IMPACT OF MONETARY POLICY ON THE PERFORMANCE OF DEPOSIT MONEY BANKS IN NIGERIA (1994 -2024)

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Abstract

This study examined the effect of monetary policy rate on the performance of commercial banks in Nigeria, during the period 1994 to 2024. The specific objectives of the study were to investigate the impact of monetary policy rate (MPR) on the performance of deposit money banks (DMBs) in Nigeria, examine the influence of exchange rate on performance of (DMBs) and lastly, analyze the effect of inflation rate on performance of (DMBs). Banks Return on Investment (BROI) was the dependent variable, which served as proxy for performance of deposit money banks in Nigeria. The explanatory variables included monetary policy rate, exchange rate, and inflation rate. Secondary data collated from the Central Bank of Nigeria (CBN) Statistical Bulletin, were used for the study. The study utilized the Autoregressive Distributed Lag (ARDL) econometric technique for data analysis. The empirical findings revealed that monetary policy rate has a positive and statistically significant relationship with return on investment of deposit money banks in Nigeria, both at the level form and first lag. Inflation rate has positive and statistically significant relationship with banks` return on investment in the level form, but negative and statistically insignificant relationship in the first lag. Exchange rate has positive and significant relationship with the dependent variable (BROI) at the level form, but negative and significant relationship at first lag. The F- statistic value and its probability value, showed that on the overall, the explanatory variables were statistically significant. Based on the results, the study concluded that monetary policy rate (MPR), exchange rate policies, and inflation rate exert significant influence on the performance of deposit money banks in the country. Consequently, the study recommends that monetary authorities, particularly the Central Bank of Nigeria, should maintain the monetary policy rate at a level that promotes optimal performance of deposit money banks. It further suggests that monetary authorities should collaborate with fiscal authorities to design an appropriate policy mix aimed at stabilizing and reducing exchange rate volatility in Nigeria. The study also recommends that, policymakers should implement policies that ensure price stability by effectively managing and controlling inflation rate in the country.

Key words: Monetary policy rate, DMBs, Inflation rate.

1. Introduction

Monetary policy encompasses a set of coordinated actions aimed at regulating the cost, value, and quantity of money in alignment with a country's level of economic activity. Its overreaching goal is to ensure monetary and price stability. Afolabi, Adeyemi, Salawdeen and Fagbemi, (2018), describe monetary policy as governmental measures that affect the money supply and prevailing market interest rates. Governments influence these variables through instruments such as open market operations, policy rates, discount rates, and reserve requirements. Agbonkhese and Asekome, (2013), argue that central banks globally, including the Central Bank of Nigeria (CBN), deploy tools such as bank rate adjustments, open market operations, reserve requirement modifications, and selective credit controls to manage money circulation while pursuing macroeconomic objectives.

When direct monetary policy instruments are applied, monetary authorities exert influence over the balance sheets of commercial banks. Under this framework, interest rates and credit allocation are largely determined by the authorities in accordance with government economic plans. Ajayi and Atanda, (2012), note that within such a system, financial markets play a minimal role in setting financial prices or allocating credit. Conversely, an indirect monetary policy framework establishes a reciprocal relationship between monetary authorities and deposit money banks, where both influence each other's operations.

In Nigeria, as in many developing economies, monetary policy objectives include achieving full employment, maintaining domestic price stability, promoting sustainable economic growth, and ensuring external sector equilibrium. Additional goals involve smoothing business cycle fluctuations, preventing financial crises, and stabilizing long-term interest rates and the real exchange rate (Mishra & Pradhan, 2018). However, the Central Bank of Nigeria acknowledges that these objectives may conflict at times, requiring policy trade-offs. In order to achieve its goals, the CBN manipulates operational targets—particularly the Monetary Policy Rate (MPR), over which it has direct control—to influence intermediate targets that ultimately affect price stability and sustainable growth (Uchendu, 2010).

Monetary policy and Deposit Money Banks are closely interconnected. The effectiveness of monetary policy tools can often be assessed through banking system performance, especially in terms of profitability. These tools are broadly categorized into portfolio control measures and market-based interventions. According to Bala, et al (2022), banks' lending decisions are shaped by factors such as prevailing interest rates, deposit volumes, levels of domestic and foreign investment, liquidity ratios, and public confidence. In Nigeria and other developing countries, central banks employ instruments such as the cash reserve requirement, liquidity ratio, open market operations, and primary market operations to influence bank reserves and overall monetary conditions.

Monetary policy is formulated and implemented by a Central Bank, typically through a Monetary Policy Committee, to regulate money supply within the economy. It operates in two primary forms: expansionary and contractionary. Expansionary monetary policy increases money supply by lowering interest rates during periods of low liquidity, whereas contractionary monetary policy reduces money supply in circulation to curb inflationary pressures.

Deposit money banks are usually considered around the world as the most appropriate channels for implementing monetary policy by most Central Banks in many countries. It therefore, becomes necessary that regular study be conducted to examine the extent to which monetary policy explains the fluctuations in the performance of deposit money banks in Nigeria which forms the main objective of study. There had been mixed findings on the exact effect of monetary policy implementation on the Performance of deposit money banks in literature. For instance, while scholars including Gimba, et al (2020), observed that monetary policy has a significant effect on the financial performance of deposit money banks, others including Otalu, et al (2014), reported that monetary policy has insignificant effect on financial performance of

banks. This study therefore aimed to contribute to the ongoing controversy, particularly in Nigeria. The aim of this study is to examine the impact of monetary policy on Deposit Money Banks" in Nigeria.

2.1 Conceptual Review

Ekpung, et al. (2015), describe monetary policy as a set of coordinated actions undertaken by monetary authorities—namely the Central Bank and the Ministry of Finance—to directly or indirectly control the supply of money and credit in the economy, as well as to influence the structure of interest rates in order to promote economic growth, maintain price stability, and ensure balance of payments equilibrium. Similarly, Uwazie and Aina (2015), explain that monetary policy is employed to affect the availability and cost of credit with the objective of regulating money supply within an economy. Onyemachi, (2010), broadly defines monetary policy as a purposeful effort by the government to manipulate money supply, the cost and volume of credit, and the allocation of credit in order to influence economic activity and achieve macroeconomic stability.

Hogue et al. (2020), further view monetary policy as a coordinated set of actions aimed at controlling the supply, cost, and value of money within an economy, describing it as a framework for regulating the volume of financial resources to ensure price stability and sustainable economic advancement. In the same vein, Onyeiwu (2012), considers monetary policy a vital instrument of economic management directed toward attaining long-term economic growth and development, noting that countries have consistently pursued this objective since the era of Adam" Smith.

2.2 Theoretical Framework

This study is grounded in the Interest Rate Channel Theory within the wider context of the Monetary Transmission Mechanism (MTM), as explained by Ndubuisi, (2015). The monetary transmission mechanism describes the process through which central bank policy decisions influence key real economic variables, including output, investment, consumption, and inflation. Among the several channels identified in the literature, the interest rate channel is regarded as one of the oldest and most extensively examined routes through which monetary policy shapes economic performance.

Over the years, the theoretical understanding of the interest rate channel has undergone refinement, particularly following episodes of financial crises and macroeconomic instability that revealed limitations in earlier models Ndubuisi, (2015). Despite these developments, the central idea continues to rest on the traditional money view of monetary policy. From this standpoint, variations in the supply of outside money—often implemented through central bank measures such as open market operations lead to changes in short-term nominal interest rates. Due to short-run price rigidities, movements in nominal interest rates translate into changes in real interest rates. The core proposition of the interest rate channel is that an expansion in the money supply generally reduces real interest rates A decline in real interest rates lowers borrowing costs, thereby making investment ventures more attractive and economically feasible. Firms are encouraged to undertake capital investments when anticipated returns surpass the diminished financing costs. As a result, reduced interest rates stimulate private investment, increase productive capacity, and boost aggregate demand. In contrast, a contractionary monetary policy that tightens money supply raises interest rates, discourages borrowing, and suppresses both investment and consumption (Taylor, 1999).

Transmission through the interest rate channel occurs when shifts in the stance of monetary policy—whether expansionary or contractionary—produce corresponding adjustments in the overall level of interest rates within the economy. These interest rate movements affect aggregate absorption by influencing credit demand and the disposable income of households and firms Taylor, (1999). For borrowers, lower rates reduce the burden of debt servicing and promote higher spending, while for savers and lenders, changes in interest rates alter returns

on savings and shape investment choices. Through these interrelated mechanisms, monetary policy ultimately influences output, employment, and price stability. Therefore, the interest rate channel offers a coherent theoretical framework for understanding how central bank actions are transmitted to the real sector, making it an essential basis for evaluating the effectiveness of monetary policy interventions.

2.3 Empirical Review

Dang and Huynh (2022) "investigated the link between monetary policy and bank performance within a multiple-instrument framework, with particular emphasis on how different bank business models condition this relationship. Their specific objective was to assess the effects of policy rates and foreign exchange reserve ratios on banks' financial performance. Using a unique dataset covering all Vietnamese commercial banks from 2007 to 2019, the study found that banks respond to monetary policy adjustments—whether through increases in policy rates or liquidity injections via open market operations—by experiencing reduced overall returns and heightened financial instability.

Nikhil and Deene (2021), examined the impact of monetary policy instruments on the performance of banks in India, focusing specifically on the relationship between bank rate (BR) and the performance of public sector banks. The study adopted both descriptive and analytical research designs, employing correlation and regression analyses to evaluate the relationship. The findings led to the recommendation that favourable fluctuations in the bank rate should be maintained to promote flexibility within the banking system and enhance overall performance in the economy.

Alalade, Oseni and Adekunle (2020), explored the influence of monetary policy on the financial performance of deposit money banks in Nigeria using 35 years of time series data (1984–2018) obtained from the Central Bank of Nigeria Statistical Bulletin. When financial performance was proxied by total credits, the results indicated that liquidity ratio and loans-to-deposit ratio exerted a positive and significant effect in the long run, whereas the cash reserve ratio had a negative and significant long-run effect. The logarithm of lending rate was insignificant in both the short and long run. The study concluded that monetary policy significantly explains the financial performance of deposit money banks in both time horizons.

Mbabazize, Turyareeba and Ainomugisha (2020), assessed the effect of monetary policy on the profitability of commercial banks in Uganda. Monetary policy variables were included as predictors in the empirical model, while Return on Assets (ROA) served as the measure of profitability. The study concluded that monetary policy significantly affects bank profitability.

Udeh (2015) analyzed the impact of monetary policy on corporate profitability in Nigeria's banking sector and found that monetary policy has constrained corporate profitability in Nigerian banks. Similarly, Nguyen, Vu and Le (2017) examined the effect of monetary policy on commercial banks' profits in Vietnam using panel data from 20 banks between 2007 and 2014. Monetary Base (MB), Discount Rate (DR), and Required Reserve Ratio (RRR), were used as proxies for monetary policy, while profit before tax represented bank performance. The findings revealed a positive relationship between monetary policy variables and banks' profits.

Gimba, Vicent and Oyedokun (2020) investigated the effect of monetary policy on the financial performance of listed deposit money banks in Nigeria from 2006 to 2018, and reported a significant positive impact. In a related study, Akomolafe, Danladi, Babalona and Abah, (2015), examined the impact of monetary policy on commercial banks' performance in Nigeria using interest rate and money supply as proxies for monetary policy and profit before tax as a measure of performance. Employing pooled regression, fixed effects, and random effects models—with the Hausman test indicating fixed effects as most appropriate—the study found a positive relationship between monetary policy and bank profitability.

Jegede (2014) evaluated the effect of monetary policy on commercial bank lending in Nigeria between 1988 and 2008. The independent variables included exchange rate, interest rate,

liquidity ratio, and money supply, while loans and advances served as the dependent variable. Using an error correction mechanism within an ordinary least squares framework, the study established a long-run relationship among the variables. Exchange rate and interest rate significantly influenced loans and advances, whereas liquidity ratio and money supply had a negative relationship with bank lending. The study concluded that monetary policy instruments were ineffective in stimulating commercial bank lending in the long run and recommended the use of indirect monetary instruments.

Overall, the reviewed empirical studies demonstrate that the relationship between monetary policy and bank performance remains inconclusive, given the mixed findings and varying conclusions. Consequently, this present study aligns with recent research efforts to further examine the extent to which monetary policy has contributed to the performance of banks" in Nigeria.

3. **Methodology**

The study "employed the Autoregressive Distributed Lag (ARDL) approach as its principal econometric technique for data analysis. The ARDL methodology is a dynamic modeling framework used to examine both short-run and long-run relationships among time series variables. It incorporates lagged values of the dependent variable (autoregressive component) as well as current and lagged values of the explanatory variables (distributed lag component), thereby capturing the dynamic structure of economic relationships over time.

Model specification

The model is specified below

$BROI = f(x)$ ……1

$BROI = MPRC + EXCR + INFR$ ……2

$BROI = b_0 + b_1 MPRC + b_2 EXCR + b_3 INFR$…… ……3

$BROI = b_0 + b_1 MPRC + b_2 EXCR + b_3 INFR + u$… ……4

Where:

BROI is banks return on investment, which measures the performance of deposit money banks in Nigeria.

MPRC is monetary policy rate of CBN otherwise known as the bank lending rate. The rate at which the Central Bank of Nigeria lends to deposit money banks in Nigeria.

EXCR is the Naira exchange rate during the period under review.

INFR is inflation rate over the period under consideration.

Whereas, b_0, b_1, b_2 and b_3 are the constant and the parameters of the respective explanatory variables. Banks return on investment: BROI is the dependent variable.

4. Discussion of findings

Table 4.1 Descriptive Statistics

	BROI	MPRC	EXCR	INFR
Mean	16.00742	0.397407	197.3600	32.68903
Median	15.03000	13.50000	132.8900	12.88000
Skewness	0.492682	0.845953	3.350860	5.218738
Kurtosis	2.323316	5.512678	16.07600	28.49610
Jaque-Bera	1.845590	11.85246	278.8641	980.3647
Probability	0.397407	0.002669	0.000000	0.000000
Observations	**31**	**31**	**31**	**31**

Author`s computation using E views 12

Table 4.1 gives the descriptive statistics of the variables which provides a summary of vital macroeconomic indicators in Nigeria studied under the period. The average values for banks return on investment, monetary policy rate and inflation rate were 16 percent, 0.39 percent and

32.6 percent respectively. The average exchange rate during the period was #197.36 / US dollar.

The median values for banks return on investment, monetary policy rate, exchange rate and inflation rate were 15%, 13.5% #132/ US dollar and 32.68% respectively. The skewness provides information on the asymmetry of each variable`s distribution relative to its mean.

Table 4.2 Result of optimum lag

Lag	LogL	LR	FPE	AIC	SIC	HQ
0	-76.93275	NA*	15.57180	5.581569	5.770161*	5.640634
1	-75.56467	2.264413	15.20746*	- 5.556184*	5.791925	- 5.630015*
2	-75.56422	0.000709	16.33487	5.625119	5.908007	5.713716

Source: Author`s Computation using E view 12

From table 4.2 the Schwarz Information Criterion (SIC) emerged as the most appropriate and reliable for model lag selection.

Table 4.3 Unit root test result

Variable	ADF	ADF Lag	Order of Integration
	Unit root value 5%	Critical Value 5%	
BROI	3.426219	2.963972	1(0)
MPRC	3.871025	2.967767	1(0)
EXCR	3.3577377	2.981038	1(1)
INFR	4.954103	2.963972	1(0)

Source: Author`s computation using E view

The ADF unit root test result from table 4.3 shows that the variables were integrated at mixed levels, which validates the use of ECM model.

Table 4.4 BROI Model
Panel A. Long Run Output

Variable	Coefficient	Std. Error	t-Statistic	Prob.*
BROI(-1)	0.284264	0.184036	1.544613	0.1350
MPRC	0.409578	0.203575	2.011930	0.0051
INFR	0.002743	0.006682	0.410488	0.6849
EXCR	-0.004138	0.003712	-3.114691	0.0006
C	6.312791	3.214932	1.963584	0.0608

R-squared	0.317067	Mean dependent var	15.83767
Adjusted R-squared	0.207798	S.D. dependent var	3.985026
S.E. of regression	3.546902	Akaike info criterion	5.521038
Sum squared resid	314.5128	Schwarz criterion	5.754571
Log likelihood	-77.81557	Hannan-Quinn criter.	5.595747
F-statistic	2.901706	Durbin-Watson stat	2.131719
Prob(F-statistic)	0.042218		

Panel B, short run output

Variable	Coefficient	Std. Error	t-Statistic	Prob.*
BROI(-1)	0.207337	0.200259	1.035346	0.3118
MPRC	0.109518	0.299319	0.365890	0.7179
MPRC(-1)	0.400697	0.336160	3.191983	0.0024
INFR	0.002399	0.007016	2.341900	0.0057
INFR(-1)	-0.000467	0.006880	-0.067933	0.9465
EXCR	0.000153	0.006132	2.724888	0.0004
EXCR(-1)	-0.007679	0.010376	-2.401274	0.0071
C	6.712956	3.898053	1.722131	0.0991
CointEq(-1)*	-0.792663	0.178576	-4.438792	0.0002

R-squared	0.374324	Mean dependent var	15.83767
Adjusted R-squared	0.175245	S.D. dependent var	3.985026
S.E. of regression	3.619042	Akaike info criterion	5.633474
Sum squared resid	288.1443	Schwarz criterion	6.007127
Log likelihood	-76.50212	Hannan-Quinn criter.	5.753009
F-statistic	1.880279	Durbin-Watson stat	1.920743
Prob(F-statistic)	0.121827		

Source: Author`s computation using" E view

From "table 4.4 panel A, which explains the long run analysis of variables, the constant 6.32 indicates that ceteris paribus, banks return on investment has autonomous growth rate of 6.3 percent even in the absence of changes in the explanatory variables. Monetary policy has positive and statistically significant relationship with deposit money banks` return on investment. Inflation rate has positive and insignificant relationship with deposit money banks` return on investment, while exchange rate has negative and significant relationship with deposit money banks` return on investment.

Table 4.4 panel B, shows the short run analysis of the behaviour of variables in the model during the period under study. At the level form monetary policy rate has positive and statistically insignificant relationship with banks ` rate on investment, but had positive and statistically significant relationship in the first lag. Inflation has positive and statistically significant relationship with banks` return on investment in the level form, but negative and statistically insignificant relationship in the first lag. Exchange rate has positive and significant relationship with the dependent variable (BROI) at the level form, but negative and significant relationship at first lag.

The cointegration value was negative and statistically significant, suggesting the existence of long run equilibrium relationship among the variables. It also validates the use of ARDL-ECM model for the study. The F- statistic value and its probability showed that on the overall, the explanatory variables were statistically significant. Hence the regression" is not a zero-type.

Policy Implications

In the "long-run estimation, the monetary policy rate exhibits a positive and statistically significant relationship with the performance of deposit money banks (DMBs). This indicates that a moderate and stable increase in the monetary policy rate enhances the performance of DMBs in Nigeria. In the short run, the monetary policy rate shows a positive but statistically insignificant effect at the current period; however, it becomes positive and statistically significant at the first lag. This suggests that DMBs respond positively and significantly to short-run monetary policy actions, especially adjustments in the monetary policy rate. Furthermore, the inflation rate demonstrates a positive and statistically significant effect on

banks' return on investment in the long run. In the short run, inflation maintains a positive and significant impact at its level form, although it turns negative and statistically insignificant when expressed in first difference. This underscores the importance of maintaining stable inflationary policies, as policy measures relating to both monetary policy rate and inflation significantly influence banks' performance and returns. Conversely, the exchange rate shows a negative and statistically significant relationship with banks' return on investment in the long run. The first lag of the short-run dynamics also reflects a similar negative and significant outcome. This implies that exchange rate depreciation adversely affects the performance of deposit money banks in Nigeria in both the short and long" run.

5. Conclusion and Recommendations

The study concludes that monetary policy rate (MPR), exchange rate policies and inflation rate had significant impact on performance of deposit money banks in Nigeria.

Recommendations

We therefore recommend as follows

1 That monetary authorities, particularly central bank of Nigeria should adjust and keep the monetary policy rate at a value that will ensure optimum performance of DMBs in Nigeria.

2 The monetary authorities should work in conjunction with fiscal authorities to arrive at the appropriate policy mix that will reduce exchange rate in Nigeria.

3 Policy makers should pursue policies to stabilize inflation rate in the Nigerian economy.

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