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Financial Reforms and Interest Rate Spreads in the Commercial Banking System in Malawi

**By E. W. Chirwa and M. Mlachila,
IMF Staff Papers,
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A Review By
R.O. Olaitan*

I. Introduction

The specific objective of the paper was to carry out an empirical investigation on the impact of financial sector reforms (pre-and-post liberalization periods) on interest rate spreads in the commercial banking system of the Malawian economy. Following the approach used by Randall (1998), Demirgüç- Kunt and Huuizinga (1999), and Barajas et al (2000), the authors specified an empirical model under the framework that a bank is a profit or wealth-maximizing firm. They made use of monthly panel data from five Malawian commercial banks covering period of ten years, from 1989 to 1999.

II. Major Highlights of The Paper

The paper posits that pre-liberalization period of the Malawian financial sector was predominantly under the control regime. This policy regime also encompassed the country's monetary policy design and management, specifically, the ceiling on interest rates, credit limits, and the specification of a fixed exchange rate regime, among others.

A major feature of the banking system in Malawi during this period was the relatively smallness in size. Two banks exerted monopoly power over the rest, accounting for the largest share of deposit market. Such a structure was capable of stimulating collusive behaviour. The financial sector reform embarked upon in Malawi was, therefore, justified.

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The importance of financial sector liberalization in facilitating economic development and growth was also emphasized. This reflects the view in the literature that financial liberalization is always in tandem with growth. Financial sector liberalization is therefore expected to lower interest rate spreads *ceteris paribus*, engender competitiveness and sophistication of the banking system, cost structure of the market, as well as, macroeconomic environment.

The authors' appraisal of the Malawian financial sector and its reforms - an aftermath of the adoption of structural adjustment programs, revealed that there have been some substantial growth and development in the sector (improvement in financial dept), though, the full impact may yet be realized. The Malawian financial sector reforms however began in 1989, leading to the growth in the number of banks to seven (Four Commercial banks, two Merchant banks and one Trade and Financing) and Deposit taking institutions to six (Three Leasing and Financing, one Discount House, one Trade and Financing, and one Mortgage Financing).

A major development brought about by the financial sector reforms was the complete overhauling of the legal framework, leading to new and revised legislation - Reserve Bank of Malawi (RBM) Act of 1989 and the Banking Act of 1989. This led to, among others, increased supervision and regulation of the sector; financial liberalization and deregulation of the licensing of new banks; introduction of indirect monetary instruments to deal with excess liquidity in the system, with the use of treasury bills for Open Market Operations (OMO) while relatively high liquidity reserve requirements still played a prominent role in the design of monetary policy. Another development was the adoption of a floating exchange rate regime.

From an empirical analysis of the impact of financial liberalization of interest rate spread the authors observed the following:

- Monetary variables and market concentration substantially accounted for high interest rate spreads in Malawi,
- The liquidity reserve ratio (LRR), which was a sort of financial taxation to the banks, had been quite high and had since mid-1995 maintained at 35%.

- The bank rate (BDR) has been trending upwards over the years;
- The effect of new entrants (commercial banks) has been minimal because of the Malawian market fundamentals; and
- Overall, the financial liberalization has not benefited both the depositors and borrowers in Malawi as banks have been shifting most risks and costs (inefficiency) to the customers.

III Comments and Relevance of the Paper

The author has undertaken an incisive quantitative study on one of the most pertinent issue in the financial sector of any economy, particularly in the developing economies. The relevance of the paper cannot be overemphasized as the issue discussed is both topical and germane not only to the Malawian financial sector but also to major developing countries, including Nigeria. The strength and depth of the paper lies on its empirical findings and the underlying policy implications emanating therefrom.

There is no doubt that financial reforms embarked upon in Malawi significantly impacted on the sector. However, whether or not it has consequential effects on interest rate spreads is another thing entirely. The empirical evidence also corroborated with major findings in Latin America and the Caribbean countries except for Colombia where there are evidences of a marginal decline in bank spreads after liberalization.

The effect of financial sector reforms on interest rate spreads seems to be peculiar among developing countries, including Nigeria compared to developed countries. The resultant effects of the post-Structural Adjustment Programme since 1986 in Nigeria, had led to major transformation of the country's financial system, most especially in the banking sector. Since then, the interest rate spreads in the banking system have been fluctuating on a wide margin till date. The growth in the liquidity reserve ratio since deregulation and liberalization of the financial sector in 1986 and the issues of small number of banks controlling the total deposit base of the sector may have contributed positively to the persistent wide interest rate spreads.

The overall effects of the rising interest spreads have been the incessant increases in the cost of borrowing and/or non-significant lending to the productive sector for investment purposes. Likewise the resultant loopholes found in the foreign exchange market, which had been highly funded and patronized by deposit money banks (DMBs) in order to earn abnormal profits. This may have resulted from non-sequencing of the financial sector liberalization reform as important changes in the foreign exchange/exchange rate regime also took place, increasing number of new banks, oligopolistic structure of the banking system, the inadequacy of regulatory and supervisory capacity, among others.

Consequently, the need for the monetary authority in Nigeria, in the light of changing economic fundamentals, to proactively and continually review regulatory laws, review upwards the capital base of the deposit money banks (DMBs) so as to facilitate their competitiveness and capacity of fulfilling the financing requirements of the real sector possibly at low spreads; review minimum rediscount rate; low banks' liquidity reserve requirement. Other measures are the effective curtailment of the inflation rate, most especially in a country susceptible to a large pass-through of foreign inflation so as to keep real interest rate positive.