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INTEREST RATE RESTRICTIONS POLICY: POSSIBILITIES AND CONSEQUENCES FOR UKRAINE

This paper investigates historical examples and experience of interest rate restrictions, consequences of such policies for economy, reasons and outcomes of easing IIR policies as well as possibilities, possible outcomes and recommendations regarding IRR policy in Ukraine. It might be concluded that though some sort of "anti-usury" restrictions can be reasonable, administrative regulation (ceiling) of interest rate level will generate more negative than positive consequences for the economy and will unlikely be effective. Authorities should concentrate on more "thoughtful" regulations which would constraint information asymmetry, provide balanced monetary policy and develop important modern segments of financial markets.

Keywords: interest rate ceiling, interest rate restrictions, usury laws, monetary policy.

Introduction and literature review. The research topic on suitability, effectiveness and consequences of interest rate restrictions (ceiling) is relevant for current situation in Ukraine as well as extremely high level of interest rates during last two years produced many proposal by policymakers to introduce administrative regulations of interest rates. Some resent research shows that discussion regarding interest rate restrictions is important and relevant for other countries as well (see, for example, recent EU report [10]).

The topic of economic consequences of interest rate restrictions and anti-usury laws was investigated by number of researchers such as Eichengreen and Garber [4], Bodenhorn [1], Duval [3], Fernando [5], Glaeser and Scheikman [6], Reifner [10], Rockoff [11], Tuccillo, Masciandaro, Davis, Temin and Voth, and many others.

The main goals of this paper is investigation of macro and micro reasons of the long period of high real interest rates, which has few precedents in economic history, as well as possible consequences of imposing administrative interest rate restrictions policy in current Ukrainian institutional environment. Main findings and recommendations are given in the section 5 "Conclusion" and can be briefly summarized as follows. Implemented in isolation, interest rate restrictions will likely produce more negative than positive economic consequences. At the same time, reduction of market interest rates, which is considered as desirable for the economy, can be achieved by complex set of coordinated policy: from changes in monetary policy to regulatory and institutional reforms aimed at development of more efficient financial market.

Main research results

1. Reasons for High Levels of Real Interest Rates. Figure 1 shows inflation and average deposit and credit rates in Ukraine during 2012–2013. Starting from the beginning of 2012 consumer price

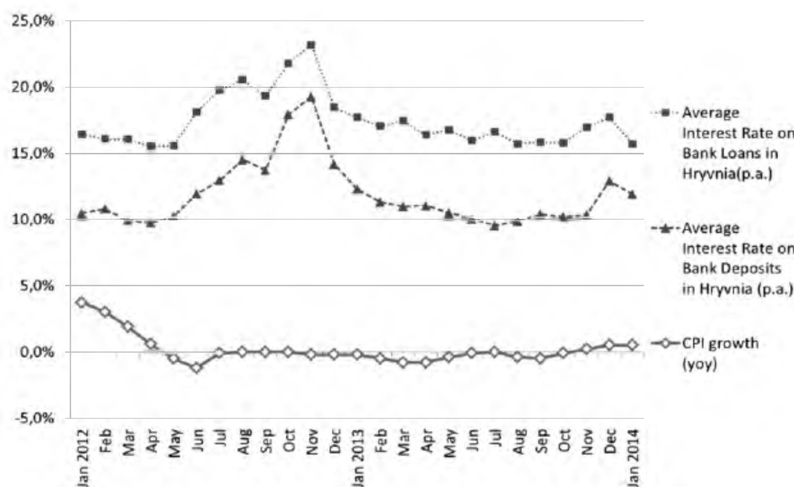

Fig. 1. Inflation, Average Credit and Deposit Rates in Domestic Currency in Ukraine, 2012–2013
Source: National Bank of Ukraine/

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inflation was almost zero while interest rates on loans remained at levels above 15 %. In reality interest rates on business loans were well above 20 %. As for consumer credit, effective interest rates were in the range from 15–20 % (for car loans and mortgages) to 30–80 % or even more in some cases (credit cards and other unsecured loans).

There can be several reasons for such high levels of real interest rates:

(1) Expected devaluation. One of the common reasons to explain high interest rate in domestic currency is interest rate differential between domestic and foreign currency interest rates due to devaluation expectations. Relatively high level of dollarization explains the fact that only substantially higher hryvnia interest rates can stimulate economic agents to hold deposits in domestic currency.

(2) High sovereign risk of default. While Ukraine is not deeply connected with international markets, interest rates on Ukrainian Eurobonds may influence internal interest rates through many channels. Quotation on Ukrainian CDS (credit-default swaps) during 2012–2013 rarely fell below 6–7 %. It directly influences the cost of foreign financing for Ukrainian companies, particularly banks and through this channel creates pressure on local interest rates.

(3) Monetary policy. High interest rates are often associated with tight monetary policy. In the case of Ukraine is difficult to say that monetary policy after the 2008 crisis was really tough. Money supply grew at a rate significantly higher than the growth rate of GDP. There were no significant restrictions on bank refinancing. Refinancing rate of the National Bank of Ukraine has consistently declined. It should be noted that in the case of Ukraine, the possibility of a more expansionary monetary policy limited to the balance of payments and low international reserves, which consistently declining during 2012–2013. By the beginning of 2014 the volume of reserves barely exceeds 15 billion dollars, which is less than three months of imports.

(4) Asymmetric information and market power. Credit market, especially some its segments (e.g. consumer loans), can be described with high degree of asymmetric information. This asymmetric information may lead to exercising of market power by lenders and high level of prices (effective interest rates). As for the Ukrainian banking system, Mertens and Urga [7] reported the result on inefficiency of Ukrainian banking system and noted that "one of the main findings of the research is that banks operate more efficiently in terms of cost but less efficiently in terms of profit. This difference could suggest the existence of market power in the Ukrainian financial sector where large banks can realize greater profits having at the same time greater costs". It is worth to note that this market power may result not from industry concentration but rather induced by asymmetric information and non-rational behavior of some consumer segments.

2. Interest Rate Restrictions and Usury laws in US and Europe. So-called "anti-usury" regulation has long history in Western countries. As noted by Bodenhorn [1] "few pieces of economic regulation are ubiquitous as usury limits" and one of the most important reason for usury laws is to "protect small borrowers from the depredations of unscrupulous lenders when interest rates rise markedly". Nearly every U.S. state and almost every European country imposed a usury limit. According to Glaeser and Scheikman [6], interest rate restrictions are among the most pervasive forms of economic regulations. Interest rate limits could be Pareto improving because agents borrow when they have temporary negative income shocks – interest rate restrictions transfer wealth to agents who have received those negative shocks and whose marginal utility of income is high. The history of usury laws suggests that this social insurance mechanism is one reason why usury laws persist, but it also suggests that usury laws have had different functions across time (e.g. rent-seeking, limiting agency problems within the church, limiting over-commitment of debts, and attacking commerce generally).

In the United States, legislation to limit usury exists today at the legislative level in almost all states: usually there is a so-called legal interest rate (5 % to 10 % per annum) and restrictions on "usury" interest (12 % to 24 % in absolute terms or in relation to the existing rates of the Federal Reserve banks). While in most states there is a large number of exceptions for certain segments of the debt market imposed by modern laws or court decisions, legislative restrictions are maintained.

Published in 2011 the European Commission report [2] indicates that almost all EU member states have regulatory rules in some form of interest rates restrictions. 14 countries have either absolute (Greece, Ireland, Malta) or the relative restrictions on certain basic rates (Belgium, Estonia, France, Germany, Italy, Netherlands, Poland, Portugal, Spain, Slovenia). The spread of interest rate ceilings is usually high. For example, "in France the spread between ceilings for the different forms of credit was between 5.72 % pa and 21.63 % pa as at March 2010" [2]. It is also worth to note that "some countries provide such ceilings only exceptionally". There is also a wide range of different enforcement systems in different European countries, as well as "common principles of fairness in competition, standard contract terms and consumer information law, already harmonized through the respective EU Directives, do not cover the pricing of credit".

3. Economic Consequences of Interest Rate Restrictions (IRR). The reasons for governments and businesses to propose administrative methods of interest rates ceiling are that high real interest rates may have a very detrimental effect on the economy. In general equilibrium long-term equilibrium level of the real interest rate corresponds to the rate of economic growth. Only in this case, the increase in production and income allows firms and households to pay off creditors without reducing equity (for companies) and real income (for households). Excessive interest rates mean for businesses that only high yielding and often – the most risky projects can be implemented, while projects with a "normal" level of return on capital are unable to obtain financing and that fact negatively affects economic growth. In the household sector, high interest rates lead to increase in income inequality, because income growth cannot offset the cost of the loan. High interest rates on deposits significantly limit the development of non-banking financial market segments, and in the banking sector creates adverse selection phenomenon – when the most favorable terms of deposits are offered by the least reliable banks.

Credit market in some countries and during some historical periods can be described as a market with high level of information asymmetry. Some economists also argue that consumer behavior can be characterized as non-rational in many cases. According to Reifner at al [10], "Behavioral biases (such as wishful thinking or underestimation of exponential growth) may lead to systematic (and predictable) deviations from rational behavior which lead to suboptimal consumer decisions. … As a consequence of wishful thinking, consumers` beliefs about event risk may be distorted: they may be willing to borrow money even when it is rather unrealistic that their future income will be sufficient to repay the debt. Consumers may also underestimate the true cost of borrowing. This might occur because they hold erroneous beliefs about the actual time period during which they will use the credit." Information asymmetry and non-rational behavior may lead to market inefficiency and market power exercised by lenders.

With regard to the negative consequences of administrative restrictions in interest rates, most studies note the following (e.g. [3; 4; 5; 10; 11]):

1) administrative regulation of interest rates, as well as any price regulation may distort the market. Market equilibrium may become unreachable and many categories of borrowers lose access to credit;

2) banks are trying to compensate for the decline in interest rates through an increase in commissions and charges;

3) administrative restrictions can lead to increased illegal credit market and to increase of credit from non-bank sources (late bill payments, etc.) According to Bodenhorn [1], when usury ceilings become binding, banks unable to equate supply and demand through price increases will adjust other terms of the loans to push the market toward equilibrium. Substantial changes in the non-price terms of credit can actually make small borrowers worse off because they are either cut off from credit or they are driven to other, sometimes disreputable, sources of credit. Interest rate ceilings force some borrowers into the hands of lenders who employ inefficient and extra-legal methods of enforcement and collection;

4) administrative regulation of interest rates reduces the volume of lending in the economy because e.g. "high-risk or low-wealth borrowers are excluded from credit markets when freely fluctuating market rates rise above the usury limit".

Nonetheless, reality is not so unambiguous. For example, EU study [2] shows (table 1) that it is plausible

Table 1. **Research Conclusions on Interest Rate Restrictions (IRR) in European Union**

Hypothesis	**Conclusion**
IRR reduce credit access, in particular for low-income borrowers.	plausible
IRR lead to a decline in the volumes of consumer credit granted.	unlikely
Without IRR, more product types exist in the market.	plausible
IRR lead to credit from non-bank sources, such as paying bills late.	inconclusive
IRR lead to a substantial illegal market in lending.	inconclusive
The lack of IRR leads to a higher level of over-indebtedness.	unlikely
The lack of IRR has particularly adverse effects on default rates/overindebtedness in the presence of negative shocks (e.g. recessions) to the economy.	inconclusive
The average consumer, – or even more so: low-risk consumer, – would be granted cheaper credit in the presence of IRR.	inconclusive
IRR lead to increased charges as providers will try to compensate the reduced interest revenues by increased charges.	plausible
IRR represent barriers to consumer credit market integration.	inconclusive
IRR lead to lower levels of competition in the consumer credit industry.	unlikely
IRR lead to a convergence of all consumer credit interest rates at the level of the interest rate cap.	inconclusive

Source: [2].

that interest rate restrictions reduce credit access, in particular for low-income borrowers, reduce number of product types in the market and lead to increased charges as providers will try to compensate the reduced interest revenues by increased charges. At the same time, there is no unambiguous evidence that such restrictions lead to increase of credit from non-bank sources, produce particularly adverse effects on over-indebtedness, and create barriers to consumer credit market integration. It is also unlikely that interest rate restrictions lead to lower levels of competition in the consumer credit industry or to decline in the volumes of consumer credit granted.

4. Possibilities and Consequences of Interest Rate Restrictions in Ukraine. The first important question regarding possibility to introduce interest rate restrictions in Ukraine is whether or not such restrictions will be really effective. Banks have plenty of opportunities to replace high interest rate with larger charges and commissions. Even now some banks announce extremely low interest rate on loans (for example, 0.1 % p.a.) but effective rate is extremely high (more than 100 % in some cases) because of high charges. It follows that significant changes in regulation practices are needed to make interest rate regulation policy effective.

The second factor which must be taken into account is connection between the state of internal financial market and constraints for monetary policy in Ukrainian economy. Ukraine is a small open economy with *de facto* fixed (while *de jure* floating) exchange rate regime. Amount of international reserves is extremely low and that fact substantially restricts possibilities of monetary expansion and interest rate regulation. Exchange rate plays a central role of the only anchor for macroeconomic stability. Monetary authorities and foreign experts during long time discuss necessity to switch to a kind of "inflation targeting" regime which would allow more flexible monetary policy. But such a regime change require a complex set of measures not only in monetary policy but also in regulation of financial markets, development of not only banking but also non-banking segments of financial markets, as well as changes in market participants' perception of the stable exchange rate as the only sign of macro stability.

The third important set of problems is general state of financial markets in Ukraine. It is still extremely underdeveloped. The stock market is almost absent after 2008 crisis. Bank deposits became the almost only internal possibility to invest for average savers. In this situation any administrative measures to decrease interest rates could lead to sharp decline in banking deposits and hit negatively banking sector and financial system as a whole.

5. Conclusion. Taking into account the current international experience in implementing direct administrative limits on interest rates, research results, as well as the current state of Ukrainian economy, financial markets, the regulatory sphere, the following conclusions are made based on comparative analysis of IRR policy and corresponding research:

1) the introduction of severe restrictions on the level of interest rates without accompanying complex measures on banking regulation (in particular – control over commissions and prices for other banking services, transparency and completeness of information for customers, etc.), and measures regulating non-banking financial market segments is unlikely to be sufficiently effective. The banks have enough tools to compensate for the limitations of interest rates by increasing charges and prices for related services while administrative possibilities to prevent such behavior of banks are limited;

2) administrative restrictions on interest rates are unlikely to lead to the expansion of credit in the economy, but it can reduce the volume of deposits in local currency;

3) restrictions on interest rates are ineffective in absence of other measures aimed at reducing information asymmetries and limit market power lenders, protect consumers (borrowers) sufficiently.

Instead of simple administrative decision to limit the interest rates, the government and the National Bank of Ukraine could implement a set of measures in the field of development of financial markets, in particular:

1) a complex institutional reforms (notably in the field of protection of property rights, corporate governance, judiciary system) that would allow the inflow of foreign investment and decrease interest spreads on Ukrainian debt. Such inflows achieve two goals: a) increase of the international reserves in order to mitigate the negative effect of expansionary monetary policy on the solvency of Ukraine, b) increase the money supply, which would finally help to reduce interest rates;

2) gradual steps towards the creation of a floating exchange rate regime and switching toward a sort of inflation targeting regime. This, in turn, provides a set of measures to change the key objectives and instruments of monetary policy;

3) the introduction of a floating exchange rate regime should be accompanied by a consistent policy to reduce the dollarization of the Ukrainian economy;

4) the program of action for building an open, transparent and efficient debt market, in the first place – market of government bonds. Transparent and efficient market will create the conditions for effective pricing of credit resources;

5) administrative measures should be aimed primarily at reducing the information asymmetry and reducing the market power of banks in the credit market for better consumer protection;

6) certain anti-usury limits on consumer credit interest rates may be introduced, but such a policy should be comprehensive, to limit the effective rates inclusive of all commissions and other payments, to impose strong requirements for banks regarding transparent information about true terms of loans to reduce information asymmetries. In the case of the introduction of such regulation there must be an effective system of supervision – not only in the banking sector, but also in other segments of the financial market.

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Мертенс О. В.

ПОЛІТИКА ОБМЕЖЕННЯ РІВНЯ ПРОЦЕНТНИХ СТАВОК: МОЖЛИВОСТІ І НАСЛІДКИ ЗАСТОСУВАННЯ В УМОВАХ УКРАЇНИ

У 2012–2013 рр. рівень інфляції в Україні був практично нульовим, тоді як ставки за кредитами перевищували 20 % річних. Ситуацію, коли реальні процентні ставки знаходяться на такому високому рівні, можна пояснювати багатьма причинами, у тому числі сподіваннями суб'єктів ринку щодо знецінення гривні, жорсткістю монетарної політики, відносно високими ризиками суверенного дефолту, а також – неефективністю ринку, спричиненою високим ступенем асиметрії інформації між кредиторами і позичальниками, нераціональністю суб'єктів ринку, відсутністю чи нерозвиненістю важливих сегментів фінансового ринку. Все це спричинило появу пропозицій щодо прямого адміністративного регулювання граничного рівня процентних ставок по депозитних і кредитних операціях. У цій статті досліджено історичні приклади та досвід адміністративних обмежень на верхню межу процентних ставок, наслідки таких обмежень для економіки, причини та умови відмови від практики прямого регулювання процентних ставок. Здійснений аналіз дозволяє спрогнозувати наслідки та сформулювати рекомендації щодо введення подібних обмежень в Україні.

Ключові слова: обмеження процентних ставок, монетарна політика, лихварство, фінансові ринки.

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