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E-NEWSLETTER

WHY IS INTEREST RATE HIGH IN NIGERIA?

The interest rate is dependent on the base rate or monetary policy rate which is fixed by a country's central bank. The base rate for Nigeria is 14%. In contrast, that of Kenya is 10% and that of South Africa is only 6.75%. Banks in Nigeria factor in the high cost of doing business and set their lending rate at 25% or more. Why is our interest rate so high at least compared to these other countries?

Here are a few factors for this:

Inflation

Inflation affects the interest rate in two ways. First the CBN has kept the benchmark rate at 14% as a way of checking inflationary pressure. There is an inverse relationship between interest rates and inflation. When interest rates are reduced people are able to borrow more and spend more and this leads to an increase in inflation rate.

On the other hand, when interest rate is high, inflation is checked because people are discouraged from borrowing and thus spending is reduced. The second way in which inflation affects interest rate is that banks cannot fix their lending rate lower than the inflation rate else they run at a loss. Since the inflation rate in Nigeria is currently 15.37%, this means that the lending rate cannot be lower than this.

Cost of doing business

The cost of doing business is high in Nigeria. For banks these include the costs associated with defaults, high speed broadband internet and technology, running the branches including cost of diesel to power the generator and the cost of security personnel for the branches.

These are all passed on to the borrowers in form of higher lending rates.

Fiscal Policy Stance

When government adopts an expansionary fiscal policy stance and increases its spending to boost the economy, the interest rate increases because the higher the amount spent by government, the lower the amount available to the private sector to spend. The central bank responds to an expansionary fiscal policy by attempting to neutralize the effects of government injection by raising the interest rate.

High Financial Intermediation Cost

Financial intermediation costs include administrative costs incurred by banks, cash reserve requirement (CRR) and liquidity ratio requirement. We have already established that administrative costs are high for banks because of the high cost of doing business. The cash and liquidity ratio requirements are also high at 22.5% and 30% respectively. The high intermediation cost incurred by banks is reflected in high interest rates charged to borrowers.

Having considered the causes of high interest rates in Nigeria, are there any dangers of this phenomenon? The answer is a resounding yes. In the first instance, with high interest rates individuals are unwilling to borrow and the effect of this is a reduction of economic activity as people borrow not just to spend but to invest. Thus, high interest rate impede economic growth. The way out of this is for the Central Bank to make the base rate a single digit and for this to happen it must first adequately reduce the level of inflation in the economy.