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Impact of Financial Liberalization on Private Investment: Empirical Evidence from Nigerian Data

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Abstract: This study examines the nature of the relationship between financial liberalization and private investment in Nigeria from 1970 to 2012. The regression analysis reveals that financial liberalization, proxied by real interest rate (RINTR) has a statistically significant positive impact on private investment. Furthermore, the Chow-test result shows that there was a structural break between financial liberalization and private investment in Nigeria within the period under review. This change in relationship can be attributed to the Structural Adjustment Programme (SAP) embarked upon by the Nigerian government in 1986 which liberated the financial sector from acute repression. In addition, the Granger causality test shows that although there was dependence between financial liberalization and private investment, none caused the other. This study therefore concludes that private investment which is enhanced by private savings, financial liberalization and other key variables, is fundamental in the achievement of sustainable economic growth and development. The study therefore recommends that government should create enabling environment for private investment to thrive.

JEL Classifications: E22, E44, G21, O16

Keywords: Financial liberalization, Private investment, Granger causality, Chow test, Nigeria

1. Introduction

Studies on financial sector reforms and private investment outcomes have become a prominent feature of recent empirical endeavors (Guzici 2007; Fowoye 2011 and Asare 2013). The seminal works of McKinnon (1973) and Shaw (1973) actually gave birth to the modern economic analysis of financial liberalization and financial policy in developing countries as we have it today. As opined by Williamson (1998), both authors drew attention to the widespread "financial repression" in developing countries. Agenor and Montiel (1996) argue that financial repression describes an environment where the financial system is repressed or marginalized by series of government interventions that have the effect of keeping interest rates that domestic banks offer to savers very low and sometimes negative. This low interest rate discourages savings, makes investment unattainable and economic growth becomes elusive. Shane (2013) and Achy (2005) equally contend under the financial repression regime, the monetary authorities impose high reserve requirements, bank-specific credit ceilings and selective credit allocation, mandatory holding of treasury bills and bonds issued by the government, and finally a non-competitive and segmented financial system. 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. This approach to financial liberalization is pretty much the old view.

We now understand financial liberalization as a process involving a much broader set of measures geared toward the 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 (Murat Ucer, 1998). Also, the term financial liberalization is 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). In addition, financial liberalizationis the removal or loosening of restrictions imposed by the government on the domestic financial market (Sulaiman, Oke and Azeez, 2012 & Agu, Orji and Eigbiremolen, 2014). It encompasses those policies aimed at freeing up financially-repressed economies from the effects of such growth-retarding financial policies like ceilings on interest rates, directed credit to priority sectors, and a small number of banks which are mainly government owned and very inefficient (Fowowe, 2011, Murat 1998).

Private Investment on the other hand is an investment made by businesses, institutions or investors rather than the government. In others words, private investment refers all other kinds of investment outside that made by the government.

Before the advent of the Structural Adjustment Programme (SAP) in Nigeria in 1986, the financial sector was dominated by static 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 inefficiencies and distortions. The Pre-SAP period was seen an era of financial repression characterized by the policies of directed credit and interest rate ceiling, believed to have caused imperfections in the operations of the financial market (Akingunola et al., 2013). Consequently, the government of Nigeria 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. Specifically, 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. Proponents of liberalization argue that it keeps interest rate relatively high and competitive, encourages savings mobilization, motivates private investment and engenders economic growth while repression has a negative impact on the quantity and quality of investment and hence economic growth (Obamuyi and Olorunfemi, 2011).