Article

Real Sector Output and Financial Liberalisation in Nigeria

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Abstract

This study investigates the impact of financial liberalisation on real sector output in Nigeria by adopting the Ordinary Least Square (OLS) modeling technique for the econometric analysis. Pre-estimation tests such as the Stationarity and Cointegration tests were also done. The results show that the variables of interest in the model are cointegrated and that financial liberalisation (proxied by private sector credit) has a negative impact on manufacturing sector, while it has a positive impact on agricultural sector. This implies that credit to private sector was diverted to some unproductive ventures, rather than productive activities. Furthermore, poor infrastructure, high level of corruption, political and economic instability and high cost fund were found to have constrained the contribution of private sector credit to economic development. On the other hand, its positive impact on agriculture shows that there is an improvement in the agricultural sector since the commencement of financial liberalisation. The study concludes that efforts should be geared towards militating against the socioeconomic cum institutional factors that constrained the contribution of private sector credit to manufacturing output growth in Nigeria within the period under review.

JEL Classification: E44, O41, O13, L16, N17

Keywords: Financial liberalisation, real sector, agricultural sector, manufacturing sector, Nigeria

1. Introduction

Before financial liberalisation, the Nigerian government practised financial repression. They subjected the administrative framework of the financial system to the formulation of financial policies which were implemented to suit its desires.

The financial liberalisation movement that took place in the developing countries between the 1980s and the 1990s as part of the general move towards giving markets a greater role in development was a reaction to several factors specific to finance, such as costs, corruption and inefficiencies. Due to the countless benefits gotten from financial liberalisation, the Nigerian government in order to achieve economic

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stability encouraged liberalisation of its financial sector. Developing countries (including Nigeria) implemented the economy recovery programme called structural adjustment programme (SAP) in order to revamp their economy.

Before the introduction of SAP in 1986, the Nigerian financial sector was characterised by stiff exchange and interest rate controls, mandatory sectorial allocation of bank credit and quantitative ceiling in bank credits to the private sector, all of which engendered distortions and inefficiencies that resulted in low direct investment. With the SAP in 1986, market-based reforms were proposed to ensure that true cost of capital would be achieved in Nigeria. However, the initial attempt at financial liberalisation yielded poor results: a poorly supervised and inefficient financial sector, weak institutions and poor governance.

Following financial liberalisation and the relaxation of rules for bank establishment in 1987, there was a rapid increase in the number of banks from 41 in 1986 to about 120 by 1992. The banks were buying foreign currency at low official prices and resell in bureau de change or parallel market to make profits. However, some banks engaged in short-term arbitrage activities, many of the banks had poor balance sheets and made limited lending to the private sector. Weak regulation of financial institutions led to a widespread concern about the rising systematic risk in the Nigerian banking sector in the 1990s. In 1993 alone, a total of 26 banks including listed ones were put to liquidation (Okpara 2006), and by 1995 it was estimated that about half of the licensed banks were distressed (Okogu and Osafo-Kwako 2006).

Available statistics indicate that the share of the banking system's credit to the private sector improved significantly from 34 per cent in the 1980s on the average to about 49 per cent in the 1990s and early part of 2000. The bulk of the credit to the private sector was mainly on short-term investment. The depth of the financial sector measured by M2/GDP ratio, contrary to expectation, did not improve in the 1990s as a decline was recorded from 32.6 per cent on the average in the 1980s to 26 per cent. In 2006, the financial sector deepened with an increase in M2/GDP ratio from 16.4 per cent at the end of 2005 to 16.9 per cent in 2006. The banking system's capacity to finance economic activity was strengthened with a higher ratio of credit to the private sector to GDP than the preceding year. The ratio of credit to the private sector to GDP was 23.1 per cent at the end of 2006. (Bassey, Bessong and Effiong 2012).

It appears that this improvement in the measures of financial indicators did not stimulate an enhancement in agricultural and manufacturing activities. Rather than resulting in a steady growth of productive activity, it generated oscillation in the business cycle. For instance, growth in agricultural sector, manufacturing and capacity utilisation has experienced 'violent' oscillations and fluctuations over the years of financial liberalisation.

The main aim of this article is to investigate the impact of financial liberalisation on real sector investment, with particular focus on agricultural and manufacturing sector outputs in Nigeria. The rest of the article is structured as follows: Section 2 reviews the literature, Section 3 is on methodology, the result is presented in Section 4 and Section 5 concludes the article.

2. Review of Related Literature

2.1 Theoretical Literature

Several studies have assessed the impact of financial liberalisation on saving, investment and growth in the economy. Schumpeter (1911) asserts that creation of credit by banks is essential for economic development, and makes the assumption that only the entrepreneur needs credit. Credit provides the entrepreneur