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Financial Liberalization and Output Growth in Nigeria: Empirical Evidence from Credit Channel

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ABSTRACT: This study examined the impact of financial liberalization on output growth in Nigeria over the period of 1986-2011. Employing the Ordinary Least Square method of estimation in its analysis, the empirical findings showed that financial liberalization policy (proxied by credit to private sector/GDP) is negatively related to output growth in Nigeria within the period under review. Thus, this suggests that credits to private sector may have been used for buying and selling of consumables, or diverted to some unproductive ventures, rather than production activities, which would have increased economic growth. Moreover, available evidence shows that the amount of credit to the private sector, as a proportion of the total credit to the economy, is too negligible to contribute positively to economic growth. The results also show that there is unidirectional causality running from output growth (LRGDP) to financial liberalization. This implies that policies promoting economic growth in Nigeria will likely stimulate the gains from financial liberalization in the long-run. The co-integration test reveals that there is a long run relationship among the variables in the model. We therefore conclude that the banking sector should not serve only the government and influential borrowers, thereby leaving genuine private sector borrowers with little or no credit. Further, the government needs to encourage banks to increase their lending to the private sector, especially small and medium enterprises that are ready to invest in the real sector of the economy to enhance output growth.

Keywords: Financial liberalization; Credit, Private Sector; Output; Economic Growth
JEL Classifications: B26; D14; E44; F43.

1. Introduction

Prior to financial liberalization, the government of developing countries practiced financial repression thereby subjecting the administrative framework of the financial system to its whims and caprices, such that financial policies implemented will suit its desires. Their development strategies were designed such that the government or its agencies were vested with the responsibility to make decision regarding the allocation of resources thereby giving the market forces a less important role to play in economic development. Due to the widely spread benefits attainable from financial liberalization; many developing countries in order to achieve economic buoyancy have experienced the gradual but apparent liberalization of its financial sector. The state-dominated development paradigm has shifted towards a more market determines strategy of development in the recent years due to the relatively low growth rate of incomes, industrial output and recurring balance of payment crises in the state-dominated paradigm and also influenced by the astonishing success of Japan and East Asian countries in accelerating growth through the market-determined strategy of development (Nair, 2004).

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In the financial liberalization theory, Shaw (1973) and Mckinnon (1973) argued that financial liberalization policies would increase savings which consequently spurs investment and induce economic growth. They argued that higher interest rate brought about by liberalization leads to a more efficient allocation of resources, higher level of investment and economic growth. The focus of liberalization has been to replace the severely constrained 'command and control" system with a relatively liberalized regime with prices reflecting economic costs, along with a greater reliance on the private sector as the engine of growth (Bhaduri, 2005).

Financial liberalization has become an important economic policy package in both advanced and advancing countries. For more than a decade now, financial liberalization in developing countries has been cited as a necessary and significant part of an economic policy package promoted by what used to be called the "Washington consensus" (Ghosh, 2005). The developing countries in order to revamp their economy implemented the economy recovery programme famously called "Structure Adjustment Programme" introduced by the Bretton woods institutions (World Bank and International Monetary Fund) aimed at liberalizing prices in distress and melt down economies. The adoption of this programme signals the phasing out of financial repressive policies in the economy.

Financial liberalization serves as a panacea to financial constraints in a financially repressed economy. Under the financial repression regime, the monetary authorities impose high reserve requirements, bank-specific credit ceilings and selective credit allocation, mandatory holding of treasuring bills and bonds issued by the government, and finally a non-competitive and segmented financial system (Achy, 2003). Theories of financial repression associated especially with Mckinnon and shaw postulated that administrative control of financial markets by the government distorts interest rate thereby lowering it. The resultant effect of this is that savings is discouraged, consumption is encouraged and the quantity of investment is crippled.

Following the globalization trend, Nigerian embraced the Structural Adjustment Programme (SAP) in 1986 as a corrective measure to the deteriorating economic situation. The real GDP growth rate averaged only 1.5% per annum during the period 1973 to 1985 thereby registering negative growth rate in 6 years during the period (Adebiyi, 2001). The SAP was proposed as an economic package to rapidly end effectively transform the Nigerian economy. The basic thrust of the economic reforms embodied in SAP is deregulation, particularly financial deregulation (Okpara, 2010).

Given that interest rate policies as an instrument of monetary policy remained flexible and responsive to changes in market conditions the central bank of Nigeria in the year 2000 indirectly influences the level and direction of changes in interest rate movement through its intervention rate on various many market assets, especially the Minimum Rediscount Rate (MRR) as well as the stop rate of the weekly tender for treating bills. The Minimum Rediscount Rate (MRR) continued to be used proactively in line with prevailing economic conditions while the rate of treasury bill is made market related and competitive with comparable money market instruments (CBN, 2006A).

The benefits of financial repression, as opposed to financial liberalization, are debated on several points. In theory, it is believed that financial repression creates a better control over money supply and a lower interest rate (usually below market rate) which can induce a higher investment. Another argument in favour of financial repression is that government controlled usury controls on financial markets are needed, especially for capital scarce economies of developing countries. The main conviction of the advocates for financial repression is that the government knows better than the market.

The Nigeria financial sector, like those of many other less developed countries was highly regulated leading to financial disintermediation which retarded the growth of the economy. Most third world countries (including Nigeria) had in the past used governmental interventions as a tool in allocation of resources. These interventions have been described as not only repressive but a major factor retarding the growth process of the economy in addition to being harmful to the banking sector whose interest in liberalization is aimed at protecting. Indeed, the Nigeria growth performance has become worrisome over the last two decades. During this period, growth was sluggish and dismal to the extent that the efficacy of the various dosages of different reform polices remains an open- ended question. Hicks (1969) holds the view that the financial system play a crucial role in the mobilization of capital for industrialization, while Robinson (1952) argues that economic development creates demand for certain financial instrument, Honohan (2000) argues that the process of liberalization is