Banking - interest rates

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Benefits and costs of low Japanese interest rates for the banking industry

Interest rate is one of the major factors affecting economies productivity. It also has direct effects on inflation rates and is one of the monetary policies that governments use to ensure stability of their economies. Interest rate in Japan has been low over the past decade with indication that it will remain low. This paper reports on the effects of the low interest on the Japanese banking sector through discussing advantages and disadvantages of the low rates on banks. One of the effects of the low interest rate on the Japanese banking sector is reduced productivity. Banks have been forced to operate under low revenue level and net interest margins explain this. Interests that banks charge on their customers on loans forms a significant percentage of their income, while interest that banks pay on their customers' deposits contribute to the banks' expenditure. Maximizing revenues would therefore require optimizing the gap between interest charged on loans and interest paid on deposit. The country's low interest rate however offers a restricted interest rate margin by putting an upper limit on what the banks can charge. At the same time, competition in the industry dictates minimum limits that banks can offer on deposits and the two factors means high expenditures on interest on deposits and limited revenues from interest on loans to customers. This has reduced profitability from lending and has forced some banks in Japan to seek alternative sources of revenues, apart from domestic lending (Weistroffer 2). Reports by the International Monetary Fund support the position that low interest rates have reduced profitability in the Japanese banking sector. According to the organization, the net interest margin has been declining and this has forced Japanese banks to venture into foreign markets. The low interest rate has also been associated with poor lending rates and this could be due to the banks’ change in interest from lending to other investment activities. Another cost of low interest rates, according to the International Monetary Fund, is the reduced capital accumulation potential of banks and this increase the banks’ susceptibility to loses. This means a significant level of instability that could be increasing and threaten the country’s banking sector (International Monetary Fund 9). The low interest rates also affect banks through other industries. Its effects of reduced net interest margin means that higher lending rates is a remedy for increasing revenues from lending and this may mean risky lending to other sectors of the economy. Consequences of such lending such as the recent housing bubble then affect the banking sector as value of property declines. Investors in the industries then default on their loans and the banks are not able to recover their money, even from sale of securities because of devaluation. This contributes to net capital accumulation and therefore increases the risk of instability of the banking sector. Effects of low interest rates on demand for loans also promotes borrowing that savings and is likely to increase the country’s inflation rate, a condition that affects all sectors in an economy, including the banking sector (Kliesen 1). Empirical studies on effects of low interest rates and shows that the rates benefits borrowers but disadvantage depositors. This means that customers would be motivated to take loans from banks and not to deposit with banks. Banks in such regulated economies therefore have limited investment opportunity because of limited reserves. Assumption of future stability would mean that banks might not be able to operate profitable because their major activities generate limited profit levels (Parck and Pennacchi 16- 18). The low interest rate also has benefits to the Japanese banking sector. As it suppressed the banks' revenues from lending and deposits' interest, the low rates motivated the Japanese banks to diversify into other investment activities. Government bonds are one of the areas that the banks have ventured into and offer a wider basis for profitability and sustainability in the banking sector. Diversification, for example, spreads risks and means that a collapse in a sector such as the case of the housing bubble would reduce revenues from a section of customers and may even cause loss, but the other operations will ensure stability of the banking industry. This is contrary to a case of high interest rates that would influence banks to focus on lending as a source of revenue. Expansion into foreign markets and creativity into new business models are other positive effects of the low interest rate in Japan and has promised stability of the country's banking sector (Weistroffer 5- 9). The low interest rate in Japan has led to reduced profit margin and forced banks to additional ventures in order to ensure profitability and sustainability of the banking sector. The low interest rate is also a threat to other sectors that determine stability of the banking sector. While the additional ventures may be demanding on the banks, they diversify risks in the sector and therefore promote stability. Such benefits are however not as significant as the costs and the report recommends a consideration of higher interest rates. Works cited International Monetary Fund. Japan: Basel core principles for effective banking supervision- Detailed assessment of compliance. Washingtone, DC: Andrews McMeel Publishing, 2012. Print. Kliesen, Kevin. 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