

Adverse Effects Of High Interest Rate Spreads On The Nigerian Economy

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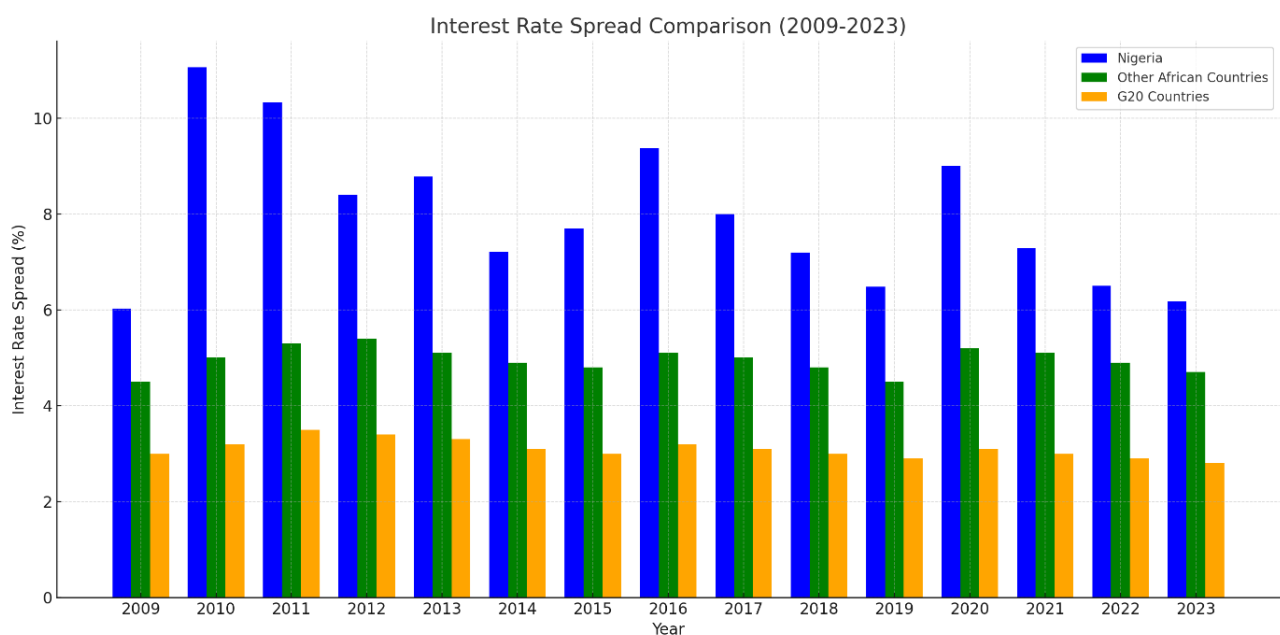
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Introduction

The interest rate spread is the difference between the interest rates charged on loans and the interest rates paid on deposits. This has been an area of concern since the Nigerian banking liberalisation regime. The unusually wide spreads in comparison to regional and global banking institutions, suggests there are intrinsic and systemic inefficiencies within the Nigerian banking system and distortions in the economy at large. Stringent monetary policies and a tight regulatory regime also impact rate spread and invariably impact the economy.

In the past years 2023-2025 interest rate spreads for Nigerian banks have on average increased and reached a record high from 6% to 19%.

High-interest rate spreads in Nigerian banks have significant implications for the country's economy and various key economic indicators. High spreads often indicate structural inefficiencies, higher risks, or restrictive monetary conditions which can hinder economic performance. Low spreads reflect a well-functioning, competitive financial system that promotes growth and stability. In this article, we seek to explore the causes, impacts, potential remedies, and strategies for reducing the interest rate spreads.



Here is a bar chart comparing the interest rate spreads of Nigerian banks with those of other African banks (averaging South Africa and Kenya) and G20 countries over the past 15 years. The chart highlights Nigeria's consistently higher spreads, reflecting structural and operational factors unique to its financial system.

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Causes of High-Interest Rate Spreads in Nigerian Banks

Regulatory Requirements, Charges and Taxes

The CBN's regulatory requirements, especially the high Cash Reserve Ratio (CRR) now at 50% and the Liquidity Ratio, are impacting the interest rate spread and reducing funds available for lending. The AMCON levy, NDIC premiums and the impending windfall tax are also included. Banks are charging higher interest rates on loans to compensate for the opportunity cost of holding reserves and passing on all these costs to customers via higher spreads.

Monetary Policy Stance

Tight monetary policy by the Central Bank of Nigeria (CBN), such as high benchmark rates, influences lending rates. CBN monetary policy decisions, such as setting the Monetary Policy Rate (MPR) influences the interest rate spread. A higher MPR in the process of taming inflation invariably leads to higher lending rates and a wider spread.

Liquidity and Funding

Nigerian banks' access to cheap funding and liquidity can impact the interest rate spread. If banks face funding constraints or prohibitive costs of borrowing, they may charge higher interest rates on loans to maintain profitability.

High Credit Risk

The prevalence of non-performing loans (NPLs) forces banks to charge higher rates to mitigate default risk. Risk Premium: Nigerian banks often charge higher interest rates on loans to account for the perceived higher risk of lending in the country. This risk premium contributes to a wider interest rate spread.

Impact of High-Interest Rate Spreads on the Economy

Reduced Investment

High spreads have both direct and indirect effects on the economy, affecting growth, investment, and general welfare. High lending rates discourage borrowing for productive investments, stifling economic growth.

Limited Access to Credit

Small and medium enterprises (SMEs) and individuals face difficulties accessing affordable credit, which can limit their ability to invest in new projects and expand their operations, creating employment and economic growth.

Higher Cost of Doing Borrowing

Increased borrowing costs raise operational expenses, reducing business profitability and competitiveness. Reduced demand for loans and slowing down economic growth.

Slower Economic Growth

A constrained credit market limits the capacity of businesses to expand, impacting GDP growth.

Inequality and Poverty

Limited credit access exacerbates income inequality and poverty, particularly in rural areas and among low-income populations.

Low Savings Rate

High interest rates on loans and low interest rates on deposits can discourage savings and reduce the overall savings rate in the economy.

Key Economic Indicators Affected

Gross Domestic Product (GDP)

Growth rates are suppressed due to lower investments. Our research shows that there is a high correlation between higher rate spreads and lower GDP growth rates and low-rate spreads and higher GDP growth rates.

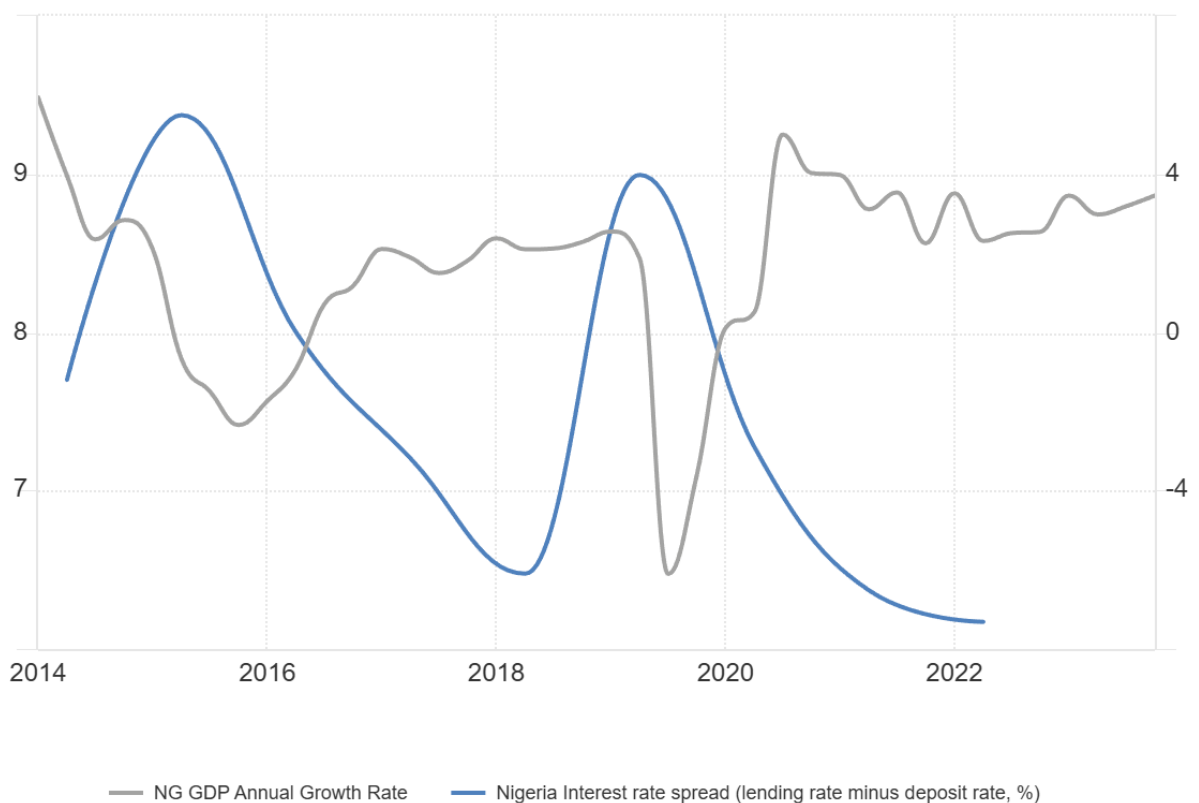
Unemployment

Limited access to financing reduces business expansion and job creation.

Financial Inclusion

High spreads reduce the affordability of financial services for the broader population.

Source: tradingeconomics.com



Lowering High-Interest Rate Spreads

To reduce interest rate spreads, a combination of regulatory, structural, and market-based approaches can be employed:

Lowering Cash Reserve Requirements

Reducing statutory reserve ratios to increase available lending funds.

Monetary Policy Reforms

Adjusting the monetary policy framework to lower benchmark interest rates achievable in a non-inflationary environment.

Fiscal Policy Reform

Reduction of elevated levels of government deficit and borrowing. Elevated level of government borrowing increases money supply which drives inflation and the response of monetary authorities to increase rates in a bid to tame inflation.

Advantages of a Low Interest Rate Spread Regime

Low Credit Risk

Effective risk management and a stable macroeconomic environment reduce the cost of credit.

Operational Efficiency

Technological advancements and streamlined processes lower operational expenses.

Competitive Banking Sector

A competitive market forces banks to reduce margins.

Supportive Monetary Policy

Lower reserve requirements and favourable policy rates reduce borrowing costs.

Increased Borrowing and Investment

More affordable loans encourage businesses and consumers to borrow and invest.

Higher Economic Growth

Increased credit availability supports business expansion and innovation.

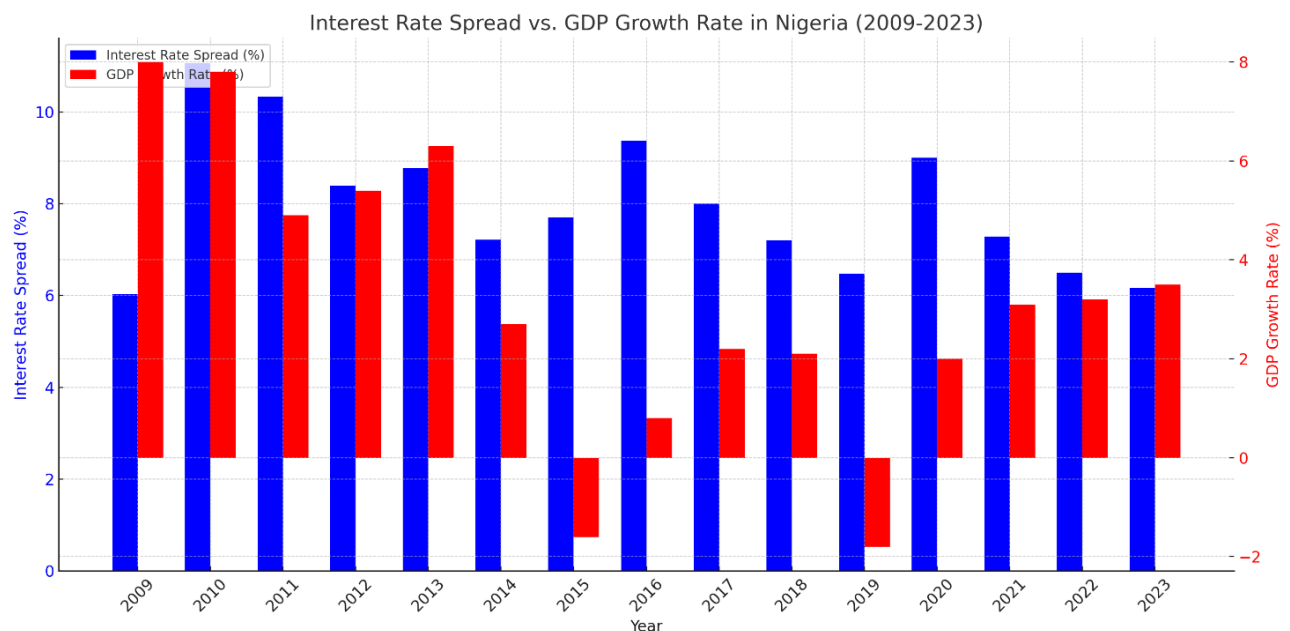
Greater Financial Inclusion

More people can access affordable credit products.

Summary & Conclusions

The high interest rate to deposit spread in Nigeria has significant consequences for GDP growth rates. A wide spread is a consequence of high lending rates, relative to low deposit rates, making it more expensive for individuals and businesses to borrow money. This can reduce investment, consumption, and economic growth. Furthermore, a high-interest rate spread can also lead to a decrease in deposit rates, making saving less attractive. This can reduce the amount of money available for banks to lend, further exacerbating the problem.

In Nigeria, the high-interest rate spread has been shown to have a negative impact on the output gap, which is the difference between the actual and potential output of the economy. A high-interest rate spread can also lead to a decrease in manufacturing output, as high lending rates make it more expensive for manufacturers to borrow money. Overall, the high interest rate to deposit spread in Nigeria from our research, shows an inverse correlation with GDP growth making it essential for policymakers to address this issue. Key consequences are reduced investment as high lending rates make it more expensive for individuals and businesses to borrow money, reducing investment, consumption and decrease in



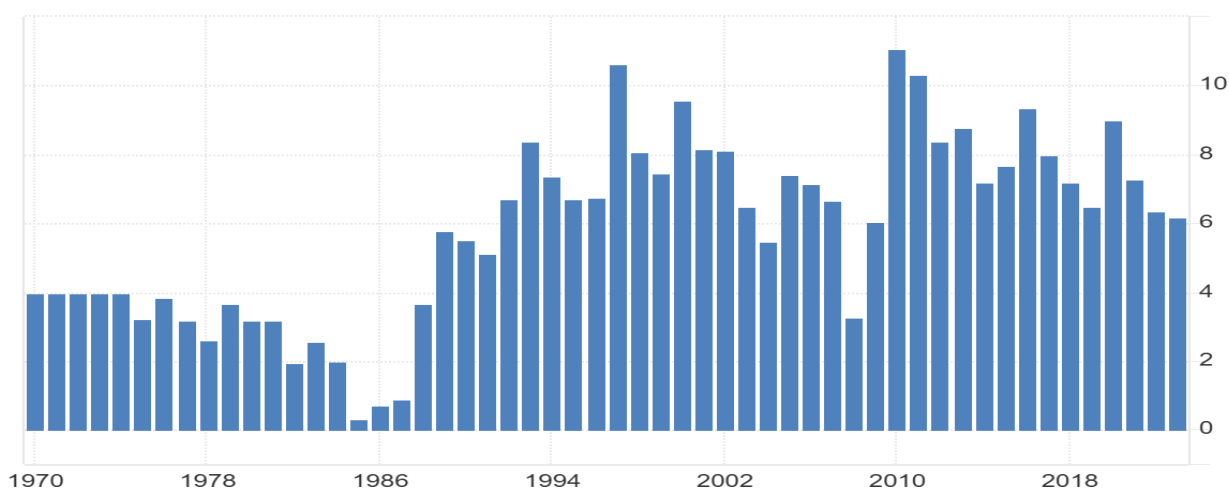
The graph above shows the relationship between interest rate spreads in Nigerian banks and Nigeria's annual GDP growth rate from 2009 to 2023. The trend illustrates how fluctuations in interest rate spreads correspond to periods of higher or lower economic growth, highlighting the potential impact of financial intermediation efficiency on macroeconomic performance.

deposit rates, making saving less attractive. The negative impact on output gap in Nigeria, has decreased manufacturing output as is it more expensive for manufacturers to borrow money, which in turn affects productivity and reduced GDP growth rates.

Resolving the high interest rate to deposit spreads in Nigeria requires a multi-faceted approach. To start, the Central Bank of Nigeria (CBN) can play a crucial role by implementing policies that narrow the interest rate spread. This can be achieved by either decreasing lending rates or increasing deposit rates and a review of levies. Another strategy is to improve the overall efficiency of the banking system. This can be achieved by investing in technology, reducing operational costs, and enhancing risk management practices. By doing so, banks can reduce their lending rates and increase their deposit rates, thereby narrowing the interest rate spread.

Additionally, the government can also play a role by implementing policies that promote economic growth and stability. This can include investing in infrastructure, promoting entrepreneurship, and implementing policies that attract foreign investment. The high interest rate to deposit spread in Nigeria has significant implications for productivity, GDP growth and profitability. For instance, high lending rates can make it difficult for businesses to access credit, which can limit their ability to invest in new projects and expand their operations. This will have a direct negative impact on productivity and economic growth. On the other hand, high

Nigeria Interest rate spread (lending rate minus deposit rate, %) - %



Source: tradingeconomics.com | World Bank

deposit rates can attract more deposits, which can provide banks with more funds to lend. However, if the lending rates are too high, it can discourage borrowing and reduce the overall effectiveness of monetary policy. In terms of profitability, a high-interest rate spread can be beneficial for banks, as it allows them to earn higher margins on their lending activities. If the spread is too high, it can lead to a decrease in lending and a reduction in bank profitability over the long term.

Overall, resolving the high interest rate to deposit spread in Nigeria requires a coordinated and balanced approach that involves both monetary and fiscal policy measures. By implementing policies that promote economic growth and stability, and by improving the overall efficiency of the banking system, Nigeria can reduce its interest rate spread and promote more sustainable economic growth.

Specific Recommendations

- 01 Release of 20-25% CRR funds to be directed to lending to critical real sectors of economy at interest rate of not more than 20%. This will reduce average lending rates, stimulate productivity and increase GDP growth.

- 02 Rationalise the statutory costs to banks AMCON, NDIC, EMTL, Cybersecurity tax, Windfall tax and other taxes and levies that reflect on the interest rate spread. These costs are passed unto the customers by a lowering of deposit and increase in lending rates

- 03 Effective Coordination of Fiscal, Monetary, Trade, Industry and Industrial polices.

By addressing the structural and regulatory inefficiencies that drive high-interest rate spreads, Nigeria can improve its credit market, foster economic growth, and enhance financial inclusion. With a progressive and coordinated policy implementation approach, the monetary and fiscal authorities can reduce the high interest rate to deposit spread in Nigeria and promote more sustainable economic growth.

