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FINANCIAL OPENNESS AND OUTPUT VOLATILITY IN NIGERIA: A DEFACTO AND DE JURE APPROACH

Anthony Orji*, Jonathan E. Ogbuabor* and Onyinye I. Anthony-Orji*

Abstract: *Using quarterly data from 1986-2011, this study investigates the impact of financial opennesson output volatility in Nigeria. The paper adopts two measures of financial openness: de facto (total capital flow variables) and de jure (Chin-Ito Index measures)for empirical analysis. The study applies the Generalized Autoregressive Conditional Heteroscedasticity (GARCH) Model to address its core objective. The results show that none of the two measures of financial openness contributed to output volatilityin Nigeria, within the period under review.The paper therefore recommends that the government and monetary authorities in Nigeria should lay more emphasis on developing amore robust domestic economic structural reforms that will promote competitive and viable domestic banking system, with adequate regulatory and supervisory framework. This should also be complemented by other macroeconomic stabilization policies. That means, fiscal deficits, rapidly depreciating exchange rate and high inflation should beput in check. This is one of the ways to ensure that financial openness continues to contribute togrowth while lowering output volatility.*

Key Words: *Financial Openness, Output, Volatility, De facto, De Jure, Nigeria*

JEL Classification: *B26; E32; E44; F65; G15; G20; F41; O16*

1. INTRODUCTION

A fundamental issue that has caught the attention of economic researchers is the relationship between financial openness and macro economic volatility. Some authors have argued that financial openness could be a source of greater macro economic volatility, exposing vulnerable countries to sudden reversals of capital flows (Stiglitz, 1998, Kaminsky and Reinhart, 1999). According to this school of thought which emerged after the financial crisis of the 1980's and 1990's following capital account liberalization reforms by some countries, higher macro economic volatility could be

* Department of Economics, University of Nigeria, Nsukka, Nigeria, *E-mail: anthony.orji@unn.edu.ng; jonathan.ogbuabor@unn.edu.ng; onyinye.anthony-orji@unn.edu.ng*

experienced by countries, either because they lack adequate financial institutions to cope with large and sudden reversals of capital flows or because they lack policy instruments to smooth cycles. In fact, Stiglitz (1998) suggested that the financial liberalization thesis is "based on an ideological commitment to an idealized conception of markets that is grounded neither in fact nor in economic theory". On the other hand, some authors have argued that opening the capital account can yield lower output volatility by promoting production base diversification and enhance international capital flows (Razin and Rose, 1994, Bekaet, 2006).

From a welfare perspective there are two alternative ways to view the relationship between financial openness and macroeconomic volatility. The first view is that financial openness should help countries to untie consumption streams and output streams, allowing risk-averse agents to smooth consumption and leaving output volatility inconsequential for welfare. Another way is to consider that in addition to consumption volatility, output volatility is also detrimental to welfare. In view of this, Ramey and Ramey (1995) are of the opinion that volatility has a detrimental impact on output growth even after controlling for investment.

Prior to the introduction of Structural Adjustment Programme (SAP) in Nigeria in 1986, financial liberalization had become an emerging trend in both developed and developing countries. This was the prescription of the World Bank and the IMF following the structural imbalance and severe economic woes experienced by developing countries as a result of oil price shocks, rigid exchange and interest rate controls and escalating real interest rate for external debt servicing of the 1970s and 1980s (Agu *et al.*, 2014; Okpara, 2010). Furthermore, the basic thrust of the economic reform embodied in the SAP was deregulation, particularly, financial deregulation. Some developing countries like Nigeria, Cameroun, Ghana, Botswana, Malawi, Senegal, Kenya and Zambia adopted the liberalization of interest rate as a prominent feature of their financial reforms. Also interest rates were fully deregulated in Indonesia, Philippines and Srilanka in the early 1980. While Nepal freed most key interest rates in 1986, Korea, Malaysia and Thailand relaxed control by more frequent advertisement (Fry, 1997).

The proponents of liberalization suggest that it is ideal for an economy. Honohan (2000) argues that the process of financial liberalization is expected to increase the variability of interest rates with its associated distributional consequences. The overall effect is to induce competition within the financial services industry and in the entire economy, however, the experience of several countries in the 1980s and 1990s indicate otherwise. For example Chile experienced some banking problems right after deregulating the financial sector. Caprio and Kliengebiel (1995) also argue that many banking systems experienced different problems after liberalization. Bakeart *et al.* (2005) suggest that in developing countries, financial liberalization may not yield intended benefits because of the strength of domestic institutions and other factors. Demirguc-kunt and Detragiache (1998) conclude that the benefits of financial liberalization should be weighed against the increased potential for fragility.