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Financial Liberalization, Private Savings and Private Investment in Nigeria

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Abstract

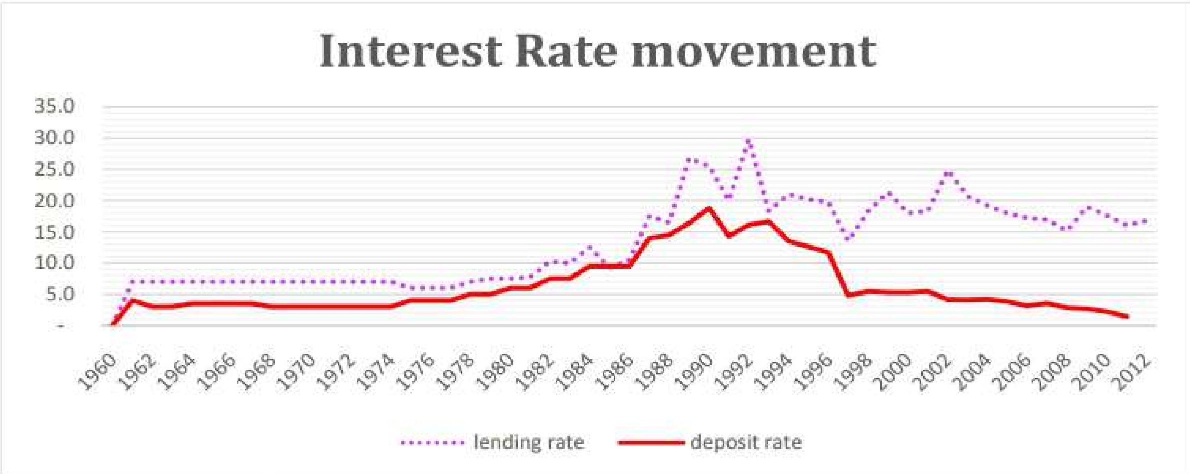
Using secondary data from 1981 to 2012, this paper empirically examines the impact of financial liberalization on private savings and private investment in Nigeria within the framework of the McKinnon-Shaw Hypothesis. The Ordinary Least Squares Methodology was adopted and cointegration analysis was carried out. The study finds that financial liberalization had a significant negative impact on private savings and a significant positive impact on private investment within the period under review. The cointegration result shows evidence of a long-run relationship among the variables. Furthermore, the error correction model shows a significant speed of adjustment to equilibrium for the private investment model but none for the private savings model. The studytherefore concludes that the Nigerian government and policy makers should formulate complementary policies that will support private savings and also strengthen private investment in the Nigerian economy. This is how the benefits of the liberalization process can be enhanced in the economy.

Keywords: Mackinnon, Shaw, Financial liberalization, Private Savings, Private Investment
JEL Classification: B26, D14, E44, F43.

1.0 Introduction

The liberalization thesis which was propounded by Mackinnon (1973) and Shaw (1973) has become an important subject of discussion in economic development literature. This is because the policy prescription made by these scholars have generated a lot of controversies and mixed outcomes among the countries that accepted the full or partial dosage of this economic pill. Prior to the financial liberalization in 1986/1987, Nigeria practiced what could be known as a financially repressed system with high reserve ratio, legal interest rate ceilings, fixed exchange rates etc. Nigerian government and monetary authority controlled the financial system. Interest rate were fixed and administratively determined by the Central Bank in Nigeria. Interest rate was relatively fixed in this era, though there were marginally increases like increase in the lending rate from 7.50% in 1980 to 10.50% in 1984 which is a 40% increase in 1984 from 1980 and an increase in the deposit rate from 6.00% in 1980 to 9.50% in 1984 showing a 58.33% increase in 1984. The figure below depicts the movement of interest rate from 1960 to 2012. The graph shows the pre-liberalization and post liberalization movement of interest rate in Nigeria.

Figure 1: Interest Rate Movement from 1960 to 2012



Source- Researchers from CBN Statistical Bulletin

When Nigeria liberalized her financial system in 1987, the nominal deposit and lending rates rose from 9.5% and 12% in 1986 to 14% and 19.2% respectively in 1987 showing an increase of 47.4% and 60% increase respectively. As a result of the interest rates reform and by 1990, the deposit and lending rates have risen to 18.8% and 27.7% respectively which is a 34.3% increase and a 44.3% increase in deposit rate and lending rate respectively. However, the government intervened in 1991 and pegged the deposit and lending rates at 14% and 21 % respectively. The deposit rate continued a downward trend while the lending rate showed fluctuations in movement, but has an increasing trend on the average. The low deposit rates implies that savings will likely be discouraged, and this will negatively affect funds mobilization by the banks which will in turn affect the amount of funds available for investment causing economic growth to be retarded (Obamuyi and Olorunfemi, 2011). On the other hand, the high lending rate is detrimental to productive investment and hence economic growth. Some of the significant measures adopted during the liberalization period include: Establishment of the Nigerian Deposit Insurance Corporation (NDIC) to insure the deposit in depository financial institutions, Licensing of more banks to increase the competition in the financial system in 1992, greater discretion was given to banks in the allocation of credit in 1987, regulatory measures that used to discriminate between commercial and merchant banks (in relation to liquidity ratios, cash reserve requirement and credit ceiling) were unified to give similar treatment to banks in general, partial deregulation of interest rate in January 1986 and full deregulation making all interest rates market determined by August 1987, payment of interest on current account deposit, among others (Ogun and Akinlo 2011).

However, it is strongly argued by McKinnon (1973) and Shaw (1973) that financial liberalization can have strong positive effects on economic performance and it can be seen that financial liberalization generates tremendous financial booms and bursts in the short-run, but these booms and bursts have not intensified in the long-run. After the prescribed financial liberalization, the domestic economy has failed to experience impressive performance such as attraction of foreign investment or halt capital flight (Akpan, 2004). With the adoption of financial reform in Nigeria since