PD-ABC-774

A.I.D. EVALUATION SUMMARY - PART I

1. BEFORE FILLING OUT THIS FORM, READ THE ATTACHED INSTRUCTIONS.
2. USE LETTER QUALITY TYPE, NOT "DOT MATRIX" TYPE.

IDENTIFICATION DATA

A. Reporting A.I.D. Unit:

Mission or AID/W Office USAID/GAMBIA
(ES#)

B. Was Evaluation Scheduled In Current FY Annual Evaluation Plan?
Yes [ ] Slipped [X] Ad Hoc [ ]
Evaluation Plan Submission Date: FY 90 Q 4

C. Evaluation Timing
Interim [ ] Final [ ] Ex Post [X] Other [ ]

D. Activity or Activities Evaluated (List the following information for project(s) or program(s) evaluated; if not applicable, list title and date of the evaluation report.)

Project No.	Project /Program Title	First PROAG or Equivalent (FY)	Most Recent PACD (Mo/Yr)	Planned LOP Cost (000)	Amount Obligated to Date (000)
635-0228	African Economic Policy Reform Program	FY87	12/90	6,000	6,000

ACTIONS

E. Action Decisions Approved By Mission or AID/W Office Director

Action(s) Required	Name of Officer Responsible for Action	Date Action to be Completed
None.		

(Attach extra sheet if necessary)

APPROVALS

F. Date Of Mission Or AID/W Office Review Of Evaluation: (Month) 6 (Day) 6 (Year) 91

G. Approvals of Evaluation Summary And Action Decisions:

	Project/Program Officer	Representative of Borrower/Grantee	Evaluation Officer	Mission or AID/W Office Director
Name (Typed)	Fred Witthans		John Babylon	John Babylon/A
Signature				
Date	6/7/91		6/7/91	6/7/91

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ABSTRACT

Evaluation Abstract (Do not exceed the space provided)

The African Economic Policy Reform Program in The Gambia (GEPRP) sought to eliminate preferential or administrative pricing of credit, arbitrary cash crop buying margins and hidden budgetary subsidies for parastatals. The interim evaluation having established that the latter two objectives had been accomplished, this final evaluation focussed on the impact of market-determined interest rates (MIRs). The major findings and conclusions are:

- MIRs were in effect throughout the program period.
- Administrative credit pricing was virtually eliminated during the program period, even in the programs of some other donors.
- Positive real interest rates increased domestic savings and investment.
- Although high interest rates continue to attract much adverse comment, term lending by banks increased throughout the program period, from 17% to 24% of all loans.
- The spread between deposit and lending rates is high, implying that greater commercial banks competition is needed.
- The link between MIRs, exchange rate stability and inflation is demonstrably close and sensitive.
- Treasury bill auctions determine interest rates.. But T-bills are sold to absorb excess liquidity, not to influence credit markets.

The evaluator recommended:

- Slowly reduce the tender volume of T-bills.
- Develope debt instruments, and a secondary market, to enable a yield curve to emerge.
- Study interest rates in relation to other key variables. Consider modifying bank reserve requirements.
- Use cost/benefit analysis of alternative agricultural technologies to estimate the demand for agricultural credit.

COSTS

I. Evaluation Costs

1. Evaluation Team

Name	Affiliation	Contract Number OR TDY Person Days	Contract Cost OR TDY Cost (U.S. $)	Source of Funds
Richard Fraenkel	REDSO/WCA	17	Unknown	OE

2. Mission/Office Professional Staff Person-Days (Estimate) Two

3. Borrower/Grantee Professional Staff Person-Days (Estimate) -

A.I.D. EVALUATION SUMMARY - PART II

SUMMARY

J. Summary of Evaluation Findings, Conclusions and Recommendations (Try not to exceed the three (3) pages provided)
Address the following items:

- Purpose of evaluation and methodology used
- Purpose of activity(ies) evaluated
- Findings and conclusions (relate to questions)
- Principal recommendations
- Lessons learned

Mission or Office:	Date This Summary Prepared:	Title And Date Of Full Evaluation Report:
USAID/Banjul	June 7, 1991	Implementation, Impacts and ... 3/5/91

In 1986, Gambia's Economic Recovery Program introduced market-determined interest rates into the financial sector as a replacement for administered interest rates. The thrust of the conditionality in the GEPRP program related to supporting interest rate form. The reforms undertaken by the GOTG resulted in a jump in the key, short-term deposit rate from an average of 11.3% in 1980/81-1985-86, to 18.3% in 1986/87-1988/89. Real positive interest rates have also been in effect during the 1986-90 period.

Market interest rates (MIRs) were introduced at the time that the Dalasi became a freely convertible currency, and a flexible exchange rate policy was introduced. MIRs represented a complementary policy for supporting the Dalasi against its anticipated depreciation in the foreign exchange market. MIRs have contributed to an increase in the demand for broad money, including savings deposits, whose interest rates are linked to the interest rates on Treasury bills.

The market-interest rate policy has been operated through the sale of Treasury bills to the banking system, public enterprises, and the public at-large. T-bill sales have prevented the banking system and, indirectly, the Gambian public, from building up excess cash reserves, which would be subject to currency substitution. MIRs have been successful in reducing capital flight, and in stabilizing the exchange rate of the Dalasi.

In spite of high interest rates, investment in Gambia has been high during 1986-90. This is explained by several exogenous factors, including (1) the domestic alternatives to bank financing for private investment, and (2) the autonomous flow of foreign investment from non-interest rate sensitive sources, such as the World Bank's IDA window. For example, increased capitalization in the agricultural sector has been financed from farm household savings. Some urban entrepreneurs have invested the profits from the re-export trade in services and other facilities. Many investments have been undertaken in the public sector using donor funds.

In conclusion, MIRs have been successful in achieving monetary and exchange rate stabilization. The (expected) adverse effects on growth and investment in real sectors of the economy have been mitigated by exogenous factors. The new, Financial Sector Restructuring Program, will encourage local banks to increase lending for productive purposes.

ATTACHMENTS

K. Attachments (List attachments submitted with this Evaluation Summary; always attach copy of full evaluation report, even if one was submitted earlier; attach studies, surveys, etc., from "on-going" evaluation, if relevant to the evaluation report.)

"Implementation, Impacts, and Rationalization of Market-Determined Interest Rates in The Gambia (1986-90)"

COMMENTS

L. Comments By Mission, AID/W Office and Borrower/Grantee On Full Report

IMPLEMENTATION, IMPACTS, AND RATIONALIZATION OF MARKET-DETERMINED INTEREST RATES IN THE GAMBIA (1986-90)

A FINAL EVALUATION REPORT ABOUT GAMBIA'S
ECONOMIC POLICY REFORM PROGRAM (GEPRP)
PROJECT 635 - 0228

Prepared by: REDSO/WCA/PAE
Richard Fraenkel
Banjul, The Gambia: February 9, 1991
Abidjan, Cote d'Ivoire: March 5, 1991

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Executive Summary

In 1986, Gambia's Economic Recovery Program introduced market-determined interest rates into the financial sector as a replacement for administered interest rates. The thrust of the conditionality in the GEPRP program related to supporting interest rate reform. The reforms undertaken by the GOTG resulted in a jump in the key, short-term deposit rate from an average of 11.3% in 1980/81-1985/86, to 18.3% in 1986/87-1988/89. Real positive interest rates have also been in effect during the 1986-90 period.
Market interest rates (MIRs) were introduced at the time that the Dalasi became a freely convertible currency, and a flexible exchange rate policy was introduced. MIRs represented a complementary policy for supporting the Dalasi against its anticipated depreciation in the foreign exchange market. MIRs have contributed to an increase in the demand for broad money, including savings deposits, whose interest rates are linked to the interest rates on Treasury bills.

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Section 1 - Scope-of-Work for the Assignment

USAID/Banjul provided the following Scope-of Work:

"The principle objective of the final evaluation will be to examine the people-level impact of reforms achieved under the program. In particular evaluate the costs and benefits associated with the reforms of market determined interest rates, non preferential access to credit, and non preferential buying margins for agricultural marketing. Were there any unintended impacts from the program? Should the reforms be modified or are additional reforms needed to improve access to credit, promote investment, and increase incentives to farmers?" (Banjul C3423 para. 2)

In carrying out the assignment, data and time constraints had to be taken into account. The present writer agrees with the mid-term evaluator, in giving priority attention to the first condition precedent of disbursement of the First Tranche, III.3.1.A., as the key reform to be examined in the evaluation:

"III.3.1.A. Written evidence of the Grantee's agreement to develop, in consultation with A.I.D., (1) its policy options for (a) term lending at market interest rates, (b) agricultural credit, and (c) development lending...;"

According to the previous evaluator:

"Because of its position as the first condition, its continuation through all three tranches, and the discussion in the text of the PAAD, this condition can be considered as the keystone of efforts to reform the financial sector."

The other CPs regarding policy reforms concern (B.) restrictions on borrowing from official sources at less than market-determined interest rates; (C.) restrictions on preferential access to credit from public financial institutions, notably, the Gambia Commercial & Development Bank; (D.) uniform prices for agricultural commodities for public and private market intermediaries; and (E.) the need to budget for public enterprise capital guarantees or operating subsidies. The restrictions imposed on the banking system by CPs B. and C. are closely related to the interest rate reforms in the financial sector, and assume that market-determined interest rates are being observed. CP D, regarding price discrimination in the real goods market, and CP E, regarding government subsidies to public enterprises, refer to different matters, and are not considered in the evaluation.

To measure the implementation of market-determined interest rates throughout the economy, the (adjusted) Treasury bill rate is used as the benchmark. The Gambian Treasury bill was intended to begin the process of unifying financial markets around market-determined interest rates in Gambia. USAID/Banjul's Assessment of Program Impact statement (Target 4) adjusts the nominal T-bill rate for inflation, in order to calculate the real interest rate. These benchmark rates will be employed in the evaluation.

An eclectic approach will be used for evaluating program impact. We will use three kinds of evidence: economic theory, coupled with statistical information; econometric estimates; and household survey results.

Most of the available data and analysis have been the subject of previous analysis and commentary (cf. especially Cathy L. Jabara, Economic Reform and Poverty in the Gambia: A survey of Pre-and Post-ERP Experience). C. Jabara's paper covers the impact of the entire Economic Recovery Program (ERP) in Gambia, and is not restricted to distributional impacts of the GEPRP.

Theory and household surveys can be used to analyze the income distribution effects of financial developments; econometric estimates generally relate to national aggregates. Econometric work, done primarily by Malcolm F. McPherson and associates, estimated the effects of policy changes and foreign assistance flows upon major macroeconomic variables. In all cases, the "plausible attribution" standard regarding the evidence is taken for granted. While we shall be concerned primarily with two of the most important prices in an economy, the exchange rate and the interest rate, it is not always possible to trace the distributional consequences of the macroeconomic policy changes.

Every negative impact of an adjustment program may not be 'unintended.' Indeed, some adverse people-level impacts are an inherent part of the adjustment process. An example is the negative distributional consequences for the welfare of the urban, formal sector. In general, adjustment programs are designed to shift incentives towards the production of tradable goods, and away from government services. The nominal exchange rate is often devalued, which inevitably reduces the purchasing power of households and of firms which are net importers (e.g. Civil Service employees) and benefits the income of net exporters (e.g. cashcrop farmers). The Gambian program tends to conform to this common pattern. In focusing on the people-level impacts, it is important not to lose sight of the overall purposes of the adjustment program.

Section 2 will review government actions related to complying with the conditionality in the AEPRP.

Section 3 will review available statistical, econometric and household survey evidence regarding the impacts of interest rate and related reforms.

Section 4 examines the factors accounting for the level of interest rates in the Gambia since 1986, and the continued appropriateness of the recent, high nominal interest rates in The Gambia, for the achievement of stabilization and growth objectives. Are current interest rates appropriate for the next phase of the Sustained Development Program in Gambia, which will stress growth based on the private sector?

Businessmen in Gambia's public and private sectors naturally feel that interest rates since 1986 have been too high to support investment in expansion of capacity and new projects, and for meeting seasonal credit requirements, such as crop marketing. However, it is reported that senior government officials are pleased with the stable macroeconomic framework, and they are not likely to accept abrupt changes in the current macroeconomic policies.

The focus of Section 4 is in line with the short-term objective of the ERP and GEPRP programs, to stabilize Gambia's economy. The fundamental idea of 'getting interest rates right' was a significant reform for A.I.D. to support, justifying the series of cash grants to the GOTG. However, getting even the key, economy-wide prices right, including the price of foreign exchange and of money, coupled with the reduction in the government deficit, control of credit, etc. -- even when assembled as a coherent financial program -- is never a panacea. Stabilization under an IMF program does not guarantee a satisfactory long-term growth rate. While stabilization in Gambia has been achieved in the short-to-medium-term (1986-90), sustainable growth will be a longer-term phenomenon, requiring structural measures. (For a discussion of the problems of implementing structural measures in Gambia, see the Final Evaluation Report on the P.L. 480 206 Program in Gambia, March, 1991). Successful implementation of stabilization measures is a necessary, but not sufficient, condition of sustained economic growth.

Section 5 discusses the special problem of sequencing the introduction of market-determined interest rates in the agricultural sector. Should targeted agricultural credit, at below market-determined rates, be allowed to exist during a transition period to full implementation of market-determined rates, if foreign donors are bearing the the entire subsidy burden, if the benefits are targeted on the rural poor, or if the credit is in-kind in the form of production inputs? Or is it more important to make a coordinated effort to unify financial markets as quickly as possible?

Annex I is the Conditions Precedent in Article III of the Program Grant Agreement.

Section 2 - Government compliance with the GEPRP's conditionality

Section 2 answers the questions: What was agreed to between the United States Government and the GOTG? What, subsequently, was done? Logically, the reforms cannot be said to have an impact unless they were implemented. This is an impact, not a process evaluation. The latter type of evaluation would have evaluated the the policy dialogue between the Mission and the GOTG.

1. Key dates and program provisions:

GEPRP program Grant Agreement Signed: Sept. 10, 1987, for a government-to-government cash transfer, on grant terms, not to exceed $6 million, to be made available in three equal tranches.

Mission staff have summarized the principal aspects of Program as follows:

"Non-project assistance program involving government-to-government cash transfers to assist in debt service payments while leveraging major credit policy reforms: market determined interest rates, elimination of preferential credit allocation from official sources, agreement to finance from the national budget all subsidies of public enterprises; commitment to develop policies for term lending at market interest rates for agricultural credit and development lending. (Refs: PP, and mid and final (sic)) evaluations of AEPRP)."

For additional detail, Annex I presents Article III Conditions Precedent to Disbursement, from the Program Grant Agreement, in its entirety.

Disbursements under the GEPRP Program were as follows:

Tranche #1 released: March 29, 1988

Tranche #2 released: June 6, 1989

Tranche #3 released: Sept.11, 1990

PACD: December 31, 1990

2. Funds were transferred from A.I.D. into a special account of the Central Bank of The Gambia for the GEPRP at the Federal Reserve Bank of New York Act. Afterwards, they were used to meet GOTG's foreign debt obligations. Eligible debts were to the IMF and ADB. There are no imports associated with the program. The assistance increased the Net Foreign Assets of the monetary authorities of The Gambia, and directly facilitated making payments due to the IMF. Meeting Gambia's IMF obligations was crucial to the donors' support of the entire ERP. Where a cash

transfer is used for debt repayment, no proceeds are generated.

3. With the exception of tranche #3, the grant was disbursed as planned, with a minimum of delay. The policy reforms in Article III of the Program Grant Agreement were the principal, non-procedural conditions precedent to disbursement. The timely disbursement of the grant indicates that, in the Mission's judgement, the policy reform process in Gambia's financial sector, on balance, was proceding satisfactorily. Two evaluations and one audit were conducted previously:

July, 1989, Mid-Term Evaluation of The Gambia's AEPRP and EPRS Project, by REDSO/WCA Paul Mulligan

Sept, 1990, Impact Evaluation, The A.I.D. Economic Policy Reform Program in The Gambia, by Jan H. van der Veen, Thomas D. Hobgood and Melanie J. Marlett (fieldwork was carried out in 9/89)

December, 1990, Audit of the Gambia's EPRP, Regional Inspector General for West Africa (the audit was carried out in 3/90)

In commenting on the CPs for Tranches 1 and 2, both evaluations supported the Mission's positive view of GOTG performance. The evaluations stressed that the GEPRP fit into an on-going process of financial sector reform in Gambia, in which the Government had taken the initiative. They also noted the similar conditionality in the GEPRP, IMF, and World Bank programs.

The RIG audit, focusing on a dispute about Technical Assistance to the Gambia Commercial and Development Bank, under the related AEPRP Support project, appears to have contributed to delaying the disbursement of Tranche 3, from April to August, 1990. This occurred shortly after the Mission sought, and received, clarifications of government policy towards lending to agriculture, which had threatened to slow down the disbursement process. Details regarding the disbursements of tranches 1-3 follow:

4. Tranche 1: According to PIL No. 4, the GOTG had complied with CPs to the first tranche. Evidence was contained in a letter from Permanent Secretary, Ministry of Finance, dated March 3, 1988. The major undertakings were:

A. Agreement to develop annual workplans regarding policy options for term lending, agricultural credit, and lending. The fact that Dr. Parker Shipton, of the Harvard Institute for International Development (HIID), had conducted a study of rural credit in Gambia, also was cited as evidence of meeting this condition.

B. Restatement of government policy to make credit available from official sources at market-determined rates

C. Restatement of government policy regarding the independence of public sector financial institutions, the elimination of preferential access to credit, and a promise not to require the GCDB, in particular, to grant any preferential loans or overdrafts. Government policies regarding market-determined interest rates and elimination of preferential access to credit, and the independence of public sector financial institutions from the government were first articulated in government agreements with the IMF and the World Bank in 1986, as outlined in the Memorandum of Economic Policies (August 1, 1986) and the Letter of Development Policy (August 1, 1986).

D. Commitment of the Government that the Gambia Produce Marketing Board henceforth would pay the same price to public and private produce traders.

E. Commitment of the Government to define, identify, and determine the magnitude of capital guarantees or operating subsidies to the public enterprises.

5. Tranche 2: According to PIL No. 5, the GOTG had complied with CPs to the second tranche. In the letter to the Government dated June 7, 1989, the Mission agreed to substitute reports, studies, and other relevant documents for semi-annual workplans. It requested a list of capital guarantees and operating subsidies, and GOTG procedures for handling them. This was provided on July 19, 1989, in a letter from the Acting Permanent Secretary, Ministry of Finance, to the AID Director. The biggest subsidy was for groundnut producer price support. The subsidies were respectively D83 million 1986-87, D50 million 1987-88, and D13.2 million 1988-89. The letter also notes that "under an agreement with the World Bank these subsidies are being reduced to zero in 1989/90."

6. The disbursement of Tranche 3 was requested by letter of the Permanent Secretary, Ministry of Finance, March 29, 1990. Actual disbursement was not made until September 11, 1990. In the intervening period, the disbursement of Tranche 3 was delayed by disputes between the Mission, the Ministry of Finance and the Central Bank over interest rates for agricultural credit, and technical assistance to the Gambia Commercial and Development Bank (GCDB). In response, the government issued a policy clarifying that market-determined interest rates would apply to lending by the World Bank ADP II to the GCU. It also accepted technical advisors to restructure the GCDB. This paved the way for the third and last tranche to be released on September 11, 1990.

The conclusions of the evaluation regarding the Government's compliance with GEPRP conditionality are:

1. Market interest rates, linked to Treasury bill rates, have been in effect in Gambian financial institutions since 1986. The market interest rates have been positive in real terms (that is, after inflation).

Table 1: Key nominal interest rates, 1984-89

	1984	1985	1986	1987	1988	1989
Discount	9.50	15.00	20.00	21.00	19.00	18.00
Deposit	9.00	9.75	16.13	15.75	15.00	12.92
Lending	18.00	14.48	28.00	27.92	29.54	26.83

Source: IFS, 1990

The jump in 1986 in the key nominal interest rates shows the implementation of GEPRP conditionality.

Table 2: Real interest rates

	1985	1988	1990
Treasury bill	-10.4%	9.5%	6.0%
Deposit rate	-10%	n/a	1.0%

Source: USAID/Banjul, "Assessment of Program Impact," July 1, 1989-June 30, 1990, p.13

As the result of introducing market-determined interest rates, the real interest rate became positive after 1985. However, interest rate fluctuations have not varied significantly in response to fluctuations in inflation, demonstrating the controlled nature of financial markets in Gambia. For example, the real deposit rate was only slightly positive (1.0%) in 1990.

2. Most commercial bank lending is short-term. However, term lending by commercial banks has increased from 13% of total commercial bank lending in December, 1984, to 24% of total lending in December, 1990 (cf. Table 3). According to the classification system of the Central Bank Research Department, "term lending" is defined to consist of loans for Fishing, Building and Construction to individuals and partnerships, Tourism for Premises, and Tourism for Capital Equipment.

3. Government guarantees of commercial bank loans have been eliminated. However, it is especially difficult for the Gambia

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TABLE 3: COMMERCIAL BANKS' CONSOLIDATED LOANS AND ANNEXES SECTORWISE - DECEMBER 1984 - DECEMBER 1990

(IN D'000)

	DEC. 1984		DEC. 1985	DEC. 1986	DEC. 1987	DEC. 1988	DEC. 1989	DEC. 1990	
1. AGRICULTURE	56361	0.2805	99030	79058	44200	55281	22577	27285	0.099007
(a) Production	10680		14388	16770	7849	9594	12071	12728	
(b) Processing	788		2014	2598	2912	3227	4753	4739	
(c) Marketing	44893		82628	59690	33439	42460	5753	9795	
2. FISHING	7995		17494	19317	18108	22398	19208	23472	
3. MINING AND QUARRYING	531		552	677	783	452	534	1110	
4. BUILDING AND CONSTRUCTION	14393		21182	31845	22105	20319	22497	15802	
(a) To Companies and Corporations	10488		13368	22458	15901	14338	16850	6844	
(b) To Individuals and Partnership	3905		7814	9387	6204	5981	5647	8958	
5. TRANSPORTATION	6076		9178	9979	12215	14612	4044	3295	
(a) To Companies and Corporations	4621		4615	6882	9513	12137	1875	238	
(b) To individual and Partnerships	1455		4563	3097	2702	2475	2169	3057	
6. DISTRIBUTIVE TRADES	58823		46875	65931	55183	54179	51918	74975	
(a) To Companies and Corporations	25726		15012	15640	18993	23075	26397	43112	
(b) To Individual and Partnership	33097		31863	50291	36190	31104	25521	31863	
7. TOURISM	20620		12568	22251	19763	29222	38196	40511	
(a) For Premises	13554		9436	16716	14929	19942	29231	30822	
(b) For Capital Equipment	862		1696	2400	633	1068	1864	2203	
(c) For Working Capital	6204		1436	3135	4201	8212	7101	7486	
8. FINANCIAL INSTITUTIONS	-		-	-	-	-	-	-	
9. PERSONAL LOANS	28130		26086	27676	30030	33588	39095	42361	
10. OTHERS	7960		17135	28630	28446	37926	44860	46773	
TOTAL	200889		250100	285364	230833	267977	242929	275584	
TERM LEND	26316		36440	47820	39874	49389	55950	65455	
XTERMLEND	0.1309977		0.1457017	0.16757544	0.1727395	0.1843031	0.2303142	0.23751378	

Commercial and Development Bank to eliminate preferential access to credit. Preferred customers now must pay market interest rates.

The Managing Director of the GCDB stated (1/91) that lending by his institution now is guided by "standard banking practice." He conceded that it has been difficult for GCDB to escape from its origins as "The Gambian Bank," and to avoid granting preferential access to credit, however. For example, when the Ministry of Finance was unable to pay teachers' salaries due to the need to meet an IMF government spending target, the Minister of Education turned to the GCDB for a bridge loan. The Managing Director stated that the GCDB provided the funds, but at market rates of interest. It would be difficult to eliminate this kind of preferential access to credit. Such a practice is less detrimental to financial market development than if the GCDB had been forced to make an interest-free advance, an abuse which occurred in the past.

The Gambia Produce Marketing Board (GPMB) continues to receive preferential access to credit. Since December, 1990, the Central Bank has underwritten the issuance of 41 million Dalasis in Groundnut bills, which substitutes for seasonal advances which GPMB previously received from the Central Bank. The Groundnut bills have the same terms and conditions for buyers as Treasury bills. While GPMB continues receiving preferential access to credit, it must now pay market interest rates, plus an additional premium for being underwritten by the Central Bank, which currently total 25%. Again, the G-bills represent significant progress over giving interest free advances to GPMB.

Section 3 - People-level and other impacts of market interest rates (MIRs)

The GEPRP's overall goal of introducing market-determined interest rates in Gambia had various aspects that were addressed by the Mission during program implementation: 'getting the cost of capital right' in Gambia as a concept; an interest rate policy for financial institutions reflecting the cost of borrowed funds; and the management of instruments and procedures by the political and monetary authorities and the banking system to mobilize savings and to allocate lendable funds. All these aspects of MIRs were closely related, and had to be considered in implementing financial sector reform. A policy of MIRs may be implemented using various instruments, and should not be associated with any particular instrument, such as Treasury-bills. The financial sector reform process also included complimentary legal and institutional reforms such as doing away with preferential access to credit, and protecting the independence of the commercial banks and the Central Bank from outside pressures.

The GEPRP program addressed Gambia's national financial system. That is, it did not work work at the village level. A common characteristic of financial markets in developing countries is their fragmentation. For example, the interest rate differentials between informal village money lenders and urban commercial banks tend to be quite high. Collateral which is accepted in a village setting, such as livestock, would be unacceptable to an urban, commercial bank. A grassroots, PVO project might have been more attuned to the sociological texture of credit arrangements in Gambian villages, but its impact, of course, would have been geographically limited.

Some impacts of introducing MIRs can be associated with distinct groups in the Gambian population (e.g. the rural poor; the formal urban sector; exporters; importers, etc.). At times, specific financial institutions, such as commercial banks, may receive windfalls from liberalization. Other impacts are long-term and will be fully visible only in the future (e.g. MIRs' impact on the volume of savings and investment). The impact of MIR reforms may be direct or indirect. An example from Gambia of the latter is the simultaneous adoption of a 15% rate of return requirement for projects financed under the Public Investment Program.

In our discussion, financial, government and real sector impacts will be taken into account. Impacts will be analyzed based on (1) theory and statistical evidence, (2) econometric estimates, and (3) household survey results.

The impacts of MIRs in Gambia have been:

1. Market interest rates (MIRs) benefit individual savers and firms having surplus funds.

From June, 1986 to June, 1990, private sector time and savings deposits increased from D66.9 million to D180.1 million. Source: Central Bank of the Gambia Bulletin, Quarter 2, April-June, 1990

2. MIRs penalize holders of real money balances.

McAuliffe and McPherson (1990) provide econometric estimates of the demand for money as a function, ceteris paribus, of the real interest rate (Table 1, equation 6); and of the real interest rate as a function of GDP and the price level (Table 1, equation 7). While the demand for money is inversely related to the real interest rate, the estimated relationship is not statistically significant.

In future econometric modeling, it also would be interesting to examine the relationships among the real interest rate, the exchange rate, savings and investment. The latter, in particular, would be subject to data availability.

3. MIRs penalize previous recipients of subsidized loans.

This impact was mitigated in the rural areas by longstanding agreements to restrict interest rates to farmers participating in projects. An example is a cotton project supported by France.

Von Braun <u>et al.</u> report, however, that the rural poor received subsidized loans for crop production and marketing prior to the reforms. In-kind below market credit also was provided by the Gambian Cooperative Union, but this practice has stopped.

4. MIRs benefit importers by protecting FX reserves against capital flight, thereby preventing the exchange rate from further depreciation.

As previously noted, the flexible interest rate policy was put into effect by the GOTG along with the flexible exchange rate policy. MIRs, along with central bank FX reserves, serve to stabilize the exchange rate of the Dalasi. The standard interest rate parity model fairly well describes the relative stability of the exchange rate of the Dalasi, and the relative absence of capital flight. According to this model, the rate of interest in Gambia will equal the "world" rate of interest plus (minus) the expected rate of depreciation (appreciation) of the dalasi. It suggests that market-determined interest rates have been acting as a counterweight to expectations of currency depreciation.

In the absence of adequate reserves and market-determined interest rates, small, open economies which have introduced flexible exchange rates have had problems with the rapid depreciation of their currency. An example nearby Gambia where problems occurred is Guinea-Bissau. In Guinea-Bissau, the flexible exchange rate policy has led to rapid devaluation, causing social tensions, due to the lack of reserves and complementary interest rate measures.
With absorption (consumption plus investment less exports) of D 2039 million exceeding gross domestic product of 1793 million Dalasis (or 13.7%), the average Gambian household is a net importer by the same magnitude (1989/90 IMF data). The stabilization of the exchange rate penalizes those households in the rural areas whose sales of agricultural commodities, such as groundnuts and horticultural products, exceed the value of imported goods which they purchase. In recent years, however, many rural households have become net purchasers of imported goods, indicating that they too are benefitting from the linkage between the exchange rate and MIRs.

5. MIRs penalize businessmen in the short-run, since the cost of funds from the banking system for investments increases. In the long-run, however, MIRs increase savings and investment component of GDP, and reduce consumption by stimulating additional savings. This will bring down interest rates, and increase the supply of

investable funds.

Table 4 shows the improvement in national savings, investment, and the reduction in consumption, as a percent of GDP, starting in 1983.

6. MIRs serve as a realistic accounting price of capital for public enterprises and private businesses, making the costs transparent, and disclosing useful information to portfolio managers and potential investors. MIRs discourage accumulation of cross-debts and arrears among economic agents.

7. The objective of MIRs lends itself to external monitoring using quantitative indicators, in the style of the quantitative benchmarks in an IMF program. Given the donors' stress on evaluation, verifiable indicators may attract additional balance of payments support from donors. USAID/Banjul believes that program assistance is of higher quality than project assistance since it leverages important policy reforms. Headquarters monitoring may permit the donors to assist Gambia without the administrative costs of maintaining resident personnel. Cash transfers from donors help the beneficiaries of government spending, mitigating the effects of domestic budget cuts and restrictive credit policy.

8. MIRs hurt cyclical, interest-sensitive industries.

This impact is somewhat theoretical in Gambia's case. For instance, even housing does not appear to be an interest-sensitive industry in Gambia, as the recent volume of cement sales and casual observation of new housing starts indicate. This is probably due to the importance of self-financing in the housing sector.

9. MIRs benefit financial institutions.

Commercial bank profits have been high since 1986, reflecting the wide spread between deposit and lending rates, commissions on foreign exchange transactions, and other fee income. For instance, in 1988, the profit (before taxes) of one of the commercial banks was 148% of equity (share capital plus reserves). Gambia levies a 50% profits tax on companies, so that the after-taxes return on equity still was 73%. Commercial bank profits generally are attributed to the non-competitive structure of the commercial banking system in Gambia. Another significant factor is policy reforms liberalizing financial and foreign exchange markets. Despite the latter, the GOTG has not applied a windfall profits tax to the commercial banks.

10. MIRs are a disincentive to the GOTG's revenue collection effort.

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Table 4: The Gambia: Growth of gross domestic product by sector, 1983/84-1988/89 (constant 1980 prices)

	1983/84	1984/85	1985/86	1986/87	1987/88	1988/89a/
			(percent)			
Agriculture	-21.0	3.0	.6	9.4	2.5	-4.1
Groundnuts	-45.7	-15.3	-6.4	42.7	8.2	-21.4
Other Crops	-32.3	21.6	68.5	-13.5	-.5	6.5
Livestock	31.5	3.5	-35.4	1.1	2.2	-1.3
Fishing	-10.6	3.6	-48.2	224.4	0.0	-13.7
Forestry	1.2	0.0	51.7	20.4	15.1	-57.3
Industry	47.2	5.9	-37.8	12.9	6.2	6.0
Manufacturing	92.5	4.5	-41.4	8.6	5.0	-11.3
Construction	-2.1	11.2	-32.7	21.4	8.8	2.2
Elect/Water	17.6	-10.0	-11.1	6.2	0.0	-5.9
Services	6.4	-.5	4.4	3.7	4.7	-.4
Trade	69.0	6.3	13.6	.4	4.9	-8.5
Groundnuts	416.3	-15.0	-30.7	36.2	-7.4	-38.8
Other trade	26.5	17.0	9.7	-6.5	8.2	.6
Hotels/Rest	-36.9	9.1	8.3	-2.7	3.3	9.0
Transport/Comm	-16.7	-2.8	0.0	36.4	9.9	5.3
Business	-7.0	-4.1	-20.3	5.7	4.0	3.4
Government	-5.8	-6.3	-4.5	-9.3	1.5	3.8
Other	0.0	-5.6	-23.8	18.7	2.6	.8
GDP(Factor Cost)	-.5	1.5	-2.7	6.5	4.1	-2.2
Indirect Taxes (net)	.8	14.2	14.7	1.5	12.1	40.3
GDP (constant prices)	-.4	3.2	-.2	5.2	5.3	4.7
Memorandum Items:			(in percent of GDP)			
Private consumption	83.2	86.5	76.3	72.9	73.0	72.0
Domestic savings	-3.8	-4.6	7.3	4.4	7.0	7.1
Domestic investment	17.3	19.2	15.8	20.4	18.5	17.9
			(percent)			
GDP (constant prices deflated by CPI)	-.6	-4.4	-7.7	-15.0	5.0	5.3

a/ Estimate

Sources: IMF (1987, 1988, 1989).

This refers to the universal effect, of interest to economists since Ricardo, that revenue from sales of government obligations affects the tax burden. The tendering of Treasury bills at market-determined interest rates increases government revenues to meet current expenditures, without the short-run need to collect taxes. Of course, in the long run, taxes must be raised to meet domestic interest payment obligations as government bonds are rolled over.

11. MIRs, coupled with the issuance of Treasury bills, increase recurrent government domestic interest payments. This makes the government's budget less flexible for responding to new needs and launch new programs, since domestic interest payments represent a new, non-discretionary component of the budget. The GOTG does not have recourse to a "Banjul Club" for re-scheduling domestic interest payments on the public debt.

12. MIRs, as the cost of capital, induce appropriate choice of technique given the resource endowment of Gambia's capital-scarce economy. They stimulate use of labor-intensive methods, and discourage capital intensive methods. They encourage investment in light equipment which can be manufactured locally.

Since MIRs were introduced, the services and truck gardening sectors have grown. Although detailed evidence is lacking, the adoption of small-scale processing equipment reportedly has been accelerated in the traditional agricultural sector, such as groundnut shelling, oil seed processing, and animal traction.

13. MIRs emphasize the need to increase efficient use of existing capacity, through rehabilitation and maintenance, rather than expansion of new capacity. This tends to increase employment since rehabilitation and maintenance tends to be more labor-intensive than installation of new capacity which, by definition, is capital-intensive.

During the 1986-89 period, the emphasis of the Public Investment Program "was shifted toward maintenance and rehabilitation of infrastructure ..." (SAC I Project Performance Audit Report, p. 34)

14. MIRs cause large-scale, formal sector companies to sub-contract for needed inputs and services to avoid long-term commitments of funds, rather than making the investments and contracting with labor for providing them in-house. This stimulates small and medium enterprises.

An example is the private transport of groundnuts for the Gambia Produce Marketing Board.

15. MIRs and financial sector liberalization improve Gambia's position in the subregion by (a) creating an offshore financial services center and (b) lessening the need to collect taxes,

thereby increasing revenue of unrecorded cross-border trade. By strengthening Gambia's financial sector, MIRs stregthen Gambia's overall position vis-a-vis Senegal. It creates an interest in the French-Senegalese business community in having Gambian commercial banks serve as a convenient, offshore financial services center. For example, one of the commercial banks reportedly transports CFAF currency obtained from the re-export trade by air from Banjul to Bruxelles. An important part of the GOTG's tax revenue stems from taxes on trade. The cross-border trade is highly elastic with respect to import duties.

16. MIRs force the use of more stringent selection criteria for new investment projects in the private <u>and</u> the public sector.

In 1987, "strict criteria were imposed for inclusion of new projects in the core Public Investment Program, e.g., a detailed economic appraisal, including recurrent cost implications, and a minimum rate of return of 15%." (SAC I Project Performance Audit Report, July 19, 1990, p. 34).

While the accounting price of capital for public sector investments (15%) lagged behind private sector borrowing rates, it would have been inconsistent to have market-determined interest rates for the private sector, while permitting the public sector to continue financing uneconomic projects. Fortunately, a parallel adjustment in the cost of capital to the public sector also was made.

17. MIRs benefit urban savers more than rural savers due to lack of rural bank branches.

The lack of rural branch banks has contributed to the continued fragmentation of financial markets. Rural interest rates as high as 40% per annum have been reported.

18. MIRs benefit large savers because T-bills have a minimum of D5,000.

However, since deposit rates are linked to T-bills, small savers also have access to MIRs. By statute, the 3 month deposit rate is pegged at 5% below the Treasury bill rate.

Section 4. Problems of the level and structure of interest rates

Recommendations concerning further reforms of interest rates responds especially to the second part of the scope-of-work:

"Were there any unintended impacts from the program? Should the reforms be modified or are additional reforms needed to improve access to credit, promote investment, and increase incentives to farmers?" (Banjul 003423, para. 2)

Current nominal interest rates are as follows:

Table 5: Current Nominal Interest Rates

	1984	1985	1986	1987	1988	1989	1990
Treasury-bills	8.0	15.0	19.0	20.0	17.0	17.0	19.0
3 month deposits	10.5	15.5	18.0	15.0	15.0	12.5	12.5
Ag lending	10.0	27.0	24.0	22.0	22.0	29.0	29.0
Manufac lending	16.0	30.0	30.0	28.0	28.5	26.5	26.5

Source: Central Bank of Gambia

Several aspects of recent interest rates are noteworthy:

1. On average, real interest rates, or the nominal interest rate minus the rate of inflation, have been positive during the 1986-90 period. The real positive deposit interest rates have stimulated savings. The demand for loans has been reduced.

2. Commercial bank lending rates during the 1986-90 period have been consistently higher than deposit rates, which have tended to decrease. Due to the wide spread between lending and deposit rates, the after-tax profits of commercial banks have been high.

3. Since 1986, commercial banks have had a recurring surplus of lendable funds due to (a) the problems with the quality of loan proposals, (b) high lending rates of interest, (c) collateral requirements, and (d) prior to September, 1990, quantitative credit ceilings.

During the period June 1986-June 1990, time and savings deposits by the private sector increased from D66.9 million to D180 million (or 172%), while loans to the private sector increased only from D181 million to D242 million (or 34%).

4. In contrast to standard practice in most other countries, the GOTG does not use T-bills principally for financing its budget deficit. In general, the GOTG has sold Treasury bills to absorb excess liquidity of the commercial banks, resulting from the influx of outside money and increased savings. T-bills are risk-free obligations carrying a market rate of interest. The remaining structure of interest rates is linked to the T-bill rates. Most T-bills are held by the commercial banks or the public sector enterprises, rather than by individuals. The policy of the Central Bank is to increase holdings of private individuals. The public benefits from T-bills indirectly through the automatic link with with the 3 month deposit rate.

5. The T-bill policy of the government has had the unintended impact of 'crowding out' the private sector from commercial bank borrowing. To bring down interest rates and improve the willingness of commercial banks to lend to the private sector, the amount of Treasury bills tendered for sale in biweekly auctions could be reduced. The amount of T-bills tendered has not been subject to ceilings. In the program with the IMF, neither the government expenditure target nor, prior to September, 1990, the bank credit ceilings (which no longer exist) controlled the T-bill tender volume. Indeed, the rationale for the volume of the T-bill tender is not clear.

6. In the second half of 1989, the Central Bank reportedly reduced the T-bill tender in order to provide relief from high interest costs to the government and private business sectors. The result, however, was downward pressure on the Dalasi, and an increase in inflation. The Central Bank's action also was noted by the IMF, which considered that a key element of macroeconomic stability had been breached. This suggests that it is necessary to reduce the amount of T-bills tendered slowly. Evidence from the 1986-90 period suggests that a small reduction in the T-bill rate would not, by itself, cause a decrease in commercial bank lending rates.

7. To increase the interest of commercial banks in lending to the private sector, the reduction in the amount of T-bills tendered would need to be coupled with structural measures which increased competition in the financial sector. These will not be discussed here. Additional financial sector reforms will be supported by the next AEPRP program for Gambia, the Financial Sector Restructuring (FSR) Program, which has already been designed.

8. Regarding the term structure of interest rates, new debt instruments also could be aggressively marketed, allowing a yield curve to emerge on the basis of market forces. Treasury obligations of differing maturities might be introduced. The aggressive institution of differing maturities, including Treasury long bonds for sale to non-captive investors, would require the establishment of a complimentary secondary market for government securities.

An opportunity to bring about reforms in this area was missed recently at the time Groundnut bills were introduced (December, 1990). The G-bills could have been issued with a different maturity than the T-bills. This might permit a distinction between the costs of short-term credit (e.g. collateralized crop marketing finance) and long-term, development financing.

9. Interest rates will need to be brought down as a contribution to economic growth. Gradual reductions will probably be needed,

however, due to the trade-offs of interest rates for the exchange rate and inflation. To anticipate the macroeconomic effects of interest rate changes on stabilization objectives, on-going analysis should be continued concerning the relation between the interest rate and other objectives of national economic policy, e.g., the stability of the Dalasi, financing the government budget deficit, and bank lending to the private sector.

10. It may be worthwhile to consider another increase in the bank reserve requirements, as an alternative to the continued, heavy reliance on Treasury bills, for absorbing the excess liquidity in the banking system. The last time that the reserve requirements on demand deposits were raised, from 10% to 24%, was in June, 1987. T-bills have been popular due to the substantial income transfer, in the form of interest payments, which they provide from the Treasury, through the financial institutions, to the general public. However, the sustainability of large T-bill tenders needs to be re-examined due to the recurrent domestic interest payment costs to the Treasury.

Section 5. Agricultural credit: a special problem

The conditionality of the GEPRP requires the GOTG to develop and implement an agricultural credit policy. In the past, the banking system has provided few term loans from its own funds for agricultural development. The high interest rate policy in effect since 1986 has further reduced the demand for agricultural credit.
According to Ministry of Agriculture-National Agriculture Sample Survey data, the agricultural sector is becoming more capitalized, using draft animals, implements (seeders, weeders, and moulboard plows, etc.), fertilizer, and so forth. Financing generally has come from family earnings and village-level credit mechanisms (cf. articles by Parker Shipton).

Since the advent of market-determined interest rates, the impact upon agricultural credit has become a public policy issue in Gambia. The agricultural community feels that it has been hurt by the high interest rate policy. The Gambia Co-operative Union (GCU) is the leading farm pressure group, representing Gambia's "110,000 farm families." In a recent policy statement, which acknowledged the Government's policy regarding market-determined interest rates, GCU stated that it nevertheless "will continue to focus the attention of Government and donor agencies upon its need to have access to concessionary funds for its credit programme." "... the further development of [GCU's] lending programme forms part of the development of a productive national infrastructure which cannot be conducted on the basis of funds raised in the commercial market."

In contrast, the AID Mission has defended rapidly unifying the financial system, including agricultural lending, around market-determined interest rates, without allowing any transition period. It has discouraged proposals to retain, even on an exceptional, staged basis, special, targeted, subsidized credit programs for the agricultural sector.

As Gambian agriculture develops through the greater use of capital inputs, however, the contribution of credit to its development will need to evolve. The fact that formal agriculture credit has not been widely used in the past should not be cited as the basis for pre-judging its future role. For example, the "Agriculture Sector Assessment" (Experience Incorporated, October, 1990) made a preliminary identification of a wide range of potential new technologies, practices, and interventions for the agricultural development, and it noted those which have significant financing requirements. After more detailed studies to establish economic feasibility, the need for additional bank credit as term lending to the agricultural sector should be foreseen. The evaluator recommends that the Mission use discounted cost/benefit analysis techniques to analyze investments identified in the Agriculture Sector Assessment, to estimate the demand for agricultural credit. This would contribute to development of a credit policy which takes potential agricultural sector growth into account.

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ARTICLE III: CONDITIONS PRECEDENT TO DISBURSEMENT

SECTION 3.1: Disbursement of the First Tranche:

Prior to any disbursement of the Grant or to the issuance by A.I.D. of documentation pursuant to which disbursement for the first tranche will be made, the Grantee will furnish to A.I.D., except as the parties may otherwise agree in writing, in a form and substance satisfactory to A.I.D.:

A. Written evidence of the Grantee's agreement to develop, in consultation with A.I.D., (1) its policy options for (a) term lending at market interest rates, (b) agricultural credit, and (c) development lending; and (2) its semi-annual work plans which indicate the steps involved in developing these policy options;

B. Written evidence of the Grantee's agreement that no public or private sector enterprise or individual will be permitted to borrow from official sources at less than market-determined interest rates;

C. Written evidence of the Grantee's agreement that [illegible] ill not request, instruct or permit the Gambia Commercial & Development Bank (GCDB) or any other public sector financial institution to grant preferential access to credit;

D. Written evidence of the Grantee's agreement that in the matter of its agricultural marketing, in particular for produce buying, it shall ensure that the same levels of remuneration are provided to all buyers, public or private;

E. Written evidence that the Grantee will define and identify all capital guarantees or operating subsidies being provided to public enterprises by the Grantee, will determine their magnitude, and will identify those capital guarantees or operating subsidies which are in the national interest; and

F. A comprehensive list of all eligible debts, as defined in Section 5.3.A., arranged in order of priority, for which payment will be made from the proceeds of the first tranche.

Section 3.2: Disbursement of the Second Tranche:

Prior to the disbursement of the Second Tranche of the Grant or to the issuance by A.I.D. of documentation pursuant to which the disbursement will be made, the Grantee shall furnish to A.I.D., except as the Parties may otherwise agree in writing, in a form and substance satisfactory to A.I.D., the following:

A. Written evidence that it has decided upon its proposed policies for (1) term lending at market interest rates, (2) agricultural credit , and (3) development lending, and that it has composed its semi-annual work plans which indicate the steps involved in adopting procedures to implement these policies;

B. Written evidence of its agreement that any type of capital guarantee or operating subsidy being provided to public enterprises in the national interest will be fully calculated and the costs thereof provided for in a timely manner through budgetary allocations.

C. A comprehensive list of all eligible debts, as defined in Section 5.3.A., arranged in order of priority, for which payment will be made from the proceeds of the second tranche.

<u>Section 3.3: Disbursement of the Third Tranche:</u>

Prior to the disbursement of the third tranche of the Grant or to the issuance of documentation pursuant to which disbursement will be made, the Grantee shall agree to furnish to A.I.D., except as the Parties may otherwise agree in writing, in a form and substance satisfactory to A.I.D., the following:

A. Written evidence that the Grantee's policies for (1) term lending at market interest rates, (2) agricultural credit, and (3) development lending, are being implemented;

B. Written evidence which indicates that the full costs of capital guarantees or operating subsidies be provided to public enterprises in the national interest are being provided for at the appropriate time through budgetary allocations; and

C. A comprehensive list of all eligible debts, as defined in Section 5.3.A., arranged in order of priority, for which payment will be made from the proceeds of the third tranche.