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Financial Reform and Financial Development in Nigeria: A Graphical Analysis

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Abstract

The study is a graphical illustration of the impact of the financial sector reform in Nigeria on some financial sector and real sector variables. The study showed that most of the variables used portrayed a failure in achieving the desired results. This puts Nigeria in the League of Nations that failed to achieve their objectives of the reform.

Introduction

The McKinnon-Shaw (MS) (1973) hypothesis posits that regulations in the financial markets are not only repressive in the market but also distort incentives of savers and investors in the economy. They cite regulations such as deposit, interest rate ceiling, minimum/maximum lending rates, and quantitative restrictions on lending, high reserve requirement as the causes of negative and unstable real interest rates especially in the presence of high inflation in an economy. McKinnon (1973) is of the view that capital accumulation is the most critical element of economic growth while Shaw (1973) emphasizes the ability of the banking system to intermediate adequate amounts of credit to finance higher economic growth. Both argue that liberalization of the financial sector- removing interest rate and credit allocation controls will ease the repression of the financial system, which would improve the rate of economic growth through increased efficiency in financial intermediation subject to better financial discipline. The two focused on clarifying the linkages between higher interest rate and savings as well as investments and economic growth.

Gibson and Tsakalotos (1994) also emphasize the importance of financial sector liberalization for resource mobilization, capital accumulations and economic development. Thus the attempts to liberalize restrictions on the financial sectors in many emerging economies arise from the knowledge that such policy actions are growth-promoting in the long run. This was thus the driving force behind financial liberalization policies in developing countries especially in Asia, Eastern Europe, Latin America and Nigeria

This view however, it should be pointed out, is not only opposite to both Classicals and Keynesians,(Keynes 1936), but also some empirical observations show that not all countries have benefited to the same extent from liberalization attempts. While some countries succeeded in mobilising savings, stimulating investment and accelerating growth, few others experienced financial crises with very little economic growth following the reforms.

This paper aims at explaining graphically the effects of the financial sector reform on very important financial sector and real sector indicators. The remainder of the paper is organized in the following manner. In section two, we provide an enabling literature review. In section three, we will discuss the policies meted out in the Nigeria financial sector in both the periods of the so- called repression and the reform. In section four we will present the graphical analysis of the outcome of the two era. In section five, we will conclude the paper.

Literature Review

Mamoon (2004) stated that generally monetary aggregates (e.g. M1, M2 and M3) provide a set of variables to measure the extent of financial development in the banking sector. These monetary aggregates have also been used by a number of empirical studies to analyse the correlation between financial intermediation and economic growth. King and Levine (1993) had noted that

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different definitions of monetary aggregates may act as proxies for different roles of financial intermediation.

The ratio of broad measure of money stock M_2 to the level of nominal income (M_2/GDP) seems to be the most commonly used (Berthelemy and Varoulokis 1995). This ratio measures the degree of monetization in the economy. Thus it shows the real size of the financial sector of a growing economy in which money provides valuable payment and saving services. While the best measure for payment services is the narrow money M_1, the broad money measures best the savings function. Narrow money is expected to rise in line with economic transaction, while broad money should rise at a faster pace if financial deepening is taking place (Lynch 1996).

While broad money aggregates may be a better indicator of the extent of financial development than the narrow money aggregate Gregorio and Guidotti (1995), there are alternative monetary aggregates which can be used as quality proxies of financial development. One of such measures advocated by Luintel and Khan (1999) is the ratio of bank deposit liabilities to income (BANK/GDP). This choice is based on the fact that in developing countries a large component of broad money stock is currency outside the banking system which implies that a rising ratio of broad money to income may reflect rather the more extensive use of currency than an increase in the volume of banks deposit. In other words, a more representative measure of financial development may of a necessity be broad money stock minus currency in circulation.

Odedokun (1989) posits the ratio of domestic credit to income (DOM/GDP) as a quality proxy for financial development. It is a major item on asset side of balance sheet and it represents the domestic assets of the financial sector. It is expected to change in response to change in real interest rates.

According to Gregorio and Guidotti (1995), a more direct measure of financial intermediation is the private sector credit to GDP ratio (Priv/GDP) which, because it excludes the credit to public sector, represents more accurately the role of financial intermediaries in channeling funds to private market participants. Consequently the proxy should be more closely related to the level and efficiency of investment, and hence to economic growth.

While much of the evidence on the relationship between finances and growth utilizes bank-based measures of financial development, more recently, there has been an increasing shift of emphasis to stock market indicators. Before the recent bubble burst in different stock markets, world stock market capitalization grew to an all time high in the 1990s from $ 4.7 to $ 15,2 trillion between the mid 1980s and early 1990s, Demirguc-kunt and Levine (1996). The total value of shares traded in developing countries rose to over 25 fold too between 1983 and 2000 and continued to rise until the 2008 stock market burst.While that of emerging markets jumped from less than 3% of the $1.6 trillion world total in 1985 to 17% of the $9.6 trillion world total in 1994 (Demirguc-kunt and Levine, 1996). Thus according to Levine and Zervos (1996) well developed stock market may be able to offer different kinds of financial services which provide different kind of impetus to investment and growth comparable to the banks.

Specifically, increased stock market capitalization measured either by ratio of the stock market value to GDP or the number of of the listed companies may improve an economy's ability to mobilize capital and diversify risk. Mamoon (2004) also argued that liquidity is another important indicator of stock market development in that it may be inversely related to transaction costs, which impede the efficient functioning of stock market. Liquidity is measured by turnover ratio which is the total value of shares traded relative to either GDP or total market capitalization. Turnover ratio can be used as indicator of the level of transaction costs.

Various measures of equity market activity have been demonstrated to be positively correlated with measures of real activity across different countries, Levine and Zervos (1966), (1993. According to Levine and Zervos (1966) the association is positively strong for developing countries and can explain current and future economic growth.

The Nigeria Financial Sector

Prior to the institution of the Structural Adjustment Programme in Nigeria in 1986, the Nigeria financial sector faced interventionists' policies. There were statutory interest rate ceilings, directed credits, accommodation of government borrowing, exchange rate controls and informal modes of intermediation. The formal banking sector by mid- 1980s had been largely static. In 1986, 29 commercial banks and 10 merchant banks were operating. The commercial banks represented 60% of assets in the banking system, out-numbering the merchant banks by almost three to one. The industry had an oligoplistic structure as the 'big three' commercial banks (First bank, UBA and Union Bank) were dominant. Several institutions, including four development banks were wholly owned by government. A number of other

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large banks reflected mixed private public ownership, while about 15 firms were controlled by domestic private owners. The Federal Government held a controlling share in the country's leading commercial and merchant banks along with an average of 47% stake in 14 insurance companies. Overall, about 80% of assets in the commercial banks and 45% of assets in the merchant banks were under de facto federal control (NDIC, 1993). In addition, state governments had equity in 24 banks. The Central Bank of Nigeria supervised by the Ministry of Finance (MOF) controlled about a third of assets, while federally owned development banks, with less than 3% assets, played a negligible role in rooting domestic capital.

One of the sub policies out of structural adjustment programme was the reform of the financial sector. The sequence of reforms in the financial sector shows that it started with liberalisation. The first being liberalization of lending and deposit interest rates aimed at guaranteeing efficient allocation of resources. This was followed by deregulation of entry barriers into the banking sector where the three largest banks namely First bank, Union bank and UBA had dominated the market. Deregulation lead to astronomical increase in the number of banks from 34 in 1987 to 90 in 2003 before the recapitalization policy of 2004 that reduced the number of banks to 24 bigger banks compared to what they were earlier. The aim of this was to encourage competition in the banking sector and thus break the existing monopoly.

Partial removal of credit ceilings on banks was in operation before the 1992 effective removal of credit ceilings on banks adjudged healthy by the Central Bank

The Nigeria Deposit Insurance was established in 1988 to ensure safe and sound banking practices through effective supervision and to assist CBN in formulating banking policies in the performance of its statutory duty. The reforms of other regulatory and supervisory framework which started in 1991 with the introduction of the CBN Decree No. 24 of 1991 and the Banks and Other Financial Institutions Decree No 29 also of 1991 gave the CBN a higher degree of autonomy in the conduct of monetary policy and increased banks regulatory and supervisory powers over the deposit money banks and such other financial intermediaries like finance companies.

There were also various upward reviews of the minimum capital for entry by banks; the latest being that of 2004 that made minimum capital N25 billion,

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all in the bid to ensure adequate capitalization against rapid increases in bank activities.

There was then licensing of some new financial institutions like community banks, peoples banks and finance houses.

Indirect Monetary Control was introduced in 1993 when formal Open Market Operation in Treasury Bills was launched in order to regulate the flow of money and credit through market based auction mechanism of government securities,. In orde to facilitate the activities of OMO, Discount houses were also licensed as from 1993.

Deregulation of capital market was in 1993 but its full reform started in 1999. What happened in 1993 was that pricing and other direct controls were replaced by indirect control by the regulatory bodies. The enactment of Investment and Securities Act (ISA) 45 of 1999 helped in the reconstitution of the Securities and Exchange Commission and introduced measures that helped in alleviating difficulties involved in listing disclosures and check insider trading.

Foreign Exchange market reform started in 1986 when a second-tier foreign exchange market was established. Reforms in this market have witness several policy reversals and modifications to date. In 2000 reforms in the area of foreign exchange deposit took place, allowing the public to receive foregn currency in a domiciliary account so as to ensure that such remittances were retained in savings within the banking system.

The universal banking reform of 2001 freed banks to operate both banking, securities and insurance businesses, so as to ensure efficient delivery of all financial services at reduced costs and also improve bank risk-return profile through diversification, Asogwa (2005).

Graphical Presentation

Figure 1 shows that where as the number of banks increased consequent of liberalization, it did not significantly change the level of competition. This is shown by the little change in Asset Concentration Ratio (CRA_3) which portrayed a little sign of improvement in the 1990s but fell back to pre-reform level even after the N25billion recapitalization of 2004.

The interest rate spread which was expected to get smaller as more efficient business practices are pursued sequel to increasing competition continued to increase even to double digits percentage points as can be seen in the graph

Fig 2 shows the graph of the ratio of M_2 to GDP.The pre-reform M_2/GDP was consistently above 30% but was generally lower than 30% from reform to date. In 1995, 1996 and 1997 it was below 20%. If reform brought about deepening as M-S theory posits, the graph should show otherwise. Instead it was consistent with Nissanke and Aryeetey (1998) submission that savings mobilization and credit allocation expected of reforms may not be achieved in some countries. This ratio suggests that the growth of the real sector GDP may not have been engineered from the financial sector.

The ratio was also consistently lower in reform period than the pre-reform until the turn of the century. The ratio fell to its lowest in 2001. With universal banking instituted in 2001 one would have expected a rise. Thus the annual average was much lower in reform compared to pre-reform era; from an annual average of 27.92% before 1986 to as low as 14.74% between 1987 and 2003. Whereas the reform activities in the banking sector are expected to lead to increase in this ratio, the graph shows otherwise through the reform period till 2004-a probable case of confidence-crisis by the banking public. It could also mean more interest shown in stocks because the stockmarket had become very attractive. Within 2004 to 2007 it was very irregular though with an increasing trend and may give an average higher than pre-reform era which may mean a return of confidence by the banking public.

How much of this deposit was channeled to the economy can be deciphered as we look at Fig 4 the domestic credit to GDP ratio (DOM/GDP). This ratio fell from an average of 15% in the pre reform period to about 8%. We need to find out whether it was due a decline of credit to either the public sector or to the private sector or both. In case the domestic credit fell because of decrease of credit to public sector, the financial sector has shown maturity and independence. However, if the decline in overall domestic credit is accredited to squeeze in credit to private sector, financial development has failed to sublime into productive investments.

In this investigation, Fig 5, the ratio (PRIV/GDP) shows that in the reform years banks on average channeled lesser resources to private ventures.

The PRIV/GDP ratio ranged between 14% in 1980 to 24% in 1986.This ratio consistently deteriorated from 23% in 1987 to 14% in 1990 and there after fluctuated between 8% and 16% in reform era. This lower average ratio recorded post reform indicates relative narrowing of the financial sector, which is a contradiction of what the reform should present.

The all time low we see in Fig 5 was because more credit was going to public sector until 2000 when it appears otherwise because credit to the federal government especially from the central bank was no longer reported.

It is pertinent to point out that more than two decades into the reform neither the monetary aggregates M_2/GDP nor the aggregates nearer to real economic activit for example Private Credit/GDP and the Private Credit/Domestic Credit showed any improvement of the expected workings of financial institutions. Infact Fig 5 shows rather a period of severe repression as whatever was the little resource in the economy was allocated to the public sector. The financial reform has not really enabled the banking sector improve its credit allocation. Neither the monetary aggregates nor the aggregates nearer to the real economic activity show improvements of the financial institutions. Nigeria economic and socio-political activity may have witnessed all time low since the reform years relatively.

There is always a risk of two-way causality between the finance and growth [see Patrick 1966, Demetriades and Hussein 1996]. Therefore we cannot outrightly assert that what positive impact the financial sector reform would have had in the Nigerian economy may have been offset by low economic activity and socio-political uncertainty experienced by Nigeria since democratic transition. We still need to probe into the financial sector by describing certain non-traditional monetary measurements of financial activity

Fig 7, 8 and 9 show the overtime changing ratios of Currency/ Total Deposit, Time Deposit/ Total Deposit and Currency/M_2 respectively. It is evident that the banking public confidence is not higher than what it was before the reform.The ratio CUR/TOTAL DEPOSIT took a turn for the worse immediately the reform started rising as high over 63% in 1994 before falling. On average it is still higher than what the average was prereform.Fig 8 TIME DEPOSIT/TOTAL DEPOSIT of course is the opposite of Fig 7 and has also behaved abnormally. Fig 9 shows that cash intensity through out the reform era was on average more severe, indicating a worsening trend. According to Lindgren and Odonye (2003) it was at least 4.5 % out of line with Africa average of 22.5%. From 2002 it has shown signs of slight improvement falling back to pre reform average of 20%. None of these ratios can be said to attest differently.They are as a matter of course confirming what conventional ratios had earlier presented.

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Finally, Fig 10 Market Capitalization / GDP ratio (MC/GDP) as a barometer of the performance of a country's real sector shows a gradual but positive performance of the country's secondary market development. It rose from 10.43% in 1996 maintaining the level till 2001, when it rose to 12.07% and still rising until the global financial melt down. With this we can argue that the effects of financial reform were being felt in the capital market until the worldwide market crash of 2008 which obviously affected the market as part of the global market.

Conclusion

The above discussion provides us enough information to conclude this paper, we can say that reforms initiated in the financial sector in the later part of 1980s may not have led to improvements in the financial markets. The graphical analysis of most indicators attested to a failure and where positive performance was recorded, it was very insignificant..After over two decades of reform in the financial sector, Nigeria may not be one of the countries that have had a success story of financial sector reform positively influence real macroeconomic activity as proposed by MS thesis. A graphical analysis may not conclusively show the failure of the reform but it is enough to show that the outcome of the various measures so far taken is not encouraging.

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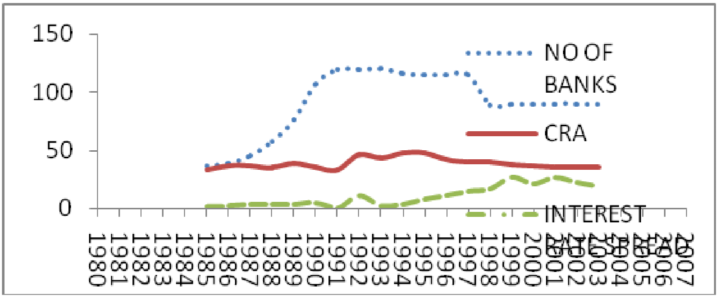
Figure 1 shows that whereas the number of banks increased consequent of liberalization



Source: CBN Bullion various issues

Fig 2 shows the graph of the ratio of M_2 to GDP

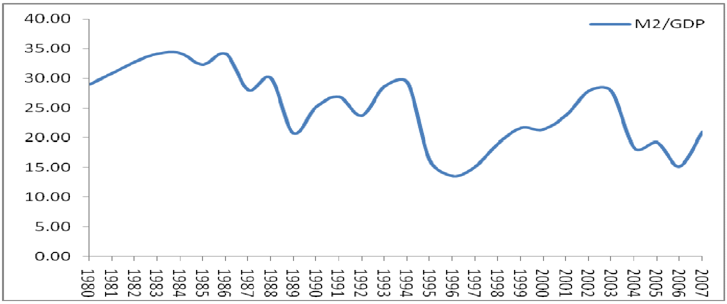


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Fig 3

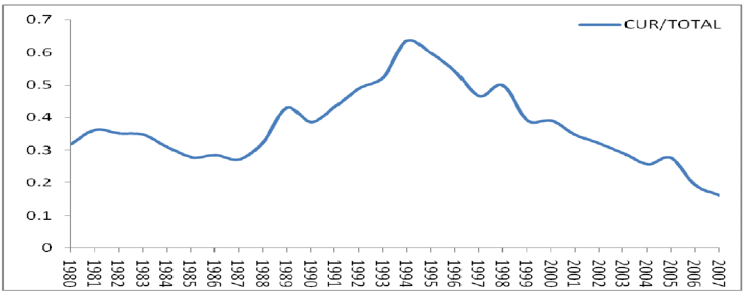

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Fig 4 shows the graph of the ratio of bank deposit to GDP.

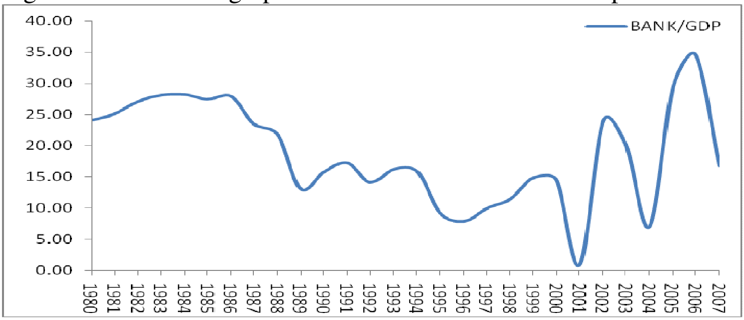

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Fig 5

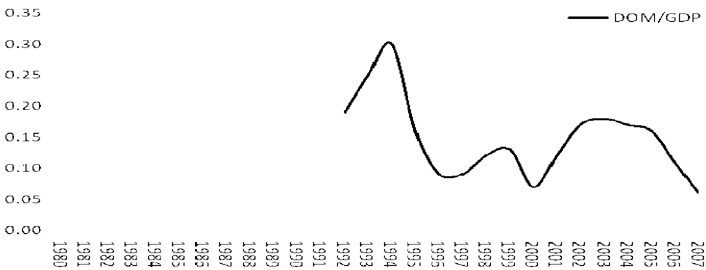

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Fig 6

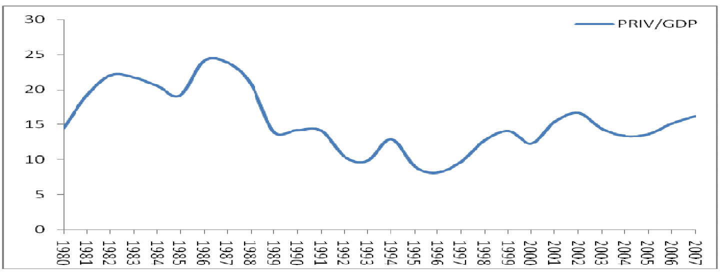

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Fig 7

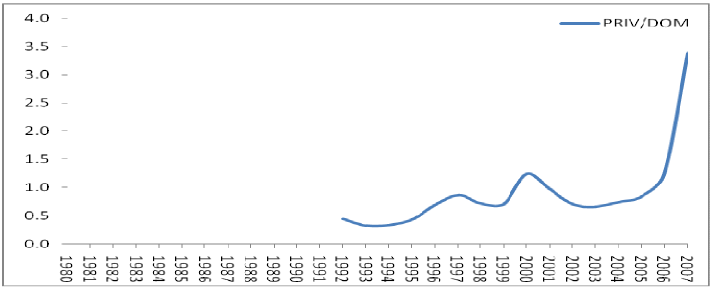

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Fig 8

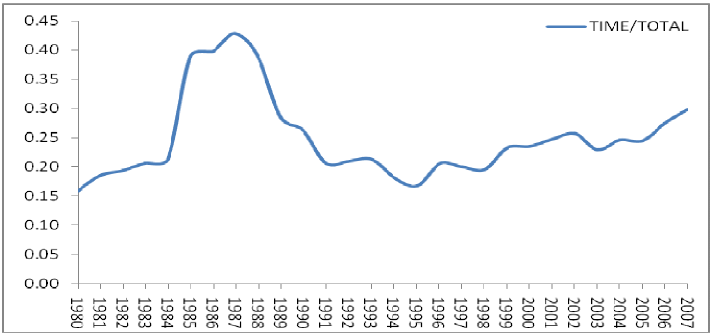

Fig 9

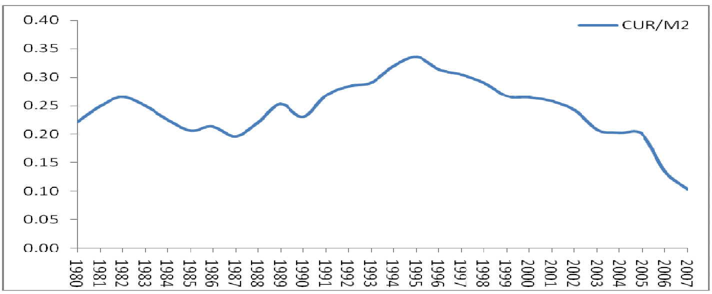

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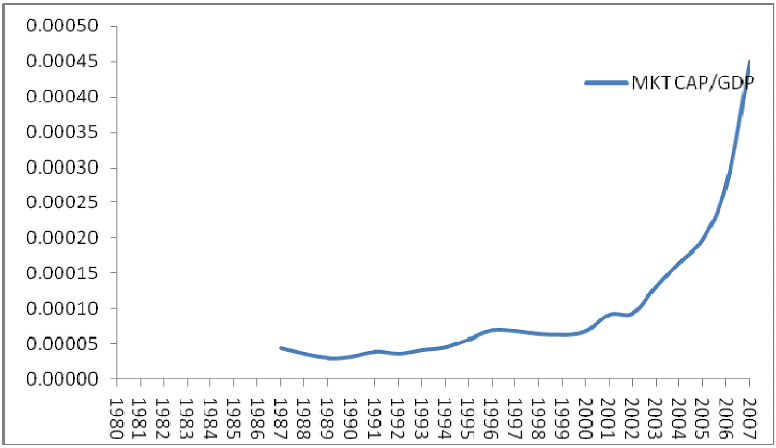
Fig 10



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