# Reaction Paper on Laya's "Note on the Spread Between Borrowing and Lending Rates"

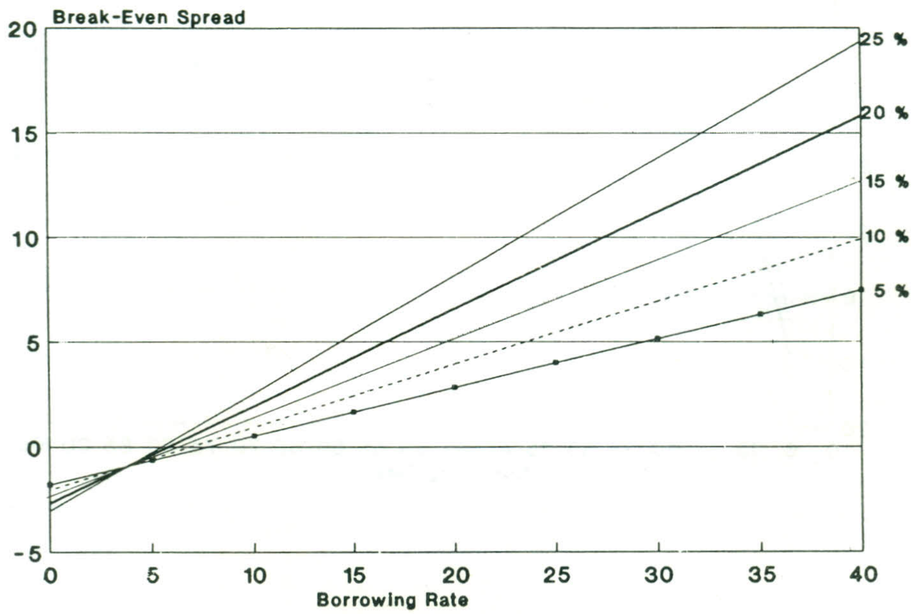
By *Gerardo Agulto, Jr.*

Dr. Laya's paper makes an important contribution in clarifying the relationship between current bank regulations and breakeven lending rates. A correct understanding of the impact of the regulatory variables on bank breakeven lending spreads seems especially important to government policy makers who are, or should be, concerned about the efficiency of financial intermediation.

Laya demonstrates that bank breakeven spreads widen as bank borrowing rates as well as the regulatory parameters increase. Among the Gross Receipts Tax, the Agri-Agra lending requirement, and the reserve requirement, Laya points to the reserve requirement as having the greatest impact on the breakeven spread.

The sensitivity of the breakeven spread to the reserve requirement is more readily seen in Chart 1 below.

**Chart 1**
**Break-Even Spreads at Alternative Reserve Requirements**

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It can be seen that the slope of the breakeven spread line increases as the reserve requirement increases. In short, the rate at which the breakeven spread widens as bank borrowing rates increase also increases as the reserve requirement is raised.

Chart 2 below gives another picture of the behavior of breakeven spreads at different borrowing rates and reserve levels. Expressing the breakeven spread as a percentage of the borrowing rate, it is seen that the breakeven spread increases continuously, though at a decreasing rate, relative to the borrowing rate. At a 25% reserve level, breakeven spread rises to over 30% of the borrowing rate when the bank borrowing rate is 15%. By contrast, the breakeven spread is only 10% of the same borrowing rate when the reserve requirement is 5%. In both Charts 1 and 2, the same assumptions as those of Laya are used, namely, GRT is at 5% and the Agri-Agra requirement is at 10%.

The implications of these are not trivial. Since interest rate increases are translated into increases in the breakeven lending rates by a compounded factor, this leads to:
a) an accentuation of the volatility of bank lending rates and, b)a rapid escalation of intermediation costs as interest rates rise.

Chart 2

B-E Spreads as a % of Borrowing Rates
At Alternative Reserve Requirements