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REVIEW ARTICLE

FINANCIAL LIBERALIZATION, INTEREST RATE STRUCTURE AND SAVINGS MOBILIZATION: THE NIGERIAN EXPERIENCE

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ABSTRACT

A critical review of literature reveals that the debate on financial liberalization thesis still remains largely unresolved. Thus, using a quarterly time series data, this study examines the nature of causality among financial liberalization, real interest rate and savings mobilization as well as how they interact with one another in Nigeria. Granger causality test was employed in determining the nature of causality between financial liberalization and real interest rate on one hand and real interest rate and savings mobilization on the other hand. Impulse response function of the VAR system was used to ascertain how financial liberalization, real interest rate and savings mobilization interact with one another. The granger causality test shows an absence of causality between financial liberalization and real interest rate, a scenario that was replicated between real interest rate and savings mobilization. The results of the impulse response function reveal a positive interaction between financial liberalization and real interest rate as well as a positive or direct interaction between financial liberalization and savings mobilization. We therefore recommend that the monetary authorities in Nigeria should be consistent in evolving and maintaining policies that will enhance the full maximization of the benefits of liberalization.

INTRODUCTION

The theoretical and empirical links between financial liberalization and economic outcomes have been identified by many authors such as Schumpeter (1912), McKinnon (1973), Shaw (1973), Pagano (1993), Emilio and Price (2002), Andersen and Tarp (2003), Chaudhry (2009), Adeusi *et al.* (2012), and Akingunola andOlusegun 2013. Schumpeter (1912) in his postulations discarded the common belief at that time that money's sole function was a medium of exchange and nothing else. He disagreed with Ricardo's belief that banks cannot contribute to the process of wealth creation but emphasized that banks and all financial intermediaries are created not only for transporting money but also for granting credit. Schumpeter's pioneering work revealed that creation of credit by banks is essential for economic development, and made the assumption that only the entrepreneur needs credit. Credit provides the entrepreneur with purchasing power without which, it would be impossible to produce. Credit can therefore be seen to feed industrial development. However, credit does not just come automatically but has to be borrowed and this can be done only through financial intermediaries. Financial intermediaries are seen to perform the role of bridging the gap between products and means of production and they achieve this by providing the entrepreneur with purchasing power. Economic development can then proceed once the entrepreneur has been empowered by credit (Fowowe, 2010).

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Consequent upon this, the modern analysis of financial liberalization and financial policy in developing countries started with the seminal works of McKinnon (1973) and Shaw (1973). Both authors drew attention to the widespread "financial repression" in developing countries (Williamson, 1998). Financial repression is a term used to describe a country's environment whereby the financial system is repressed by a series of government interventions that have the effect of keeping very low (and often at negative levels) interest rates that domestic banks can offer to savers (Agenor and Montiel, 1996). On the other hand, financial liberalization is the process of breaking away from a state of financial repression. Since financial repression has been most commonly associated with government fixing of interest rates and its adverse consequences on the financial sector as well as on the economy, financial liberalization, in turn, has come to be most commonly associated with freeing of interest rates, elimination of various restrictions on the financial sector, such as the removal of portfolio restrictions on the banking sector, the reform of the external sector, as well as changes in the institutional framework of monetary policy (Ucer, 1998). Financial liberalization is also used to cover a whole set of measures, such as the autonomy of the Central Bank from the government; the complete freedom of finance to move into and out of the economy, which implies the full convertibility of the currency; the abandonment of all "priority sector" lending targets; an end to government-imposed differential interest rate schemes; a freeing of interest rates; the complete freedom of banks to pursue profits unhindered by government directives; the removal of restrictions on the ownership of banks, which means de-nationalization, full freedom for foreign ownership, and an end to "voting caps"; and so on (Patnaik, 2011).Although the imperfections and externalities existing in the financial system of developing countries due to financial repression are much more pronounced than those of the developed countries, it should be noted that financial repression is not restricted to developing countries. Governments all over the world intervene in the operations of their countries' financial systems. For instance, the U.S government intervention in the operations of the financial markets resulted in the introduction of Regulation Q which imposed interest ceilings on the deposits of Federal Reserve member Banks between 1933 and 1983. As it were, the government of Nigerian embarked upon financial liberalization as part of its Structural Adjustment Programme (SAP) in 1987 with the belief that reduction of all sorts of regulation on the financial sector would engender economic growth. A lot of studies have also been carried out in Nigeria to ascertain or investigate the nature of financial liberalization and its impact on the economy. Most of these studies have majorly focused on determining the impact of financial liberalization on economic growth. Studies by Ojo (1991), Anyanwu (1995), Obamuyi and Olorunfemi (2011), Sulaiman *et al.* (2012) and Akingunola *et al.* (2013) all show that financial liberalization helps to improve the economy in Nigeria.

However, little or nothing has been done in ascertaining how financial liberalization and its channels of transmission (i.e., interest rate structure and savings mobilization) interact simultaneously with one another and the nature of causation that exist between financial liberalization and these transmission channels. It is on this basis that this study departs from previous works. In order to bridge this gap in knowledge and also contribute to existing literature, we therefore aim to empirically investigate the nature of interactions among financial liberalization, interest rate structure and savings mobilization in Nigeria and also check for the direction of causality between liberalization, interest rate structure and private savings in Nigeria in this paper. The rest of the paper is organized as follows: The next section gives an overview of the Liberalization exercise in Nigeria while section 3 provides a review of the literature. The methodology is presented in section 4 and this is followed by analysis and presentation of results in section 5. The last section concludes the paper.

Brief Overview of Financial Liberalization Exercise in Nigeria

Prior to the introduction of the Structural Adjustment Program me (SAP) in Nigeria in 1986, the Nigerian financial sector was characterized by fixed and relatively low interest rates, mandatory sectoral allocation of bank credit and quantitative ceilings on bank credit to the private sector, all of which engendered distortions and inefficiencies. The Pre SAP period was an era of financial repression characterized by the policies of directed credit and an interest rate ceiling, believed to have caused imperfections in the operations of the financial market (Agu, 1988; Akingunola *et al.*, 2013). Officially, the Nigerian financial sector liberalization or reforms began with the deregulation of interest rates in August 1987 (Ikhide and Alawode, 2001). Prior to this period, the financial system, as earlier stated, operated under financial regulation and interest rates were highly repressed. The resulting low or negative interest rates discourage saving mobilization and channeling of the mobilized savings through the financial system. This has a negative impact on the quantity and quality of investment and hence economic growth (Obamuyi and Olorunfemi, 2011). The expectation of the financial liberalization process was to encourage domestic savings and make loanable fund available for investment which will in turn bring about economic growth. Lewis and Stein (1997) cited in Atsede and Adeniji (2008) asserted that liberalization of the interest rate enhanced the ability of banks to charge market-based loan rate to guarantee the efficient allocation of resources. Thus, in 1991, high level of interest rates led to the re-imposition of interest rate controls. A ceiling of 21 per cent and 13 per cent was placed on lending and deposit rates, respectively. The monetary authorities' reason for the re-imposition of interest rate controls in 1991 was that the deregulation of interest rates had been accompanied by a structure of deposit and lending rates which had been largely unresponsive to the steady decline in inflation (Odozi, 1995). Furthermore, government's observation on interest policy as highlighted in the 1991 budget is that interest rates have risen to levels which could destroy productive investments and damage the banking system if many borrowers are unable to pay their debts (Agu, 1992). However, after a year of controls, market forces were permitted again to determine all interest rates in 1992 and 1993 while in 1994, the pre-reform policy of controls has been retained. In the same year, the conditions for licensing new banks were relaxed. In contrast with the average of two entrants per year in the preceding decade, 9 ventures were launched in 1987, 16 the following year, 15 in 1989 and 25 in 1990. Of which merchant banks comprised more than half of new operations, reflecting a shift in both industry composition and the concentration of assets. The ratio of assets in commercial and merchant banks narrowed from approximately 5:1 to 3:1 within four years. The financial liberalization process in Nigeria can be aptly summarized in the Table 1.1 below:

Review of Literature

Conceptually, financial liberalization has come to be most commonly associated with freeing up of interest rates, elimination of various restrictions on the financial sector, such as the removal of portfolio restrictions on the banking sector, the reform of the external sector, as well as changes in the institutional framework of monetary policy (Ucer, 1998). Financial liberalization is also used to cover a whole set of measures, such as the autonomy of the Central Bank from the government; the complete freedom of finance to move into and out of the economy, which implies the full convertibility of the currency; the abandonment of all "priority sector" lending targets; an end to government-imposed differential interest rate schemes; a freeing up of interest rates; the complete freedom of banks to pursue profits unhindered by government directives; the removal of restrictions on the ownership of banks, which means de-nationalization, full freedom for foreign ownership,