CASE STUDIES

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THE EFFECT OF INTEREST RATE DEREGULATION ON LIQUIDITY AND PROFITABILITY OF THE JORDANIAN COMMERCIAL BANKS.

Banking services performance has been influenced by the economic openness and globalization challenges. The joining to the world Trade organization (WTO) has led to free the international service trade and the dealings with it, add to it what Basel commission (11.1) has brought in this regard; All of these has caused the liberalization of money markets and capital flows with in a rapid technological advancement. Because of the importance of banking sector in the development of the national economy due to the significant services this sector provides such as: savings, and the provision of required payment means to finance the economic development; thus, the expansion of banks rote in development and to give importance to this role depend directly to specific factors such as: economic and political stability, a banking functions within mechanisms and standards of investment funding financing and monetary and financial policies.

While commercial banks have the efficiency in their operations, and the ability to compete sensibly within economic globalization, and economic openness necessities the examining of the interest rate deregulation and its effect within the monetary system which has taken into effect on February, 1990.The purpose of this examination is to reveal the effects which interest rate deregulation has caused.

Since their establishing, commercial banks have used to operate under minor and limited changes that occur on the interest rate structure in banking markets; thus situation lasted until the Jordanian banks have entered in early 1990s the deregulation experience. This left an impact on liquidity, profitability and competitiveness of the Jordanian commercial banks.

The problem of the study :

Many factors have influenced the decision to deregulate interest rate which has entered into effect on February,1990. These factors include:

- The decision for an open economy in Jordan.
- Jordan's joining to (WTO).
- The opening of Jordanian financial service markets to foreign banks under the same criteria and conditions of local banks.
- These factors have directed this research towards the examining of the impact of deregulation on domestic banks profitability, liquidity and the level of their competitiveness with foreign banks.
- This research will attempt to answer the following questions:

1- Does the interest rate deregulation have an impact on the Jordanian banks profitability?
2- The extent of deregulation decision effect on the Jordanian banks liquidity.
3- Does this deregulation decision elevate the Jordanian banks ability to compete(with foreign banks)??
4- The extent of deregulation effect on the volume of investments and its contribution to enhance growth rate.

Hypotheses of the study:

Hypotheses of the study have been derived from the topic of this research, they are as follow:

- **Hypothesis one**,-there is a correlation between interest rate deregulation and Jordanian banks competitiveness rate.
- There is no correlation between interest rate deregulation and Jordanian banks competitiveness rate.
- **Hypothesis two,-** There is a correlation between interest rate deregulation and volume and type of banking facilities.
- There is no correlation between interest rate deregulation and volume and types of banking facilities.

Hypothesis Three :

- There is correlation between interest rate deregulation and commercial banks profitability during deregulation period.
- There is no correlation between deregulation and banks profitability.

Methodology of the study:

Researcher has relied on the descriptive/ analytical style in order to clarify the relationship between interest rate deregulation and the competitiveness of Jordanian commercial banks.

Jordanian Monetary policy and the structure of financial Apparatus.

The current conservative monetary policy in Jordan has been able to stabilize the monetary situation in Jordan, through relying on the stability of purchasing price of the Jordanian diner, and maintaining the general level of prices within an appropriate interest rate structure. Whereas, the central bank maintained the utility of indirect management in monetary policy, safety, and competency enhancement of banking sector's functions, and support competitiveness among its components, after mandating banks to apply the most modern standards and accepted international measurements in monitoring, accountancy and auditing.

In addition, central bank authorized gradually in 2001 a series of reductions in the use of monetary policy tools (discount rate and rediscount) while taking into consideration the condition of the national economy and the international in general. In addition to the development pf prevailing interest rate in worlds markets. All of these have caused the lowering of the interest rate in domestic market. Low interest rate has affected banks activities in Jordan for example, total savings in 2001 has grown by 6%, the same with total facilities provided to the private sector by 11,4% while for public sector by 20.9%, this has resulted in the diversity of banking and financial system in Jordan remarkably . Whereas the structure of the Jordanian financial system consists of a set of financial and banking organization; whereas commercial banks come first, investment banks, specialized banking institutes and other non-banking financial organizations such as Insurance companies, Amman's money market, and social security corporation. However, the most important component is the banking sector because it is the main source for credit, loans and savings.

The Jordanian banking sector has witnessed numerous actions, reorganization and new legislations which aim to strengthen the financial capabilities, enlarge work base and diversify services.

The orientation has been towards liberalizing of interest rate, and reducing restrictions on commercial banks in order to enable these banks to play a larger role in banking world, to enhance banking activities and improve competitiveness among commercial bank.

The next period witnessed a clear indication to encourage and promoting the establishment of national banks, appeal to foreign banks to open branches in Jordan, table(1) shows the number of banks in Jordan for the year 2003(**www.obj.gov**).

Year	**Total banks**	**Jordanian banks**	**Non-Jordanian banks**	**Islamic- and non Investment**	**Branches Total**
1964	8	4	4	-	14
1990	18	9	5	4	280
2003	21	9	5	7	449

(source : the Jordanian central Bank,2004 Research Dept.)

Chartered banks sector witnessed a visible level of performance which can be traced to 1981 whereas the total banks assets and liabilities from 1330 million diner in 1981 to 3780 million diner in 1989 to 14153 million diner in 2001 as it is shown in figure(2).

figure (2)

Unified budget of Jordanian commercial banks for the period of (1981-2001).

Total Savings Average%	6-4%	5-4%	1-7%	4-7%	Total Assets	Total timed saving	Total on demand savings	Total saving	Loans from central bank	Other liabilities	Capital Reserve allocations	year
20	68.	32.	08.	73.	1330.7	661.2	316.5	977.7	14.7	104.9	112.6	1981
19	70.	30.	10.	75.	1553.5	815.0	354.5	1169.5	39.1	109.5	159.8	1982
19	72.	28.	19.	75.	1863.3	1010.1	387.7	1397.8	64.7	128.8	172.6	1983
15	74.	26.	09.	75.	2136.0	1193.4	409.7	1603.1	89.1	145.6	187.8	1984
9	79.	21.	08.	73.	2392.1	1372.7	374.5	1747.2	103.8	171.6	201.2	1985
11	81.	19.	08.	74.	2634.8	1575.7	370.6	1946.3	118.7	182.1	214.3	1986
10	82.	18.	08.	74.	2898.5	1762.4	380.0	2142.4	112.6	200.3	2292	1987
9	79.	21.	08.	72.	3250.5	1911.1	435.0	2346.1	115.2	240.9	250.6	1988
12	81.	19.	07.	69.	3780.3	2116.1	509.3	2625.4	221.2	375.9	280.8	1989
0.5	80.	20.	08.	65.	4090.0	2103.9	538.7	2642.6	449.2	434.6	312.4	1990
52	79.	21.	06.	72.	5599.1	3175.5	846.6	4022.1	408.7	549.4	348.6	1991
18	77.	23.	06.	75.	3611.1	3641.4	1107.6	4749.0	423.1	601.6	348.5	1992
4	79.	21.	07.	73.	6747.5	3907.2	1032.2	4939.4	344.0	781.0	492.7	1993
9	81.	19.	08.	72.	7527.8	4380.5	1011.0	5391.5	362.4	868.8	5828	1994
7	82.	18.	08.	69.	8430.4	4763.4	1024.1	5787.5	404.3	993.4	701.7	1995
3	85.	15.	09.	68.	8857.7	5063.2	925.6	5988.8	390.5	1075.5	771.0	1996
7	84.	16.	11.	66.	9679.2	5349.9	1038.0	6387.9	370.3	1232.2	10477	1997
6.6	84.	16.	11.	65.	10460.2	5742.0	1069.4	6811.4	357.8	1506.4	1181.3	1998
10.1	85.	15.	11.	65.	11551.2	6392.0	1110.4	7502.4	333.6	1689.9		1999
96	84.	16.	11.	64.	12913.5	6908.6	1315.9	8224.5	3234	2015.7	1377.9	2000
6.0	82.	18.	10.	62.	14153.6	7195.1	1526.2	8721.3	336.1	2470.8	1436.2	2001
13.3	78.7	21.3	8.5	70.5								

Source- Central Bank 2004. Research Dept.

Commercial Banks funds sources

They are two types: - Internal finance sources

External finance sources

A- international finance sources (own- sources) :It includes :

B- paid capital, capital mandatory and optional reserves, transmittal profits, and other allocations such as doubtful loans, consumption allocations , and long tern bonds(Safa Hadi Sulleiman 1998) By reviewing figure(2) above we see capital has a relative increase by 10% in 2001 from 7% in 1989. This shows that banks rely on externs sources more than internal ones.

External financing sources: It includes bank deposits. Which are the most important source.

Development of Banking Savings:

Savings constitutes an essential pillar in the economic development due to its characteristics of being the national savings; furthermore, savings represent one of the most important aspect of banks functions.

Savings witnessed tremendous changes: for the period of 198-2001 for instance, the volume of savings went up from JD977 million in 1981 to JD2625 million in 1989 and JD8721 million in 2001 this is equal to a growth rate of 232%in 2001(central Bank 1989).

Banking Savings carry great importance for banks because it constitutes a major source of banks assets while enabling banks to function and perform its traditional tasks.

2- The development of banking credit facilities:

Hence savings constitutes one of banking success indicators, credit facilities constitutes the other side of banking equation. It constitutes the primary means for a bank to achieve its goals and the essential measurement that shows the extent of the development and growth of a bank during a given period. Furthermore; credit facilities are considered to be the largest and the most important part of banks profits, Thus is reflects an aspect of the current economic activity.

And the characteristics of a given period of economy status: whereas banks provide substantial credit facilities during a flourished periods such as in 1970s but not in the 1980s. Credit facilities went up from JD721 million in 1981 to 1729 million in 1989 and by the end of 2001 it reached up to JD 4948 million which is equivalent to a growth of 186% than it was in 1989.

Interest rate deregulation and its impact on Jordanian banks:

Principle and Margin price:

Interest structure, and goods and services price levels, currency exchange are determined simultaneously, according to the volume and level of the real economic activity. Interest rates are determined by supply and demand principle.

Interest rate is defined as the percentage or certain period of time –usually one year- (Uraiqat 1994). Interest rate is the monetary primary tool to achieve monetary stability. Thus, external influences must be avoided as much as possible in order to have the financial policy plays its role as required.

Interest rate plays a core role in financing from two aspects: first; Interest rate is considered to be the foundation for financial decisions such as making a purchasing decision, while the second aspect is determining the structure the capital and capital costs. Thus Interest rate represents the capital or money price or the price of consumption (MA Maydani 1999).

While interest margin is the difference between interests which the bank receives as a result of investing available money and the interest with bank pays as a result of the investment by others with the bank (Jafari,humsl,1993).

Conception of interest rate deregulation policies :

Deregulation is grant freedom for dept and credit interests rates. Its determined by market factors (supply and demands). Thus banks provide credits with fluctuated interest rate as interest rate as the orientation of market in regard to interest rate ('Muhasien, 1994).

Deregulation policy impotence is stemmed from being a tool that lead top the better use of available resources, and paying hefty interests on the diner and gives flexibility to finance authorities to deal with inflating and promote investment, (Bkeen 1994).

In the other hand deregulation may increase in credit cost and instance new investment when interest rate goes up. Some of the reasons that caused the adoption of interest rate deregulation is to hi8re and employ the excessive capital because they are not invested due to its surpluse.

Tow kinds of plicy have been adopted:

First – during deregulation the interest rate for debt and credit would be left to fluctuate according to demand and supply rule.

Second – it fix interest rate, here, central bank intervenes and fix interest rate at a fixed or certain level.

Factors affecting interest rate:

Factors affecting interest rate are categorized in to two categories or groups.

First group: factors are linked to economy elements and movements as a whole. (Macro economy) such as

a) Changes in income, and investment level.
b) Changes in money supplies.
c) Monetary policy.
d) The shape of returns curve.

e) Levels of current inflation (Reilly, Brown 2002).
f) Status of current budget.
g) Levels of economy activities.

All these factors, when it is in the positive, leave a positive effect by lowering the interest rate, and vise versa.

Second group: factors of borrowing and lending market: These include: level of credit in the market (Hammam, 2001).

2 – Credit duration – interest rate is low on shorterm loans.

C – volume of size of the loan: increase in loan amount means lower interest rate (Arabiyat 1994).

d) Competition level – degree among banks.

e) Project size and its credit rating.

f) Cost of savings, reserve, capital cost and overhead cost, characteristics of applying interest rate deregulation policy:

1 – Deregulation achieves the ideal allocation of resources available, and in favor of the most profitable ones.

2 – The establishment of banking managements that are skilled with higher competency.

3 – Adpat interest rate according to risk level.

4 – Deregulation leads to create good competitive factors in the market.

5 – deregulation leads to logic, function according to the market.

Management of interest rate in the Jordanian economy:

The development of interest rate has gone through to main phases:

Phase one: The period of the direct management of interest rate (interest rate is determined by the monetary authority this lasted until the end 1980s.

Second phase: The phase of interest rate deregulation: It started on February, 1990s a result of central Bank directive.

It has left a great positive impact on the economy; whereas it can be said that no clear impact of interest rate on economy during the previous phase.

Deregulation Impact on profitability:

There is a maximum interest rate ceiling and a minimum one thus, banks are obliged to the central bank mandates when they provide loans. The stability of interest rate close to the level of the central Bank has led to the avoidance of some risks accompanied the interest rate. Thus if affected the marginal profits Banks try to avoid this by lowering operational and other costs and charging customer higher interest rates leveled to higher marginal profits. However, the policy of interest rate deregulation has affected positively the banks marginal profits: Whereas it was reported that profits jumped from JD 40 million in 1989 to JD 122 million in 2001 which is equivalent to 60% growth than in 1989.

Interest rate deregulation impact on investment volume: It has affected positively, for instance the volume of investment in Jordan has jumped, as a result, form JD 554 million in 1989 to 1239 million dinar in 2001 or a growth rate by 123% more than it was before deregulation.

- It has left a positive impact on putting limits on the bidding against the Jordanian diner especially when it comes to its value against the American dollar.

Impact on Bank Competitions: Interest rate deregulation has left the banks to provide and excellent services and products. Whereas, competitive Jordanian banks are characterized by:

a – Transparency – the clarity of monetary policy and the reflection of its application. These can be measured by the size of transaction in the Jordanian money market: whereas in 1989 it was JD 367 million, 86 million banks share (23.4%) while in 2001 it bank share or 44.9%.

2 – Safety and product diversity.

3 – Money flows freely.

4 – financial and Banking depth – volume of liquidity, bank assets.

5 – Banking services in terms of quality and price (cost).

6 – Reputation and the rank in credit classification.

7 – location, staff competency and treatment to their clients and customers.

Result and Recommendations:

Results:

Banks establishing has stated earlier in Jordan and significantly developed with accelerated seeped. It has been under the influence of interest rate deregulation. This can be included in the study's results which can be summarized as follows:

1. There is a quantities development on the number of banks and their branches in Jordan.
2. Banks performance enhancement whereas their assets jumped from JD 3780 million in 1989 to JD 14153 million in 2001.
3. Deposits volume has witnessed a substantial increase between the years 1981-2001 or 13.3%.
4. Bank sector is fast in responding to the financial and monetary policies consequences and current economic development.
5. Credit facilities witnessed a lactated levels whereas it was low in 1980 – 1989 then it showed growth in 1993 by 23%.
6. Interest rate has developed in two stages which were explained earlier.
7. interest rate deregulation has led to the dependency on:

a – the extent of accumulative knowledge, experience and skills of decision – makers.

B – Deriving newer services and products.

8. Jordanian banks are reaping good profits whereas other productive sectors are not affected by the banks hefty profits.
9. Interest rate in Jordan still higher, in comparison with the international interest rate.

Recommendations

Based on the Study's results the following recommendations have been set forward:

1. It is essential for commercial banks to enhance its assets, liquidity and marginal profits.
2. The transformation form the concept of "traditional banks" to comprehensive banks.
3. Banking mergers have shown that it is one of the supportive procedures to achieve competitiveness among banks.
4. pay more and close attention to promotion of banking services.
5. Banking sector competitiveness has relation with other variables such as possessing new technology, competency of staff and others.

6. Increase banks contribution for investment in other productive sectors in order to reduce unemployment which was 10% in 1989 to become 14.7% in 2001.

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