

# The impact of liberalized financial system on savings, investment and growth in Nigeria

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**Abstract:** For the past twenty years, an enhanced financial sectoral deregulation has been a major economic tool in the agenda of most less developed economies and Nigeria is no exception. The discouraging level of growth with reference to the savings and investment culture of the people and government involvement in these economies has call to question whether financial sector liberalization have an impact on savings and investment in the economy and by extension on the level of growth and development of such economies. This study attempted to take a cursory look at the issue by examining the impact of financial system liberalization on savings and investment and by extension growth and development in Nigeria between 1997 and 2008. Some of the policy recommendations centred on the government creating an enabling environment for private investment to thrive. This will go a long way in helping to promote private investment with significant benefits in the long run for growth and development to the advantage of the citizenry and the economy at large.

**Keywords:** Financial Sector Deregulation and Liberalization

## 1. Introduction

Since the mid-1980s, financial liberalization in several African countries has been implemented largely through on-going structural adjustment programmes. As a prerequisite for the financial liberalization

programmes, stabilization policies have been designed to ensure macroeconomic stability, low inflation and reduced budget deficits. The focus has been on liberalizing interest rates, deregulation of the financial sector, strengthening the banking system, introduction of new financial instruments, and

development of securities markets, in particular the stock market. Stock market is viewed as a medium to encourage savings, help channel savings into productive investment, and to improve the efficiency and productivity of investments, (Ali,1995). The emphasis on the growth of stock markets for domestic resource mobilization has also been strengthened by the need to attract foreign capital in non-debt creating forms.

It is an established fact that financial system played an important role in the economic development of any nation. In this instance the financial services industry denotes an important link between the macro economic policies of a country with the rest of the globe and her basic role in this regard is resource mobilization and resource allocation among the productive sectors of the economy via financial intermediation; funds are attracted from the surplus sectors of the economy and channeled to the deficit sectors of the economy for investment purposes. Whenever any financial system is repressed, domestic capital are usually fragmented with adverse impacts on the quality and quantity of accumulation of real capital. The adoption of financial liberalization under any of these situations has been recommended so as to enhance the level of economic growth and development of less developed economies.

The objectives in this regard via the use of stabilization policies as a prerequisite to financial liberalization programmes had been to liberate interest rates, deregulate financial services sector, strengthen the banking system, introduce new financial products and develop the securities market. Adverse economic challenges that faced the Nigerian economy between the tail end of 1985 and 1986 led to the introduction of the Structural Adjustment Programme (SAP) and one of

its major strategies was the adoption of appropriate pricing policies in all sectors with greater reliance on market forces and reduction in complex administrative controls. The deregulation of the financial market therefore led to an enabled market forces in determination of credit costs within the economy. This attracted a number of significant changes in the rules and regulations governing financial operations and these includes;

- Relaxation of controls on interest rates and also on conditions of granting banking licence.
- Abolition of credit ceilings and guidelines
- Complete deregulation of money and capital markets

In the light of the above, and according to the Central Bank of Nigeria Annual Report (various years) this resulted in a tremendous increase in the number of new entrants into the banking industry rising by over 100% from 58 banks in 1985 to 189 in 2004 prior to banking consolidation exercise which reduced the number of banks further to 24 banks. The banks' branches also rose from 1,288 in 1985 to 2,489 in 1993, thus bringing the kilometer per square of 689.4 in 1986 to 356.75 in 1993. The money and capital markets were also affected in one form or the other by the programme and a major development in the money market was the introduction of auction-based system in 1989 on Federal Treasury Bills and Treasury Certificates issuance.

With the post-consolidation situation, the universal banking model is being reviewed and this will definitely portray Nigeria as a country with policy inconsistency since the current policy is less than five years in operation and we are reverting back

to the previous order. It is worthy of note that the current move could be of strong similarity with other less developed economies like Nigeria. In the light of current developments, Nigerian banks are to be categorized into national banks (N25 billion for banks operating in Nigeria only and N100 billion for banks with operations outside Nigeria) and regional banks (N15 billion minimum capital requirement and must have the word "Regional" in its name) (CBN, 2010)<sup>1</sup>.

The major aim of financial liberalization is an enhanced economic performance via improved level of competitiveness with a robust efficiency posture within financial markets and with accrued benefits indirectly flowing to the coffers of non-financial sectors of the Nigerian economy. Since the application of the prescribed financial liberation, the Nigerian economy has not been able to experience impressive performances such as an enviable attraction of foreign investment or to checkmate capital flight.

The study is intended to critically assess the impacts of liberalization of the financial system on savings and investment and by extension on growth and development in the Nigerian economy over the period of 11 years between covering 1997 and 2008. Emphasis will therefore centre on the macroeconomic indicators of gross domestic product, inflation rates, and savings as well as investment variables in the economy.

*The objectives of the study are:*

1. To examine the nature and challenges of the financial systems.
2. To analyse and assess the concept

of financial liberalization in the content and context of legal and institutional framework.

The study will proffer probable policy recommendations on the identified flaws in the financial system liberalization for the benefit of the economy. This will lead to an enhanced standard of living and by extension the desired economic growth and development will become achievable.

The study will also reveal how effective the various reforms in the financial services sector have been and thereby illuminate on areas requiring effective controls. The remaining part of the study is structured as follows: next is the literature review, followed by the theoretical framework. Methodology and analysis are in section IV. Discussion of findings, recommendations and conclusion is in the last section.

## 2. Review of literature

Financial liberalization in Nigeria commenced as an effort towards participation in the globalization of the world economies. The United Nations via International Monetary Fund (IMF) tends to achieve a union in the world economy and therefore launched a programme aimed at achieving a turn-around on the economic situation faced by many of the less developed economies. The programme was named Structural Adjustment Programme (SAP). Several objectives expected of the programme to be achieved include the following according to Central Bank of Nigeria (CBN, 2004)<sup>2</sup>.

- Market liberalization to promote efficient resource allocation

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<sup>1</sup> Central Bank of Nigeria (CBN), 2010. Review of Universal Banking Model. [www.cenbank.org](http://www.cenbank.org) (accessed on 24th April, 2010).

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<sup>2</sup> Central Bank of Nigeria (CBN), 2004. Statistical Bulletin.

- Expansion of savings mobilization base
- Promotion of investment and growth through market-based interest rates
- Foster healthy competition in the provision of services
- Laying the basis for inflation control and economic growth

Most developing countries liberalized their financial sector in an attempt to integrate globally by removing government interventions and restrictions. The reason behind the shift to financial liberalization is based purely on a straightforward implication of the following economic principles: financial markets allow proper allocation of savings to productive investments which accelerates economic growth. Generally, nations' wish to have a smooth consumption pattern over time and in the course of achieving this, financial liberalization allows them a smoother consumption pattern via international risk sharing.

They are less constrained by domestic endowments due to their ability to borrow from global financial markets by avoiding substantial falls in national consumption in case of dramatic decrease in output. Soyibo (1994)<sup>3</sup> observes that the reforms in Nigeria were carried out under conditions of severe macroeconomic imbalances and instability in the financial system. Financial systems liberalization came into being because it is believed that a well functioning system pro-

vides adequate support for economic development while its poor functioning causes more problems for development.

### 2.1 Financial liberalization

The basic programme of financial liberalization contains two main components:

1. Removal of ceilings on interest rates to allow for market determined ones.

2. Reduction in quantitative controls to allow financial intermediaries greater control over the use of their liabilities. (Levine, 1996)<sup>4</sup>. Financial restructuring of the banking sector constitutes other aspects of financial sector reforms. These include the following as enunciated by World Bank, (1989)<sup>5</sup> report:

1. Causes of bank insolvency and restructuring or closing down of insolvent firms.

2. Improved management of banks.

3. Increased competition in the banking sector as well as the development of a more diverse range of financial institutions such as insurance and pension firms, development finance institutions et cetera.

4. Removal of entry barriers to private sector financial institutions.

5. Improved legal controls and powers that are of benefit to lenders.

6. Improved government supervision.

7. Reduction of taxation either directly or indirectly via large reserve requirements. Development of money and capital markets.

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<sup>3</sup>Soyibo, A. 1994. Conceptual and Theoretical issues in the Study of Informal Finance", pp. 82-94 in E.U. Olisadebi and Ajakaiye Olu.(eds.), Conceptual and Methodological Framework for Informal Sector Research in Nigeria, Ibadan: New World Press Statistics, Vol. 52, (May), pp. 169 – 210.

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<sup>4</sup>Levine, R. (1996). Foreign Banks, Financial Development and Economic Growth. International Financial Markets: Harmonization versus Competition, pp. 224-54, Washington D.C.: AEI Press.

<sup>5</sup>World Bank, 1989. Private Capital Flows to Developing Countries: The Road to Financial Integration. New York: Oxford University Press.

## 2.2 Legal and institutional framework for financial liberalization

### a. Legal Framework

Liberalized financial systems cannot be effective without sound legal and institutional framework. Evolutionary and proactive strategies are possible approaches to financial system development, (Obstfeld and Taylor, 2004)<sup>6</sup>. In the evolutionary strategy, financial markets are allowed to develop gradually with the economy.

As major distortions or bottlenecks emerge, government intervenes through improvements or changes in laws or regulations. In this strategy, financial deepening and financial system development are basically market driven within an adaptable legal, regulatory and prudential framework. Sander and Kleimeier (2006)<sup>7</sup> see this as the appropriate strategy for African and other developing countries for three main reasons:

- Inadequate neutral incentive environment and market forces that is insufficiently strong for financial markets to develop by themselves.
- Lack of institution-building capacity to determine the pace and strength of financial markets development.
- Need for flexibility to allow for the use of the most efficient institutional set-up, required training infrastructure and choice of technology that is most suited to the local conditions and level of development.

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<sup>6</sup>Obstfeld, M. and Taylor, A. M. 2004. *Global Capital Markets: Integration, Crisis, and Growth*. New York: Cambridge University Press

<sup>7</sup>Sander, H. and S. Kleimeier, 2006. "Interest Rate Pass-Through in the Common Monetary Area of the SACU Countries", *South African Journal of Economics*, Vol. 74, No. 2. pp. 215- 229.

The proactive approach suggested by Sander and Kleimeier seem to agree with the views of the World Bank (1989)<sup>8</sup>, which sees the legal and institutional framework of most developing countries as inadequate to support modern financial processes.

### b. Institutional Framework

The legal, regulatory and prudential framework discussed in the preceding section is essential for fostering financial market functions and promoting and anchoring its institutional framework. The ultimate function of financial markets, as earlier indicated, is to mobilize and allocate resources through financial intermediation in order to accelerate the process of economic growth. The function is performed through two distinct but interrelated components (the money and capital markets). The money market and the capital market are inter-related. First, the development of the money market usually precedes capital market development. Second, the same institutions may operate actively in both markets. Hence, the money market serves as a source of liquidity for the long-term investment needs of operators in the capital market. Bloch and Tang (2003)<sup>9</sup> has argued that in order to develop and achieve the objective of supporting economic growth, the capital market requires environment in which government policies are generally favourable to economic growth. In such environment, resources are allocated in accordance with market forces rather than government directives.

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<sup>8</sup>World Bank, 1989. Op. Cit.

<sup>9</sup>Bloch, H. and S. H. K. Tang, 2003. "The Role of Financial Development in Economic Growth," *Progress in Development Studies*, Vol. 3, No. 3, pp. 243-251.

During the period 1970–1985, Nigeria's financial sector was characterized by financial repression, macroeconomic imbalances and instability (Soyibo 1994)<sup>10</sup>.

Prior to 1970, banking regulations were largely prudential, aimed mainly at ensuring sound banking practices and protection. From the early 1970s, the aims remained broadly the same as in the previous years, but the control instruments became rather restrictive. The system was so regulated that by the mid-1970s, the Central Bank could stipulate what loans and advances each commercial bank should make to each of the sixteen different priority sectors of the economy, as well as maximum interest ceilings for agricultural and other priority areas (King and Levine, 1993)<sup>11</sup>. Government controlled 60 percent of commercial bank share capital while the Central Bank controlled 33 percent of the financial assets. Prior to the implementation of financial liberalization, government took no serious measures to establish appropriate legal framework under which the financial system would operate. No appropriate safety nets were established to safeguard against liquidity crises and no adequate regulatory and monitoring framework to prevent collusion and excessive risk-taking was put in place.

### 2.3 Financial liberalization and the informal sector

Financial liberalization acts directly on the formal sector financial system, through

<sup>10</sup>Soyibo, A. 1994. Op. cit.

<sup>11</sup>King, R. G, and R. Levine, 1993. "Financial Intermediation and Economic Development", in Mayer, C. and Vives, X. (Eds), *Capital Markets and Financial Intermediation*, London: Center for Economic Policy Research

the removal of interest rate and other controls. As noted, however, the majority of small scale borrowers, particularly women, gain access to financial services through the informal sector.

For this reason, it is important to look at the indirect effects of financial liberalization on the informal sector, to see how the provision of, access to and use of financial services by women relative to men might change under liberalization. Few studies to date focus on the impact of liberalization on the informal financial sector. In terms of predictions, this depends to some extent on the view taken regarding dualism. There are competing views as to why Less Developed Countries (LDC) financial markets are characterized by segmentation, fragmentation, or dualism and thus about the nature of relations between the different segments and how these are likely to evolve (Nielsen et al, 2005)<sup>12</sup>.

The theory of financial repression sees the development of informal sector finance as linked to distortions in financial markets caused by government controls, leading to the creation of parallel markets, to serve those crowded out of regulated markets by rationing. In this view, the informal sector should recede in favour of the formal sector, with interest rates converging, as liberalization proceeds. Savings will increase and move into the formal sector as interest rates rise, increasing the funds available for loan and investment. Informal sector operators may move into the formal sector as entry barriers, controls and taxes on the formal sector are removed or reduced.

<sup>12</sup>Nielsen, H., Uanguta, E. and S. Ikhida, 2005. "Financial Integration in the Common Monetary Area", *South African Journal of Economics*, Vol. 73, No. 4, December, pp. 710-721.

An alternative view is that problems of imperfect information are the main cause of market segmentation and fragmentation, i.e. that high information and transactions costs lead to market failure and lack of institutional development (Nielsen et al, 2005)<sup>13</sup>. In this view, credit rationing persists even with liberalization, so that the need for the informal sector persists, or possibly expands, as demand for financial services grows under adjustment. To a large extent, the effects will depend on the degree of market integration prior to liberalization. They find little evidence of market integration between formal and informal sectors in four Sub-Saharan African countries including Nigeria. Some informal intermediaries place deposits with banks, mainly for security, since these are short-term and rarely interest bearing. Formal financial institutions are reluctant to lend to informal operators who on-lend.

### 3. Theoretical framework

Most developing economies implemented financial reforms as part of a larger market-oriented reforms since 1980s and in the light of this, several versions of the financial liberalization hypothesis exists (Aziakpono, 1999)<sup>14</sup>, but the one mostly adopted particularly by less developed economies is the orthodox approach of McKinnon and Shaw.

The orthodox approach in this instance suggests that financial liberalization increases both savings and investments and thus leads to enhance and efficient investment as posited by Shaw (1973)<sup>15</sup>. With the elimination of controls on interest rates, credit ceilings and direct credit allocation, financial liberalization is expected to lead to the establishment of positive interest rates on deposit loans. In such instance, it makes both savers and investors appreciate the scarcity of capital, leading to a reduced dispersion in profit rates amongst varying economic sectors, improved allocative efficiency and higher output growth, (Villanueva and Mirakhor, 1990)<sup>16</sup>. Though the financial liberalization theory places more emphasis on the desirable effects of raising interest towards equilibrium, it also postulates that the effect of a change in interest rate depends on whether the actual interest rate is below or above equilibrium. If below the equilibrium, investment is constrained by savings. An increase in the interest rate towards equilibrium will increase savings and investment. Therefore as long as the equilibrium interest rate is not reached, investment is positively related to the interest rate. Beyond the equilibrium however, increase in interest rate will have a negative effect on investment as the economy moves along the negatively-sloped investment demand curve, (Gourinchas and Jeanne, 2003)<sup>17</sup>.

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<sup>13</sup>Nielsen, H., Uanguta, E. and S. Ikhide, 2005. Op. Cit

<sup>14</sup>Aziakpono, J. M. 1999. Effects of Financial Integration on Financial Development and Economic Performance of the SACU Countries World Bank (1997) Private Capital Flows to Developing Countries: The Road to Financial Integration. New York: Oxford University Press.

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<sup>15</sup>Shaw, E., 1973. Financial Deepening on Economic Development, New York, Oxford University Press.

<sup>16</sup>Villanueva D. and A. Mirakhor, 1990. Strategies for Financial Reforms. IMF Staff Papers, Vol. 37, No. 3, pp. 509-536.

<sup>17</sup>Gourinchas, P. and O. Jeanne, (2003). The Elusive Gains from International Financial Integration, Working Paper Series No 9684, National Bureau of Economic Research.

This implies that as financial savings and the rate of interest are positively related, interest rate may also have a positive effect on investment through the process of financial deepening as well as the provision of credit to the private sector while it could be negative since an upward swing in the price of credit adjusted for inflation is expected to discourage investment spending in the economy. The net effect of interest rate on investment therefore will depend on the relative strength of its negative effect through the cost of investment and its positive effect through the provision of credit, (Eatwell, 1997)<sup>18</sup>.

The Harrod-Domar Growth Model on the other hand posits that every economy must save a certain proportion of its national income if only to replace worn-out or impaired capital goods. However and in order to grow, new investments representing net additions to the capital stock are very necessary, (Esen, 2000)<sup>19</sup>. Therefore the variables that could stimulate the rate of savings in an economy apart from income, as well as how savings and capital formation (investment) could generate the required level of growth and by extension economic development in the developing economies like Nigeria become imperative as reflected in the formula below. It implies income (Y) as a function of the stated variables:

$$Y = f(S, GCF, NBB, INF)$$

Where

Y = Income or GDP

S = Savings

GCF = Gross Capital Formation or Investment

NBB= Number of Bank Branches

INF = Inflation

### *Description of Variables*

**Gross Domestic Product (GDP)** data at current market prices. This is the Gross Domestic Product at current factor cost plus indirect taxes net of subsidies. It is the GDP valued at the market prices which purchasers pay for the goods and services they acquire or use.

**Aggregate Savings (S)** is the part of the national income that would not be spent on consumer goods. Klein (2005)<sup>20</sup> defined savings as "abstinence from consumption, an exchange of present income against an equal amount of income in the future or against the security accompanying a store of wealth". In this instance, savings is not hoarding since it involves the productive use of funds not spent on present consumption.

**Gross Capital Formation (GCF)** This is also known as Gross Domestic Investment and it connotes the total change in the value of fixed assets plus changes in stocks.

**Number of Bank Branches (NBB)** is the total number of branches per bank operating in the country at a particular period of time.

**Inflation (INF)** is a deceleration of economic growth and a massive disequilibrium of international payments.

### **Hypothesis of the study**

The following hypothesis is formulated

<sup>18</sup>Eatwell, J. (1997). "International Financial Liberalization: The Impact on World Development". Discussion Paper Series 12. New York: United Nations Development Programme.

<sup>19</sup>Esen, O. 2000. Financial Openness in Turkey, International Review of Applied Economics, Vol. 14, No. 1. pp. 5-23.

<sup>20</sup>Klein, M. W. 2005. Capital Account Liberalization, Institutional Quality and Economic Growth: Theory and Evidence. Working Paper Series No 11112, National Bureau of Economic Research



in order to find answer to the problem of the study as stated above:

*Ho: There is no significant difference on the impact of liberalized financial system on savings, investment, growth and development.*

**4. Method of analysis**

The sources of relevant data utilized for this empirical work were collected from

economic journals, internet sources, Central Bank of Nigeria Statistical Bulletins and Annual Reports, World Bank Reports, United Nations Development Programme (UNDP) Annual reports and other relevant periodicals. This study adopted the One- way Anova method of data analysis using Microsoft Excel Analytical tool to justify the study so as to be able to capture the impact of the study on the economy.

**Data analysis and results**

**Table: Relevant Data on the Required Variables of Study**

YEAR	GDP	SAVINGS	GCF	NBB	INFLATION
1997	2,801,973	177,648	205,553	2,551	10.67
1998	2,708,430	200,065	192,984	2,298	7.86
1999	3,194,015	277,667	175,736	2,298	6.62
2000	4,512,127	385,191	268,895	2,444	6.94
2001	4,725,086	488,045	371,898	2,994	18.87
2002	6,912,381	592,094	438,115	3,018	12.89
2003	8,487,031	655,739	429,230	3,247	14.03
2004	11,411,067	797,517	456,970	3,492	15.01
2005	14,572,239	1,316,957	*804,400	3,492	17.85
2006	18,564,595	N/A	*1,546,525	3,004	8.24
2007	20,657,251	2,693,554	*1,917,000	3,897	5.38
2008	23,842,126	4,118,172	*2,283,050	3,897	11.60

Source: National Bureau of Statistics; \* United Nations Statistics; CBN

**Test of hypothesis**

**Anova**

SUMMARY

Groups	Count	Sum	Average	Variance
Column 1	12	1.22E+08	10199027	5.65E+13
Column 2	12	11702649	975220.8	1.5E+12
Column 3	12	9090356	757529.7	5.41E+11
Column 4	12	36632	3052.667	328890.1
Column 5	12	135.96	11.33	20.14402

## ANOVA

Source of Variation	SS	Df	MS	F	P-value	F crit
Between Groups	9.25E+14	4	2.31E+14	19.72899	4.05E-10	2.539689
Within Groups	6.44E+14	55	1.17E+13			
Total	1.57E+15	59				

**Analysis of results**

From the above analysis the F-ratio of 19.7 is greater than the F-critical value of 2.53. The null hypothesis is rejected. We conclude that there is significant difference on the impact of liberalized financial system on savings, investment, growth and development in Nigeria.

**5. Discussion of findings and recommendations**

Based on the outcome of the study the following recommendations were of relevance:

1. Financial liberalization should be well coordinated with policies that encourages growth and stability of the economy and thus enhances credit worthiness of borrowers via prudent economic policies of great importance to achieve desired success.

2. Financial liberalization as it were stimulates investment better than it will stimulate national aggregate savings and the implication is that foreign borrowing will increase. In this instance, capital inflows require stringent regulations most importantly short term capital inflows to ensuring that activities of export industries are not in any way disrupted. However, it must be noted that capital inflow could not be objected to if such do not result to a foreign debt problem.

3. The government should focus more on the creation of conducive atmosphere that will make private investment interesting and attractive. Such conditions could include but not limited to stable macroeconomic environment, provision of adequate property rights such as adequate access to credit, imported inputs by investors, stable and reliable energy supply, good and decent road network, improved telecommunication services as well as the provision of adequate and consistent security.

4. Financial liberalization policies should promote private investment with significant benefits for long term level of growth and improved standard of living.

5. Enhanced growth and development becomes achievable where financial institutions channel available funds to the productive sectors of the economy like the industrial sector and not for consumption purposes that violates the economy. The effect of this is being felt via the global financial crisis due to the poor quality of credit granted courtesy of the sub-prime credit saga in the United States of America.

**6. Conclusion**

The main objective of this study is to determine the impact of financial system liberalization on savings, investment and growth

in the Nigerian economy. The study focuses on the provision of evidences from the economy with regards to the performances of the Nigerian financial system on the liberalization exercise.

A major aspect of the reform has to do with the financial sector restructure as well as the liberalization of the regulations concerning financial institutions and markets. In this study an improvement in financial intermediation was considered as a necessary ingredient for stimulating investment, improving

capacity building and fostering economic growth and development. The McKinnon and Shaw hypothesis on financial liberalization was adopted because of its relevance to developing economies like Nigeria. The basis of the hypothesis is that financial markets in developing economies are somehow fragmented and in that instance, the repressed nature of the financial systems in these economies tends to vitiate on the efficient allocation of resources which eventually leads to poor investment quality.

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