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The Interest Rate Deregulation and Bank Lending in Nigeria

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Abstract
This study examined the interest rate deregulation and bank lending in Nigeria within the period of 1987 to 2011. The study was carried out to show the relevance of the hinges on the fact that credit and its costs (interest) perform a private role in shaping the economic future of Nigeria. The ordinary least square (OLS) techniques were utilized to estimate the parameters of the modeled independent variables/regressors on our chosen dependent variable. The hypothesis that the interest rate deregulation has a significance impact on bank lending was tested and validated with the result. Our findings gave rise to statistically significant t-statistics, which confirms the effects of the independent variables on the dependent variables. Some of the recommendations to further accelerate growth of the banking sector are more efforts to recommend that government through central bank should implement stringent fiscal and monetary policies aimed at reducing inflation. Others include that banks have been over-reacting to interest measures by increasing the rates to unprofitable levels especially during the period of deregulation.
Keywords: Interest rate, deregulation, bank lending

1. Introduction

One of the most regulated sectors in the Nigerian economy is unarguably the banking industry. The reason includes the use of intervention by authorities to short comings of the price fixing mechanism in the capitalist system to ensure what is commercially rational for an industrial bank, approximate social rationality.In the determination of interest rate it banks and their customers are free to negotiate to arrive at the suitable interest rate on both loans and advances. Despite the regulation, a number of challenges still arose. The approach to banking was the use of direct control by the central bank. The degree of compliance varied among banks. At times, withdrawal of privilege or facilities was the case with banks that failed for comply, for example most banks defaulted on ceilings imposed credit expansion and allocation on sectional basis (Ibimodo, 2005).

Interest rates are defined as the rental payment for the use of credit by borrowers and return for parting with liquidity by lenders, (Ibimodo, 2005). Like other prices, interest rates perform a rational function by allocating limited supply of credit among the many competing demands. In the (1987) budget announcement of the then president, General Ibrahim Babangida, it was observed that the pegging of interest rate contrary to expectation, commercial banks encourage savings and since investments are made out of savings, the establishment of commercial especially in rural areas makes savings possible, hence economic development is accelerated (Anyanwu 1997).

Socially, interest rate charged by banks could be regulated to encourage savings mobilization, ensure and foster adequate investment for rapid growth and development, bearing in mind the view of (Goldsmith 1969) that the financial superstructure of an economy, accelerates economic performance to the extent that it facilitate the migration of funds to the funds yield the highest social return.

Under the deregulated interest rate system, the market forces of demand and supply plays a very prominent role and investment is inconclusive (I.Adofu 2007). Central bank is trying to deregulate the interest rate aim at strangulating a lot of industries particularly the small and medium scale industries, because interest rate deregulation will lead to a very high lending rate, and the medium scale industries could not afford because of their limited capital and production base (Ani, 1988).

2. Literature Review

Interest rate is the reward for parting with liquidity, for a specified period. According to Ologu (1992) in a study of the impact of CBN monetary policy in "Aggregate investment Behavior" found that interest rate was significant in influencing investment decision, noting that this is not surprising since it is a situation of limited resident funds, as in Nigeria, the cost of capital should exert significant influences on both the frequency and volume of demand for investible funds by investors.

2.1 Interest Rate Deregulation in Nigeria

Because of the counterproductive nature of the pervasive controls, one of the aims of SAP, was financial liberalization and deregulation, and in general the reduction of complex administrative control and encouragement of greater reliance on market forces. In determine interest rates credit allocation and even the

conduct of monetary policy.

According to Iyoha (1996), said that with financial liberalization which was introduced under the auspices of SAP, the Central Bank of Nigeria (CBN) was no longer expected to set ceilings on interest rates or directly control credit under the new dispensation. It was expected that financial intermediates would be left free to administer credit and that the interest rate would be determine d by market forces of supply and demand. Thus, the ultimate objective of financial liberalization under SAP was to bring about improved financial intermediaries; enhance the role of banks in effectively mobilizing domestic savings and optimally allocating investable resources. Thus enabling them to play this historic role as an engine of economic growth.

According to Anyanwu (1994), he said the prescription was necessitated by the observed rapid increase in bank lending rates in 1989 and 1990 in spite of a fall in inflation rate and expansion in domestic liquidity in 1992. However, this increase was removed, thus leaving all interest rates still to ally deregulated. It is also important to note that in 1989, the policy of paying interest on current account deposit was introduced and made mandatory in 1990.

According the central bank statement issued in (1989) set some guidelines on the speeds of banks average cost of funds their maximum lending rates as well as minimum level of saving deposit rates. This prescription was necessitated by the rapid increase in bank lending rates.

Also, according to inside business, May (2004), the Nigeria economy, however appears that interest rate destined to climb and keep climbing the price ladder with the attendant woes of low capital utilization, poor borrowing capacity by genuine investors, declining small scale participation, high cost of production, raising cost of basic necessities and a general fall in the living standards. Worried by the high interest prevailing and the country, the federal government and banks met in April 2002 and made a joint agreement that would bring the monstrous rate clown. Based on this tripartite accord, CBN agreed to fix a minimum rediscount rate (MRR) to 20.5% in which commercial banks were not to raise their interest expect with an additional 4% administrative charge. The federal government, on its part was to create an enabling environment for the survival of the agreement through the provision of infrastructure such as uninterrupted power supply, cheaper telecommunication and security official lending rate which was pegged at 19%, while government will aid bringing down lending rate by reducing cost of placement of its funds to 5%.

Early in the SAP implementation, interest rate deregulation was accepted as a major element of financial liberationzation. Thus, early in 1987, the interest rate structure was adjusted upward as a means of improving the efficiency of the financial system in mobilizing saving and improving resources allocation. However, the principle of maintaining a minimum level of interest rate on savings and time deposits and a maximum lending rate was refunded. However, in August 1987, controls on interest rates were removed and the central bank adopted the policy of fixing only its minimum discount rate to indicate the desired direction of interest rate charges.

In terms of this study, interest rate will be defined as the return or opportunity cost of determining current consumption into the future.

The ideal of real interest rate was developed by Irvin Fisher when he tried to establish the relationship between consumption and investment. They are crucial in financial intermediation which involves transferring from surplus to deficit units in an economy.

According to Balassa (1989) as well as Arrita (1988) reviewed the literature on interest rates in developing countries as well as its effect on savings and concluded that even though most studied have indicate a positive relationship between savings and interest rates, they are inconclusive on whether saving is significantly affected as a result of data measurement and exclusion of appropriate lag structure.

The World Bank (1989) has viewed that positive interest rates and liberalization can help to promote growth. The relevant question here is do positive interest rate effect apply to growth or also to investment or to savings the world confirms a positive effect of real deposit rate on investment and growth but no significant effect on savings.

According to Rama (1990) investigated the theoretical and empirical determinant of private investment in developing countries and identified that macroeconomic and institutional factors such as financial repression, foreign exchange shortage, lack of infrastructure, economic instability as important variables that explaining private investment. Rama not that the empirical results occurrences were diminished by errors measurement of economic variables and reassert methodology.

According to Agu (1988) reviewed the determinant and structure of interest rates in Nigeria and noted the existence of very low minimal and negative effect of low interest rates on savings and investment using the usual McKinon financial repression diagram. His main conclusion was that the relationship between real interests and savings is inconclusive.

Agu's conclusion based on theoretical analysis prompted Reichel (1991) to investigate the empirical

relationship between, the real interest rate and saving in Nigeria.

According to Ayanwu J.C (1994) analysed the effect of real deposit interest rate on savings rate and investment rate for Nigeria between 1986 and 1994. The regression result confirmed the effect of real interest rates on growth but there is no significant effect for savings and investment rates. The effect is negative for both, albeit insignificant. This is however surprising when the correlation between the GDP growth rate and savings and investments is examined: 0-19 and -).25 respectively for the period 1986-1994.

2.2 Theories of Interest Rate

The theory of interest rate is very controversial. This is indicated by the diverse attempts made by economists over the last one hundred years to develop an acceptable theory of interest rate. The various theories that have been developed are difficult to classify although it is possible to trace the chronological order of the development of these theories from pre-classical to the classical through the neo-classical. (Loanable Funds). The Keynesian version and finally heading to the Hick general equilibrium approach and the monetarist view on interest rates.

2.3 The Classical Theory of Interest Rate

This theory is associated with the name of David Ricardo, Marshall, Piggon, Cassels, Walras, Tansing and Knight. According to the classical theory, rate of interest is determined by the interaction of demand and supply of capital or to be more accurate, by the intersection of the investment demand schedule and the savings schedule. It could also be stated that the interest rate is determined by the equality of savings and investment under the condition of perfect competition. The rate of interest is constructed be the balancing factor, which equates the volume of savings with the volume of investment. There is an inverse relationship between the rate of interest rises, the demand for capital declines. In the same manner, if the rate of interest falls, the demand curves for capital rises. That is why the demand curve for capital slopes downward from left to the right.

The supply of capital on the other hand, at any particular time depends on a number of factors. An important factor influencing the supply according to the classical economists is the rate of interest. The public saves more at a higher rate than at a lower rate. This is why the supply curves of capital slopes downwards.

The classical economists believed that the rate of interest must be high enough to induce the saver to forego consumption. If the public saves less, the total supply of capital will fall short of the total demand and intimately the rate of interest will have to rise high enough to compensate the saver.

2.4 The Neo-Classicals Or The Loanable Funds Theory Of Interest Rate

The neo-classical or the loan-able funds theory of interest was first pro-founded by the Swedish economist Wicksell and later developed and supported by several leading American and Swedish economists including professor Robertso, Bertil, Lindhal and Mydal (Seth 1983). However, the theory in it present form is associated with Professor Robertson. According to the theory, the rate of interest of determined by the demand and supply of loan able funds and those who borrow them the rate of interest will be such as shall bring about equilibrium between, the demand and supply of loan able funds. The loanable funds are wide in scope and include not only savings out of current income but also bank credit, dis-hoarding and dis-investment. The classical theory of interest rate refers only to saving out of investment. And current income, they do not include bank loans, wealth or disinvested assets actually; bank loans represent important funds which are available on payment of interest to the borrowers. Likewise, hoarded wealth can also become available for the purpose of investment Dis-invested wealth is another source of funds available to the borrowers since the loanable fund theory is more comprehensive, it is often referred to as real as well as monetary theory of interest. This theory is one of two general approaches that have been followed in developing the modern monetary theory of the rate of interest.

2.5 Keynes Liquidity Preference Theory of Interest

As opposed to classical theory, which might be termed as the real theory of interest, Keynes after criticizing the classical theory propounded his own, theory of interest. This Y may also be called the monetary theory of interest because according to this theory, the rate of interest can be controlled through variations in the supply of money. According to Keynes, interest is purely a monetary phenomenon because the rate of interest is calculated in terms of money. It is also a monetary phenomenon in the scene that it is determined by the demand for and the supply of money. Keynes defined interest as the reward paid for parting with liquidity for a specified time. He was further to state that money is the most liquid asset and people generally like to keep their assets in cash. Therefore, if they are asked to surrender this liquidity, they most be paid a reward.

This is paid in the form interest. The greater the desire for liquidity, the higher shall be the rate of interest demanded for parting with liquidity.

2.6 Demand Side

Like the price of an ordinary commodity, the rate of interest is determined by the supply and demand of money. According to Keynes, the rate of interest of governed by the liquidity preference of the community. The liquidity preference arises due to necessity of keeping adequate cash for meeting curtaining requirements. Keynes discussed these requirements under the headings namely:

a. The transaction motives
b. The precautionary motive
c. The speculative motive

The demand for money arising under these motives constitutes the aggregate demand for money. It should however be remembered that the demand for money in the Keynesian sense is the demand to hold money.

2.7. Can We Have A Strong Naira And A Low Interest Rate At The Same Time, When Inflation Is High And Rising

Exchange interest and inflation rates are fundamental macroeconomic variables, capable of changing the director and growth pattern of a country's economic development and stability. Several factors determine the value of any country's currency. These includes speculation, trade and current account balances, the relative price level, the productivity growth of the economy both at home and abroad; the growth in spending decision; the export base of the economy, the relative cost of credit (interest rate) in the country and foreign decisions.

To appreciate the need to fight inflation, it is imperative to understand the implications of frequency price increases in the Nigerian system. Some of these implications include:

1. Discouragement of long term planning
2. Reduction of savings and capital accumulation
3. Reduction of investment
4. Creating uncertainty and distortions in the economy
5. Increase in the cost of financing bank loans and advances.

This because of the inverse relationship between inflation and real interest rates; a high and rising inflation rate has bee show to have reduce the domestic real rate of interest and currency value.

2.8 Nigeria: Inflation and the State of the Economy

Recently, a good and encouraging record trick led from national Bureau of Statistics that inflation rate receded to 9.4% in July, the lowest so far in three years. This is a significant improvement from persistent inflation that was surging upward that compelled the central bank of Nigeria (CBN) to aggressively tighten monetary policy. As of June, the inflation rate stood at 10.2% and this made the Sanusi's CBN to raise the interest rate to 8.75%. There is no doubt that the monetary policy of restraining and mopping up liquidity at the monetary base aided to slow down the raising inflation.

Financial writer (This day), Obinna Chima observed that "The CBN had always expressed disdain for double. Digits inflation rate in the country this has been the apex bank's monetary policy committee (MPC), adjusting various monetary policy instruments to achieve that ambition. The MPC which has operational independence in setting of interest rates in the country had increased the benchmark interest rate – the monetary policy rate (MPR) four times since the beginning of 2011. the benchmark interest was raised from 6.5% in January to 7.5% in March, 8% in May and to 8.7% at the July meeting other monetary policy tools such as cash reserve requirements (CRR) has also been reviewed upward.

The increasing of interest rate of dry up the market excessive liquidity in order to achieve the desired goal of restraining inflation may have a reverse effect at some point. As the interest rate increases, it will dampen economic growth by making the availability of credits and loans to tighten. The scenario may once again usher in credit crunch and the financial flow of liquidity in the capital market. This is not the result that CBN is trying to achieve, that is why a comprehensive outlook is needed to continuously wrestle down inflationary trends.

When the interest rate was raised to 8.75% at the end of CBN's monetary policy committee (MPC) session, it issued a statement that "the committee observed that the inflation outlook appears uncertain owning to the expected implementation of the new national minimum wage policy and the imminent deregulation of petroleum prices. Significant inject of liquidity from FAAC in the third quarter coupled with the impact of AMCON recapitalizing intervened bank to the tune of N1.6 trillion will both add the inflationary pressures", consequent on increased in interest rate which will definitely affect bank lending in the commercial banks. That is supposedly the case but is not the whole story; the excessive government spending and borrowing played a role to state of inflation.

Budget deficits operated by Nigerian federal government has its attendant woes. These deficits are financed through debt which is sourced more domestically through commercial banks by issuing securities. This reduced

availability of loans for private investors and individuals and consequently lead to credit crunch in the banking sector, the result is high interest rate which stands between 19% to 20%.

But there are also coming attractions to the economy according to (Samir Godioo), an emerging market strategist at standard bank group ltd that makes outlook on inflation "uncertain":. Those coming attractions include the doubling of the monthly minimum wage to 18,000 naira ($116) and to deregulate fuel prices, central bank governor Lamido Sanusi Said. Core inflation, which excludes food, will probably accelerate in the second halt of the year. "These activities have the propensity to increase inflation.

3. Model Specification

Since our objective in this research study is to undertake an empirical investigation of interest rate deregulation and its effect on bank lending in Nigeria, we therefore specify the model thus;

Theoretical function specification:

BLE = F (MS, INTR, MRR, TBD, INFL)

Where

BLE = Bank Lending

MS = Money Supply

MRR = Marginal Rediscount Rate

TBD = Total Bank Deposit

INFL = Inflation rate

GDP = ɣ 1+ ɣ 2 BLE + ɣ 3 MS + ɣ 4 INTR + ɣ 5 MRR + ɣ 6 TBD +ɣ 7 INFLR + μ

μ = Stochastic term:

(ɣ 1>0, ɣ 2>0, ɣ 3<0, ɣ 4<0, ɣ 5<0, ɣ 6<0, ɣ 7<0)

The variables included as explanatory variables in the model are meant to capture bank lending generally and individually. However, emphasis will be on interest rate deregulation as it affects bank lending in Nigeria. Money supply on a priority is expected to have a possible affect on bank lending since it's believed that increase in money supply would enhance the credit creating ability of commercial banks thus increasing the amount of loans and advance to non banking public.

Similarly, total bank deposit, (TBD) which incidentally is a combination of demand deposit, time deposit and savings deposit is envisaged to impact positively on bank lending.

3.1 Presentation of Regression Result

The use of the ordinary least square (OLS) method in estimating the parameters of the model specified in the previous chapter produced the following result extracted from appendix 1.

TIME SERIES REGRESSION MODEL EQUATION:

BLE = F (MS, INT, MRR, TBD, INFL)

Where:

BLE = Banks Lending

MS = Money Supply

INT = Interest Rate

MRR = Marginal rediscount Rate

TBD = Total Bank Deposit

INFL = Inflation Rate

The dependent variable is Banks lending while the independent variables are, money supply interest rate, marginal rediscount rate, inflation rate, total bank deposit.

In the study, the following results were obtained from the regression analysis using ordinary least square estimation (see table 1).

3.2 Interpretation of Results

The model: BLA= α_0 + α_1 LR + $_{2\alpha}$ CRR + α3TBD + α4 GDP + ei

The equation:

$$BLA = -348067.2 + 17306.1LR + 27961.91CRR - 3.30TBD + 0.27GDP + ei$$

(-0.88) (1.01) (0.91) (-5.81) (25.32)

R^2 = 0.97

$\acute{R}^2$ = 0.96

F-stat = 191.91

Dw-stat = 2.31

NB: The t- ratios are in parenthesis under the coefficient of each variable.

An overview of the ordinary least square (OLS) regression above indicates that the dependent variable Banking Lending and Advances (BLA) has varying degree of relationship with the explanatory variables Lending Rate (LR) Cash Reserve Ratio (CRR) , Total Bank Deposit (TBD) and Gross Domestic Product (GDP) while, it is positively related with LR, CRR and GDP, it is negatively related to TBD: The result shows that about 97% of the total systematic variation in the dependent variable (BLA) have been explained by all the explanatory variables taken together this is indicated by the coefficient of determination (R^2) of 0.97 and after adjusting for the degree of freedom the model could still explain about 96% of the total systematic variation in BLA as shown by the adjusted coefficient of determination (Ŕ2) of 0.96. This means that only about 4% of the total systematic variation in BLA was not capture by the model, but captured by the stochastic error term.

On the basis of the overall statistical significant of the model as indicated by the F-statistics, it was observed that the overall model was statistically significant since the calculated F-value of 191.91 is very high and significant at 1% level of significant. This means that there is a significant linear relationship between the dependent variable (BLA) and all the explanatory variables.

Based on the individual statistical significance as indicated by the t-ratios of the explanatory variables. Only TBD and GDP are statistically significant at 1% level with calculated t-ratios of -5.81 and 25.32 while LR and CRR with calculated t-ratios of 1.01 and 0.91 are not statistically significant at either 1%, 5% or 10% level. This means that only TBD and GDP have significant impact on BLA during the period under consideration.

The relationship between the dependent variable and the explanatory variables is indicated by the coefficient of each of the explanatory variable. A unit increase in LR will increase BLA by 17306.1, while a unit increase in CRR will increase BLA by 27961.9. However a unit increase in TBD will decrease BLA BY 3.3; while GDP is significantly and positively related to BLA as a unit increase in GPD will increase BLA by 0.27.
The Durbin Watson (DW) statistics of 2.3 can be approximated to 2 is an indication of the absence of auto correction.

3.3 Policy Implementation

Based on the above regression results explanatory, the explanatory independent variables namely, ending rate, Cash Reserve ratio, Total Bank Deposit and Gross Domestic Product have different degree of relationship on the dependent variables Bank Lending and Advances (BLA), hence its implications.

1. Lending Rate (LR) has positive relationship with BLA such that a unit increase in lending rate will result (LR) will result in 17306.1 unit changes in BLA in the same direction.
2. Cash Reserve Ratio (CRR) has a positive relationship with BLA such that a unit increase in CRR will result in 27961.91 unit change in BLA in the same direction.
3. Gross Domestic Product (GDP) also has a positive relationship with BLA such that a unit increase in GDP will result in 0.273271 unit change in BLA.
4. Total Bank Deposit (TBD) ahs a negative relationship with BLA such that a unit change in TBD will result in 3.302101 unit change in BLA in the opposite direction.

Because of the individual significant test results, a close look will show that interest rate which is a monetary tool, is used by monetary authorities has a great tendency of impacting on the general welfare to the economy. Other variables namely money supply, marginal rediscount rate, Bank Lending, Total Bank deposits and inflation rate are closely linked with interest rate.

It is therefore imperative for the monetary policy authorities to set optimum interest rate which will stimulate greater savings that can be channeled to loans for investments purposes. Low interest rate could lead to inflation and consequently low purchasing power in the value of money.

Likewise, high interest rate could lead to idle funds and consequently capital resources under utilization which will affect the general economic condition.

What needs to be done is to set an optimum interest rate and other rates should be allowed to find their levels. Other determinants like minimum rediscount rate and money supply are tools used for inter-bank transaction from the central bank to the commercial banks and money supply is used to boost demand when there is shortage of money in circulation.

To this end, interest rate should be deregulated, banks should determine their rates, and this will bring out competitiveness, efficiency and effective use of resources. Central bank on its own should serve as watchdog monitoring the activities of commercial banks to ensure price stability, capital utilization and attainment of full employment which will boost the gross domestic product.

4. Summary of Findings

A summary of the findings show that:

1. Lending rate (LR) has a positive relationship with Bank lending and Advances (BLA) such that a unit

change in lending rate (LR) will result in 17306.1 units change in BLA In the same direction.

2. Cash Reserve Ratio (CRR) has a positive relationship with BLA such that a unit change in CRR will result in 27961.91 unit change in BLA in the same direction.
3. Total Bank Deposit (TBD) has a negative relationship with BLA such that a unit change in TBD will result in 3.302101 unit change in BLA in the opposite direction.
4. LR and CRR are not statistically significant at 1%, 5%, and 10% level with a calculated t-ratio of 1.01 and 0.91.

Instability in prices i.e. inflation ratio or rate has been undermining deposit which has resulted only real assets rather than financial assets. Other financial institutions like merchant banks pay higher deposit rates, which necessitates commercial banks to shift from retail to wholesale. Banking lending rate have generally remained below market clearing level, government policy regarding open market operations including its stabilization securities have had serious consequences an commercial banks ability to extend more loans and advances to investors.

5. Recommendations

Having looked at the problems that have besieged banks before and after deregulation, coupled with the findings from estimation, the following recommendations become necessary in ensuring the growth of the banking sector.

1. Since the level of inflation had been undermining the ability of banks to use their deposit rate to attract financial resources, it is therefore recommended that governments through central bank should implement stringent fiscal and monetary policies aimed at reducing inflation. This will increase the real value of money and hence, a greater response for the public to interest rate changes.
2. Banks have been over-reacting to interest measures by increasing the rates to unprofitable levels especially during the period of deregulation. Thus Banks have to pursue policy that would relief them from ruinous competition, by summing at maintaining the rates between certain limits as prescribed by central bank. This is quite necessary as banks cannot predict future events that would affect them.

6. Conclusion

In conclusion, this study showed that commercial banks deposits and profits been responsive in one way or the other to interest rate policy.

Attempts have been made in course of the study to explain the phenomena, the implications of the response of deposits and loans and advances to interest rate policies is that interest rates should be facture to encourage financial savings without discouraging loans and advances for investment purposes. Therefore, interest rate policy as well as other factors such as, economic stability, investment opportunities and the economic environment should be as curtained to enable financial resources to be channeled to productive investment.

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TABLE 1

REPORTING OF RESULT

Dependent Variation: VLA
Method: Least Squares
Date: 07/18/12 Time: 15:46
Sample: 1981 2009
Included observation: 29

Variable	**Coefficient**	**Std. Erro**	**t-Statistic**	**Prob.**
C	-348067.2	396072.1	-0.878797	0.3882
LR	17306.1	17132.96	1.010106	0.3225
CRR	27961.91	30663.02	0.91191	0.3709
TBD	-3.302101	0.56869	-5.8065	0
GDP	0.273271	0.010794	25.31809	0
R-squared	0.969683	Mean dependent var		1132941
Adjusted R-squared	0.964631	S.D. dependent var		2255720
S.E. of regression	424227.4	Akaike info criterion		28.90951
Sum squared resid	4.32E+12	Schwarz criterion		29.14525
Log likelihood	-414.1879	Hannan-Quinn criter		28.98334
F-statistic	191.9116	Durbin-Watson stat		2.308228
Prob (F-statistic)	0			