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Interest Rate Liberalisation in Nigeria: Implications and Prospects

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Abstract

The objective of the paper is to review the empirical and the theoretical literature on the challenges and implications of Interest rate liberalisation policy in Nigeria. The results of the review show that, in Nigeria, the outcome of the policy has been positive on the economy. However, in some cases, the policy has led to other challenges in some sectors of the economy. This paper therefore, points out that, careful considerations should be given to the implementation process as it may have unexpected impacts on other non-financial sectors of the economy. Thus, policy makers should consider putting in place, proper sequencing of the liberalisation policies to thwart any possible negative effects that may occur, as a result of the implementation of interest rate liberalisation.

Keywords

Nigeria; Interest rate; Liberalisation

Introduction

The theory of interest rate liberalisation as was first put together by McKinnon et al., [1] and Shaw et al., [2]. The theory holds, as its ultimate aim or objective, the full liberalisation of interest rates of the domestic financial markets. It postulates that, it is only the liberalisation of interest rates that will accelerate real economic growth. Whereas the critics are of the view that, liberalisation of the interest rates will lead to stagnation as well as inflation and therefore the strategy for accelerated growth should be through increased capacity utilisation. However, the speed at which interest rate liberalisation should occur, the way it should be integrated into macroeconomic stabilisation programmes and the prerequisites for its success are still under debate.

The opponents of the theory further argue that, household choices of investments do not include only financial assets and time deposits but also loans to business through the informal sector and gold or foreign currencies, and that in response to increase in interest rates on deposits, household will substitute bank deposits for gold, cash, foreign currencies and loans in the informal sector in developing countries. In addition, they are of the view that the outcome of the theory depends crucially on one implicit assumption on asset market structure, an assumption that is never stated by the proponents of the theory: Thus, the portfolio shift into bank deposits are coming from "*unproductive*" assets like gold, cash or inventories. Furthermore, they stated that, it is not at all obvious that bank deposits are closer substitutes to cash or gold than loans extended to the informal sector. They argue that liberalisation of interest rates is thus, financial crisis and stagflation (Owusu and Odhiambo) [3].

Policy prospects and implications in Nigeria

Interest rate liberalisation policy was implemented in Nigeria under the Structural Adjustment programme (SAP) in 1986. The outcomes have had positive on the account that, it has significantly reduced the black market for foreign exchange (foreign currencies can now be exchange through the forex bureaux and foreign currency account can be opened in the domestic banking system), it has increased foreign capital flow, it had improved the reserve position of the country, it has stabilised and propelled increased financial savings and it has prevented and reversed the falling financial deepening and resource mobilisation. However, according to Obamuyi et al., [4], the impact of the interest rate liberalisation policy to real GDP growth in Nigeria could only be marginal.

Nevertheless, on the whole, the interest rate liberalisation policy has brought with it a number of interrelated challenges which would have to be addressed by policy makers. These challenges include the large interest rate spread or margins, Real interest rates have worsened since the implementation of the policy. (Owusu and Odhiambo) [3,4] increase in the amount of foreign currency deposits in the country, constant depreciation of the domestic currency, increase in imports, and reduction of credits to the productive sectors of the economy (Owusu and Odhiambo) [3]. The share of private sector credits in the total credits has reduced significantly after the implementation of the policy. This paper is of the view that, in addition to lack of competition, other factors such as lack of information on loan terms available at other banks, unwillingness of the banks to reduce lending rates, See Obamuyi et al., [4] cultural ignorance and high operational costs could explain this. To solve these problems the paper recommends that: (i) the authorities must "*guide*" the interest rates by setting the margin; (ii) strictly enforce the law on the display of deposit and lending rates in the banking halls or failing that made to publish their rates in the newspapers; and (iii) the central bank in conjunction with the banks mount a public educational campaign on banking issues as well as microfinance and other forms of formal financial sectors. The extent to which the government should intervene in the financial market to "*guide*" credit is still under discussion. The discussion centres on whether government should only concentrate on creating "*the rule of the game*" and capacity building, while the market is allowed to freely determine sectoral allocation of credit, or whether it should go beyond that to partially intervene in the allocation of credits. It should, however, be noted that setting the margin is not the same as setting the ceiling. Here the authorities must allow the market to determine the rates, and then guide it by setting the margin. Another challenge of the interest rate liberalisation policy, which the government or policy makers should address urgently, is the issue of high lending rates which have discouraged investment in the productive sectors like, small and medium enterprises (SMEs) which are the engine of the economy in developing countries.

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The case of Nigeria, however, supports the interest rate liberalisation hypothesis as theorised by McKinnon and Shaw [1,2] and various empirical evidence. An empirical analysis using econometrical method, autoregressive distributed lag or the bounds testing approach was conducted by Owusu et al., [5], Owusu and Odhiambo [6,7] to support this. This is because financial savings have increased post the implementation of the policy. Also, financial deepening as measured by the ratio of money and quasi money (M2) to gross domestic product (GDP) and which was 32.0% before the financial liberalisation policy stands at an average of 38.4%. In additions, economic growth has been steady at an average of 4.8% after the financial liberalisation compared to 0.3% pre the policy. Furthermore, investments which stood at 13.7% at the beginning of the policy, stands at an average of 33.8% of GDP post policy and savings which were about 17.0% before the policy have not changed since the policy (Owusu and Odhiambo) [3].

The interest rate liberalisation policy in Nigeria has brought to light some of the weaknesses of the financial liberalisation theory. The results in Nigeria, suggest that, the theory overlooks the issue of foreign currency deposit in the domestic banks and the monetary policies associated with such deposits. It pre-supposes a closed economy, which limits its applicability in open economies. However, by recognising these drawbacks does not make the theory less important, but rather it tells us that, policy makers should attempt to solve the problems in various ways by taking into consideration peculiarity of each country. Alongside interest rate liberalisation, particular attention should be given to institutional development of each country. Under normal circumstances, a country like Nigeria with a high degree of openness (41.4% pre and 55.4% post the implementation of the policy) As measured by the ratio of export and import to GDP and successful interest rate liberalisation is envisaged to effect a shift of resources from foreign currency deposits to domestic currency deposits and from the component of the leakage to the formal financial sector because of increase in the deposits rates but instead one sees a strong condition for the phenomenon of foreign currency deposits or what is termed "*Dollarisation*" in the literature. Foreign currency deposits stood at about 1.0% of total deposits or financial savings in 1989. This increased to 12.2% in 2008.

Moreover, if authorities and the people of Nigeria are discouraged from saving in their domestic currency because of fast depreciation in the value or inadequate savings rate and lack of confidence in the banking system as a whole, then there is always the fear that Nigerians will change to holding their savings in foreign currency which is unfortunately the only reasonable option in Nigeria and most other developing countries due to the underdeveloped nature of the domestic financial market. This will increase the pressure on the exchange rates and lead to capital flight (if the domestic situation is perceived to be unstable). This could be averted through the stabilisation of the exchange rate and the development of capital markets to introduce alternative financial products such as stocks, corporate bonds, treasury bills and government securities. These financial products will provide good alternatives or substitutes to the holding of foreign currencies and allow Nigerians to diversify their investments and mitigates the risk of holding assets expressed in the domestic currency in times of unstable economic situations.

Conclusion

The empirical literature review suggests that country studies and time-series analysis provide mixed results on the relationship between interest rate liberalisation and economic growth than cross-sectional analysis. Also, those studies employing the cross-sectional analysis do generally produce results that are in favour of the hypothesis that states that, interest rate liberalisation leads to economic growth. For Nigeria, the results of the interest rate liberalisation policies so far are positive. The policy implication arising from the review of the literature is that, for greater impact of interest rate liberalisation, proper sequencing of the implementation procedure must be agreed at the onset.

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