ISSUES ON THE LEVEL OF INTEREST RATES IN NIGERIA

Professor Chukwuma C. Soludo

Governor

Central Bank of Nigeria

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Outline

- Stylized Facts
- Is the Level of Interest Rates in Nigeria High?
- From Regime of Controlled Interest Rates to a Liberalized Regime
- Interest Rate Dynamics in Nigeria Under a Liberalized Regime
- Elements of Banks' Cost of Funds
- What can be Done?
- The Road Ahead

Stylized Facts

What constitutes "High" or "Low" Interest Rate?

- Interest rates are regarded as "high" or "low" relative to some economic fundamental, namely:
  - The level of inflation rate;
  - The degree of uncertainty and risks economic agents face; and
  - How developed and deep financial markets are;
  - The structure of the banking system—how competitive it is;
  - The cost of funds to the banks including deposit rates;

Stylized Facts

- The demand for credit by government when it runs deficit and whether it competes with the private sector.

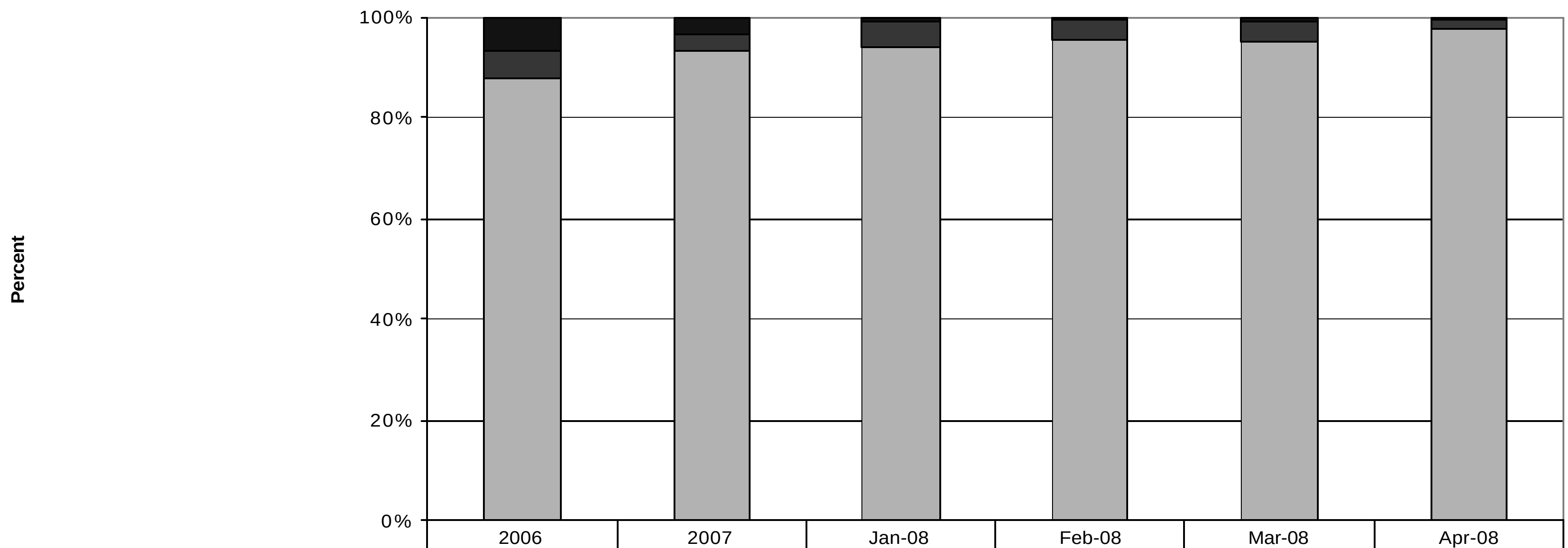
- There are conflicting and competing views about what constitutes an appropriate interest rate depending on whose perspective—savers or lenders/borrowers.

Stylized Facts

- Generally, interest rates are prices and must be right and attractive to:
  - Reward depositors and encourage long-term savings as well as reward lenders;
  - Long-term savings can only occur when inflation is tamed;
  - Currently over 90 percent of deposits mobilized by banks are short-term (0-365 days), hence they are constrained to lend short (see next slide).

Stylized Facts

Figure 1: Maturity Structure of DMBs Deposits

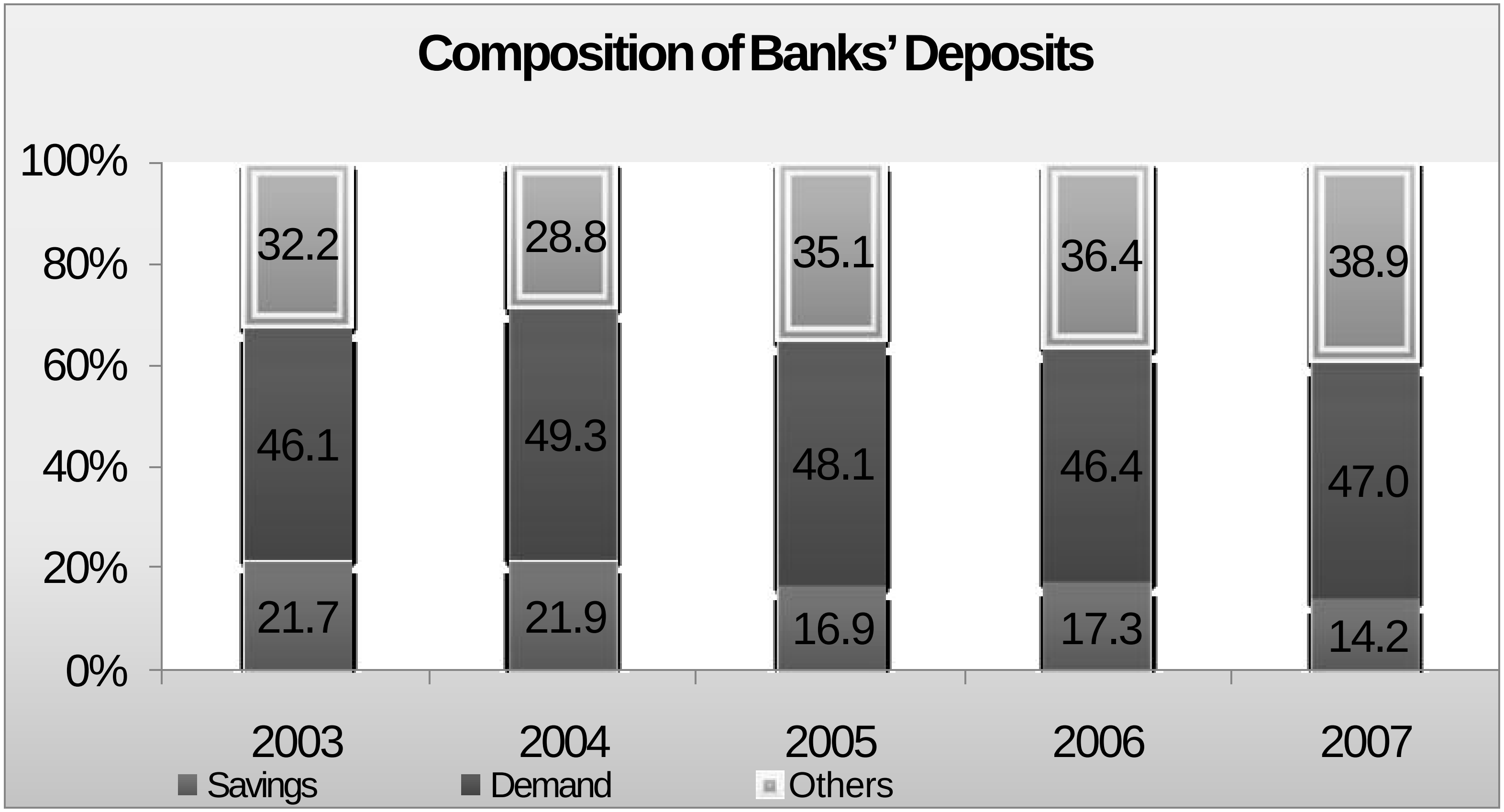


	2006	2007	Jan-08	Feb-08	Mar-08	Apr-08
Long-term (3 yrs and above)	6.5	3.3	0.5	0.4	0.7	0.3
Medium-term (Above 1yr and below 3yrs)	5.4	3.3	5.6	4.2	4	2.2
Short-term (0-365 days)	88.11	93.34	93.88	95.37	95.27	97.47

Month/Year

Short-term (0-365 days) | Medium-term (Above 1yr and below 3yrs) | Long-term (3 yrs and above)

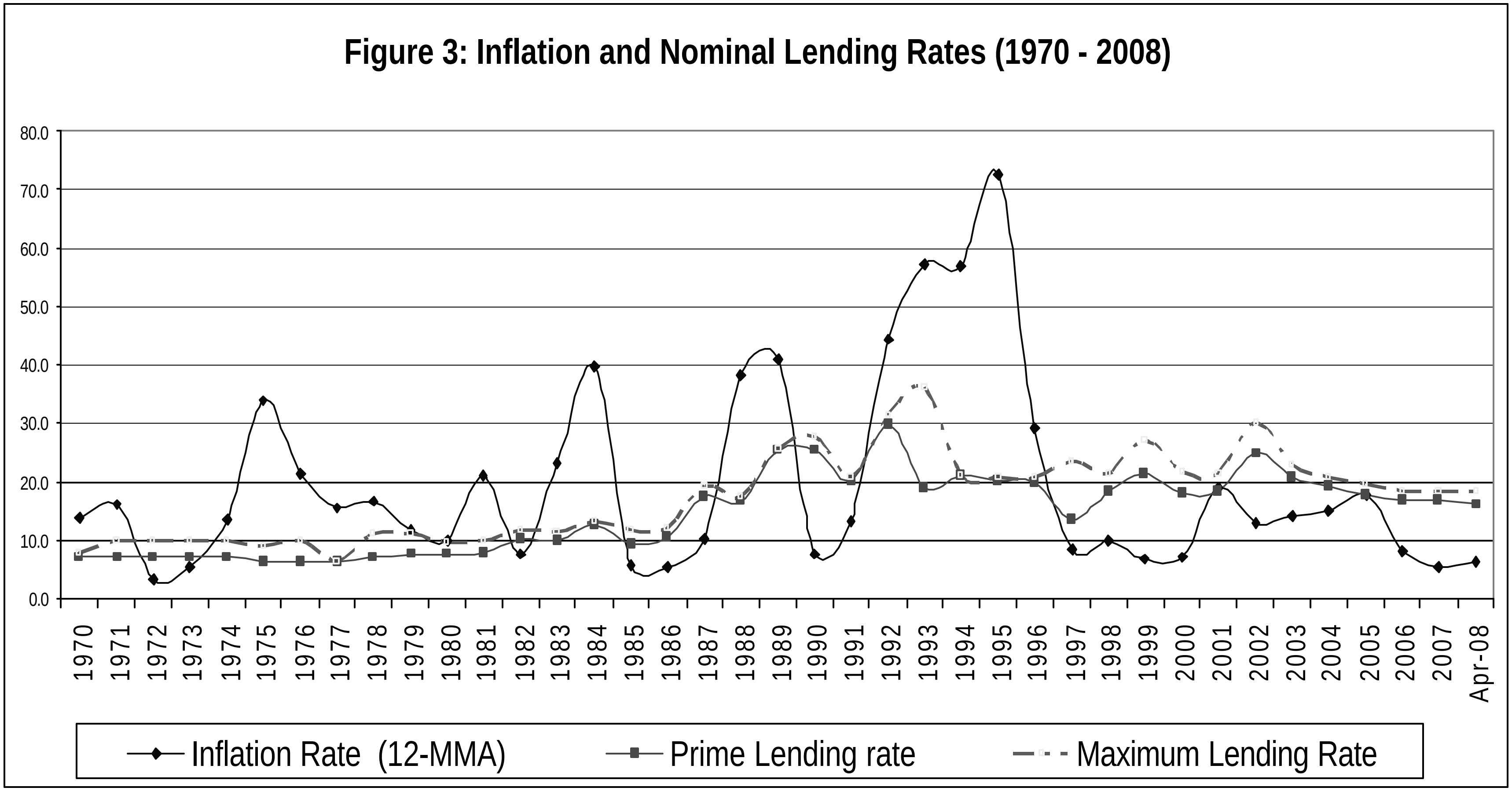
Stylized Facts



Stylized Facts

Table 1: Maturity structure of Deposits in India			
Period	Short term	Medium term	Long term
2000	28.9	38.2	32.9
2001	31.1	37.2	31.6
2002	34.8	36.5	28.7
2003	35.2	40.9	23.9
2004	38.1	34.1	27.8
2005	39.4	34.1	26.5
2006	39.5	36.0	24.5

Is the Level of Interest Rates in Nigeria "High"?



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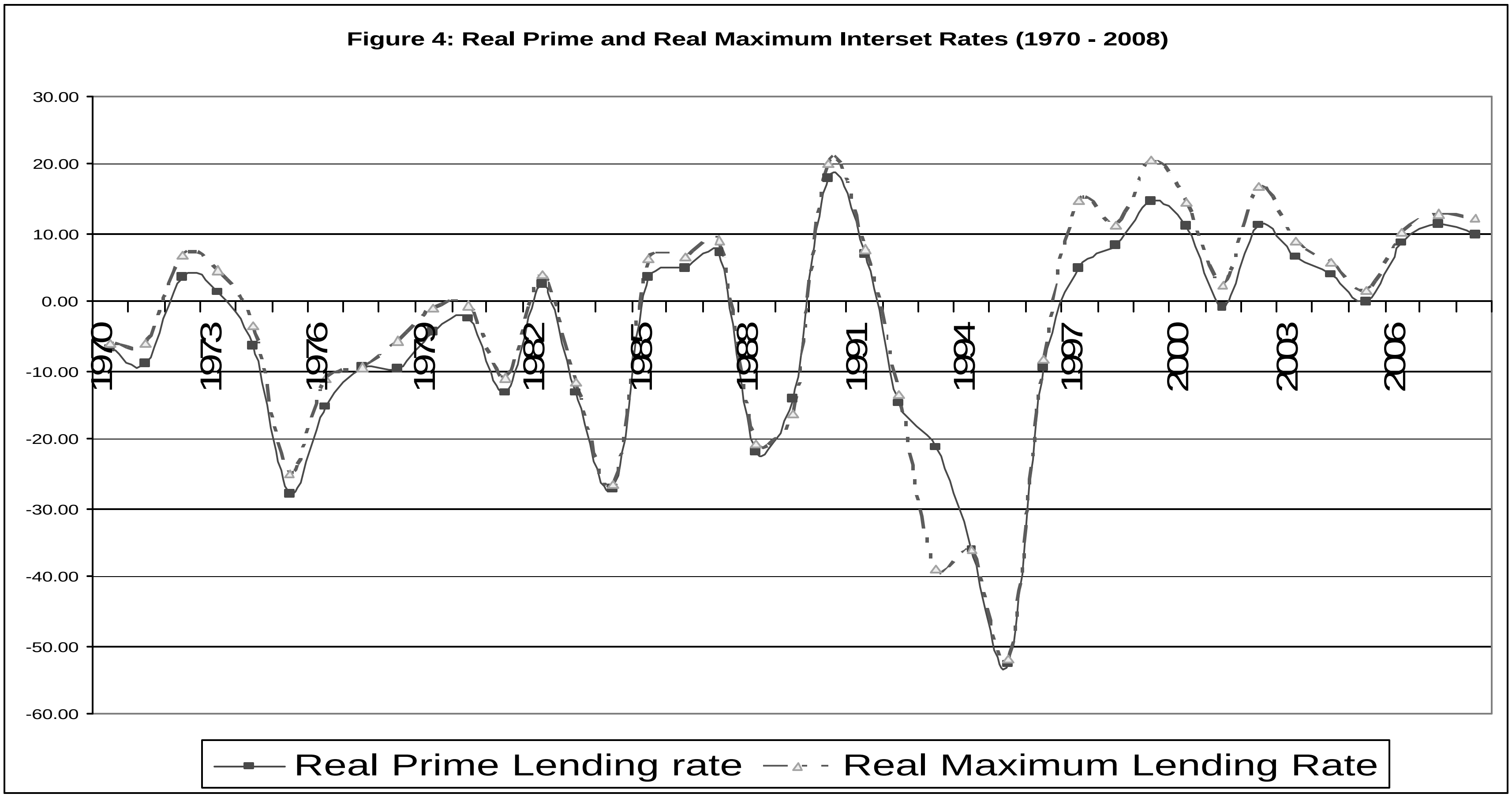

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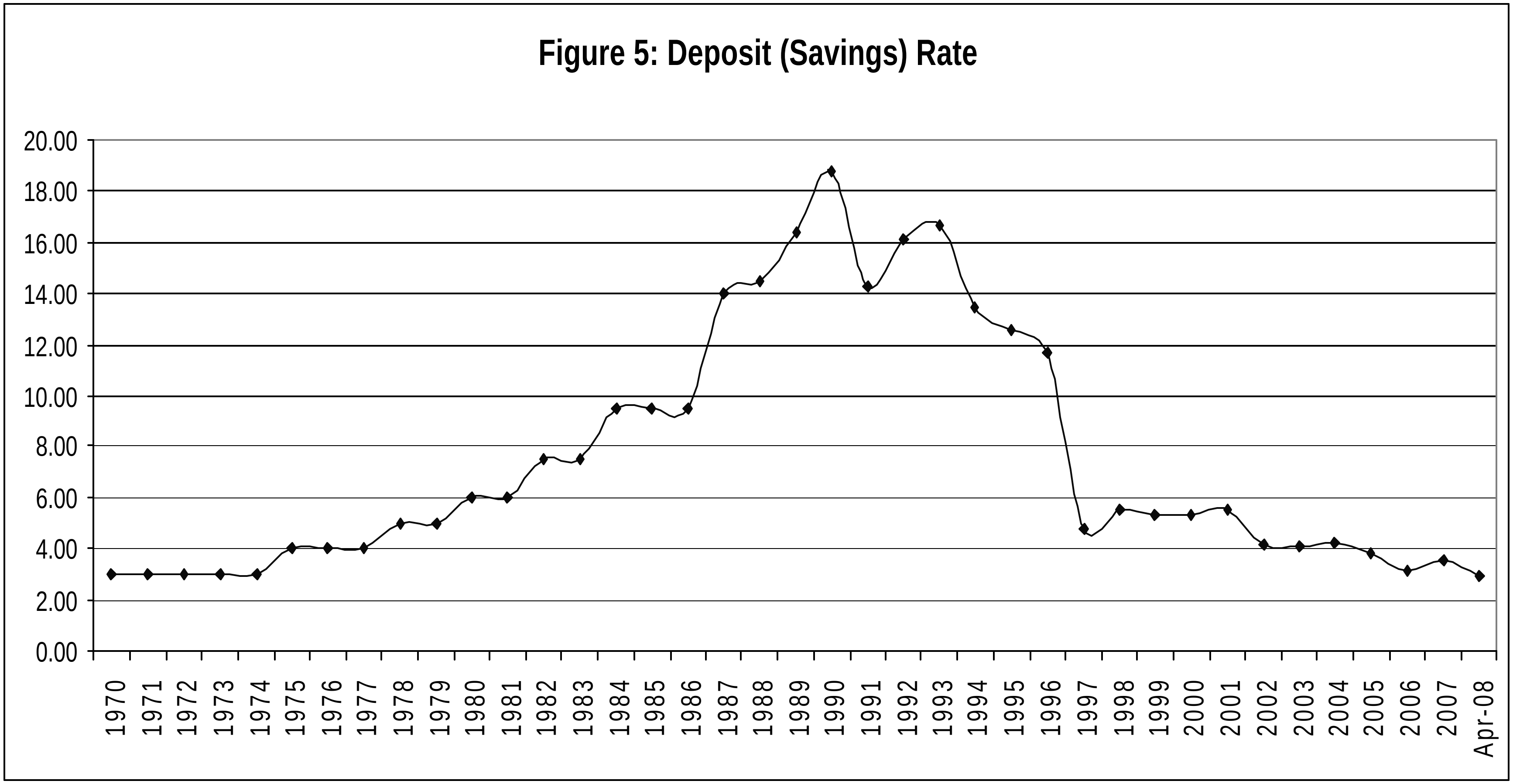

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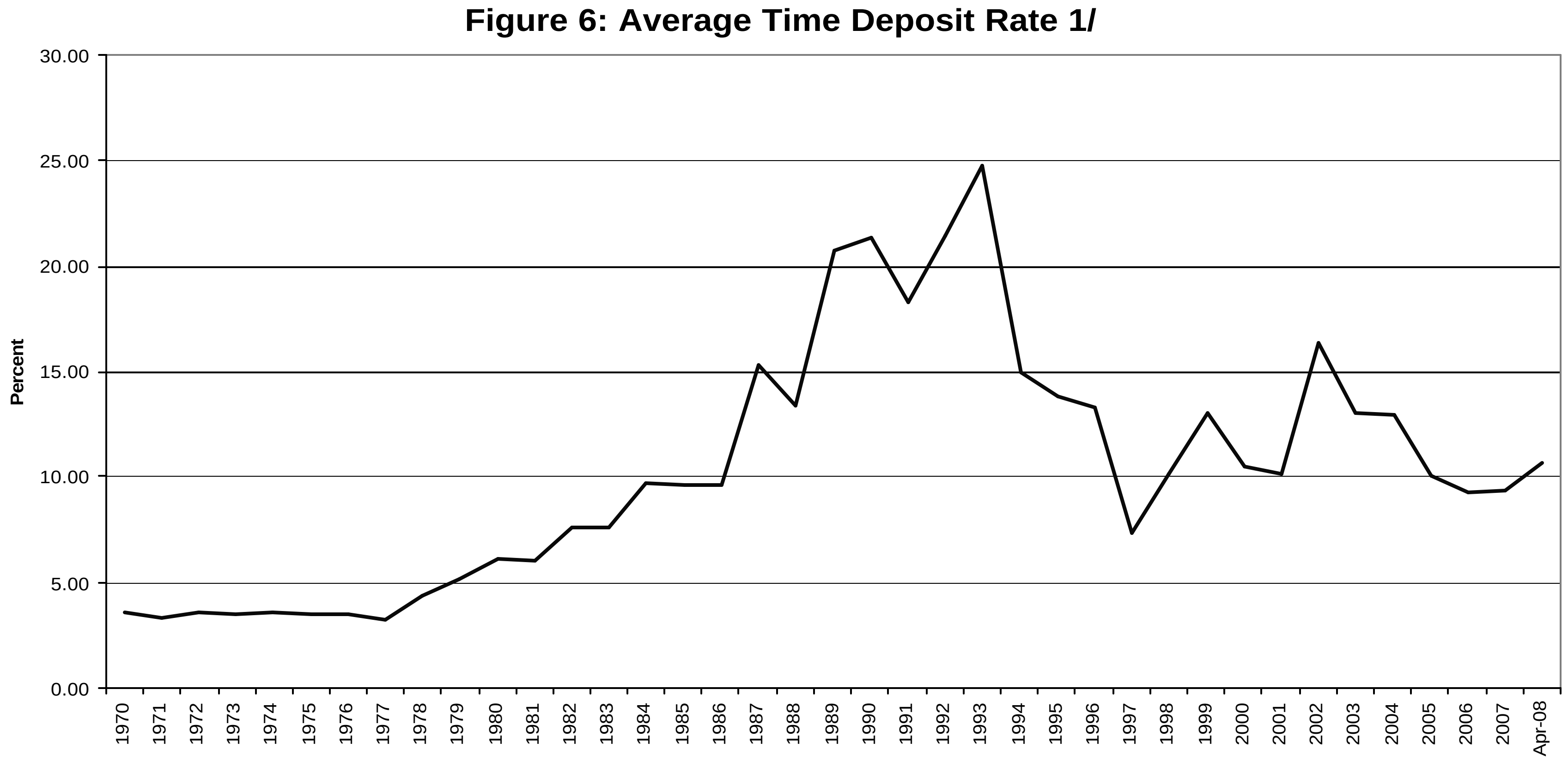
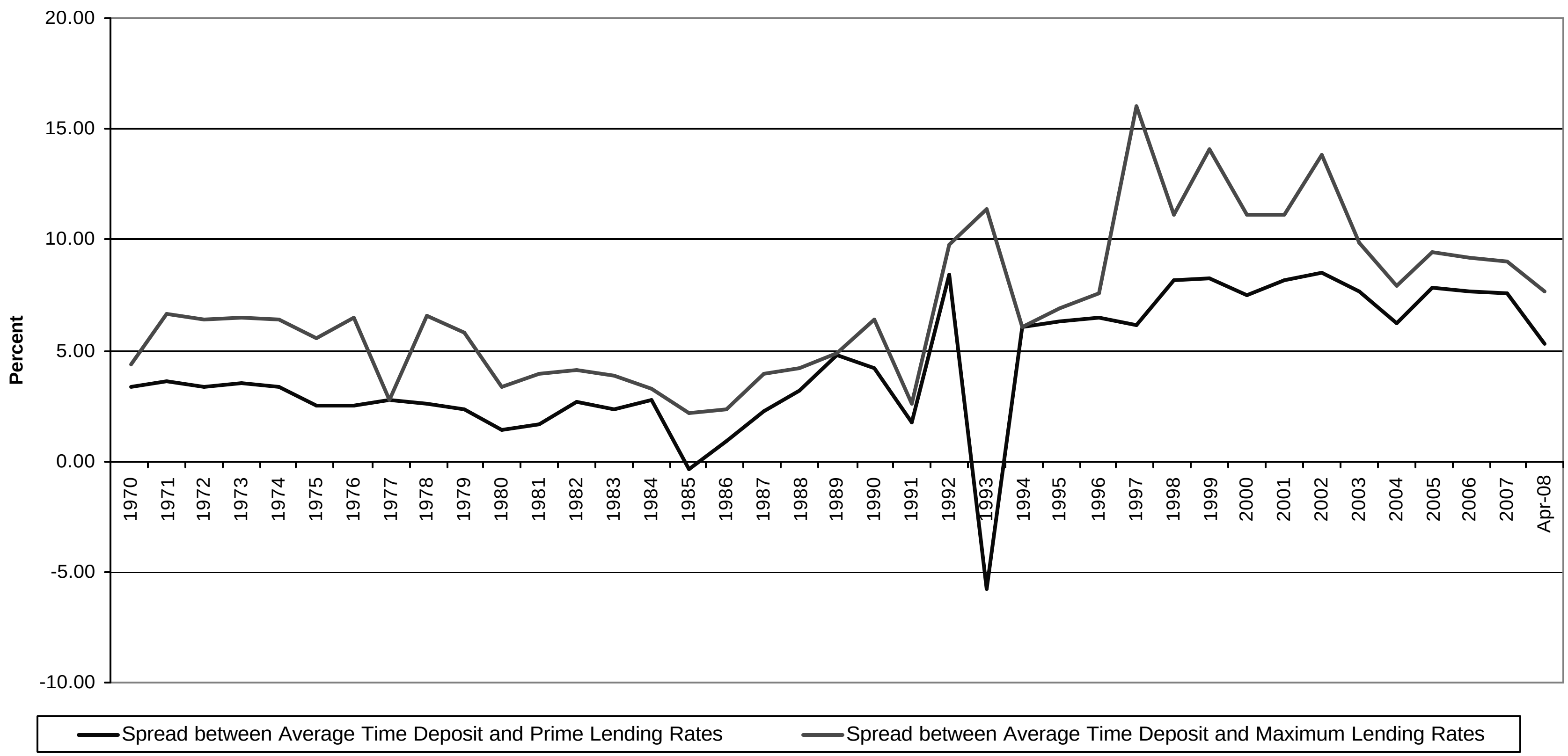


1/ 3 Months Deposits and Above.

Is the Level of Interest Rates in Nigeria "High"?

Figure 7: Interest Rates Spread Between Average Time Deposit and Lending Rates



Is the Level of Interest Rates in Nigeria "High"?

- For Depositors?
  - Deposit rates are generally low, except for the period between 1986-1989 immediately following liberalization and 1990-1995 period of banking sector distress.
- For Lenders/Borrowers?
  - Relative to the periods 1986-1998, lending rates in the last three years have been low largely because inflation has declined on a sustained basis.
  - This is the first time since 1995 that lending rates have recorded such a feat.

Table 2: Comparative Average Lending Rates in Nigeria and Selected Countries

	Algeria			Botswana			Egypt		
	Average Lending Rate	Inflation Rate	Real Lending Rate	Average Prime Lending Rate	Inflation Rate	Real Lending Rate	Average Lending Rate	Inflation Rate	Real Lending Rate
2000	10.00	0.34	9.66	15.48	8.60	6.88	13.22	2.68	10.53
2001	9.50	4.23	5.27	15.75	6.56	9.19	13.29	2.27	11.02
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	8.03	8.18	13.79	2.74	11.05
2003	8.13	2.58	5.54	16.40	9.19	7.21	13.53	4.51	9.03
2004	8.00	3.56	4.44	15.75	6.95	8.80	13.38	11.27	2.10
2005	8.00	1.64	6.36	15.74	8.61	7.13	13.14	4.87	8.27
2006	8.00	2.53	5.47	16.46	11.56	4.90	12.60	7.64	4.96
2007	8.00	3.51	4.49	16.22	7.08	9.13	12.51	9.32	3.19
2008	8.00	4.84	3.16	16.00	8.71	7.29	12.10	11.28	0.82

	Mauritius			South Africa			Uganda		
	Average Prime Lending Rate	Inflation Rate	Real Lending Rate	Average Lending Rate	Inflation Rate	Real Lending Rate	Average Lending Rate	Inflation Rate	Real Lending Rate
2000	20.77	4.20	16.57	14.50	5.34	9.16	22.92	2.83	20.09
2001	21.10	5.39	15.72	13.77	5.70	8.07	22.66	2.00	20.65
2002	21.00	6.47	14.53	15.75	9.16	6.59	19.10	-0.32	19.42
2003	21.00	3.88	17.12	14.96	5.86	9.10	18.94	7.84	11.10
2004	21.00	4.77	16.23	11.29	1.39	9.91	20.60	3.31	17.29
2005	21.04	4.91	16.14	10.63	3.40	7.23	19.65	8.15	11.49
2006	21.08	8.91	12.18	11.17	4.64	6.52	18.70	6.61	12.09
2007	21.87	9.34	12.53	13.17	7.10	6.07	19.11	6.24	12.87
2008	22.56	7.41	15.14	14.50	16.00	-1.50	19.44	8.25	11.19

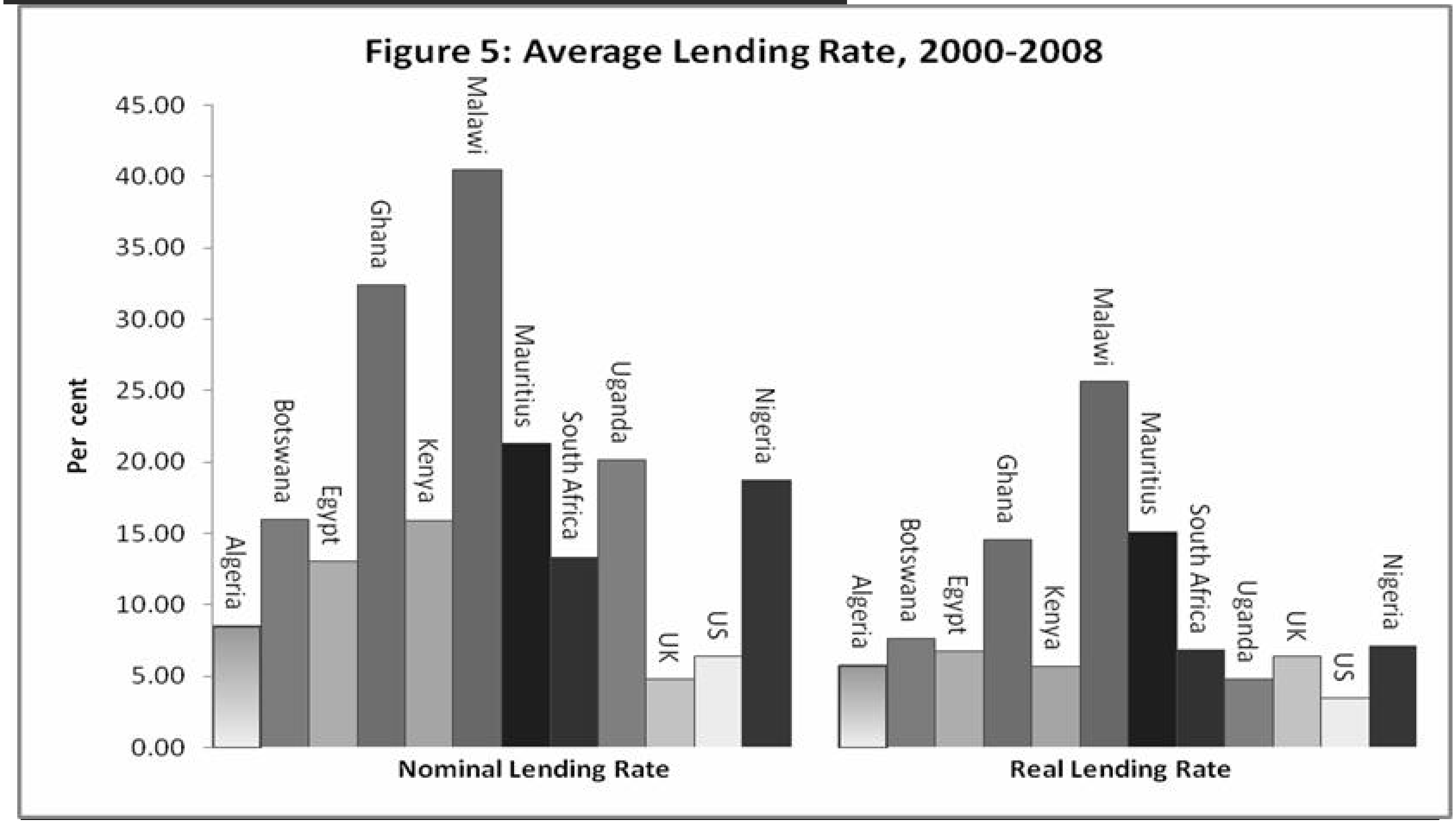
Sources: IMF (IFS), Central Bank of Nigeria and Bank of Ghana Statistical Bulletin. Algeria, Malawi, Mauritius, South Africa, and UK are as at March 2008; Botswana, Egypt, Ghana, Kenya, and Uganda are as at February 2008; and Nigeria and US are as at April 2008.

Table 2 (contd.)

	Ghana			Kenya			Malawi		
	Average Lending Rate	Inflation Rate	Real Lending Rate	Average Lending Rate	Inflation Rate	Real Lending Rate	Average Maximum Lending Rate	Inflation Rate	Real Lending Rate
2000	47.00	25.19	21.81	22.34	9.98	12.36	53.13	29.58	23.54
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	13.93	56.17	22.70	33.47
2002	38.50	14.82	23.68	18.45	1.96	16.49	50.54	14.74	35.80
2003	35.25	26.67	8.58	16.57	9.82	6.76	48.92	9.58	39.34
2004	28.75	12.62	16.13	12.53	11.62	0.91	36.83	11.43	25.40
2005	26.00	15.12	10.88	12.88	10.31	2.57	33.08	15.41	17.67
2006	24.25	10.91	13.34	13.64	14.45	-0.82	32.25	13.97	18.28
2007	24.17	10.70	13.47	13.34	9.76	3.58	27.72	7.95	19.76
2008	24.17	11.50	12.67	13.81	18.68	-4.87	25.36	7.96	17.40

	United Kingdom			United States			Nigeria		
	Average Lending Rate	Inflation Rate	Real Lending Rate	Average Prime Loan Rate	Inflation Rate	Real Prime Loan Rate	Average Prime Lending Rate	Inflation Rate	Real Lending Rate
2000	5.98	2.93	3.05	9.23	3.38	5.86	17.98	6.90	11.08
2001	5.08	1.82	3.26	6.92	2.83	4.10	18.29	18.90	-0.61
2002	4.00	1.63	2.37	4.68	1.59	3.09	24.85	12.90	11.95
2003	3.69	2.91	0.77	4.12	2.27	1.85	20.71	14.00	6.71
2004	4.40	2.96	1.43	4.34	2.68	1.66	19.18	15.00	4.18
2005	4.65	2.83	1.82	6.19	3.39	2.80	17.95	17.80	0.15
2006	4.65	3.19	1.45	7.96	3.23	4.73	16.89	8.20	8.69
2007	5.52	4.27	1.25	8.05	2.85	5.20	16.94	5.40	11.54
2008	5.38	3.97	1.41	5.97	4.06	1.91	15.97	6.10	9.87

Is the Level of Interest Rates in Nigeria “High”?



Summary Message

- In the last two years we have witnessed a sustained decline in nominal/real lending rates
- Relative to some selected countries, Nigeria's real and nominal lending rates are not outliers.
- The wide gap between lending and deposit rates in Nigeria is dominantly explained by: the depth of financial markets, level of inflation, risks and uncertainty.

From Regime of Controlled Interest Rates to a Liberalized Regime

- Prior to 1986, interest rates were fixed administratively by the CBN
  - It was intended to obtain socially optimum resource allocation
  - To promote orderly growth in the financial market
  - To facilitate flow of credit to the preferred sectors-agriculture, manufacturing, etc.
- Nominal interest rates lowest during this period, but the price paid was high inflation.
- Real interest rates were generally negative as a result of the repressed regime; consequence is financial disintermediation—leading to low savings, low investment and low growth.

From Regime of Controlled Interest Rates to a Liberalized Regime

- **Effects**
  - Failed to achieve the desired policy objective of enhancing investment and growth in the real sector
  - Resulting low interest rates were unable to keep pace with inflation
  - Negative real interest rates discouraged savings
  - Perpetuated inefficient pricing and misallocation of resources
  - It discouraged competition—neither the real nor the financial sector grew.

From Regime of Controlled Interest Rates to a Liberalized Regime

- Following liberalization of interest rates in 1986 with the adoption of SAP, the level of interest rates has been market-determined.
- Interest rates have risen relative to repressed regime era.
- Inflation rate moderated significantly (lowest) since then, particularly during 1998-2006, except for the aberration between 1993-1998, the period of "guided deregulation".

From Regime of Controlled Interest Rates to a Liberalized Regime

- Real interest rate generally positive since liberalization.

Interest Rates Dynamics in Nigeria Under a Liberalized Regime

- In a liberalized environment, a choice must be made with regard to the main objective and instrument of monetary policy.
- Under a liberalized regime, where market forces are at play, low inflation constitutes the *key objective* while interest rates become the main *policy instrument* leaving prices to adjust to ensure price stability.

Interest Rates Dynamics in Nigeria Under a Liberalized Regime

- Hardly any two customers are charged the same lending rate.
- It depends on a number of factors:
  - Customer's risk assessment
  - Information available to customer
- Prime customers tend to attract lower lending rate relative to non-prime borrowers.

Interest Rates Dynamics in Nigeria Under a Liberalized Regime

- What drives interest rates? Essentially, interest rate level is affected by movement in price level or inflation rate, fiscal policy stance, and intermediation cost (cost of funds), how deep and developed financial markets are, level of risks and uncertainty, among other factors.
- **Inflation Expectation (or Expected Movement in General Price Level):**
  - If inflation is expected to increase, the nominal interest rates need to adjust to induce positive real interest rates, which will not render savers worse-off.

Interest Rates Dynamics in Nigeria Under a Liberalized Regime

- In other words, lenders/savers will want to be compensated for inflation (for loss of purchasing power) and will push the nominal interest rate up to get the desired real rate of interest.

- **Fiscal policy stance:**
  - Because of peculiar source of government revenue, increase in benchmark oil price crowds-out the private sector

Interest Rates Dynamics in Nigeria Under a Liberalized Regime

- Sterilization actions of the central bank to neutralize the effects of the injection by fiscal authorities puts upward pressure on interest rates.
- This is worsened by current regime where higher benchmark oil price are used and at the same time run fiscal deficit.
- If banks acquire this riskless asset at such high rate of interest, it pushes interest rates up and risky private sector lending takes place at a much higher premium.

Interest Rates Dynamics in Nigeria Under a Liberalized Regime

- The higher the government spends, the lower the amount available to the private sector to spend.
- The variable to adjust to keep inflation under control becomes the interest rate.

Interest Rates Dynamics in Nigeria Under a Liberalized Regime

- **Intermediation Cost:**
  - Financial institutions incur cost in extending their services. Interest rates will tend to be high when intermediation cost is high. Intermediation costs include administrative costs and cash reserve and liquidity ratio requirements.

Table 3: Cash Reserve Requirement (CRR) and Liquidity Ratios (LR)

Year	Cash Researve Requirement (CRR) %	Liquidity Ratio ((L/R) %
1995	6%	30%
1996	8%	30%
1997	8%	30%
1998	8%	30%
1999	12%	40%
2000	10%	35%
2001	10% and 11% from Feb and 12.5% from March	35% and 40% from March 2001
2002	12.5% and 9.5% for real sector Banks	40%
2003	12.5% and 9.5% for real sector Banks	40%
2004	9.50%	40%
2005	11% and 5% from October 05	40%
2006	5% and 3% from November 06	40%
2007	3%	40%
2008	3% and 4% from June 08	40%

Interest Rates Dynamics in Nigeria Under a Liberalized Regime

- **Structural factors**, encompassing the following:
  - High cost of doing business—cost of power, communication and other infrastructural facilities, provision of security, high tax burden, etc;
  - Structure of the banking industry—oligopolistic structure where few banks control a significant share of the industry.
- **Judicial process:**
  - Ease of resolving commercial disputes and front-loading of future possible costs/losses through higher interest rates

Interest Rates Dynamics in Nigeria Under a Liberalized Regime

☐ Low Level (Volume) of Long-term Savings:

- Net savings in Nigeria has averaged less than 10% of GDP as against over 18% in many emerging countries such as Indonesia, Malaysia and South Africa.
- The domestic interest rates, in conjunction with the rate of return on foreign financial assets, and the expected change in exchange rate determine the allocation of accumulated savings among domestic financial assets, foreign assets and goods that are hedged against inflation.

Interest Rates Dynamics in Nigeria Under a Liberalized Regime

- Boosting the levels of long-term savings is core to achieving the desired level of interest rates as well as sustaining high investment and output growth.
- The predominance of short-term deposits (over 80%--see slide 6).
- Ability to encourage long-term savings depends on success in sustaining low inflation.

Interest Rates Dynamics in Nigeria Under a Liberalized Regime

- Other factors that could influence changes in interest rates include:
  - Maturity period of the financial instrument and perception of risks associated with the instrument. Those with longer-term maturity and with higher probability of incurring loss carry higher interest rates.
  - Large holdings of non-performing assets (NPAs) in banks' portfolio makes them more cautious in their lending. This will tend to induce an increase in interest rates charged as such costs are passed on to new borrowers.

Interest Rates Dynamics in Nigeria Under a Liberalized Regime

- Inability of specialized institutions, such as development finance institutions (DFIs), to play the specific roles for which they were set-up—due maily to low budgetary appropriations to capitalize these institutions appropriately.

Elements of Banks' Cost of Funds

- ☐ Interest Rates
- ☐ Financial charges
- ☐ Overhead and Operational Costs

Elements of Banks' Cost of Funds

Table 4: Effective Cost of Funds to Banks (Percent) 1/

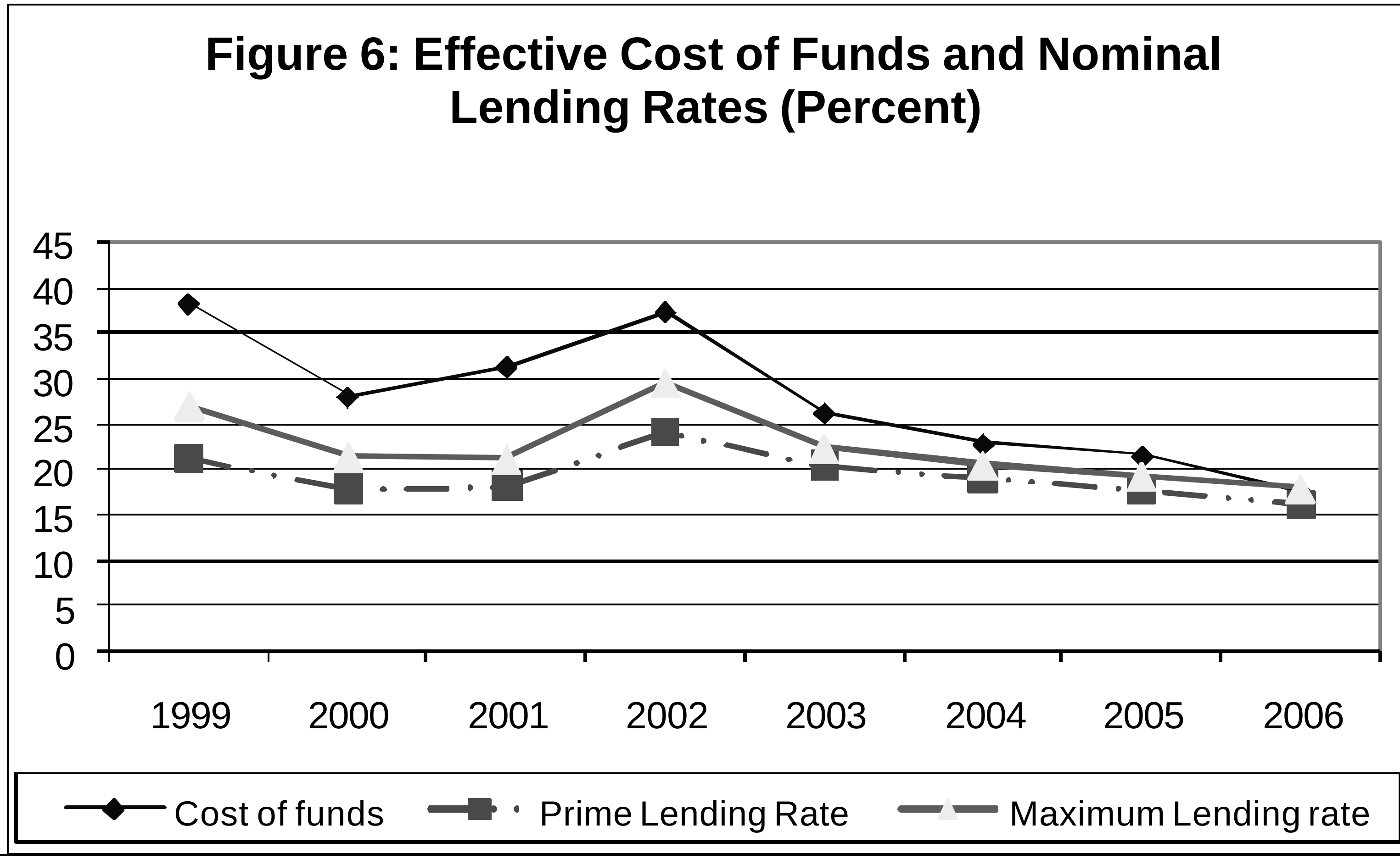
1999	2000	2001	2002	2003	2004	2005	2006 2/
38.3	28.1	31.4	37.4	26.3	22.9	21.6	17.6

Source: Banking Supervision Department, CBN.

1/ Effective cost of funds include: interest expense, overhead costs, insurance premium and adjustment for cash reserve requirements (CRR).

2/ March 2006.

Elements of Banks' Cost of Funds



Elements of Banks' Cost of Funds

- The effective cost of funds plus the cost of doing business (infrastructure, security, etc.) can significantly impact on interest rate.
- So the lower they are the lower interest rates are likely to be.

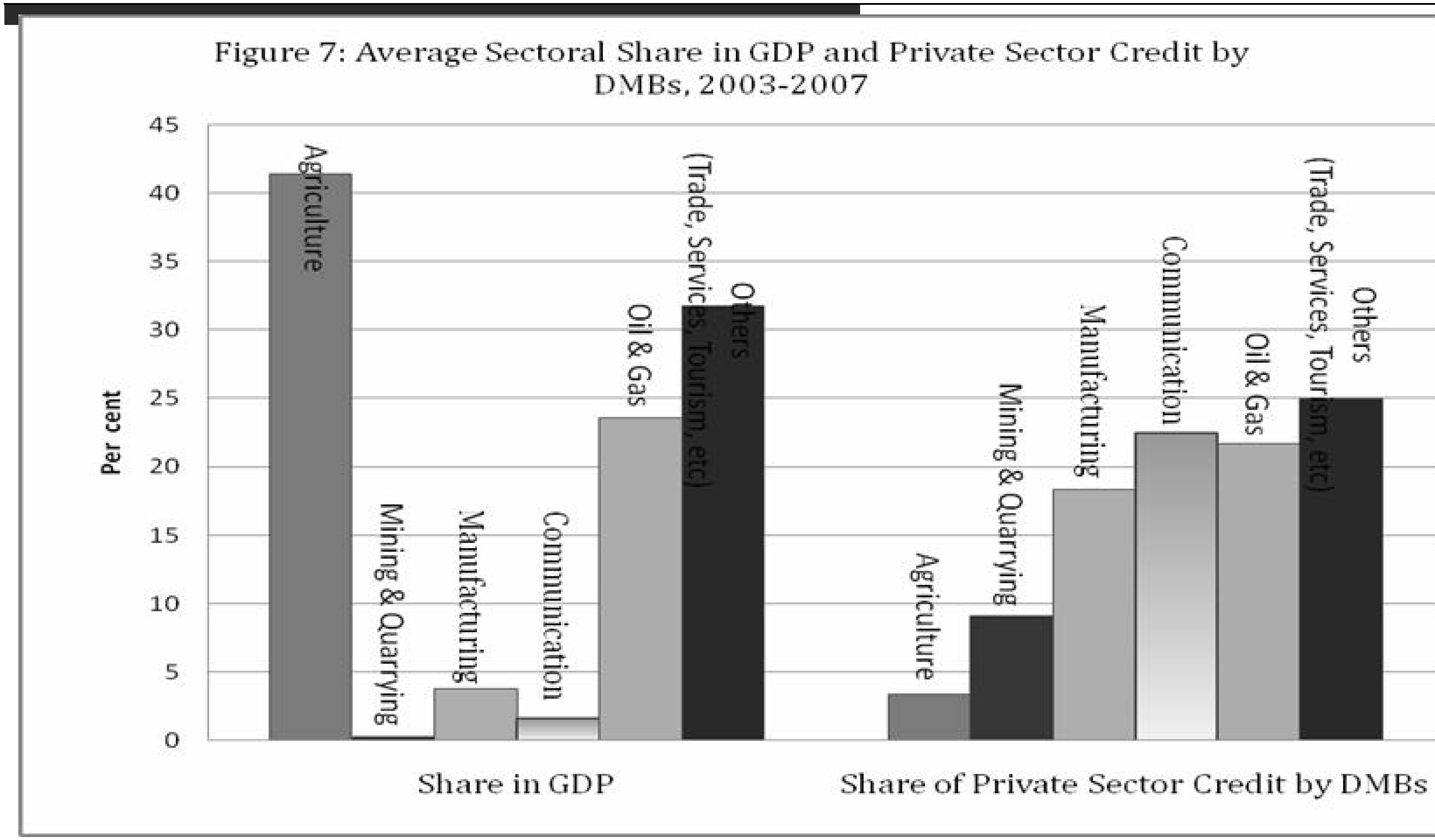
What Can Be Done?

- Sustain the current economic reform and maintain sound fiscal and monetary policy so that as inflation trends to single digit on a sustained basis, interest rates will inevitably come down to single digit as has happened everywhere else in the world, including.
- Government budget should be maintained at the same or lower benchmark oil price so as to put less pressure on interest rates, while the CBN mops up the liquidity injection by government.

What Can Be Done?

- Alternatively, the oil receipts should be monetized through the DMBs to avoid excess liquidity injections.
- In the medium term, government needs to address the high cost of infrastructure, especially power and security to banks (currently banks spend heavily on these two items and pass on the cost to borrowers).
- In the short-run, government should make special sectoral interventions—subsidy to selected sectors. From Figure 7, Agriculture deserves special attention.

What Can Be Done?



What Can Be Done?

- Manufacturing sector receives more than its proportionate share of bank credit. Its major problem is not lack of access to credit.

The Road Ahead

- Meanwhile, government needs to device a better way of administering subsidies to agriculture and manufacturing .
- In the short-term, governments/National Assembly should use the budget to increase the capitalization of the DFIs—Bank of Industry (BOI), Nigerian Agricultural, Credit and Rural Development Bank (NACRDB), Federal Mortgage Bank of Nigeria (FMBN), and Nigeria Export-Import Bank (NEXIM).
- The National Assembly should enact relevant legislations to deepen the financial markets.

The Road Ahead

- All states/FGN Judiciary to mainstream Commercial Courts.
- The N50 billion Micro Credit Fund—for micro entrepreneurs as replacement for SMEEIS
- CBN continue with promotion of Entrepreneurship Development Centres.
- CBN will continue with the interest subsidy on agriculture.
- CBN experimenting with “Inflation Targeting Framework.
- The Bank will undertake a careful review of the liquidity ratio.

The Road Ahead

- A careful review of the NDIC premium will also be undertaken.
- The CBN will work with Bankers' Committee to rationalize the non-interest charges/commission and enforce greater transparency in their administration.
- The Bank will continue with the ongoing efforts at deepening the financial markets, especially the secondary market trading of bonds.
- National Assembly/FGN to curtail fiscal expansion as this leads to higher interest rates.
- All governments to continue to improve the enabling environment for competitive industrialization—infrastructure, regulatory regimes, industrial parks, etc.

Thank You for Listening