CAPPING INTEREST RATES: - BAD ECONOMICS OR A NECESSARY INTERVENTION

NON - INTERVENTIONIST VIEW.
First we should look at the theory of a Free Market.

Criteria of a Free Market
This is regarded to be the most ideal type of a market.

1. No barrier to entry – you simply enter the market for goods and services. No regulator or rules governing entry.

2. No restrictions to exit the market. That is to say if you feel you no longer want to provide your goods or services, you simply exit without conditions.

3. There are thousands of participants both in the Supply and Demand side.

4. Price of goods or services is determined by Supply/Demand mechanism.

5. No single individual or group can determine the price. In other words no Cartels and no Monopoly.

6. The goods or services are Homogenous e.g. cereals, milk, tomatoes, potatoes, air time e.t.c. However, branding can be done to help distinguish the supplier and quality.

CASE FOR INTERVENTION

Free Market Failure.

The financial sector does not satisfy the criteria of a Free Market.

1. There is barrier to entry. In case of Kenya; The Central Bank is the regulator and therefore determines entry into the market.

2. There is restriction to exit the market. i.e no Financial institution can exit the market until the Central Bank of Kenya is notified until some conditions are met.

3. There are a few Players on the supply side i.e there are less than Sixty (**60)** Banks in Kenya today, and thousands of bank consumers.

4. The price is determined by the Banks and not by the Demand/Supply mechanism.

5. The banks behave as Cartels through The Kenya Bank Association. Banking consumers are therefore disadvantaged.

6. Banks however can be said to be Homogenous. This is because the product they offer are distinguishable. (retail banking period).

COMPARISON

1. UNITED STATES OF AMERICA:-

In the U.S. the base rate of interest is set by the Federal Reserve Bank quarterly. Because of good business ethics and strong Consumer Protection institution funded by the government; the banks are more disciplined and tend to behave as if they are being capped. The Interest Rates they charge their consumers tend to revolve around the base Rate set by the Federal Reserve Bank. Very rarely above 2%.

2. UNITED KINGDOM

The base rate is set by the Monetary Policy Committee quarterly in line with other economic fundamentals prevailing at the time. The Banks as in the case of USA have good business ethics developed over a long period of time and therefore tend to set the rates they charge to borrowers very much in line with the base rate. Again usually not more than **2%** above the base set rate.

3. THE EUROPEAN UNION COUNTRIES:-

The European Union Central Bank also sets the base rate quarterly. There are other twenty seven (**27)** member countries who tend to comply and pass the benefits of the low rates to the Consumers.

4. KENYA

From the time the banking operation started in Kenya in 1906 until 1992 i.e **86** years the interest rates were capped. The banks made reasonable profits and most of them prospered. From 1993 the banks started making Abnormal profits. In economics Abnormal profits is defined as unfair profits derived from privileged position. This is different from windfall profit which comes from an act of God e.g sudden change of trading conditions or change of weather destroying a competitors crop in case of farming.

In the year 2000 the Donde Bill tried to redress the situation obtaining from 1993 but received very hostile response from the banks. Through the powerful Kenya Bankers Association the banks went to Court and managed to stall the process.

The Donde Bill debate however managed to bring some sanity in the Financial Sector without the support of legislation. The situation has since changed and Central bank allowed the Foreign Exchange market to be manupilated in November last year.

The Monetary Policy Committee which was part of the Donde Bill was put into operation in year 2004 and in May 2007 the In-duplum rule which was also part of the Bill came into operation through a Gazette notice.

As of now the Interest Rate cap of **4%** above the base rate and of **70%** of the base rate to be paid to savers which was the key feature in the Donde Bill is back in parliament. The powerful forces are at work again and as of today the Finance Bill which was to be ammended include the Rate capping has not been passed.

In Kenya it is necessary to cap the Interest rates since the banks cannot self regulate themselves despite the fact that the Monetary Policy Committee is now in place as enviseged in the Donde Bill. The coming of COFEK is going to paly a big role to dialoque with the Bankers Association so that the rates can be lowered not only in the interest of consumers but for the development of the country. The presence of COFEK creates an organised front in which the consumers can voice their concern as opposed to a one man show as seen during the Donde Bill debate. It is hoped that COFEK is going to be seen in the same light as other Consumer Protection institutions which ensures that the consumers get value for their money and are not exploited. It is important COFEK is properly funded so that it can engage the various palyers in the economy on behalf of the Government.