DETERMINANTS OF INTEREST RATE SPREADS IN UGANDA'S COMMERCIAL BANKING SECTOR: A PANEL DATA ANALYSIS

BY

ROBERT NABENDE

A DISSERTATION SUBMITTED IN PARTIAL FULFILMENT OF THE REQUIREMENTS FOR THE AWARD OF A MASTER OF ARTS DEGREE IN ECONOMICS OF MAKERERE UNIVERSITY

DECEMBER, 2018

ABSTRACT

Liberalisation of financial markets is associated with a reduction in interest rate spreads. However, interest rate spreads have persistently remained high in Uganda despite the financial liberalisation that was undertaken by the government in the early 1990s. High interest rate spreads point to the low level of efficiency and lack of competitiveness in the financial sector. The study assesses determinants of interest rate spreads in Uganda's commercial banking sector. The analysis is based on the Ho and Saunders (1981) model and its subsequent extensions by Maudos and Fernandez de Guevara (2004). Panel data estimation techniques, specifically system generalised method of moments (GMM), are applied. We find that among the bank specific factors, interest rate spreads increase with increase in credit risk, liquidity risk, and capital adequacy ratio. Bank size is shown to be negatively related to interest rate spreads. For banking industry specific factor, foreign bank participation in the loans markets is associated with higher interest rate spreads. And for macroeconomic factors, high inflation rates are shown to be associated with high bank spreads, whilst high real gross domestic product (GDP) growth rates and broad money supply to GDP (M2/GDP) are associated with lower interest rate spreads. Going forward, banks and government should devise mechanisms to encourage loan repayment, and banks should be encouraged to reduce on holding excess liquid assets. At a macro-level, Bank of Uganda should maintain its stance on curbing inflation. Economic growth and financial development should as well be encouraged.

Key Words: Interest rate spreads; bank specific factors; industry specific factors; macroeconomic factors; dynamic panel; Uganda's commercial banking sector.

JEL Classifications: C23; E43; E44; G21; L11