The Economist

Interest-rate caps

Cut-price logic

A bad idea that is remarkably common

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THE Kenyan government has a problem. Its banks will not lend cheaply to the private sector. Tired of asking nicely, the government has taken matters into its own hands. This month it will put a cap on commercial banks' interest rates: charging borrowers more than four percentage points above the central bank's base rate, which now stands at 10.5%, will be illegal (see article (http://www.economist.com/news/finance-and-economics/21706515-curbing-lending-rates-makes-good-politics-bad-economics-ceiling-whacks)). Shares of the largest Kenyan banks plummeted by 10% in response to news of the cap.

This sort of crude meddling in the market may seem antiquated, but it is remarkably common. A review by the World Bank in 2014 found then that at least 76 countries impose a limit on interest rates. Half the countries in sub-Saharan Africa have such caps. Rich countries are also fond of them. In America, 35 states have ceilings on payday-loan rates. Lending at a rate of more than 17% in Arkansas, for example, is forbidden; any higher, and the borrower can claim back double the illegal interest paid.

The financial crisis of 2007-08 seems to have made governments more willing to intervene in this way. From Japan to El Salvador, lawmakers have either tightened their existing caps or slapped on fresh ones. British financial regulators limited interest rates on payday loans in 2015.

Policymakers usually mean well: by controlling the cost of credit, they may hope to improve access to finance. But rate caps often have precisely the opposite effect. The most expensive loans are pricey because they go to the riskiest borrowers: younger firms without collateral, poorer consumers without credit histories. If lenders cannot charge interest rates that reflect these risks, they may not lend at all.

When microfinance loans in west Africa became subject to interest-rate limits, small loans to the poorest borrowers in the most remote areas were the first to be axed. In Nicaragua an interest ceiling introduced in 2001 reduced lending growth from 30% a year to just 2%, according to a local microfinance body. After Ecuador introduced rate caps in 2007, the average size of bank microloans jumped, indicating that smaller loans had become less viable. A cap on payday-loan interest rates in Oregon, which became binding in 2007, increased the share of people reporting difficulties in getting short-term credit by 17-21 percentage points: many resorted to paying bills late instead. With fewer options to choose from, some borrowers may instead turn to loan sharks. One study suggests that illegal lending was at the time more widespread in Germany and France than in Britain because of their penchant for price caps.

Sometimes conventional lenders keep extending credit but recoup their costs in other ways. A study of car loans in America between 2011 and 2013 found that dealer-lenders jacked up the price of cars, and thus the amount of credit they were extending, in response to interest-rate limits. Borrowers ended up no better off. In Nicaragua and South Africa lenders introduced so many extra fees and commissions in response to interest-rate caps that loans became more expensive overall. An interest-rate ceiling introduced in 2005 in Poland prompted lenders there to add a convenience fee that handily fell outside the definition of administrative fees and charges, also capped at 5%. A review by the European Commission found that rate limits were unlikely to cut the level of over-indebtedness.

If the cap doesn't fit

No one doubts that price-gouging happens. Some people should not be borrowing in the first place. But rate caps target a symptom of a malfunctioning credit market, not the underlying problem. Exorbitant interest rates usually stem from weak competition or from insufficient information about borrowers and lenders. Transparency about fees, more sources of funding and credit scoring all tackle market failures much more directly than price caps. In Kenya's case, a fiscal splurge has pushed up interest rates on government debt so much that banks make healthy returns by lending to the government and have scant incentive to make the effort to lend to the private sector. Ham-fisted price manipulation might make for good headlines. But imposing rate caps is shoddy economics.

From the print edition: Leaders