European Journal of Economics, Finance and Administrative Sciences
ISSN 1450-2275 Issue 65 May, 2014
http://www.eurojournals.com/EJEFAS.htm

The Effects of Global Financial Crisis on Nigeria's Financial Sector and its Implication for Monetary Policy Responses

Victor A. Malaolu
CBN Entrepreneurship Development Centre (EDC), Ikeja Lagos, Nigeria

Jonathan Emenike Ogbuabor
Corresponding Author Department of Economics
University of Nigeria, Nsukka, Enugu State, Nigeria
E-mail: jonathan.ogbuabor@unn.edu.ng
Tel: +2348035077722

Anthony Orji
Department of Economics, University of Nigeria
Nsukka, Enugu State, Nigeria

Abstract

The financial system in any economy plays the important role of promoting economic growth and development through the process of financial intermediation. However, this system was recently hit by a global financial crisis that emerged from the U.S.A in 2007. This study empirically examined the impact of global financial crisis on Nigeria's financial sector using time series data that spanned from 1970 to 2010 and applied the econometric methodology of Autoregressive-Error Correction Model (AR-ECM). The results indicate a long run relationship between banks asset, Money Supply and the dummy variable used to capture global financial crisis. The results also show that global financial crisis significantly affected the banking sector negatively. The study therefore recommends that the Nigerian government should strengthen the growth of institutions like the pension fund, Housing fund, and Health insurance fund in order to enhance the liquidity of the financial system. Formulation and implementation of more vigilant regulatory measures should be adopted for the financial system in Nigeria. There should be proper co-ordination among regulators; while the CBN is urged to continue with and strengthen the banking system consolidation programme as well as the cashless policy.

Keywords: Financial Crisis, Financial Sector, Monetary Policy, Error Correction Model, Nigeria

1. Introduction

The backbone of a nation's economy centres on its financial system. The role of financial sector in economic development of a nation cannot be overemphasized; it is central to growth and development. The financial system promotes economic growth and development through the process of financial intermediation. In Nigeria, the functions of the financial system include ensuring and fostering monetary stability in the economy, issuing legal tender currency, maintaining the value of the domestic currency, enhancing mobilization of funds and facilitating competition among banks and other non-bank financial institutions within the systems (CBN 2001).

In the work of Schumpeter (1911), he argued that financial services are paramount in promoting economic growth. In this view production requires credit to materialize, and one can only become an entrepreneur by previously becoming a debtor. What the entrepreneur needs first is credit because before he requires any goods whatever, he requires purchasing power. He is the typical debtor in capitalist society. In this process, the banker is the key banking sector agent. Keynes (1930), in his book titled 'A Treatise on Money' also argued for the importance of the banking sector in economic growth. He suggested that bank credit is the pavement along which production travels, and the bankers if they knew their duty, would provide the transport facilities to just the extent that is required in order that the productive powers of the community can be employed at their full capacity.

However, despite the important roles played by the financial sector, the sector has recently been hit by a global financial crisis that emerged in the U.S.A in 2007. The extent and severity of the crisis that began with the bursting of the housing bubble in the United States in August 2007 varies from country to country, Nigeria inclusive. UNIDO (2011) reported that the global economic crisis has impacted on the Nigerian economy through several channels, namely, the decline in oil prices, the fall in FDI foreign direct investment inflows, net outflows of portfolio investment and falls in credit availability from the banking sector, that taken together, have led to a reduction in aggregate demand and a decline in foreign exchange reserves. The global financial crisis has led to mergers and acquisitions in the Nigerian banking system while some top management staff of some banks are being prosecuted by the Economic and Financial Crimes Commission (EFCC) for various unprofessional banking practices in the wake of the crisis.

2. Statement of the Problem and Motivation for the Study

The Nigerian financial system is one of the largest and most robust in sub-Saharan Africa. In recent years, the system has undergone significant changes in terms of the policy environment, number of institutions, ownership structure, depth and breadth of markets, as well as in the regulatory framework. These changes have been influenced largely by challenges posed by deregulation of the financial sector, globalization of operations, technological innovations and adoption of supervisory and prudential requirements that conform to international standards. Although a wide variety of financial institutions and markets exist, commercial banks overwhelmingly dominate the financial sector and traditional bank deposits represent the major forms of financial savings. In 2006, about 25 most capitalized banks came into existence in the Nigerian banking sector via the banking consolidation/reforms under the National Economic and Empowerment Development Strategies.

The Nigerian financial sector has evolved with the growth of the Nigerian economy. The sector has been predominantly equities-driven with the banking sector making up an important proportion of total market capitalization. Prior to 2008, the sector enjoyed a decade of unprecedented growth, driven principally by the banking sector reform. However, following the global financial crisis, most of the financial indicators were subjected to volatility. For instance, exchange rate depreciated from N117 to N135 per US dollar as at end of December 2008, and there was a reduction in foreign exchange inflow due to drop in the price and volume of crude oil sold. It is also noted that limited foreign trade finances for banks led to drying-up of credit lines for some banks during the period of the crisis. Higher provisions for losses by banks led to reduction in profitability and lending.

Furthermore, interest rate spread shot up as funds dry up, liquidity squeeze came upon the financial market, interest rates were reset higher in the money market, interest rates on deposits went up as investors moved from the stock market, while lending rates also shot up to cover risks occasioned by the economic downturn. For instance, prime lending rate rose from 15.14% 2008 to 18.36% 2009, while minimum lending rate rose from 18.70% in 2008 to 22.90% in 2009 (CBN 2010). The global financial crisis has a devastating effect on every economy in the world as it affects the rich and the poor because as income and tax revenues reduce, profit and prices drop while unemployment has rises from 25% to 33% in some countries (Steuert (2009). Even though Karem (2009) argued that the effects of the financial crisis are dependent on the nature of the economy, Soludo in 2008 had already