FINANCIAL LIBERALISATION IN NIGERIA: AN ASSESSMENT OF RELATIVE IMPACT

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1. Introduction

Financial sector liberalisation can be defined as a set of reforms and policy measures designed to deregulate and transform the financial system and its structure with a view to achieving a liberalised market-oriented system within an appropriate regulatory framework. The success of financial sector reform throughout the world has been the introduction of market-based procedures for monetary control, the promotion of competition in the financial sector, and the relaxation of restrictions on capital flows. Specifically, the move away from a tightly controlled financial sector to a deregulated one results in greater flexibility in interest rates, enhancement of the role of markets in credit and foreign exchange allocation, increased autonomy for commercial banks, greater depth of money, securities and foreign exchange markets, and a significant increase in cross-border capital flows.

Traditionally, financial sector development literature is associated with the works of Goldsmith (1969), McKinnon (1973) and Shaw (1973). The Goldsmith-McKinnon-Shaw analysis emphasizes the connection between a country's financial superstructure and economic development. Though the direction of the causal relationship has never been settled, the argument is that the services of the financial sector of reallocating capital to the highest use without substantial risk of loss through moral hazard, adverse selection, or transactions costs are a crucial catalyst for economic growth (Levine and Zervos, 1998b). Typically, stagnant

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economic growth in developing economies was attributed to, *inter alia*, underdeveloped and repressed financial systems. The policy prescription of financial liberalization proposed by McKinnon and others therefore, places faith in undistorted (perfect) markets as the principal mechanism that leads to macroeconomic stability, increased investment and growth. This is founded on the premise that goods and asset markets move towards stable adjustment under a freely operating price-clearing mechanism.

Given the interest generated by the financial liberalization hypothesis, including the perceived benefits that could accrue there from, several studies have investigated the validity of the hypothesis. In this evolving literature, it is possible to detect a clear lineage stemming from the original Mckinnon-Shaw contribution, albeit one which represents an increasingly sophisticated theoretical and empirical development of the original hypothesis.

In what seems to be a comparable terrain, several authors acknowledge the advantages of liberalization, insisting that financial liberalization helps to improve the functioning of financial systems, increasing the availability of funds and allowing cross-country risk diversification. Obstfeld (1998) maintains that international capital markets can channel world savings to their most productive uses, irrespective of location. Stulz (1999) and Mishkin (2001) assert that financial liberalization promotes transparency and accountability, reducing adverse selection and moral hazard while alleviating liquidity problems in financial markets. These authors argue that international capital markets help to discipline policy makers, who might be tempted to exploit an otherwise confined domestic capital market. The prime benefits that the literature associates with liberalised financial system to the users of the financial services include the reduction in the cost of services to both savers and borrowers with the introduction of more competition, and improvements in services from more efficient, customer friendly financial institutions. Savers expect to receive higher rates of return, a broader choice of saving instruments and easier access to financial products. Borrowers benefit from more accurate appraisal of risk; reduced waiting period and expanded access to funds through more sophisticated lending instruments available in a wider range of maturities. The benefits of financial liberalization can therefore, be grouped into increased access to domestic and international capital markets and increased efficiency of capital allocation.

However, critics of financial liberalization policies have contended that the efficient markets concept is fundamentally misleading when applied to capital flows. In the theory of the second best, removing one distortion need not be welfare enhancing when other distortions are present. If the capital account is liberalized while import competing industries are still protected, for example, or if there is a downwardly inflexible real wage, capital may flow into sectors in which the country has a comparative disadvantage, implying a reduction in welfare.

If information asymmetries are rife in financial markets and transactions, in particular in countries with poor corporate governance and low legal protections, there is no reason to think that financial liberalization, either domestic or international, will be welfare improving (Stiglitz, 2000). Furthermore, in countries where the capacity to honour contracts and assemble information relevant to financial transactions is least developed, there can be no assumption that capital will flow into uses where its marginal product exceeds its opportunity cost. Stiglitz (1994) argues in favour of certain forms of financial repression. He claims that repression can have several positive effects such as improving the average quality of the pool of loan applicants by lowering interest rates; increasing firm equity by lowering the price of capital; and accelerating the rate of growth if credit is targeted at profitable sectors such as exporters or sectors with high technological spillovers. However, these claims can be doubtful given that they increase the power of bureaucrats, who can be less capable than imperfect markets, to allocate financial resources.

The financial reforms carried out in several Latin American countries during the 1970s, aimed at ending financial repression, often led to financial crises characterized by widespread bankruptcies, massive government interventions, nationalization of private institutions and low domestic saving (Diaz-Alejandro 1985). Demirguc-Kunt and Detriagiache (1998) however, have shown that the likelihood of a crisis following liberalization decreases with the level of institutional development in the country. In this sense, the arguments that Stiglitz (1994) advancesin favour of government intervention in financial markets in the form of prudential regulation and supervision are convincing. The key argument is that the government is, to all intents and purposes, the insurer of the financial systems, and hence a financial failure can have significant fiscal repercussions.

Since the 1980s many emerging economies, including Nigeria embraced financial sector reforms and have had mixed results (Akyuz and Kotte, 1991). Bossone (1998) provides insights on the role of finance in economic growth and financial sector stability from a microeconomic perspective that lends further credence to the importance of financial sector reforms in emerging economies. Whilst the early emphasis was on reforming the banking sector, the late 1980s saw financial reforms encompassing the promotion of emerging stock markets and debates about the beneficial effects arising from their external liberalization (Singh, 1993 and 1997). Starting in 1986, Nigeria's financial system began to be deregulated and by 1992, substantial changes had taken place. Consistent with trends in other developing countries, institutions and markets are growing and developing, leading to an increasing role being played by the financial system in the development of Nigeria's economy.

The main objective of this paper is to assess the impact of financial sector reforms in Nigeria, especially on the development of the financial sector. To achieve this objective, the remaining part of the paper is organized as follows: part two dwells on theoretical issues and brief review of literature. Part three contains a brief analysis of financial sector reforms in Nigeria, while part four assesses the impact of the reforms on the financial sector. Summary, conclusion and recommendations are presented in part five.

2. Theoretical Issues and Review of Literature

2.1 Theoretical Issues

An examination of the role of finance from several theoretical perspectives is imperative in order to discern how financial development aids corporate growth and economic development. The debate on financial sector reform is invariably preceded by an examination of the theory of financial development and the relationship between financial intermediation and economic growth. Goldsmith (1969), McKinnon (1973), Shaw (1973) and others have argued that financial development correlates with growth. Pagano (1993) demonstrates that financial development has a positive effect on economic growth by acting on the saving rate. Greenwood and Jovanovic (1990) observe that the dynamics of financial development resembles a demand-following approach that implies that finance is passive and hence financial markets develop out of the market needs. This argument agrees with the reasoning of Rajan and Zingales (1998) that financial development may predict economic growth because financial markets anticipate growth.

In developing countries where financial markets are relatively under-developed, dominated by monopolistic banks and where state interventions are rampant, earlier proponents of financial liberalization, including McKinnon (1973) and Shaw (1973), view constraints to economic growth as arising from financial repression. The policy recommendation from their analysis was financial liberalization, i.e., heaving the rate of interest and allowing market forces to operate. Theoretically, this was expected to result in increased volumes of savings and investment, increased efficiency of investment, and long-term economic growth. Economic growth was then expected to support the growth of the financial sector that would further facilitate the process of savings mobilization and the allocation of finance to productive investment. Nevertheless, this expected outcome has been open to debate both theoretically and empirically. Akyuz and Kotte (1991) show evidence from cross-country studies that higher real interest rates may, contrary to theoretical forecast, result in lower aggregate savings when the effects of income distribution, tax treatment of interest payments and corporate financial distress are taken into account.

Another effect of financial repression, to which the original hypothesis made only scant reference, stemmed from the implicit *credit rationing* effect which results from the feast and famine consequences of excessive government intervention in money and credit markets in developing countries. Given that real interest rates are prevented from adjusting to clear the market, other *non-market* forms of clearing have to take their place. These can include various forms of arrangements to ration the available credit such as auctions, quantitative restrictions, etc., which themselves may be open to bias or even outright corrupt practices. In effect, these manifestations of financial repression mean that not only is the quantity of savings, and by extension, investment low and/or irregular; it also implies that the level of activity which does occur is of poor quality. This is really what the term financial repression involves. If the real interest rate is not allowed to clear the money and credit markets, both the overall level as well as the quality of savings and investment will be repressed. The quantity and the quality effects compound each other. In a feast and famine milieu, the typical borrower may borrow too much (too little) and this very tendency will reinforce the feast and famine problem itself. The early hypotheses of McKinnon and Shaw assumed that liberalization, which would be associated with higher real interest rates, as controls on these are lifted, would stimulate saving. The underlying assumption is, of course, that saving is responsive to interest rates. The higher saving rates would finance a higher level of investment, leading to higher growth. Therefore, according to this view, we should expect to see higher saving rates (as well as higher levels of investment and growth) following financial liberalization.

On theoretical grounds, it has been postulated that a relaxation of liquidity constraints will be associated with a consumption boom and a decline in aggregate saving. More specifically, Campbell and Mankiw (1990) postulate that there are two types of households in the economy: the first type of household, x, is liquidity constrained and their consumption is entirely determined by the evolution of current income, while the second type (1 -x), has free access to capital markets and can smooth their consumption inter-temporarily. Such a theoretical development led these authors to challenge the implicit Mckinnon-Shaw assumptions that were based on a homogenous household set in which it was assumed that all relevant households had free access to capital markets within the domestic economy. This argument stemmed from the Stone-Geary utility function where the inter-temporal elasticity of substitution, which determines the sensitivity of consumption to real interest rates, is determined by permanent income and subsistence consumption. Thus, increases in real interest rates will affect consumption/saving decisions in varying degrees. In countries where the representative household is close to subsistence, consumption (and saving) will not be sensitive to changes in the real rate of interest. Only in wealthier countries would consumption decline (and saving increase) following an increase in real interest rates. Hence, in this analysis, the magnitude of the increase in saving following the higher real interest rates associated with financial liberalization will depend on the level of income (which was used as a proxy for how close are actual consumption levels to subsistence levels).

There are many reasons that the depth of financial sector development could promote economic growth. In sum, more intense use of financial intermediaries and increased amounts of intermediation will encourage savings and investment and improve the allocation of savings to investment projects. This in turn encourages a higher level of capital formation and greater efficiency in the allocation of capital. The effect of inflation occurs through a wide variety of direct and indirect channels.

Inflation increases transactions and information costs which directly inhibit economic development. For example, economic agents will find planning difficult when inflation makes nominal values uncertain. Firms and individuals will be reluctant to enter into contracts when inflation is imperfectly predicted and judgments about absolute and relative prices are uncertain. The reluctance to enter into contracts over time will inhibit investment and entrepreneurship, which will affect resource allocation and economic growth. Inflation will inhibit the development of the financial sector and result in financial repression. High inflation will also discourage any long term financial contracting and financial intermediaries will tend to maintain very liquid portfolios. Thus, in an inflationary environment, intermediaries will be less eager to provide long-term financing for capital formation and growth; both lenders and borrowers will also be less willing to enter into long-term nominal contracts. High inflation is often associated with various forms of financial repression as governments take actions to protect certain sectors of the economy. For example, interest rate ceilings and directed credit allocations are common in high inflation environments. Such controls lead to inefficient allocations of capital that inhibit growth. The relationship between financial repression and inflation can also be bi-directional. In some instances, repression is a crude effort to protect certain sectors from inflation. In other instances, financial repression that is introduced to assist the government in financing its own activities is a cause of both inflation and resource misallocation.

Moreover, inflation will have contemporaneous effects on the finance ratios that are used to measure financial sector development. High inflation will increase the opportunity costs of holding money and lead agents to economize on money holdings. Thus, the ratio of money to GDP might decline as a direct consequence of inflation. Further, the ratios of financial assets to GDP might decline in a high inflation environment if nominal debts do not increase as rapidly as GDP. This is particularly likely if the financial repression that is common in high inflation episodes keeps real interest rates low or even negative. Rousseau and Wachtel, 2001) showed that inflation affects financial depth and has a direct effect on growth as well.

2.2 Review of Literature

The broad empirical literature varies greatly in terms of both empirical approach and country coverage. The McKinnon-Shaw hypothesis literally spawned hundreds of such empirical studies across many different contexts, countries and periods. The empirical literature, in general, suggests that the relationship between saving rates and real interest rates is at best ambiguous. Yet surprisingly, and somewhat perversely, financial liberalization also has a mixed track record regarding saving rates. Indeed, in the studies reviewed here, in most of the cases liberalization appears to lead to a decline in the saving rate.

The empirical literature on the interaction between saving and the real rate of interest is inconclusive. Some researchers have been unable to detect much of an effect of changes in real interest rates on domestic saving in developing countries. For example, Giovannini (1985), who examined this issue in eighteen developing countries, concludes that for the majority of cases, the response of consumption growth to changes in the real rate of interest is insignificantly different from zero and that one should therefore expect negligible responses of aggregate saving to the real rate of interest. Ogaki, Ostry, and Reinhart (1996), present evidence that consumption in developing countries may be more related to subsistence considerations -particularly in the case of extremely low - income countries - than to inter-temporal consumption smoothing. The rationale here is that if households must first achieve a subsistence consumption level-allowing inter-temporal considerations to guide their decisions only for that portion of their budget left after subsistence has been satisfied, - then the inter-temporal elasticity of substitution and the interest-rate sensitivity of private saving will be close to zero for countries at or near subsistence consumption levels, but will rise thereafter.

Bandiera, Caprio, Honohan, and Schiantarelli (2000), construct an index of financial liberalization on the basis of eight different components: interest rates; reserve requirements; directed credit; bank ownership; prudential regulation; securities markets deregulation; and capital account liberalization. Among the key findings of the estimation of their benchmark model is that there is no evidence of any positive effect of the real interest rate on saving. Indeed in most cases the relationship is negative. The general conclusion that emerges from this study is that there is no systematic and reliable real interest rate effect on saving; whilst the effects of liberalization have a mixed record.

Loayza, Schmidt-Hebbel, and Serven (2000), found that the direct effects of financial liberalization are detrimental to private saving rates. The real interest rate has a negative impact on the private saving rate. Its income effect probably outweighs the sum of its substitution and human wealth effects. The indicator of financial depth (M2/GNP) has a small and statistically insignificant impact on the private saving rate. The flow of private domestic credit, relative to income, has a negative and significant coefficient; relaxing credit constraints reduces the private saving rate. They however, suggest that though they do not find direct positive effects of financial liberalization on the saving rate, if financial reform has a positive impact on growth; it has a potentially important indirect positive effect on the saving rate.

Reinhart and Tokatlidis (2001) report that financial liberalization appears to deliver higher real interest rates, reflecting the allocation of capital toward more productive, higher return projects, lower investment, but not lower growth (possibly as a result of a shift to more productive uses of financial resources); a higher level of foreign direct investment; and high gross capital flows. Liberalization appears to deliver financial deepening, as measured by the credit and monetary aggregates, but, again, low income countries do not appear to show clear signs of such a benefit. As regards saving, the result was mixed. In some regions, saving increased following financial sector reforms; but in the majority of cases saving declined following the reforms. Indeed, it would appear that what financial liberalization delivers is greater access to international capital markets, although this appears to be uneven across regions and income groups.

Several empirical studies have tried to address the extent to which financial liberalization affects growth. In this direction two distinct empirical approaches have been followed. The first approach proxy financial liberalization with outcome variables while the other approach focuses on explicit policy measures. Regarding outcome variables, several measures have been suggested to proxy financial repression. Early empirical literature focused on the value of real interest rates as an indicator of repression. The assumption was that countries with negative real interest rates were financially repressed, while those with positive ones were liberalized. In short, it was found that countries with negative real interest rates exhibit lower growth rates compared with those with positive real interest rates. However, De Gregorio and Guidotti (1993) claim that real interest rates are not a good indicator of financial repression, and that a better indicator of repression, or lack thereof, is the ratio of credit to the private sector to GDP or a similar measure of financial development (actually financial widening rather than financial deepening).

Similar concerns were expressed regarding the measurement of financial deepening. Prior to international financial liberalization, broad money offers a good indication of the banking system's scope for credit expansion, since domestic bank deposits are the main source of finance for bank lending. When capital controls are abolished, however, capital inflows in the form of deposits made by foreign residents in domestic banks add to the funds banks have available for credit expansion but do not increase broad money (since they are excluded from it by definition). Money-based measures of financial deepening may therefore be misleading when capital inflows are important. Capital flows are not the only reason why money and credit-based measures of financial deepening may diverge. In general, government borrowing from the banking system will, for a given level of broad money, reduce the amount of credit available to the domestic private sector. If private sector activity is more productive than government expenditure, then this *crowding out* of private borrowing may have strong negative repercussions for economic performance that would not, however, be reflected in the conventional measure of financial deepening.

There is consensus that financial development has had a significant positive impact on the growth rates of countries. The extent to which these results can be interpreted as being influenced by financial liberalizations is, however, ambiguous. As noted by Rajan and Zingales (1998), it is improbable that such empirical approaches are truly identifying the impact of financial development on growth, due to the fact that financial development occurs at the same time that economies go through significant structural transformations. In the case of financial development, Rajan and Zingales (1998) caution, "...financial development may simply be a leading indicator rather than a causal factor..." Laeven (2000) finds that the liberalization process in general has eased financial constraints faced by large firms. Galindo, Schiantarelli and Weiss (2001) found that financial liberalization increases the allocative efficiency of investment. However, these findings are subject to the identification critique. Fry (1995), opines that the simultaneity of reforms appears binding for researchers: "... in practice, however, most clear cut cases of financial liberalization were accompanied by other economic reforms (such as fiscal, international trade, and foreign exchange reforms". In such cases, it is virtually impossible to isolate the effects of financial components of the reform package.

Ndebbio (2004) concluded that financial deepening as represented by the growth rate of per capita (real/nominal), money balances (GPRMB/GPMB) *and* degree of financial intermediation (FDY) *does* positively affect per capita growth of output in Sub-Saharan Africa.

King and Levine (1993) find a significant, robust and positive correlation between higher levels of financial development and faster growth, physical capital accumulation and economic efficiency. Alan Gelb (1989) confirms a positive correlation between the real interest rate (which he argues is a proxy for financial intermediation) and growth. Gregorio and Guidotti (1992) find a positive relationship between credit to the private sector and growth. However, their results for some Latin American countries indicated that credit had a significantly negative correlation with growth.

Fry (1978, 1980 and 1995) in his diverse articles finds that, across a sample of Asian developing countries gross national saving rate is positively affected by increases in real interest rates. However, Giovannini (1983, 1985) points out that the findings of Fry were not robust to the changes in time or region. Fry (1995) agrees that the effect is small and diminishes in the more recent years and is prevalent mostly in Asia. A large number of studies point out that the high level of saving in Japan and other East Asian countries was not because of high interest rates but expansion of banks into rural areas and the availability of low yielding but safe deposit instrument. There is also a group of studies that tests the existence of a non linear effect of interest rates on savings. Alejandro (1989) found that savings increase rapidly as real interest rates move from sharply negative to just below zero. However, this effect wears off, as the interest rates become positive and become negative, as real rates become highly positive. Thus most of the literature on interest elasticity of savings concludes that a low positive interest rate is ideal to maximise savings. The question that arises then is has financial liberalisation been able to produce such interest rates in Nigeria?

3. Financial Sector Reforms in Nigeria

At the commencement of comprehensive financial sector reform in Nigeria in 1987, the sector was highly repressed. Interest rate controls, selective credit guidelines, ceilings on credit expansion and use of reserve requirements and other direct monetary control instruments were archetypal characteristics of the financial system. Access into banking business was limited and government-owned banks dominated the industry. The reform of the foreign exchange market, which until then was also controlled, began in 1986. Indeed the financial sector reform was a component of the comprehensive economic reforms programme, Structural Adjustment Program (SAP) which was adopted in 1986.

The main financial sector reform policies applied were deregulation of interest rates, exchange rates and access into banking business. Other reform measures included, establishment of Nigeria Deposit Insurance Corporation, strengthening the regulatory and supervisory institutions, upward review of capital adequacy standards, capital market deregulation and introduction of indirect monetary policy instruments. Some distressed banks were liquidated while the Central Bank took over the management of others. Government share holdings in some banks were also sold to the private sector. (See Nnana, 2002 for the details and the sequencing of the reform measures)

The Central Bank of Nigeria made attempts at restructuring the financial system prior to the introduction of open market operations in 1993. Bank deposit and lending rates were deregulated at the beginning of the Structural Adjustment Programme in 1987. In 1991, the CBN in a reaction to rising nominal lending rates in the market for loans prescribed a maximum margin between the bank's average cost of funds and their maximum lending rates as well as a minimum level for their savings deposit rates. Interest rate determination was still supposed to be market-related through its link to the cost of funds.

In order to promote competition in the money market, the procedure for licensing new banks was streamlined and liberalised. Consequently, the number of banking institutions increased from 50 in 1987 to 120 in 1993 and dropped to 115 in 1996. By 1998, the number of banks surged to 155. However in 2004, the number plummeted to 89. An auction-based system for issuing treasury bills and certificates (both government debt instruments) and the issue of these instruments as treasury bearer bonds to enhance tradability was introduced. This delinking of the treasury bill rate from the MRR was aimed at improving the efficiency of public debt management and the conduct of monetary policy, enhancement of investor interest and involvement in the holding of government debt instruments, promoting greater reliance on market forces in the determination of yields on the instruments and encouraging the development of the secondary market for government short-term debt instruments.

The CBN Decree No. 24 and The Banks and Other Financial Institutions Decree (BOFID) No. 25 were promulgated in 1991. The Decrees enhanced the Central Bank of Nigeria's independence in the conduct of monetary policy augmented the CBN's regulatory and supervisory power over banks and brought under the purview of the CBN the licensing and supervision of other non-financial institutions like Discount and Finance Houses. The Decrees empowered the Central Bank to apply indirect monetary policy instruments such as open market operations (OMO), reserve requirements, stabilisation securities and special deposits to achieve the objectives of monetary policy.

Furthermore, prudential guidelines regarding ample provisions for bad and doubtful debts and loan classification, interest capitalisation, capital adequacy and limits on loan concentration were put in place in 1990. In order to mitigate the adverse effects of the implementation of the guidelines on banks' balance sheets, the Central Bank later allowed banks to write off accumulated bad and doubtful debts over a phased period of four years. Steps were also taken to strengthen the capital bases of banks. The minimum paid-up capital of banks was increased from N20, 000,000 to N50, 000,000 million in the case of commercial banks and N12, 000,000 to N40, 000,000 million in the case of merchant banks with effect from June 1992. In 2001, the Central Bank of Nigeria adopted the universal banking policy, thereby abrogating the classification of banks by the nature of their business that existed hitherto. Again, to ensure that banking contribute to the real economy and not just serve as trading post, the Central Bank of Nigeria increased the required capital of banks to N25.00 billion effective from December, 2005.

In order to facilitate the development of a secondary market for government debt instruments so as to reducing government dependence on the CBN financing of its deficit, three discount houses were licensed in 1992. In addition to intermediating funds among financial institutions, the discount houses were also expected to promote primary and secondary markets for government securities.

In 1990, the Central Bank in conjunction with the Nigerian Deposit Insurance Corporation (NDIC) commenced the process of bank restructuring. At first, six insolvent banks were identified and were allowed self-restructuring under the close supervision of the two supervisory authorities, the CBN and NDIC. In late 1992, a joint committee of the CBN and NDIC involving a sector of the BOFID assumed greater control over distressed banks. Banks thus taken over by the CBN had their board of directors dissolved and an interim management board appointed to exercise powers normally vested in a board of directors of a bank and some turn-around measures, including the down-sizing of operations through rationalisation of staff and branch-network. The boards are also empowered to appoint independent firms of auditors to ascertain the true financial condition of each of the banks. Thereafter, appropriate restructuring or liquidation options were to be adopted.

However, in September 1992, credit ceilings on banks that were adjudged healthy by the CBN were lifted. A bank was considered healthy if it met CBN guidelines on certain specified criteria in the preceding three months. These criteria were cash reserve, liquidity ratio, prudential guidelines, statutory minimum paid-up capital, capital adequacy ratio, and sound management. With the application of these criteria, about 80 banks were endorsed as healthy and exempted from credit ceilings. These same criteria were applied for determining banks that qualify to participate in the official foreign exchange market.

An intriguing element of Nigeria's was the irregularity in policy implementation. The reform of the foreign exchange market, for instance started in 1986 with the abrogation of exchange controls and establishment of a market-based autonomous foreign exchange market, including the licensing of *Bureaux de Change* in 1988. However, a fixed official exchange rate existed alongside the autonomous market. In 1993 the plodding market-based depreciation in the official exchange rate was abridged by a sharp devaluation in a bid to close the gap between the official and the autonomous exchange rate. Unsatisfied with the gap between the official and autonomous exchange rates, government prohibited the autonomous foreign exchange market and re-introduced exchange controls in 1994. But after a full year of exchange controls, the autonomous market was re-introduced in 1995. A foreign exchange subsidy of about 300 per cent, representing the gap between the official and autonomous market rates existed for some government preferred consumption, including pilgrimage and sporting events. The continued operation of the official exchange rate exerted distortions in the domestic allocation of resources in the public sector. Fiscal gains thus appeared to be an incentive factor in retaining the current structure of the foreign exchange market. A similar pattern of policy somersault was apparent in the interest rate reforms policy. First introduced in 1987, the market-determined interest rates operated until 1991 when interest rates were capped. However, a year after, deregulation of interest rates policy was once again re-introduced in 1992 and 1993. Although indirect monetary instruments (open market operations) were initiated in 1993, some measures of controls such as sectoral credit allocation guidelines continued to be applied in 1994.

Regarding bank licensing and regulation, the reform commenced with the deregulation of bank licensing in 1987. This resulted in the establishment of many new banks. However, when prudential measures such as, the increase in the required banks paid up capital in 1989 and the reform of their accounting procedure (1990) appeared insufficient to restrain the immoderation of the sector, government placed total embargo on bank licensing in 1991. Privatization of banks was suspended after applying the measure to a few banks. Some of the issues highlighted above point to the disorderly manner in which the reform has been implemented in Nigeria. Thus, Nigeria's financial sector reform has not been a smooth sailing process. This in itself could obscure the appraisal as well as its outcome.

4. Assessment of the Impact of Reforms on Nigeria's Financial System.

4.1 Measures of Financial Sector Development

A fascinating exercise is to assess the effects of liberalization on the measures of financial development that in turn are regarded as correlating with economic growth. Development of the financial sector requires a set of indicators which can be used for effective policy formulation, implementation and evaluation. As such, there is no precise definition in the literature of 'financial sector development'. However Fry (1978) observes that the key to financial sector development is the reduction and ultimate unification of the fragmented financial markets. This involves a complete set of indicators mainly covering credit intermediation, liquidity management and the risk management characteristics of the financial system. Goldsmith (1969) uses a set of measures, which he calls the 'financial interrelations ratio', in tracing the close relationship between the financial sector and economic development. In many other studies, the ratio of the broad money **(M2)** to **GDP** is taken to observe the changes in the size of the financial system relative to the size of the economy. This ratio has the advantage that the IMF and the World Bank largely standardize it across countries.

It is hard to find 'an indicator' that can directly measure the development of the financial sector. We therefore analyse the roles of the indicators that are studied in the recent literature and then choose ten indicators that encompass all the qualities of a well-developed financial sector. The eleven measures are explained as follows: Broad Money (M2) as a ratio of Gross Domestic Product (GDP)at current market prices, banking sector credit to the private sector (PSC) as a ratio of GDP, Currency Outside Bank (COB) as a ratio of Broad Money (M2), Interest Rate Spread (IRS), measured as the difference between savings and prime lending rate, Real Interest Rate (RIR), measured as the difference between the inflation rate and savings rates, Loan as a Ratio of Deposit,(L/DR) Total Assets of banks (TA) as a ratio of GDP, Loan and Advances (LA) as a ratio of GDP, Gross Savings (GS) as a ratio of GDP, Gross Domestic Investment (GDI) as a ratio of GDP and Manufacturing Capacity Utilisation (MCU). The data for the analysis were essentially sourced from the Central Bank of Nigeria. The assessment period is broken into two segments, 1980-1986 representing the pre-reforms era, while 1987-2003 represents the post reforms era.

TABLE 1 : NIGERIA - FINANCIAL SECTOR DEVELOPMENT INDICATORS 1980 - 2003

		M2/GDP	PSC/GDP	COB/M2	IRS	RIR	L/DR	TA/GDP	LA/GDP	GS/GDP	GDI/GDP	MCU
	1980	0.28	0.14	0.22	1.50	-3.90	66.70	0.32	0.13	0.11	0.21	70.10
	1981	0.31	0.19	0.25	1.75	-14.90	74.50	0.41	0.20	0.13	0.24	73.30
	1982	0.31	0.22	0.27	2.75	-0.20	84.60	0.46	0.23	0.15	0.21	63.60
	1983	0.34	0.22	0.25	2.50	-15.70	83.80	0.50	0.23	0.17	0.14	49.70
	1984	0.34	0.21	0.23	3.00	-30.10	81.90	0.50	0.22	0.17	0.09	43.00
	1985	0.33	0.19	0.21	-0.25	4.00	66.90	0.47	0.21	0.17	0.08	38.30
	1986	0.33	0.24	0.21	1.00	4.10	83.20	0.57	0.27	0.19	0.10	38.80
1980-1986		**0.32**	**0.20**	**0.23**	**1.75**	**-8.10**	**77.37**	**0.46**	**0.21**	**0.16**	**0.15**	**53.83**
	1987	0.29	0.23	0.20	3.50	3.80	72.90	0.47	0.21	0.17	0.10	40.40
	1988	0.29	0.21	0.22	2.00	-23.80	66.90	0.42	0.18	0.16	0.09	42.40
	1989	0.21	0.14	0.25	10.40	-24.50	80.40	0.30	0.13	0.11	0.08	43.80
	1990	0.24	0.13	0.23	6.70	11.30	66.50	0.31	0.13	0.11	0.11	40.30
	1991	0.27	0.14	0.27	5.72	1.29	59.80	0.38	0.15	0.12	0.11	42.00
	1992	0.24	0.15	0.28	13.70	-28.40	55.20	0.30	0.06	0.10	0.11	38.10
	1993	0.29	0.14	0.29	19.43	-40.54	42.90	0.33	0.07	0.12	0.12	37.20
	1994	0.31	0.17	0.32	7.50	-43.50	60.90	0.33	0.07	0.12	0.09	30.40
	1995	0.16	0.11	0.34	7.57	-60.19	73.30	0.20	0.03	0.05	0.06	29.30
	1996	0.13	0.08	0.31	8.05	-17.61	72.90	0.17	0.04	0.05	0.06	32.50
	1997	0.15	0.09	0.30	8.74	-3.70	76.60	0.21	0.06	0.06	0.07	30.40
	1998	0.19	0.12	0.29	12.80	-4.51	74.40	0.26	0.14	0.30	0.07	32.40
	1999	0.20	0.13	0.27	15.99	-1.27	54.60	0.34	0.12	0.30	0.05	35.90
	2000	0.21	0.12	0.26	12.69	-1.61	51.00	0.35	0.12	0.30	0.06	36.10
	2001	0.24	0.15	0.26	12.80	-13.41	65.60	0.43	0.14	0.35	0.07	39.60
	2002	0.25	0.16	0.24	19.32	-7.82	66.50	0.51	0.16	0.04	0.07	44.30
	2003	0.32	0.21	0.21	16.33	-9.85	70.00	0.42	0.15	0.09	0.07	46.20
1987-2003		**0.23**	**0.15**	**0.27**	**10.78**	**-15.55**	**65.32**	**0.34**	**0.11**	**0.15**	**0.08**	**37.72**

Source: Computed by the authors from the Central Bank of Nigeria Statistical Bulletin

Broad Money as a Ratio of GDP

One of the expected effects of financial sector liberalisation according to theory and some empirical findings is what has been known in the liberalisation literature as *Financial Deepening,* usually measured as the ratio of broad money to the GDP. In Nigeria, the ratio was consistently above 30.0 per cent in all the years of the pre-reform era except in 1980, when the ratio stood at 28.3 per cent. In the post reform era, the ratio was generally below

30.0 per cent in all the years with the exception of 1994 and 2003 when respective ratios of 31.1 and 31.7 per cent respectively were attained. Indeed between 1995 and 1998 the ratio was below 20.0 per cent. On the average the ratio worsened from 32.1 per cent in the pre-reform era to 23.5 per cent in the reform era. This clearly indicated that financial sector reforms in Nigeria did not achieve the purpose of financial deepening that is purported by theory. This outcome is consistent with the findings of Nissanke and Aryeetey (1998) who observed that expected positive effects from liberalisation, in savings mobilisation and credit allocation had been slow to emerge. Both the M2/GDP ratio and the private credit/GDP ratio to measure financial deepening showed no clear upward trend in any of those countries. In Nigeria, both indicators worsened considerably in the reform period. Indeed, in most countries, credit as a proportion of GDP declined in the reform years, even if the share of credit to the private sector rose.

Private Credit as a Ratio of GDP

The ratio of credit to the private sector to GDP has been classified as a measurement of financial sector widening (De Gregorio and Guidotti (1993). Thus, the higher the ratio the more widened the financial sector is assumed to be. The reasoning underpinning such assumption is that the private sector utilisation of credit is usually more efficient than the government sector. In the pre-reform period, the ratio ranged between 14.0 per cent in 1980 and 24.0 per cent in 1986. On the average during the pre-reform era the ratio stood at 20.0 per cent. However, the ratio deteriorated consistently from 23.0 per cent in 1987 to 13.0 per cent in 1990 and thereafter fluctuated between 8.0 and 21 per cent in the remaining years of the reform era. The average ratio of 15.0 per cent was recorded in the post reform era, indicating relative narrowing of the financial sector in Nigeria by at least 5.0 per cent during the period. This is very instructive as it contradicts the much touted impact of Nigeria's financial sector on economic development. It also confirms what some researchers, including Onwioduokit (2002), refer to as nominal growth in the numbers of banks that do not affect the financial sector positively, much less the economy.

Currency Outside Bank as a Ratio of Broad Money (M2)

This ratio measures cash intensity in the economy. One of the expected gains of the financial sector liberalisation was the development of the financial system that would improve banking habits and by extension the development of the payments system. The performance of the Nigeria's financial reforms under this criterion indicated a deteriorating trend. During the pre-reform period, this ratio oscillated between 27.0 per cent in 1982 and 21.0 per cent in 1986. The average ratio for the period was 23.0 per cent. This performance was broadly in line with the Africa average of 23.5 per cent during the period. However, post liberalisation ratio gyrated from 20.0 per cent in 1987 to 34.0 per cent in 1995 and dropped persistently to 21.0 per cent in 2003. The post liberalisation average of 27.0 per cent did not only indicate a worsening trend compared to the pre-liberalisation level but was at least 4.5 percentage points out of line with Africa's average of 22.5 per cent in during the period (see Lindgren and Odonye, 2003). Overall, the results showed that cash intensity in Nigeria in the post liberalisation era was more severe than in the pre-liberalisation era. The worsening trend could also be adduced to Central Bank of Nigeria's policy of introducing higher currency denominations supposedly to keep pace with inflation. Indeed between 1985 and 2003, about four different higher naira denominations ranging from N50 to N500 were introduced. Furthermore the absence of relevant legal regulations guiding issues such as dud cheques, until very recently, could have contributed to the observed outcome.

Interest Rate Spread

The financial sector reforms and liberalization was expected to narrow the spread between deposit and lending rate as a result of competition that was expected to ensue in the financial sector. The interest rate spread (lending – savings margins) have been dramatically high in Nigeria in the post reform period than in the pre- reforms era. The prevalence of very high lending rates and systematic widening of the lending-deposit rate margins in the post-reforms period is essentially unacceptable. Under the reform programmes, an initial increase in the spread between lending and deposit rates was expected, as banks needed time to adjust their cost structures during the changing environment. The spread was expected to narrow as more efficient business practices were embraced sequence to increasing competition and as credit demand stabilised. But more than a decade after reforms were started, the spread between the two continue to widen in Nigeria. The problem of continual increases in lending rates and low deposit rates during the post reform period is one of the most attention-grabbing effects of financial sector reforms in Nigeria. For instance the spread widened by over 8.9 percentage points on the average from 1.8 per cent during the pre-reforms period to 10.8 per cent in the post reform period.

Real Interest Rate

Real interest rate is usually used to proxy the efficiency of financial intermediation. Financial liberalization is expected to deliver higher real interest rates, reflecting the allocation of capital toward more productive, higher return projects owing to a shift to more productive uses of financial resources and enhanced financial intermediation. However in Nigeria the average real interest rate deteriorated from negative 8.1 per cent during the pre-liberalisation period to negative 15.6 per cent during the post liberalisation era. Thus during both pre and post liberalisation era in Nigeria, the real interest rates were negative, reflecting the high rate of inflation associated with fiscal prolificacy of the military government that dominated most of the period of both pre and post liberalisation in Nigeria. However the post liberalisation era as noted earlier recorded a worsening trend than the pre liberalisation period (See Table 1).

Loan as a ratio of Deposit

In line with financial prudence, it is expected that the level of loan exposure of the banks should be directly related to its assets at the wider level and deposit at the micro- firm level. Thus one of the explicit criteria of measuring bank's health is the ratio of loan to deposit. The closer it is to 100.0 per cent, the more efficient the bank's portfolio management (Lindgren and Odonye, 2003). This ratio improved from an average of 177.4 per cent in the pre-reforms era to 165.3 per cent in the post reform era.

Total Assets of Banks as a ratio of GDP

In a comprehensive study, Demerguç-Kunt and Huizingha (1999), using a bank level data for 80 countries that have undertaken reforms in the last two decades, report that a larger ratio of bank assets to GDP leads to efficiency in resources mobilisation. The average ratio of total assets to GDP in Nigeria during the regulated era stood at 46.0 per cent. However, the average ratio during the deregulation era plummeted to 34.0 per cent. This, put in perspective of Demerguç-Kunt and Huizingha's (1999) findings indicate that the level of efficiency in the Nigeria's financial system (banking system) actually deteriorated by about 12.0 percentage points on the average between the two regimes (control and deregulation).

Loan and Advances as a Ratio of GDP

The level of financial sector's participation in an economy could indeed be measured by the level of loans and advances of the sector as a ratio of the gross domestic product (GDP). It is expected that the more loans and advances made available to the economy the higher will be the level of growth if the loans are appropriately applied in the productive sector of the economy. The ratio of loans and advances to GDP during the regulated era was generally above 20.0 per cent, except in 1980, when a ratio of 13.0 per cent was registered. However, during the deregulation era, the ratio was basically below 20.0 per cent in all the years with the exception of 1987 when a ratio of 21.0 per cent was recorded. On the whole, the ratio decreased on the average from 21.0 per cent in control era to 11.0 per cent in the deregulated period. This further confirms that the impact of the financial sector on the real economy during the liberalisation era was not significant.

Gross Savings as a Ratio of GDP

Gross savings as a ratio of GDP is a direct measure of savings mobilisation in an economy. It is expected that the ratio should improve with improvement in financial intermediation activity of the financial system. On the average, the ratio was 16.0 per cent in the control period, but deteriorated marginally to 15.0 per cent during the deregulation era. This result calls to question the much advertised dividends of deregulation of the financial system in Nigeria.

Domestic Investment as a Ratio of GDP

It has been argued in the literature that savings mobilisation is only a necessary but not sufficient condition for economic growth. The sufficient condition requires the mobilized savings to be channelled into productive investment. However, the desired results of increased investments as a result of higher savings mobilisation have not been in abundance in Nigeria. Indeed, the financial systems are characterized by exorbitantly high real rates of interest and shrinkage of commercial lending by banks, in favour of bank holdings of government securities. The ratio of investment to GDP deteriorated from an average of 15.0 per cent in the control regime to 8.0 per cent in the liberalisation era. This brings clearly to the fore the nature and character of Nigeria's financial system which is almost an enclave declaring huge profits essentially obtained from dealings in the foreign exchange markets and not having sufficient impact on the real economy during the deregulation era.

This pathetic situation was captured succinctly by Soludo (2004) when he averred that

> *the small size of most of our banks, each with expensive headquarters, separate investment in software and hardware, heavy fixed costs and operating expenses, and with bunching of branches in few commercial centres - lead to very high average cost for the industry. This in turn has implications for the cost of intermediation, the spread between deposit and lending rates, and puts undue pressures on banks to engage in sharp practices as means of survival. I am sure many of you would agree with me that some of our banks are not engaged in strict banking business in terms of savings intermediation - they are traders - trading in foreign exchange, in government treasury bills, and sometimes in direct importation of goods through phoney companies. This is not healthy for the economy. Think about this caricature of what could happen under this system. A group of people get banking license, use their connections to garner some billions of Naira in deposits from one or two parastatals, and use the deposits to trade in Government treasury bills, foreign exchange and open letters of credit for importers. Such a bank can declare billions of naira in profit. It sounds like a fiction but this describes the situation with many banks in the system. With many of such banks, depositors with balances of less than N50, 000 or N100, 000 are not welcome. Today, we have more than N400 billion as currency outside of the banking system. There are many reasons for this, including the*

large informal economy, but obviously a key reason is the perverse incentive to look mostly to high net-worth agents for deposits - government agencies, blue chip companies and rich individuals. Again, this is neither sustainable nor healthy for the economy.

Manufacturing Capacity Utilization (MCU)

The level of manufacturing capacity utilization could be used to assess the impact of the financial system on the real economy. The connection is straight forward, the higher the credit to the manufacturing, all other conditions remaining unchanged, the higher the level of capacity utilization. In Nigeria, the average ratio during the control regime was 53.8 per cent compared to 37.7 per cent during the post reform era. This clearly showed a marked deterioration. However, the interpretation of this ratio should be taken cautiously as there were many other factors that impact negatively on the capacity utilisation in manufacturing outside the activity of the financial sector.

5. Summary and Conclusion

The main objective of this paper has been to assess the impact of financial sector reforms in Nigeria, especially on the development of the financial sector. In line with this, the dwells on theoretical issues and brief review of literature and presents a brief analysis of financial sector reforms in Nigeria. Attempt is also made to assess the impact of the reforms. The paper analyzes the roles of the indicators that are studied in the recent literature. The indicators that encompass all the qualities of a well-developed financial sector were selected to measure the impact of financial sector deregulation on the economy. The ten measures were Broad Money as a ratio of Gross Domestic Product (GDP), Private Credit as a ratio of GDP, Currency Outside Bank as a ratio of Broad Money (M2), Interest Rate Spread, Real Interest Rate, Loan as a ratio of Deposit, Total Assets of Banks as a ratio of GDP, Loan and Advances as a ratio of GDP, Gross Savings as a ratio of GDP, Gross Domestic Investment as a ratio of GDP and Manufacturing Capacity Utilization (MCU). The data for the analysis were essentially sourced from the Central Bank of Nigeria. The assessment period is broken into two segments 1980-1986 representing the pre-reforms era, while 1987-2003 represents the post reform era. The assessment, based on the chosen indices, shows that Nigeria financial sector reforms only impacted positively on one out of the eleven indicators compared with the pre-reforms era.

A battery of explanations has been advanced for the obvious failure of financial liberalisation programmes to address the problems of Nigeria's financial system. The most recurrent rationalization is the incompleteness of the reforms. It is argued that the persistent poor financial performance was due to lack of progress on some of the reform measures. Blame is placed on the continued use of financial systems to finance public sector activities, which is made possible by the continuing public sector ownership of a large part of the financial system (World Bank, 1994).

Soyibo (1996) opines that improper pace and sequencing in the initial reform years led to the crisis and eventual collapse of the financial system, necessitating several policy reversals in Nigeria. The crisis made policy consistency and credibility critical issues. It is obvious that Nigeria's difficulty in sustaining a consistent policy stance is partly attributable to unstable general economic and political conditions. Stein and Lewis (1996) have ascribed the failure of financial liberalisation in Nigeria largely to the political and institutional setting of reforms. The argument for this position is that the abrupt financial liberalisation led to the development of opportunities for speculative rent seeking that replaced traditional forms of rent-seeking that are based on political patronage. In sum, the faulty design of the reform programme, with respect to timing, pace and sequencing led to instability. World Bank (1994) notes that complete interest-rate deregulation should only be attempted when certain stern criteria are satisfied. Thus, in addition to stable macroeconomic conditions and adequate regulatory and supervisory arrangement, it is important that more sophisticated and solvent banking institutions with positive net worth in contestable financial markets are present. It is expected that interest rate deregulation will be ineffective where these conditions are not met. In the absence of such an environment, interest rates may be managed in the interim, moving to market-determined rates within a longer time frame.

In conclusion, it is obvious that the financial system will continue to *flourish* without adequately affecting the real economy even in the era of deregulation if the banks in particular continue to trade in foreign exchange and finance trading activities at the expense of the manufacturing sector. Again, the fiscal operation of government that resulted in persistent deficits, mainly financed by the Central Bank in most of the liberalisation era that resulted in very high inflation, adversely affected macroeconomic stability, setting in motion a vicious cycle of external and internal imbalances. The consolidation of the banking system currently embarked on by the central bank should be pursued to a logical conclusion if the financial sector in Nigeria is to develop appropriately.

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