

Strategies for Advancing Financial Markets through Interest and Profitability Rates

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Abstract: This article explores strategies aimed at advancing financial markets by examining the relationship between interest rates and profitability rates. Through a comprehensive analysis of existing literature and empirical evidence, the study investigates various strategies that financial institutions can employ to enhance market efficiency and stability. Key factors such as interest rate management, profitability optimization, and risk mitigation are discussed in detail, offering insights into how financial markets can be strengthened to support economic growth and development.

Keywords: Financial markets, interest rates, profitability, market efficiency, risk management, economic development, financial institutions, market stability

Introduction

The financial market serves as the linchpin of economic growth, orchestrating the efficient allocation of capital and resources. Amidst this intricate tapestry, interest and profitability rates emerge as pivotal determinants, sculpting investment decisions, dictating economic trajectories, and sculpting market contours. This article delves into a spectrum of stratagems aimed at nurturing financial markets through the astute calibration of interest and profitability rates.

The principal function of banks in a country is the distribution and allocation of economic resources. Banks facilitate the transfer of assets from savers to borrowers, ensuring that the operations generate sufficient income to cover costs (Ongore & Kusa, 2013). Despite the recent trend of financial disintermediation and the rise of market-based finance, the crucial role of banks in modern economies remains widely acknowledged. Al-Tamimi & Hussein (2010) found that both internal and external factors can influence the performance of commercial banks. Internal factors directly impact bank performance and act as intermediaries, while external macroeconomic factors, such as interest rates (IR), exchange rates, and inflation, have an indirect impact (Dietrich & Wanzenried, 2011). [1]

The decisions made by bank boards and management are bank-specific characteristics affecting performance, while industry-wide external factors, which are beyond the control of individual banks, can influence their profitability through macroeconomic variables. Ongore & Kusa (2013) also highlighted that the ownership identity, whether a bank is foreign or locally owned, can affect its performance. [2]

Interest rate (IR) is one of the most significant factors impacting the financial performance of banks. Quah & Crowley (2010) described IR as the cost a borrower pays for using money obtained from a lender. Interest rates play a crucial role in market development and financial regulation, being a fee on borrowed money. IR is defined as the amount of interest due as a

percentage of the borrowed or deposited sum, directly affecting returns on investments in various financial instruments. Corb (2012) noted that IR is an economic tool used to control inflation and promote economic growth. Commercial bank performance is often influenced by IR fluctuations; Mang'eli (2012) argued that the financial system as a whole benefits more from steady growth in IR rather than rapid increases. Bragt, Francke, Kramer, & Pelsser (2010) pointed out that since the 2008 financial crisis and the subsequent stock market decline, the US Federal Reserve has kept IR at very low levels. Banks profit from the difference between the cost of borrowing funds and the rate at which they lend these funds to depositors. [3]

Key profitability measures include profit margin on sales, ROE, and ROA ratios. An increase in credit demand inversely correlates with IR; if consumers fail to repay their loans on time, the amount of available credit decreases (Kodongo & Ojah, 2012). Rising IR is often prompted by increased inflation, reducing the purchasing power of money. Secured loans typically have lower IR compared to unsecured loans. Additionally, wage increases can lead to higher IR (Corb, 2012). In recent times, the IR spread in Ghana has been a topic of intense public debate, as the benefits of economic improvements have not significantly lowered IR. According to Bawumia, Belnye, & Ofori (2005), Ghana's IR in the financial sector is among the highest in Africa. [4]

Literature view:

At first, the arrangement of savings, primarily from households, and the availability of investable funds, mainly from the commercial sector, create a dynamic for interest rates (Lopez et al., 2018). Savings correspond to investments, which determine interest rates in traditional economic theory. Consequently, savings and investments are always considered equivalent and are assumed to be fully utilized in an economy by traditionalists. Therefore, businesses will borrow to spend when interest rates are lower, and at higher interest rates, more savings will be accumulated until interest rates equate savings and investments. Hence, equilibrium is established when market forces adjust the demand and supply of debtor funds as interest rates vary. Saushini & Sheefeni (2019) confirmed that the number of deposits always matches investments, and total income will continually equal total expenditure when interest rates are flexible. Additionally, the loanable funds theory, as explained by Lopez et al. (2018), is an enhancement of traditional thought, considering both financial and non-financial aspects of uncertainty (Lopez et al., 2018). Contrary to traditional thinking, the loanable funds theory posits that the equilibrium interest rate connects the supply of loanable resources, which include investments, to the demand for loanable resources, which consist of reserves and government-supported commitments. [5]

Basher, Haug, & Sadorsky (2012) maintained that, in this theory, the interest rate is determined by the demand and supply for credit. This implies that the interest rate is the value that balances the demand for debtor funds and the supply of loanable resources. At equilibrium, where the demand for loanable resources equals the supply, individual banks and commercial debtors are optimally satisfied (Irungu, 2013). The loanable funds theory is broader than traditional economic thought. [6]

It considers the interest rate as a function of four indicators: reserves, assets, the desire to hold money, and the quantity of money. Romer & Romer (2000) further explained this theory, suggesting that financial intermediaries make decisions based on their expectations. This theory, known as the rational expectations hypothesis, proposes that people use all available information to make accurate predictions about the future. Irungu (2013) asserted that the theory of rational expectations suggests that the best estimate for future interest rates is the current state, and that variations in interest rates are mainly due to unforeseen events and changes in economic conditions. Similarly, Goodhart (2009) noted that if people expect interest rates to rise, some will avoid borrowing, thereby reducing bank profitability due to lower loan income. Conversely, if people anticipate falling interest rates, they will be more eager to borrow, increasing bank profitability due to higher interest income. [7]

Understanding the Significance of Interest and Profitability Rates

Interest rates embody the cost of capital, sculpted by the hands of central banks or the caprice of market forces. Their sway extends over consumer expenditure, corporate investments, and inflationary dynamics. In parallel, profitability rates delineate the yield harvested by investors on their financial endeavors, spanning equities, bonds, and an array of investment conduits.

Variable	Definition	Source
FP	Profitability measured by Return on Asset (ROA)	World Bank indicators
SAV	Savings	World Bank indicators
BC	Bank's credit	World Bank indicators
NPL	Non-performing Loan	World Bank indicators
INT	Interest rate	World Bank indicators

This study explores the interrelationship among financial profitability, bank credit, savings, non-performing loans, and interest rates within country banks across Africa from 2000 to 2016, employing panel data methodologies. Initially, the stationarity of the variables was confirmed. Subsequently, a panel co-integration analysis, based on Pedroni and Kao's methodologies, was conducted to investigate the presence of a long-term relationship among the variables, where financial profitability (FP) was considered the endogenous variable, while bank credit, savings, non-performing loans, and interest rates were treated as exogenous factors. Additionally, a panel causality test, developed by Dumitrescu & Hurlin (2012), was employed to ascertain if causal relationships existed among these factors. The study incorporates five key factors and utilizes quantitative analysis techniques, drawing data from secondary sources, specifically World Bank indicators spanning the period from 2000 to 2016. [8]

Importance of Developing Financial Markets

- 1. Capital Mobilization:** Financial markets act as conduits for capital mobilization, orchestrating the seamless flow of savings into avenues of productivity. The modulation of interest rates shapes the saving propensities, while enticing profitability rates beckon investments into the fertile ground of financial assets, nurturing the genesis of capital.
- 2. Risk Management:** Financial markets offer a panoply of investment instruments, affording investors the canvas to diversify their portfolios and navigate risk landscapes. Through the calibrated orchestration of interest and profitability rates, policymakers can shepherd risk-taking behaviors, fortifying market underpinnings and resilience.
- 3. Stimulating Economic Growth:** A vibrant financial market catalyzes economic expansion, furnishing enterprises with the vital fuel for innovation, expansion, and employment generation. Attuned interest and profitability rates stimulate investments in ventures of merit, propelling sustainable economic progress and affluence.

Strategies for Developing Financial Markets

- 1. Monetary Policy Adjustments:** Central banks wield a formidable hand in shaping financial market dynamics through the levers of monetary policy. Interest rate maneuvers choreograph economic momentum, with rate reductions kindling borrowing and expenditure, fostering

growth. Conversely, rate hikes temper inflationary fervors and speculative excesses, preserving market equilibrium.

2. Regulatory Reforms: Governments can wield the sword of regulatory reform to fortify the bastions of financial markets. Strengthened regulatory frameworks kindle investor faith, attracting torrents of capital and fostering market expansion. By championing equitable competition and vanquishing deceitful machinations, regulatory reforms fortify the sanctity and efficiency of financial markets.

3. Financial Education: The dissemination of financial literacy empowers individuals to navigate the labyrinthine realm of financial markets. A nuanced understanding of interest and profitability rates emboldens investors to craft sagacious investment decisions, galvanizing market liquidity and efficacy. Educational initiatives, workshops, and seminars furnish individuals with the armory to navigate financial landscapes, nurturing inclusivity and enlightenment.

4. Infrastructure Investment: The edifice of financial markets stands upon the bedrock of infrastructure, underpinning accessibility and efficiency. State-of-the-art trading platforms, impregnable payment gateways, and expeditious information dissemination conduits diminish transactional frictions and amplify market liquidity. Augmented infrastructure beckons a deluge of investors, kindling market vibrancy and cohesion.

5. Promotion of Innovation: The crucible of innovation births a pantheon of financial products and services, imbuing markets with dynamism and inclusivity. Pioneering solutions, ranging from fintech platforms to avant-garde investment vehicles, cater to a mosaic of investor aspirations and exigencies. By fostering innovation, policymakers expand market horizons, elevate efficacy, and nurture financial inclusivity, birthing a more resilient and vibrant financial market ecosystem.

Conclusion

The cultivation of financial markets through judicious management of interest and profitability rates mandates a multifaceted approach, intertwining monetary policy adjustments, regulatory reforms, financial enlightenment, infrastructure augmentation, and innovation advocacy. By choreographing these strategies in symphony, policymakers can sculpt an ambiance conducive to market blossoming, nurturing economic ascendancy, financial stability, and societal prosperity.

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