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   STATEMENT OF THE PROBLEM

   OBJECTIVES

   HYPOTHESES

   RESEARCH METHODOLOGY

   RESULTS & DISCUSSION

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INTEREST RATE AND UNEMPLOYMENT NEXUS IN NIGERIA: AN EMPIRICAL ANALYSIS

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ABSTRACT

The present study investigates that rise in interest rate (lending rate) is most likely to cause new unemployment. It is also well known that a rise in interest rates will benefit savers at the expense of borrowers. The converse applies when interest rates fall, meaning that there is a dichotomy between savers and borrowers. Since it has been evident that interest rates have significant effect on unemployment in opposite direction, it will be wise for the regulatory authorities, mostly the CBN, to step up its efforts to reduce lending rates and raise deposit rates to a reasonable level that will encourage savings, thereby making fund available for investment in the economy. Change in interest rate will only be effective if businesses and consumers match the government's confidence in future economic prospects. Investors do consider the inflation rate before depositing or borrowing fund which affects the real lending and savings rates. The government, through its relevant authorities should combat inflation to less than 5% as obtainable in America (1.4%) and Republic of China (2.1%). This will go a long way in restoring the lost confidence into the Nigerian financial sector.

KEYWORDS

Unemployment, lending rates.

INTRODUCTION

Reduction of unemployment is one of the most important macroeconomic objectives as every economy wants to achieve this objective. Countries over the centuries have used different methods to solve this economic menace that causes a lot of psychological, economical and most especially social and security threat as obtainable presently in Nigeria.

Accordingly, interest rates have been considered as vital ingredients for both capital accumulation and formation and very crucial in enhancing output growth in Nigeria, due to the relative under development of the domestic capital market and the paucity of direct foreign investment in the non-oil sector of the economy. Consequently, over the years, interest rates channel per se, have been expected to play a significant role in determining the rate of expansion or contraction of private sector investment and output growth. Against this background, the stance of monetary policy in Nigeria has remained a major focus of public interest especially since the commencement of financial sector liberalization in the 1980s, which culminated into the deregulation of the interest rate regime in 1993.

Historically, the Central Bank of Nigeria via its monetary policy circulars had directly controlled the volume and cost of credit in the economy, until the era of financial liberalization in the mid-1980s. During the direct control regime, the CBN prescribed interest rates and quantum of credit which banks must allocate to the various sectors of the economy. The prescription of these ceilings was strictly enforced and therefore, was very binding while they lasted despite its inherent inefficiency and moral hazard. It has been argued by economists like Kashyap and Stein (1993) that banks make money by making loans, and not by banks pay on deposits. The paradox of the Nigerian situation is that, it actually pays the banks to lend to the government than to firms and sundry borrowers because of the prevalence of high risk premium.

In the America's economy in late December 2007, most economists realized that the economy was slowing. However, very few predicted an outright recession. Like most professional forecasters, the Federal Open Market Committee (FOMC) initially underestimated the severity of the recession. In January 2008, the FOMC projected that the unemployment rate in the fourth quarter of 2010 would average 5 percent. But by the end of 2008, with the economy in the midst of a deep recession, the unemployment rate had risen to about 7.5 percent; a year later, it reached 10 percent. (Kevin 2010)

Also in the words of Kevin, the Federal Reserve Bank of St. Louis (Fed) employed a dual-track response to the recession and financial crisis. On the one hand, it adopted some unconventional policies, such as the purchase of $1.25 trillion of mortgage-backed securities. On the other hand, the FOMC reduced its interest rate target to near zero in December 2008 and then signaled its intention to maintain a low-interest rate environment for an "extended period."

Uchendu (1993) asserted that interest rate policy is among the emerging issues in current economic policy in Nigeria in view of the role it is expected to play in the deregulated economy in inducing savings which can be channeled to investment and thereby increasing employment output and efficient financial resources utilization.

NEED FOR THE STUDY

Investment in Nigeria is very important and it is one of the most important macroeconomic variables used to resuscitate the economy from recession and depression. Economists like Anderton (2001), Sloman and Wride (2009) and Bamford and Grant (2010) have explained the relationship between interest rates and investment/savings that as interest rate rises, so investment will fall (making unemployment to increase) and savings will rise, *ceteris paribus.*

The idea of this paper is to see how interest rates could be used to solve the problem of unemployment in the country as being used in many advanced countries. Thus, this paper establishes the relationship between unemployment and interest rates.

The essence of the study is to investigate empirically, the relationship between interest rates and unemployment. Thus, this study should answer the following questions: Is there any empirical relationship between interest rates and unemployment rate? To what extent do interest rates affect unemployment rate? Which of lending rate or deposit rate affects unemployment more? Do previous interest rates have any significant effect on unemployment? What is the response of unemployment to change in interest rates?

The rest of this paper is organised as follows: in section two, we provide a brief overview of the theoretical linkages between interest rates and unemployment as well as examine the evidence, review literature on determinants of interest rates and unemployment behaviour and offer some suggestions. Section three presents the econometric models and the methodology to be employed. Section four presents the results and section five bears conclusion and policy implication with recommendations.

LITERATURE REVIEW

CONCEPT OF INTEREST RATE

According to research department of the Central Bank of Nigeria (CBN), interest rates are the rental payment for the use of credit by borrowers and return for parting with liquidity by lenders. Like other prices, interest rates perform a rationing function by allocating limited supply of credit among the many competing demands on it.

There are various rates of interest in the financial system. These are generally classified into two categories: deposit and lending rates. Deposit rates are paid on savings and time deposits of different maturities. Lending rates are interest rates charged on loans to customers and they vary according to perceived risks, the duration of loans, the costs of loanable funds and lending margins etc. Other rates of interest in the financial system include treasury bill rate, the inter-bank and minimum rediscount rates. (CBN, 1995).

The primary role of interest rate is to help in mobilization of financial resources and to ensure the efficient utilization of such resources in the promotion of economic growth and development. Interest rates affect the level of consumption on the one hand and the level and pattern of investments on the other. This could invariably affect the level of employment in a chain relation. Interest rates are very crucial in financial intermediation which involves transferring funds from surplus units in an economy to deficit units. World most developed countries use interest rates to rescue their economies from recession and depression most especially the one that hit the West in the recent past.

According to Sheng (2010), there are two reasons why advanced countries may want interest rates to be near zero. The first is that after a crisis, zero interest rates imply that central banks do not fear higher inflation. The second is that zero interest rates subsidise the borrower, which is especially pertinent nowadays when advanced economies are all highly in debt.

Economists, most especially Monetarists and Keynesians, disagree over what determines interest rates. To the Monetarists, interest rate is determined by the demand and supply of loanable funds i.e. the Loanable Funds Theory. The Keynesians argue that the rate of interest is not determined by anything other than the demand and supply of money i.e. Liquidity Preference Theory. (Anderton, 2008).

A number of factors influence the behavior of interest rates in an economy. Prominent among these are: savings; investment; inflation; government spending, monetary policy stance and taxation.

Soludo (2008) asserted that interest rates are regarded as “high” or “low” relative to some economic fundamentals, 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.

CONCEPT OF UNEMPLOYMENT

According to National Bureau of Statistics, employment is one of the most important social and economic issues in every country. As a result, measures of utilisation and non-utilisation of labour are usually of considerable concern to researchers and policy makers. The stock of unemployment usually attracts smaller attention than the flow; that is, how the rate of unemployment is moving. It is not easy to measure the rate of unemployment because of the conceptual problems of defining who is employed, unemployed or underemployed. Employment refers to the number of people who work for pay in cash or kind, work on their own account or are unpaid family workers. Unemployment figures include those out of work, able to work and looking for a job through recognised channels. This definition should be extended to include those unemployed persons who give up job-seeking out of frustration and retrenched or laid-off persons. The subsistence economy of the rural sector often creates the impression that unemployment is wage unemployment and that it is an urban phenomenon. All these call for caution in wording questionnaires to be used in labour force surveys. (NBS, 2011).

The question many people ask is then “who should be included in the statistics? Could it be everybody? The clear-cut answer is No because we would not commonsensically want to include children and pensioners. We would possibly also not want to include those who were not looking for job, such as parents choosing to stay at home to look after their children as house-wives.

Economists measure both the level and rate of unemployment. Level of unemployment is the number of people who are unemployed while the rate of unemployment measures the number of unemployed people as a percentage of the number of people in the labour force. (Bamford and Grant, 2010). This is why Sloman and Wride (2009) said that unemployment could be expressed either as a number like 1.6 million (number of unemployed people) or as a percentage like 6 per cent (rate of unemployment).

According to the Nigerian Labour Force Survey under NBS, unemployment rate is defined as the proportion of Labour Force who was available for work but did not work in the week preceding the survey period for at least 39 hours.

Bamford et al (2008) explains that the natural rate of unemployment which is usually referred to as the Non-Accelerating Inflation Rate of Unemployment (NAIRU), is largely a monetarist concept. It is the level of unemployment which exists when the aggregate demand for labour equals the aggregate supply of labour at the current wage rate and so there is no upward pressure on the wage rate and the price level. Nairu can change over time through supply-side factors, though the monetarists argue that it cannot be reduced in the long run by expansionary monetary or even fiscal policy.

In the submission of Bamford and Grant (2010), when explaining the relationship between monetary policy and unemployment, said that if an economy has high unemployment or if there is a substantial risk of unemployment increasing, the obvious monetary policy response is to cut interest rates. They asserted that the response to this cut action is that: firms may increase investment as the cost of borrowing has fallen; consumers may save less and spend more as the return from holding money in commercial banks has been reduced; consumers may also decide to borrow more money for financing large purchases such as a new house or car; the exchange rate may depreciate leading to a rise in exports.

WHAT BENEFITS COME FROM LOW INTEREST RATES?

Economic growth, economic development and favourable current account balance among others, are the great dividend of low interest rates. According to FRBSF (2011), a decrease in real interest rates lowers the cost of borrowing, that leads businesses to increase investment spending and it leads households to buy durable goods, such as autos and new homes. In addition, lower real interest rates and a healthy economy may increase banks’ willingness to lend to businesses and households. This may increase spending, especially by smaller borrowers who have few sources of credit other than banks, thus a shift of aggregate demand to the right.

Furthermore, increased aggregate demand and for the country’s goods through these different channels leads firms to raise production and invariably employment, which in turn increases business spending on capital goods even further by making greater demands on existing factory capacity. This will further boost consumption because of the income gains that result from the higher level of economic output.

Commercial real estate construction faltered during the 2007 recession and has improved only slowly during the recovery. However, low interest rates have led to higher property valuations and are clearly benefiting the sector. The recovery of commercial property prices has been notable. Some measures suggest that, in some segments of the market, prices are close to their pre-recession highs. Valuation measures do not suggest that current prices are excessive. (Krainer, 2013)

Lower real interest rates also make common stocks and other such investments more attractive than bonds and other debt instruments. As a result, common stock prices tend to rise. Households with stocks in their portfolios find that the value of their holdings is higher, and thus, this increase in wealth makes them willing to spend more. Higher stock prices also make it more attractive for businesses to invest in plant and equipment by issuing stock. This will go a long way in translating to increase in the level of employment as more workers will be needed to operate these plants and equipments. Lower interest rates could also reduce the foreign exchange value of the Naira which lowers the prices of the locally produced goods she sells abroad and raises the prices she pays for foreign produced goods. This situation will encourage export and discourage import leading to a favourable current account balance. This also leads without doubt to higher aggregate spending on goods and services produced in the country.

Another benefit of low interest rates is improving bank balance sheets and banks' capacity to lend. During the financial crisis, many banks, particularly some of the largest banks, were found to be undercapitalized, which limited their ability to make loans during the initial stages of the recovery.

By keeping short-term interest rates low, the Fed helps recapitalize the banking system by helping to raise the industry's net interest margin (NIM), which boosts its retained earnings and, thus, its capital. Between the fourth quarter of 2008, when the FOMC reduced its federal funds target rate to virtually zero, and the first quarter of 2010, the NIM increased by 21 percent, its highest level in more than seven years. Yet, the amount of commercial and industrial loans on bank balance sheets declined by nearly 25 percent from its peak in October 2008 to June 2010. This suggests that perhaps other factors are helping to restrain bank lending. (Kevin, 2010).

During times when economic activity weakens, monetary policy can push its interest rate target (adjusted for inflation) temporarily below the economy's natural rate, which lowers the real cost of borrowing. This is sometimes known as "leaning against the wind."

Advanced countries, emerging economies and top industrialised countries are reducing interest rates towards zero per cent because they want to boost their investment which will mean many things like increase in the level of employment, increase in Gross Domestic product (GDP), increase national income and per capita income and invariably lead to enhanced standard of living. The Bank of England cut interest rates to as low as 0.5% in 2009- a fresh all-time low and says it will now boost the money supply to help revive the economy. Presently, the United State of America has put its interest rate at 0.25% still in order to encourage investment which, among others, has led to increased employment. In fact unemployment in U.S.A. has recently dropped to 8.3%.

It is deplorable to note the practice of deposit money banks in Nigeria offering as low as one per cent on savings deposits and its negative implications on capital accumulation, investment and then economic growth. These are extremely low returns paid to savers and depositors as they pose a major dis-intermediation risk and are inconsistent with the development goals of financial inclusion.

Certainly, at between 0.25 and 4 per cent, savers and depositors, even time depositors, have been having a raw deal in the last two years from the banks that cite the global meltdown, liquidity squeeze, bad loans and recapitalization issues. What risks stakeholders, however, is that, while the banks discourage savings by paying so little on deposits, lending rates remain stubbornly high, reaching as much as 21-23 per cent.

According to official rates published monthly by the CBN, demand deposit rates in the 24 banks in January, 2011, ranged from 0.01 per cent to 1.25 per cent while savings were 1-3 per cent. Average rates paid on time deposits were one per cent to six per cent. By contrast, prime lending rates in the same period ranged between 12 and 19 per cent. Many customers swear that even the official figures do not always reflect the reality with deposit rates rarely exceeding four per cent, while the most common lending rate is within the 21-23 per cent band. Bank customers also complain of high bank charges outside of the borrowing rates which add to the cost of doing business, thereby discouraging savings, borrowing and investment. It is not financially ideal and even should not be acceptable for any bank to borrow at 1-5 per cent or 6.5 per cent from the CBN and lend at 22 per cent, though banks have different reasons that could lead to these differences in their interest rate charges as pointed out by Anderton (2008) that many factors which can cause interest rates to differ in the same market could include: time; expectations; risk; administrative costs and imperfect knowledge by borrowers and lenders.

ANY DRAWBACK?

Just as everything has benefits and costs, there are costs associated with keeping interest low (below natural level of interest rate). Some argue that low interest rate interest rate is not a problem within a short period but it does become an issue when the period is extended.

When interest rate is low, saving is discouraged. Households and firm will prefer holding their money in ways other than saving. This will result to low saving (low capital accumulation). Investors who want to borrow money from banks will find it difficult to obtain, thereby constraining investment. People will hold more money which could even make their demand to shoot up. If this is not backed up with increased production level, it could cause scarcity which would roll into inflation in the long run.

Without a strong commitment to control inflation over the long-run, the risk of higher inflation is one potential cost of the Federal Reserve Bank of St. Louise keeping the real federal funds rate below the economy's natural interest rate. Some point to the 1970s, when the Fed did not raise interest rates fast enough to prevent what became known as the Great Inflation (BIS 2010).

SUMMARY OF LITERATURE

Explicitly, the role which interest rates play in banks' lending habit has been discussed extensively in literatures. Greene and Villanueve (1991) have established a strong negative relationship between real interest rate (lending rate) and private investment. While Gelb (1989), also found no relationship between growth in aggregate investment and real interest rate. Between these two counter findings, Calve and Gwidotti (1991) provided ample explanation. According to the authors, very low and negative real interest rates could cause financial disintermediation, with consequence on output reduction as asserted by Mckinnon-Shaw hypothesis. They further argued that artificially low interest rate may create an excess demand for funds, such that investors may have to be rationed. This would lead banks into facing problems of excess demand for fund. Generally, they conclude that very high real interest rate that do not reflect improved efficiency in investment, but rather, a lack of credibility of economic policy or various forms of country risk, are likely to result in lower level of investment (which means lower level of employment). Nnanna (2001) tend to subscribe to this synthesis because it describes the Nigerian condition. Thus, given the significant influence of real interest rate in the credit market, we shall include this as part of the variables in the analytical framework of this paper.

ANALYTICAL MODEL: DATA AND METHODOLOGY

The unsuitable foreign investment environment, most especially in the non-oil sector and the relatively developing nature of the capital market, imply that the banking system shall remain the major provider of capital to the private sector investment in the Nigerian economy for now. Presently, private sector of the economy is dominated by the manufacturing and agriculture sectors. Thus, these two sectors are the major recipients of credit. On this, the agriculture sector gets credit through the government while manufacturing sector obtains loans from banks which are affected by interest rates of the system. Against this background, we hypothesize that all things being equal, the higher the level of lending rate for investment, the higher the rate of unemployment and vice versa since more investment will mean more employment.

In addition to exploring the impact of interest rate on aggregate unemployment rate/level, we also evaluate the explanatory power of the following exogenous variables:

i. The deposit interest rate (r_d). This is the amount paid by banks for funds withdrawable after seven days' notice though this restriction is however seldom applied. Theories have shown that savings is equal to investment. That the amount saved (in bank) will equally be borrowed for investment. It means there is the need to encourage economic agents to consume less and save more. This could only be done through increase in deposit interest rate in order to guarantee enough funds for investment. Thus, the higher the deposit interest rate, the more the quantity of funds available for investors to borrow and the lower the unemployment rate. Hence, there is negative relationship between deposit rate and unemployment.

ii. Lending interest rate (r_l). As earlier said, it is the cost/price of borrowing money i.e. for investment. When price increases, *ceteris paribus*, demand for loanable fund (investment) drops. Literatures on investment point out this fact. When investment goes down, fewer workers are employed meaning more unemployment rate. Thus, high lending rate reduces investment and increases unemployment. Hence, there is positive relationship between lending rate and unemployment.

Finally, a precise description of interest rates and unemployment relationship should necessarily reflect the role which expectation plays in obtaining investment loan. Typically, investors' behaviour is influenced by their past experience. This also applies to depositors. The effect of interest rates on unemployment, proxied by investment, will definitely be felt not immediately, but at a later period. As loan is obtained and investment made, employment is consequentially and continuously made though depending on the rate of growth in the investment. To capture this adaptive expectation behaviour, we have constructed a subsidiary model to cater for this expectation.

To summarise it, the interest rates (lending and deposit) and unemployment relationship could be written as:

$U = f(r_l, r_d, + \mu)$ ……………………………..(1)

Where:

U = unemployment rate

r_l = lending interest rate

r_d = deposit interest rate

To ascertain the extent of effect real interest (lending) rate has on unemployment, real interest rate is added giving us a second equation as:

$U = f(r_l, r_d, Rr_l, + \mu)$ ……………………………..(2)

Where:

Rr_l = real lending rate

Lastly, in order to empirically find out the influence of expectation of interest rates on unemployment, proxied also by investment, we have lagged the interest rates. Thus we could have this equation:

$U = f(r_l, r_d, Rr_l, r_{l-1}, r_{d-1}, + \mu)$ ……………………………..(3)

Where:

r_{l-1} = lagged value of r_l

r_{d-1} = lagged value of r_d

μ = standard error

Annual time-series data used in this study was gotten from CBN Statistical Bulletins of various years, and National Bureau of Statistics (NBS). The study covers a period of 1982-2012. Ordinary Least Square (OLS) method was used for the analysis.

EMPIRICAL RESULTS

The models specifications as equations 1-3 were estimated using ordinary least squares procedure. The estimation results alongside the relevant statistics are presented as below:

TABLE 1: RESULTS FROM OLS

	1	2	3
Constant	13.212 (3.299)	13.159 (3.346)	13.264 (3.802)
r_d	-1.095** (0.152)	-1.045** (0.179)	-0.985** (0.189)
r_l	0.306* (0.187)	0.291* (0.191)	0.284* (0.217)
Rr_l		0.028* (0.052)	0.030* (0.053)
r_{d-l}			-0.098** (0.085)
r_{l-1}			0.050* (0.194)
R-squared	0.671	0.675	0.693
Adj. R-squared	0.646	0.636	0.626
D.W	0.815	0.812	0.888
Prob. (F)	26.499	17.286	10.370

***(**) Significance at 5 (10) per cent**

In general, though The F-statistics result is not significant, the regression results show that there is more than average positive relationship between interest rates and unemployment within the said period, as the explanatory power accounted for by the coefficient of determination (R^2) was above 50%. Thus interest rates are responsible for 63% variation in unemployment rate in Nigeria. Previous interest rates (eq.3) did not have a stronger explanatory power (62.6) compared with 63.6 and 64.6 per cent of the actual interest rates (eqs.1 & 2).

The coefficients of all the interest rates used are correctly signed. Lending rate and real lending rates are significant at 5% while others are significant at 10%. The values in parenthesis are their standard errors. Also from the coefficients of r_d and r_l, it shows that lending rate has more significant effect on unemployment than deposit rate and they both affect unemployment in an opposite direction

However, the D-W statistics are not significant therefore indicating the presence of residual correlation and thus inconclusive.

POLICY IMPLICATION AND CONCLUSION

A rise in interest rate (lending rate) is most likely to cause new unemployment. It is also well known that a rise in interest rates will benefit savers at the expense of borrowers. The converse applies when interest rates fall, meaning that there is a dichotomy between savers and borrowers. Since it has been evident that interest rates have significant effect on unemployment in opposite direction, it will be wise for the regulatory authorities, mostly the CBN, to step up its efforts to reduce lending rates and raise deposit rates to a reasonable level that will encourage savings, thereby making fund available for investment in the economy.

Change in interest rate will only be effective if businesses and consumers match the government's confidence in future economic prospects.

Investors do consider the inflation rate before depositing or borrowing fund which affects the real lending and savings rates. The government, through its relevant authorities should combat inflation to less than 5% as obtainable in America (1.4%) and Republic of China (2.1%). This will go a long way in restoring the lost confidence into the Nigerian financial sector.

Bamford and Grant (2010) rightly said that a more general problem facing any government is that of lack of up-to-date, accurate information on the present state of the economy and forecasts of future prospects. This is particularly acute in many developing economies where the quality of statistical information available to the government is inadequate or too poor compared with most developed economies. Although the quality has much improved in recent years through the efforts of the World Bank and regional trade blocs such as CARICOM, it remains an obstacle to more effective economic management. (Pg. 287-288).

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