to the lack of data calculations for the allocative efficiency were not made.

Interest rate liberalisation and economic growth

Average GDP growth before financial liberalisation in Ivory Coast was 3.7% a year, but in the post-liberalisation period the average rate was 1.6%, a reduction of 2.1%. It is worth pointing out that Ivory Coast has had political instability for most of the past decade and therefore the apparent decline in the economic growth rate could not be attributed entirely to the financial liberalisation policy changes. Also, growth rates before financial liberalisation were very unstable compared to the post liberalisation period. The growth rates before the liberalisation was implemented fluctuated between negative 11.0% and positive 12.9% whilst the post liberalisation period saw a range between negative 3.7% and positive 7.7%. This is not in conformity with the hypothesis; however, it could also be argued that the reduction in growth may not be due to the financial liberalisation policy but rather to socio-political factors such as the civil war and political instability that ravaged the country in the early part of the 2000s. Inflation decreased on average after the introduction of the financial liberalisation policy; the level is comparable to other African countries like Senegal and Niger[14] with which Ivory Coast share the same currency. Ivory Coast has not recorded any trade deficit since the implementation of the financial liberalisation policy in 1990. While during the pre-liberalisation period it recorded an average surplus of 3.6% of GDP per annum, the post-liberalisation period has seen the average surplus doubling to 7.8% of GDP per annum (Owusu and Odhiambo, 2012c).

Spreads between lending and deposit rates

The gap between lending and deposit rates in Ivory Coast has narrowed significantly since the interest rate liberalisation policy in 1990. Before the interest rate liberalisation, the spread between the lending and deposit rates fluctuated between 6.0% in 1977 and 9.0% in 1990, with an average for the period of about 7.6%. A spread of about 7.3% was maintained between 1983 and 1986. This increased to 8.3% in 1987, then to 9.0% in 1990, but reduced to 1.5% in 1993 before settling at 1.45% from 1997 until 2008. Following the implementation of the interest rate liberalisation policy in 1990, the spread narrowed significantly from the previous high of 9.0% in 1990 to 1.45% in 1997. Between 1997 and 2008, the interest rate spread stabilised at 1.45% (Owusu and Odhiambo, 2012c).

[14] *For example the average inflation in Niger for the same period was around 4.5% per annum while that of Senegal was 3.3% (Africa Development Indicators, 2009).*

Interest rate liberalisation and foreign currency deposits

Unlike Ghana and Nigeria, in Ivory Coast citizens did not lose confidence in the domestic currency, the CFA. This led to a reduction in foreign currency deposits in the domestic banks. The main factor behind this increase in confidence is the convertibility of the CFA and its fixation against the French Franc and then the Euro. For example, whereas before financial liberalisation the proportion of total savings held in foreign currencies was about 17.35%, the post liberalisation period saw a reduction in the proportion of foreign currency by 3.3% points to 14.05% on average. This proportion has however, reduced further and stood at 10.3% in 2008, down from 30.1% in 1983 (Owusu and Odhiambo, 2012c).

4. Conclusion

It can be concluded from the preceding facts that the interest rate liberalisation policy instituted under the SAP in Nigeria has had positive results on the account that it has significantly reduced the black market for foreign exchange. It has also improved the reserve position of the country; increased the inflow of foreign capital; stabilised and propelled increased financial savings; and reversed the downward trend in financial deepening and resource mobilisation. According to Obamuyi (2009), the contribution of financial liberalisation to real GDP growth in Nigeria could only be marginal. Also, Ogunmuyiwa and Ekone (2010) show that the effect of the financial liberalisation on economic growth in Nigeria can only be mixed. They support their assertion with the fact that between 1971 and 1975, the growth rate of the economy measured by real GDP ranged from 21.3% in 1971 to 3.0% in 1975. They estimate that by 1981, the real GDP grew by 26.8% and remained negative until 1984. Using a simple variance analysis, they show that between 1971 and 1986 the mean spread of GDP was 108.7. However, between 1986 and 1994, the real GDP had a variance of 9.1. The variability of the real GDP growth was much higher before financial liberalisation while it was lower after the policy was implemented.

In Ghana, the interest rate liberalisation policy was implemented under the ERP. One could argue that it has been successful because it has increased foreign capital flow, improved the reserve position of the country, stabilised and propelled increased financial savings and prevented and reversed the falling financial deepening and resource mobilisation. Nevertheless, the policy in Ghana also brought with it a number of interrelated problems which have to be addressed by the government. Overall, the case of Ghana supports the financial liberalisation hypothesis. This is because financial savings, which started decreasing before financial liberalisation, was stabilised two years into the policy, then in the third year started to increase steadily. Financial deepening, as measured by the ratio of money and quasi-money (M2) to gross domestic product (GDP), and which was previously 13.0%, increased to 29.0% in 2007. Economic growth has been steady at an average of 4.8% after financial liberalisation compared to 1.0% previously. Investment, which was 14.0% before the policy was, applied stands at 33.0% of GDP in 2007, and the savings level, which previously was 5.0%, also stands at 10.0% in 2007. The negative factor is that the efficiency of credit allocation in the economy has suffered significantly. However, one cannot attribute this negative outcome to the financial liberalisation policy alone. Other factors include an interrelated bottleneck, rigidity and under-development of Ghana's financial system as a whole.

In Ivory Coast, the policy was instituted by the WAEMU with the help of IMF and the World Bank starting from 1989. The country abolished its preferential discount rate, leaving bank interest rates to be determined by each member country. This has had mixed results. Based on the data available, interest rates have reduced significantly since the policy was implemented and there has been an increase in foreign capital flow, an improved reserve position and a stabilised (but lower) level of financial savings. The falling level of financial deepening has been reversed and resources have been mobilised. The interest rate spread has also been reduced and lending and deposit rates lowered. The case of Ivory Coast however, supports the interest rate liberalisation hypothesis. This is because financial savings have increased during the post-liberalisation period. Financial deepening, as measured by the ratio of money and quasi money (M2) to gross domestic product (GDP), which was 27.3% on average before the financial liberalisation policy was brought in, stands at 27.8% in 2008. These levels are similar to those of Ghana and Nigeria. Economic growth has been lower, at an average of 1.6% after financial liberalisation compared to 3.7% before. This could be explained in part by the fact that the country has gone through almost a decade of political instability and civil war, and therefore the decline is not due to the implementation of the policy alone. Domestic investment, which previously averaged 19.6%, stood at 18.8% of GDP in 2005 and domestic savings which previously averaged about 23.2% dropped to an average of 18.8% after the implementation of interest rate liberalisation.

The results of implementing the policy in Ivory Coast, as well as those in Ghana and Nigeria, have brought to light some of the weaknesses of the financial liberalisation hypothesis, in West Africa in particular and in developing countries as a whole. However, this does not make the hypothesis deficient, but rather tells us that policymakers can attempt to solve problems in various ways by taking into consideration the special conditions in each country. Alongside financial liberalisation, particular attention should be given to institutional development and peculiarity of each country.

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LIBERALIZACIJA KAMATNIH STOPA U DRŽAVAMA ZAPADNE AFRIKE: IZAZOVI I POSLJEDICE

Sažetak

U ovom se radu razmatraju izazovi i posljedice liberalizacije kamatnih stopa u nekim zamljama Zapadne Afrike. Pregled dosadašnje literature ukazuje da su ishodi liberalizacije kamatnih stopa pozitivni u slučaju Nigerije, Gane i Obale Bjelokosti. Primjena ove politike pokazala se u nekim slučajevima izazovnom za neke druge sektore gospodarstva. Stoga se u radu upozorava na potrebu opreznog postupanja pri uvođenju politike liberalizacije kamatnih stopa u zemljama u razvoju, a to je posebno važno za zemlje izvoznice roba, kao što su Nigerija, Gana i Obala Bjelokosti. Za sve tri navedene države rezultati provođenja ovih politika potvrđuju brojne ranije studije koje su ustanovile da postoje pozitivni rezultati uvođenja liberalizacije kamatnih stopa na ekonomski rast. U ovom se radu također zaključuje da politike liberalizacije kamatnih stopa zajedno s drugim politikama usmjerenim prema realnom sektoru imaju pozitivan učinak na gospodarski rast navedenih država. Također se upozorava nositelje ekonomske politike na potrebu razmatranja alternativnih politika, kako bi se moglo postupati u slučaju mogućih posljedica pri uvođenju liberalizacije kamatnih stopa u tim zemljama.

Ključne riječi: Zapadna Afrika, liberalizacija, kamatne stope, Gana, Nigerija, Obala Bjelokosti