THE EFFECT OF COMMERCIAL BANK LENDING RATES ON ECONOMIC GROWTH IN UGANDA

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ABSTRACT

The study set to investigate the effect of commercial bank lending rates on economic growth in Uganda. Employing a time series analysis using the Johansen methodology, the study identified one cointegrating relationship linking economic growth to of gross capital formulation, investment in labour proxied by secondary school enrolment, lending rate, exchange rate, bank credit to government, broad money and trade openness. The study results affirmed the existence of a long run relationship between them. The long run model revealed that economic growth was only significantly related to capital formulation, lending and exchange rates. The relationship was such that economic growth is positively and significantly related to gross capital formulation while it was found to be negatively and significantly related to the lending rate and the official exchange rate.

The negative and significant sign of the exchange rate implies that as exchange rate expands, more Uganda shillings will be required to buy a unit of the dollar; this places a restriction on inter Country trade and export of critical raw materials that are externally purchased. This may result to low productivity and hence profitability which may have implications of low GDP in the country. Increase in lending rates were found to discourage economic growth. lending rates generally have a negative impact on borrowing which makes capital for investments hard to access. This in effect constrains investment led growth. Gross capital formulation also was found to significantly inform growth. This finding as earlier noted resonates well with most growth literature. The need to boost and enhance development infrastructure is a strong catalyst for growth.

The short-run dynamics of economic growth were subsequently modeled by means of an Error Correction Model and a number of diagnostic tests performed on the ECM yielded reasonable results. The short run results/findings indicated that only exchange rate and capital formulation were significant in explaining economic growth. The emphasis should be put on supporting investment in capital and managing the exchange rate largely as these have an impact on economic growth in both the short and long run.

The main policy implication of these results is that the government makes a direct attempt to control the lending. This may be done for example by way of reducing the central bank rate which informs and sets the rate for bank lending rates among others. Also The exchange rate vacillation should be managed with the proper strategies in order to stop hindering financial development and investment in capital formulation should as well be upheld.