# FINANCIAL DEEPENING AND ECONOMIC GROWTH IN NIGERIA 1975 - 1996.

BY

MATHEW ONALO AGBAWN

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## DEDICATION

This work is dedicated to God Almighty and my wife to be, Callister Jim.

## D E C L A R A T I O N

I hereby declare that this is a product of my own research. It has not been accepted anywhere for the purpose of awarding a higher degree. All references have been acknowledged by way of bibliography at the end of the thesis.

.....

M. O. AGBAWN
(CANDIDATE)

C E R T I F I C A T I O N

1. .....
PROFESSOR M. KWANASHIE
(CHAIRMAN SUPERVISORY COMMITTEE)

2. .....
DR. C. C. OKEKE
(EXTERNAL EXAMINER)

3. .....
DR. G. D. OLOWONONI
(CO-SUPERVISOR)

4. .....
DR. A. B. ESHIET
(HEAD OF ECONOMICS DEPARTMENT)

5. .....
THE DEAN OF POST-GRADUATE SCHOOL.

# A C K N O W L E D G E M E N T

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# A B S T R A C T

The place of finance in real sector development in Nigeria is not different from what conventional theories posit. This means that financial deepening is an important factor in stimulating growth in the domestic economy. What then is financial deepening? A country is said to be financially deepened if there is a phenomonal and sustainable increases in the number and type of financial institutions offering financial intermediation in the economy. This is reflected by rising ratio of total bank deposits (or total bank credits) to norminal Gross Domestic Product (GDP). If this ratio continue to increase and sustained, the economy is said to be financially deepened. Although important, the influence of financial factor on the growth of domestic output has not been established because of the ambivalent effect financial repression can produce on an economy. Consequently, some authors contend that financial deepening interferes with economic growth in a positive way. On the other hand, another school of thought contends that financial deepening interferes with economic growth in a negative way.

However, the version of the argument that applies to Nigeria has not been ascertained. That is why this study undertakes to determine the influence of financial deepening on economic growth in Nigeria for the period of 1975 - 1996. In doing this two approaches were adopted. These are the theoretical explanation

which explains the "scenario" between financial deepening and economic growth in Nigeria and the empirical analysis which uses the Granger techniques in testing the causality between financial deepening variable and economic growth. Another aspect of the empirical work is the structural analysis of the two sub-periods of the analytical time frame.

The two extreme positions are the two school of thought on the relationship between financial deepening and economic growth which are the monetarist or the liberal school otherwise known as the Mckinnon - Shaw - Fry approach, is of the opinion that when financial markets are liberalised it will interfere positively with economic growth. On the other hand, the structuralist are of the opinion that financial deepening interfere negatively to economic growth due to some structural bottlenecks among developing economics. So that, no amount of liberalization of the financial system can stimulate growth.

The inferences, from the results of the regression, especially, the Granger causality test support the structuralist's position in the place of finance in economic growth. The results shows a negative unidirectional causality from financial deepening to economic growth in Nigeria. This negative causality result is attributed to structural rigidities inherent in the long term growth and development of the economy identified as foreign exchange constrains, the imperfection of the market system, as well as socio-political and economic factors among others.

Finally, in line with this result therefore, policy makers must take a drastic measures to ensure that such structural problems are taken care of to enhance the performance of the country's financial system to boost growth. In another corrolary, policy makers must seek through every available means, the resolutions of the conflicts associated with the Nigeria's "political transition" and the establishment of durable political system that will create a condusive business climate for the performance of all the macro-economics variables, thereby eliminating these structural bottlenecks inherent within the economy.

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Chapter 1

# GENERAL INTRODUCTION

## 1.1 BACKGROUND TO THE STUDY

Nigeria has been struggling with worst experience of prolonged economic difficulties since early 1980s. Attempts to deal with these difficulties have swung from one policy extreme to the other and yet the problems apparently continued to persist. The problems of economic recovery are probably also associated with Nigeria's unending search for a generally acceptable and sustainable political system. The pursuit of profitable economic activities that generate overall aggregate growth and development is best promoted in the context of a stable political system that creates and sustains appropriate "enabling environment". This implies that solutions to Nigeria's stagnation and even decline cannot be found except in the context of a simultaneous or prior resolutions of the conflicts associated with its "political transition" and establishment of durable political system that will create a conducive business climate for an efficient performance of the financial system which will in turn influence growth and development of the country.

This underscores the fact that financial deepening is an important economic indicator of economic and development of a country. A country with a sound financial system is supposed to be developed. United States of America (USA) is a good example of this.

In the context of Nigeria, the reason for stagnation and even

decline in the trend of our economic growth in the past even to the contemporary time is discernable. Nigeria is suffering from financial repression. A Cursory survey of Nigeria's financial system will indeed unfold the empirical realities of the economy. Let us examine the down turn of events in the financial sector with a special focus on the period since the introduction of the "Structural Adjustment Programme" (SAP) in 1986, and the deregulation of the financial system in 1987. Since that time, there have been a phenomenal increases in the number and types of financial institutions leading to stiff competition in the industry. Many non-banks finance companies now offer services previously reserved for licensed banks. In addition, the banking system has been buffeted by adverse economic forces including foreign debt problems of Government, large fiscal deficits, high inflation and slow growth.

The most visible result of these forces has been the emergence of distress in the banking system which first came to the limelight in May, 1989, after the withdrawal of treasury funds from the licensed banks. According to the latest official figures, the number of banks which the Central Bank of Nigeria and the Nigerian Deposit Insurance Corporation (NDIC) classified as technically insolvent or distressed rose from 8 as at the end of 1991 to 16 as at the end of 1992 (NDIC Quarterly review, volume 3, No. 2 June 1993, P.17). There may well be many more banks on the margin of distress whose activities are being closely monitored by the Apex Bank and the National Deposit Insurance Corporation (NDIC).

The pace of activity in the financial services industry was generally subdued in 1994, reflecting the shift in financial policies of the Government, the continued distress of many banks and non-bank financial institutions and the disruptions in the economic activities in the third quarter of 1994. In the unstable economic environment that prevailed, there was little respite for the financial weaken institutions whose overall financial condition suffered further deterioration. In fact, indications were that the financially weak institutions suffered from significant "flight to safety" on the part of depositors and investors. This, of course, led to the movement of funds into inflation hedges and speculative transaction induced by the fixed interest rate and exchange rate regime.

In the bid to strengthen the financial system as a whole, the monetary authority (CBN), for the first time in several decades, closed some banks and non bank institution which were terminally distressed in 1994. These comprised three Merchant Banks, one commercial bank, and twenty finance companies (Central Bank of Nigeria (CBN) Annual Report and Statement of Accounts 31st December, 1994,
P.15-17).

In a major move to confront the insider dealings which had emerged as a major cause of distress in the banking system in recent years, the Federal Government in November, enacted The Failed Banks (Recovery of Debts) and Financial Malpractice in Banks

indicates the long-run trend in the Gross Domestic Product (GDP) performance of an economy. Gross Domestic Product (GDP) therefore is a flow concept.

BANK INSOLVENCY AND ILLIQUIDITY

Insolvency in a very simple terms refers to a condition in which the sum of assets of a bank for example is less than sum of its liabilities, including capital. A bank in this situation would therefore be unable to honour all its obligations to depositors and or creditors.

Liquidity or illiquidity on the other hand generally describes the cash flow position of a firm. An illiquid bank would typically be forced to suspend payments to its depositors, perhaps for short periods or default on maturity claims such as inter-bank placements.

However, a technically insolvent bank could remain sufficiently liquid long after it became insolvent if it has a large and stable deposit base while a technically solvent bank could be afflicted by liquidity problems due to mismatch between maturity of its assets and liabilities. Often, however, prolonged illiquidity tends to reflect underlying poor quality of assets and therefore the onset of insolvency.

## 2.2 THEORETICAL FRAMEWORK

The relationship between financial deepening and economic growth has indeed generated increase research work both in the developed and developing countries due to the realisation of the place of finance in economic growth in modern economies. That is why the Government of Nigeria has taken a bulwark approach in strengthening her financial system to efficiently boost economic growth or development of the economy.

The theoretical framework for our analysis is based on two theories; one, is the modern quantity theory of money propounded by Milton Friedman to emphasise the linkage between financial deepening (i.e component of total money supply, $M_2$) and economic growth (i.e Gross Domestic Product (GDP) or nominal income). Secondly, Harrod-Domer growth model to show the mechanism through which financial deepening transfers or mobilize fund from the surplus sector to the deficit sector through investible fund, which in turn influence or interfere with economic growth.

The choice of the monetarist's theory is premised on this hypothesis that recessions are systematically related to declines in the rate of money growth (i.e efficiency of the financial system). This presupposes that money growth (financial deepening) is positively related to economic growth in general. Secondly, the choice of Harrod-Domar growth model as a major theory of modern growth models is to underscore the transmission mechanism between finance and economic growth or the real sector of the economy. That is an increase in money supply (i.e. increase in bank

deposits) will lead to a fall in the rate of interest (i.e. increase in the available credits to private sector), which will lead to an increase in the gross investment and this through the multiplier effect will lead to an increase in the Gross Domestic Product (GDP) "Ceteris Paribus".

### 2.2.1 THE MONETARIST THEORY

Milton Friedman's version of the quantity theory of money is by far more complete than the ones produced by Fisher or the Cambridge Economists {Y. P Veneris and F. D. Sebold (1935)}. In Friedman's interpretation, the quantity theory of money is a theory of demand for money. The supply of money, the exogenous datums of the model, depends on external factors, example, the monetary policy of the Central Bank. He says "holders of money cannot alter this amount directly". If the quantity of money changes and thereby monetary equilibrium is upset, the demand for money adapts itself to the changed supply of money, and in the course of this adaptation important variables have to be altered which are of primary importance for the analysis of the economy as a whole, example, money income or prices.

Now, the question is, why do people demand for money in Friedman's theory? Friedman's approach is so-called Cash-balance approach of the quantity theory of money. Unlike Fisher's transaction approach, it does not emphasize the velocity but the holding of money. The average amount of money that people hold or wish to hold is their demand for money. But why do people wish to

Decree, 1994"[1]. The law provided for the recovery of debts improperly granted directly and indirectly to directors and management staff of banks and imprisonment for such and other malpractices, including those committed by bank - employees. In order to ensure speedy trials of cases under the law and enhance its deterrent effect, the law provided for the establishment of special court or tribunals, each headed by a high court judge. Furthermore, persons convicted for offences under the law could be sentenced for up to five (5) years imprisonment without an option of fiue.

In addition, the Central Bank of Nigeria (CBN), introduced two major regulatory changes to provide needed support for finance companies struggling to overcome their financial problems and restor confidence and profitability. Under the first of such measures, the limit on the minimum borrowing which finance companies were allowed to contract was lowered from N100,000.00 to N50,000.00 (Central Bank of Nigeria (CBN), Annul; Report and Statement of Account December, 1994, P. 17). This measure was expected to increase their potential funding base. Under the second measure, finance houses were given up to four (4) years to bring their provisions on classified assets to the minimum level permitted under the prudential guidelines applicable to them.

All these measures were geared toward achieving a virile financial sector that will essentially restore growth in the overall macro-economic performance. Hence, financial deepening significantly influence economic growth in a positive way.

Development economists have long argued that the evolution of financial markets is an important dimension of growth. A Corollary view is that financial repression in many less developed countries is a serious obstacle to progress. But unfortunately many countries have had disappointing experiences with liberalization.

According to Mark Gertler and Andrew Rose (1991) "Freeing up financial markets is often appeared to produce chaos rather than growth, forcing many countries to retreat from deregulation"[2]. Now that economic stagnation seems to persist in many developing countries, policy makers face a dilemma; should they cling to repressed financial markets, or instead, should they try the road to reform once again? That is why I supposed, financial deepening and economic growth is a good topic of research for a developing country like Nigeria, which is faced with a repressed or weak financial system.

It is important to note that economists have long debated the nature and empirical importance of the relationship between financial deepening and economic growth. Financial institutions such as Central Banks, banks, mutual funds, investment banks and brokerage houses use a variety of financial instruments (currency, demand deposits, stocks,bonds, and options) to facilitate trade in goods and services, mobilising savings, allocating credits, and allowing participants to pool, trade and price risk, financial systems may improve the flow of information, the allocation of resources, and the management of firms in ways that promote economic growth and development.

## 1.2 STATEMENT OF RESEARCH PROBLEM

The nature of the current economic crisis in Nigeria has been discussed by several others. Factors commonly identified as causes of the crisis include poor economic management, corruption and misuse of public funds, wasteful spending, deficient fiscal and financial policies and virtually lack of patriotism.

The importance of deficient fiscal and financial policies and corruption has of recent been elevated particularly,during the period of Babangida's Structural Adjustment Programme (SAP) of 1985 - 1993. Inflation attained unprecedented heights as domestic credit expanded following huge fiscal deficit that were financed solely by "ways and means". Exchange rate depreciated continuously and fuel shortages were rampant. Other indices of social life deteriorated (health, education etc). There were therefore justified calls for change.

On 17th November, 1993, a new Government was announced and some policy changes were introduced. From these changes, it appeared the Government believed that Nigerian Banks' behaviour were responsible for the economic crisis that Nigerians are now going through. Interest rate were regulated and directed credit programme restored. Foreign Exchange was to be allocated directly to end-users and exchange rate was fixed at ₦22.00 per US Dollar. The autonomous market was abolished and domiciliary foreign currency accounts banned. Finally, banks were blamed for not doing enough to better the lot of the productive sectors.

However, some of these accusations and blames called for a re-

examination of the conventional wisdom on bank's portfolio behaviours, liquidity control and the economics of parallel market. If it is understood that bank's fortune depends on the performance of the economy, and vice versa, it would not be difficult to come to the conclusion that banks could not be less desirous of national progress and development than any other group, the Government inclusive.

Consequently, if it is found that banks hold excessive liquidity and refuse or fail to lend to the productive sector, or their lending rates are considered high, something must be fundamentally wrong for the horse to have refused to graze the pastures. For banks' whose first and foremost businesses is lending to have refused to lend, required deeper investigation than we are often prepared to undertake. A bank refusal to lend to a given sector might suggest that it is uneconomical or not profitable to do so. Also, it is most unlikely that banks that have been operating within the structure and intensity of competition witnessed between 1987 and 1993 would commonly charged lending rates that are higher than competitive rates. For such might suggest that we believe that collusive pricing is compatible with intense competition.

In similar vein, if the abolition of the autonomous and parallel foreign exchange markets would do no harm to the nation's economy, there is no way it could be harmful to the banks because these markets came into existence in the first instance, because their services were required. Thus, it is desirable that we

understand why and how parallel markets exist and function to be able to determine their desirability or otherwise. Such an understanding would enable us to appreciate the portfolio behaviours of Nigerian Banks for some time now and equip us further in determining the appropriate liquidity control response of Government, as well as its attitude to the happenings in the parallel market.

Presently and almost in all developing economies of the world, the major factor identified as the causes of economic crisis is the failure of the banking system to stimulate the overall economic activities. This is because, economic growth is believed to be accelerated by the investment component of the aggregate demand. And in the same vein, investment is stimulated by the availability of investible funds which is mobilised by the banking system. The effects of bank failures is the high rate of inflation, economic stagnation, severe macroeconomic instability and increase in public sector debt which are visible indices among developing economies, Nigeria inclusive. Hence it is imperative to revisit this problem in order to ascertain its dimension with a view of putting the right policies in place (Monetary and fiscal policies) to address it.

In Nigeria, emphasis in the literatures has been the nature and causes of bank failures and decline in economic growth. Attempts have not been made to determine the causal relationship between financial deepening and economic growth. In other developing countries, the causal relationship between financial

deepening and economic growth continues to stimulate research. It is important to note, however, that those studies which have tested the causality relationship between financial deepening and economic growth (Gross Domestic Product) show mixed results which are sometime contradictory to each other. In many cases, financial deepening does not make much difference to economic growth. For other, there was no unidirectional causality (positive and negative) from financial deepening to economic growth. And for many others, financial deepening and economic growth appear to be determined contemporaneously (John Thomton, 1996). This might reflect the absence from the estimates of an additional independents factor that jointly influence both variables; alternatively, financial factors might be important only episodically.

This research is the first attempt on the causality relationship between financial deepening and economic growth using Nigeria data. The project has adopted the Granger technique (Granger C.W.J 1980) to test the causality between financial deepening and economic growth in Nigeria. In addition, other relevant statistical techniques, especially student 't' statistics were used to test the significance of the parameters estimates to see the link between financial deepening and the Gross Domestic Product (GDP).

## 1.3 JUSTIFICATION OF THE RESEARCH:

In a competitive environment, the ability of an organisation,

public or private, to plan for an uncertain future may represent the difference between growth or failure. According to Schwartz (1991) "the availability of powerful computers at reduced prices has made the creation of 'what if' scenarios one of the most useful strategic planning tools"[3]. Creating a realistic scenario clearly involves the representation not only of the internal functioning of the organisation or enterprise, but also of the environment in which this operates. It is indeed very crucial to include the macroeconomic environment in any scenario that involves a bank or financial institution. The rate at which an economy expands, or contracts, and its fiscal and institutional environment affects directly borrowing and repayment, income and wealth, assets and debt. The performance of financial institutions is closely tied to growth scenario as well as the overall performance of the macro-economy.

The linkage between financial deepening and economic growth work both ways. It is now widely recognised that a country needs a sound and efficient financial system to achieve long-term growth. Inefficient credit and capital markets would effectively "crowd out" private investment by making credit expensive or scarce to the private sector. Any analysis of a country's ability to sustain fiscal and expenditure policies in the long-term should then take into account the viability of its financial system.

From the foregoing analysis therefore, it is indeed rational to look at the empirical truth of the relationship between financial deepening - economic growth in Nigeria so as to discover

the various constrains imposed by internal or external forces on our financial system to boost economic growth in Nigeria. Or conversely, the forces that impede economic growth on financial deepening.

It is pertinent to note that the current crisis in Nigeria banking system - increased cases of insolvency and destresses in the banking industry justifies a study in this field. Because, this problem required urgent attention to arrest the imminent collapse of our financial sector, which could result to recession or economic depression in general. Therefore, the major causes of bank repression in Nigeria were succintly discussed, its effects were addressed so as to proffer possible solution to remedy these "urgly" effects. The choice of this research topic, I supposed is a good one, due to the poor performances of the macro-economics variables in the country today.

## 1.4 OBJECTIVES OF THE STUDY:

The major objectives of this research are as follows:

i. to know the causality between financial deepening and economic growth;

ii. to know the growth performance of the Nigerian economy and analyze the bottlenecks limiting that process;

iii. to examine the major causes of financial repression in Nigeria and advance possible solutions to the financial distress in banks since 1989; and

iv. to proffer policy recommendation depending on the research

findings for regulating or deregulating the financial system to boost growth performance of the economy.

## 1.5 RESEARCH HYPOTHESIS:

The hypothesis of this research centres on the major assumption of the monetarist economist as to the place of money supply in growth process.

i. That economic growth (GDP) **depended** on financial deepening (i.e total bank deposits divide by GDP);

$H_o$ ; $a_1^{11} = 0$

$H_1$ ; $a_1^{11} \neq 0$

At 5% level of significance.

[Note; $H_0$ is the null hypothesis, that the parameter of financial deepening is not significant, while $H_1$ is the alternative hypothesis that it is significant, i.e financial deepening influence growth]

ii. That financial deepening depends on economic growth.

$H_0$ ; $\beta_1" = 0$

$H_1$ ; $\beta_1" \neq 0$

At 5% level of significance.

[Note; $H_0$ is the null hypothesis, that the parameter ($\beta_1$) of the economic growth is not significant, while $H_1$ is the

alternative hypothesis that it is significant, i.e economic growth (GDP) influence financial deepening].

The above hypothesis underscore the fact that there is a symbiotic relationship between financial deepening and economic growth. A country with a sound financial system can influence its growth performance. On the other hand, financial deepening is being influenced by the growth performance of an economy. In other words, a growing economy influence the development of its financial system in a positive way. Financial deepening as an explanatory variable of growth is expected to have a positive reggression coefficient. The reverse is the case for economic growth as an explanatory variable for financial deepening. These hypothesis were tested as specified in the research model.

## 1.6 METHODOLOGY OF THE RESEARCH

The study used both descriptive and analytical tools to analyze the actual relationship between financial deepening and economic growth.

The major analytical tools in this study were the use of ordinary least square (OLS) method and the Granger techniques (C.W.J. Granger 1960) in the estimation of the parameters of the models. Granger proposed that, for a pair of linear covariances - stationery time series X and Y; X causes Y if the past values of X can be used to predict Y more accurately than simply using the past values of Y. Finally, X is said to cause Y if $\sigma^2$, ($Y_t$; $Y_{t-j}$, $X_{t-j}$) < $\sigma^2_2$ ($Y_t$; $Y_{t-j}$) where $\sigma^2$ represent the variance of forecast

error and i, j = 1,2, 3 - - k.

The study has compared the period of regulation with deregulation in order to determine the impact of regulation and deregulation on the performance of the Nigerian financial system in boosting economic growth. Four different models were specified. The first and the second adopted the simple regression analysis; 1975 - 1985 for the first regression, 1986 - 1996 for the second regression. The period 1975 - 1985 and 1986 - 1996 represents the periods of regulations and deregulation respectively. The third and the fourth models were the synthesis of both periods (i.e periods of regulations and deregulation), which is 1975 - 1996. These adopted the Granger techniques to test the causality between financial deepening and economic growth, using the distribution lag models. The third model is financial deepening on growth, while the forth is the reverse of the two variables. The separate analysis is important because it enables us to compare the impact of the structural shift on the parameters of our models over time. And the adoption of the two statistical techniques (OLS and Granger techniques) is also important in order to ascertain proper, the true relationship between financial deepening and economic growth in Nigeria.

### 1.6.1 SOURCES OF DATA

The sources of data collection for this work were extensively based on secondary source. This includes; Federal Government Publications Central Bank of Nigeria, (CBN), Journals, Articles in

Magazines, National Dailies and other available literatures in documentary units.

### 1.6.2 EXPECTED RESULTS

As already stated above, the study adopted the use of simple regression analysis and the popular concept of Granger Causality test techniques on Nigeria data to show the causality between financial deepening and economic growth in Nigeria. The study assumes a positive relationship between the two variables and the causality run on both sides. And for this to be consistent with the analysis, it is expected that the regression coefficient should give a positive magnitude to underscores the symbiotic relationship between the two variables,

### 1.6.3 SCOPE AND LIMITATION OF THE STUDY

This research has covered a period of twenty-two years (1985 - 1996). The choice of 1975, sixteen years after the regulation began, is based on the fact that there is need to see the impact of financial deepening on economic growth (or vice versa) during the oil boom era. And from 1986 - 1996, the Structural Adjustment Programmes (SAP) period, shows the period of deregulation proper. The choice of this period also is important to show the impact of deregulation on financial deepening and economic growth.

One fundamental limitation of any research work concerns the quality and adequacy of data. It is important therefore to admit the fact that some of the information and data supplied by the

Central Bank of Nigeria (CBN), the World Bank and Literatures in Documentary Units are sometimes, unrealistic and conflicting with each other due to the problem of improper record keeping method in Nigeria, especially on economic data. Nevertheless, attempt were made to reduce the impact of this weakness on the analysis by comparing the data with each other from different sources and a more realistic ones were be used.

In addition, the simple regression model used in this study assumed a way other factors that may affects economics growth in Nigeria other than financial deepening, or the other way round. Nevertheless, it is expected that the well behaved normally distributed error term has taken care of some of these factors. Hence, the conclusions and inferences of this study was still consistent with the research hypothesis.

## 1.7 OUTLINE OF GENERAL FRAMEWORK

The general framework of this research is made up of five chapters. In chapter one, an introductory aspect of the study is provided. Other aspect of the chapter include; problem statement, justification of the study, objectives of the study, the research hypothesis, methodology, which comprises of the sources of data, expected results and scope and limitation of the study.

Chapter two centres on theoretical framework, literature review and the empirical studies.

Chapter three gives a cursory survey of the over-view of the Nigeria economic growth, the growth of financial institutions in

Nigeria, the crisis in the Nigeria financial system (the economic crisis and bank's portfolio behaviours), ranging from causes and effects of bank failure on Nigerian economy, and the relationship between economic growth and financial growth.

Chapter four centres on the model specifications and estimation of the parameters of the models and the interpretation of the regression results based on the estimated coefficients in explaining the causality between financial deepening and economic growth.

Chapter five gives summary of the study, the conclusions and the policy recommendation to reduce or remedy the emergence of bank's insolvency in Nigeria. The bibliography is given at the end of chapter five, which was followed by Appendix.

## 1.8 FOOT NOTES

1. Central Bank of Nigeria (CBN) annual report and statement of account, 31st December, 1994, p.17.

2 M. Gertler and A. Rose (1991) "Finance and growth and public policy" World Bank working papers, December 1991, p.4.

3. Schwarts, Peter (1991) " The art of the long view" published by the Doubleday.

Chapter 2

## 2.0 REVIEW OF LITERATURE

## 2.1 DEFINITION OF TERMS

### FINANCIAL DEEPENING

Financial deepening as an economic indicator is defined as the ratio of total bank deposits to nominal Gross Domestic Product (GDP). Currency is excluded from this definition since it is not intermediated through the banking system. Financial deepening can also be measured as the ratio of total bank credits to private sector to nominal Gross Domestic Product (GDP).

As a component of total money supply, total bank deposits otherwise known as Quasi money is defined as money supply, $M_2$ minus money supply, $M_1$ (i.e currency outside the banking sector). A country is financially deepened if the ratio of total bank deposits to Gross Domestic Product (GDP) is high. And if this ratio is low, financial deepening is absent or low. If the ratio is as high as 45% and above, financial deepening exist, at least for purpose of this study. That is, if the ratio increase over time and is sustained.

### ECONOMIC GROWTH

Growth of an economy reflects changes in either its productive capacity or its percentage utilization of that capacity or both. Gross Domestic Product (GDP), is an indicator of economic growth. Economic growth in a nutshell, reflects increamental changes in the Gross Domestic Product (GDP) of an economy in the long-run. It

hold an average amount of money? Friedman's ultimate wealth holder holds money for its useful services, because, as a result of holding it, it is possible to bridge the period between selling and buying, and because money held provides security in the case of unforseen expenses, its possession gives its owner a sense of pride, etc. And since, according to Friedman's definition, everything which represents a source of income or consumable services is an asset, money in his opinion is therefore a kind of asset, too. And so, money is among many assets. An entrepreneur would like to hold a certain amount of money because the continuity of production requires it. Thus money held is for Friedman a productive resources, capital, and as such is also an asset. The amount of these services of money depends on its purchasing power. Friedman, as he himself admits, borrowed the interpretation of money as a sort of asset from Keynes [Antal M. D. (1980)].

Friedman's analysis of the relationship between the money supply and output can be better understood with an equation as follows:-

$$MV = PY \qquad (7)$$

where

V = velocity of circulation or the income velocity of money which is the number of times in a year that money stock circulates.

M = total money stock

P = price level

Y = real Gross Domestic Product (GDP)

In a functional form therefore, equation (7) can be transformed into equation (8) as follows;

$$M = \frac{1}{V} PY \quad \ldots\ldots\ldots\ldots\ldots\ldots \quad (8)$$

In the short run price and velocity of circulation are assumed constant, so that a change in the stock of money, M will result in a positive change in the real output, Y. This, Friedman assumed that unemployment only exist at a short-run. The question now arises that if full employment, as Friedman thinks, is in the long-rum typical of the capitalist economy, then why is it possible to achieve a transitory expansion by the increase in the quantity of money? He maintain that demand - supply equilibrium in the labour market does not exclude the so-called natural rate of unemployment, in the magnitude of which the costs of gathering information about job vacancies, newly created jobs and labour availabilities, as well as the costs of labour mobility etc find expression.

The analysis of the Friedman's quantity theory of a positive relationship between total money stock and real income (output) underscores the relevance of the theory in analyzing the relationship between financial deepening and economic growth.

### 2.2.2 HARROD-DOMAR GROWTH MODEL

As basic principle emphasised by Harrod and Domar and incorporated in all modern growth theory is the dual effect of net investment; net investment constitutes a demand for output, and it also increases the capacity of the economy to produce output. For example, constructing and equipping a new factory generates a

demand for steel, brick, and the factory once constructed and equipped increases the economy's productive capacity. This model merely imbibed the spirit of Keynesianism of the mechanism of equality between planned saving and planned investment, if there is to be equilibrium in the level of income and output. What is strange from the Keynesian model is the fact that this period's net investment also has a capacity effect; it increases the economy's productive capacity in this period and thereby increases the next period's potential output.

The basic theory involves a simple production function that relates the generation of total output to the stock of capital output ratio. Taking the techniques of production as given, some specified amount of output, if we let K represent the capital stock and Y the level of output, we may define the average capital output ratio as K/Y. This, if it take ₦3.00 worth of capital goods to produce ₦1.00 worth of final output, a capital stock of ₦300 billion is required to produce aggregate final output of ₦100 billion, and the capital output ratio is 3 to 1. In contrast, the marginal capital output ratio i.e. DK/DY tells us how much additional capital is necessary to produce a specified addition to that flow of output. This model assumed a constant technology, so that DK/DY remains constant. For more simplicity, we also assume that the constant DK/DY equals to K/Y, so K/Y is also constant.

According to the model, the actual rate of growth of output in a period G, is equal to DY/Y where Y is output. Thus

$I = SY.$

That is, investment/capital stock is identical to saving, S as a proportion of output, and thus

$$\frac{1}{\Delta y} = \frac{S}{G}$$

But I/DY is the actual increament in the capital stock divided by the actual increament of output, which is denoted by CP. Thus we can write

$$G = \frac{S}{CP}$$

Now if CP happens to be equal to C, the capital-output ratio "Warranted" by technological and other conditions, then the actual rate of growth, G, is equal to the rate which the circumstances of the economy warranted, $G_W = S/C$, and the economy is growing at an equilibrium rate.

Although, the theory further posits some possibilities of disequilibrium or instability inherent in the balance economic growth, but in the case of our analysis, we will not go further to the so called "knife-edge" instability as critiques of the model try to unfold. It is important to note therefore, that inferences can be drawn from the above model as our basic theoretical framework of this research work.

One important thing to note is that investment is seen as the basic engine of growth. And experience shows that financial factor is paramount in stimulating investment. Hence, economic growth is determined to a large extent, by the efficiency of the financial

system. Put in another way, financial deepening interferes with the process of economic growth or development of an economy.

## 2.3 LITERATURE REVIEW

Available literature on the subject of financial deepening and economic growth, the world-over, shows that financial factor interferes with growth process to a very large extent. And that a sound financial system is synonymous to a sustained economic growth and development.

McKinnon (e.g. 1973, 1991), Shaw (1993), and Fry (e.g 1978, 1988), have advanced the argument that a repressed financial system interferes with development because savings and investment are negative or unstable, and financial intermediaries do not allocates saving efficiently among competing users. When the financial; system is liberalised household are seen as substituting out of unproductive tangible assets thereby raising the total real supply of credits, the quantity and quality of investment, and the rate of economic growth. This is the so called "McKinnon - Shaw - and Fry! approach to the place of financial factor in growth.

Another approach, called the "Structuralist", has also been advanced by Baffie (1984), Taylor (1983), and Van Wijn Bergen (1983). This group argue that in the process of financial deepening, household substitutes mainly out of curb-market loans such that financial deepening reduces the total real supply of credits available and hinders economic growth. The "Structuralist" argument, often identified with the UN Economic Commission for

Latin America (ELWA) is that instability or crisis (e.g. financial repression) is inevitable in an economy that is attempting rapid growth in the presence of structural bottlenecks, or constraints, defined as certain fundamental facets of the economic, institutional and socio-political structure of the economy which in one way or another inhibit expansion. These structural rigidities in the economy jeopardise the transmission mechanism between financial deepening and economic growth. In this regard, a transition requires massive changes in the socio-economic structure of the less developed countries (LDC) which the price mechanism, operating within very imperfect structures and with limited resources mobility, is unable to achieve; given the imperfections of the system, the result of attempting major structural change had to be shortages and disequilibrium on many fronts (A.N. Livingstone (ED) 1967).

An alternative approach, is the "Monetarist" argument which is the same as the McKinnon - Shaw - and Fry approach posits that financial repression or other economic crisis is not caused by structural constraints - the inelastic supply of food sturfs, the foreign exchange bottlenecks and the financial constraints, identified by the "Structuralist", but rather from the all too frequent administrative control imposed on the economy by the Government. They assumed that this interference with the operation of market forces has a disincentive effect on many fronts, in an economy. Nigeria adopted this approach in 1986 (SAP), hence the crisis.

John (1996) in his study of the relationship between financial deepening and economies growth in developing economic using Granger - Causality tests on data for 22 Asian, Latin American and Caribbean developing economies suggest that financial deepening does not make much difference to economic growth; for eight countries no lead-lag relationship was detected and in six, more economic growth led to financial deepening.

John specified the following auto-regressive time series model to test for Granger - Causality between financial deepening and economic growth;

$$Y_t = a_o + \sum_{i-1}^{n} a^i Y_{t-i} + \sum_{i=1}^{n} B_i FD_{t-i} + U_t \text{ ------- (9)}$$

Where Y is the real GDP, FD is the financial deepening variable, and U is a well behaved normally distributed error term. To implement the Granger Causality test, in the above equation, he calculated F - statistic under the null hypothesis that the coefficients of the lagged values of FD are jointly insignificant (i.e all $B_i = 0$).

This research work imbibed the above model specification for financial deepening and economic growth in Nigeria. It adopts virtually all the hypothesis and tools of analysis as provided or used by John Thornton in his study of the relationship between financial deepening and economic growth in developing economies.

Another notable study of the relationship between financial development (deepening) and economic growth is conducted by Patrick (1966) in his study of the Japanese monetary system between the 1870s and the beginning of World War I. The study reveals that the

modern banking system evolved in 1870s, with the right to issue bank notes. This bank was constrained with the absence of a large scale demand for fund and that their activities were essentially the financing of agriculture, domestic commerce and foreign trade. It is important to note that these banks bacame the starting point of the early promotional and entrepreneural talents that initiated the industrial revolution beginning in the mid 1880s, especially in rail-roads and in cotton textiles. It became the early source of industrial fund. This study shows the relevance of financial factor in growth processes. That industrialisation was spurted by the activities of the financial institutions created at that time.

Robert and Ross (1992), in their study "financial indicators and Growth in a cross Section of Countries", shows that financial deepening and economic growth are correlated. They use existing measures of the financial system and construct many new measures, to document the relationship between financial system and long-run growth in cross section of countries between 1960 and 1989.

They consider various measures of the size of the financial system, the importance of different institutions, the financial system's allocation of credits, the financial system's efficiency, and the degree of financial repression. They use graphs, correlation and regression to gauge the robustness of the partial correlation between growth and the financial indicators. They also examine two "channels" through which financial indicators may be linked to growth; the share of GDP allocated to investment and the efficiency with which resource are used.

Their findings reveals that many of the financial system' indicators are significantly correlated with growth through both investment and efficiency. Moreover, many of these partial correlation remain strong after controlling for initial conditions, dummy variables for Africa and Latin America, and measures of monetary, fiscal and trade performance. Their analysis suggests that it is empirically important to identify which financial intermediaries are doing the intermediation and to whom the financial system is allocating credit rather than simply using proxies for the overall size of the financial system, as has been common in past studies. The four main measures of the size of the financial system includes the followings:

"$M_1Y$; The ratio of $M_1$ to GDP. $M_1$ is the sum of currency held outside of the banking system plus demand deposit at Com[illegible]al Banks.

LLY; The ratio of liquid liabilities of financial system to GDP. Liquid liabilities equals. $M_1$ plus interest bearing liabilities of the banking systems, plus demand deposits and interest bearing liabilities of the non-bank financial intermediaries, e.g, saving banks, postal savings - institutions, finance companies etc.

OLLY; The ratio of quasi-liquid liabilities of the financial system to GDP. Quasi - liquid liabilities equals liquid

liabilities minus $M_1$.

DGPY; The ratio of claims on the private sector by the Central Bank and Deposit Money bank to GDP"[2]

Mark and Andrew (1991) on their part consider the relationship between finance and growth and the appropriate role of government policy. Many economists have stressed how problems of a systematic information and contract enforcement impede the functioning of financial markets in developing countries. Gertler and Rose flesh these theories out to make them relevant to policy makers. They explains that information gaps and enforcement frictions introduce a premium in the cost of external funds. Factors such as the borrowers financial health, the efficiency of financial intermediation, and the case of enforcing private contracts govern the size of this premium. How financial factors contributes to development may be understood along these lines. As for financial structures, financial contracts and institutions ought ideally to be designed to minimize this premium.

What are the partial implications for policy makers?

According to them, a large decentralised capital market is optional. Incentive problems may inhibit the functioning of financial markets, but the most direct way for the government to mitigate them is to provide an efficient system for enforcing contracts. Publicly managing credits flow is likely only to make investments more efficient, but creating incentives problems. To the extent that some sector merit public assistance, tax credits or subsidies in conjunction with the private allocation of credits is

preferable to directly regulating credits flows. The government should refrain from active involvement in the credit business, except to act as lender of last resort in times of widespread financial crisis.

They argued that liberalization of financial market alone is not a panacea. And that financial and real development must be a joint product. Liberalization can enhance growth, but successful liberalization requires a viable borrowing class; governments that slow liberalization when borrowers' net worth is under pressure and accelerate it when the real economy is thriving are likely to experience more successful financial reforms.

According to Gertler and Rose "financialisation appears to accompany growth in the real sector"[3]. They also argued that as an economy developed, non-bank intermediaries crop up, offering borrowers and lenders a greater range of opinions. Secondly, that more capital tends to flow in from abroad, in contrast to the prediction of the simple neo-classical model. They posit that across the developing countries, the ratio of external borrowing to GDP tend to rise with GDP[4]. And that the composition shifts from public sources to private sources.

They further stressed that "as development proceeds further, markets for direct debt and equity emerged"[5] And so, the variety and magnitude of financial institutions and services continue to grow, improving the allocation of saving and investment.

Finally, Gertler and Rose's analysis suggests a symbiotic relationship between finance and growth. They said "Development of

the real sector tend to reduce the premium attached to external finance, which in turn serves to stimulate further development"[6] According to them, several broad empirical regularities are associated with this process; evolution from self-finance to external finance; development of intermediation, and subsequent development of markets for direct credit; increased access to World Capital Markets; and finally, narrowing of the spread between loan and deposit rates, along with a rise in the risk-less rate.

Rose (1996) is another notable researcher on the relationship between economic growth and financial deepening. Levine argued that the preponderance of theoretical reasoning and empirical evidence suggests a positive, first order relationship between financial development and economic growth. There is even evidence that the level of financial development is a good predictor of future rates of economic growth, capital accumulation and technological change.

Moreover, cross-country, case study, industry level and firm level analysis document extensive periods when financial development (or the lack thereof) crucially affects the speed and pattern of economic development. He explains what the financial system does and how it affects, and is affected by economic growth. Theory suggests that financial instruments, markets, and institutions arise to mitigate the effects of information and transactions costs. A growing literatures shows that differences in how well financial system reduce information and transaction cost influence saving rates, investment decision, technological

innovation, and long-run growth rates.

A less developed theoretical literature shows how changes in economic activity can influence financial systems. Levine advocated a functional approach to understanding the role of financial systems in economic growth. This approach focuses on the tiers between growth and the quality of the functions provided by the financial instrument, such as money, or a particular institution, such as a bank. Instead, he address the more comprehensive, and difficult question; What is the relationship between financial structures and the functioning of the financial system? According to him, the primary function of finance to economic growth can be broken into five basic functions, which includes;

- to facilitate the trading, hedging, diversifying, and pooling of risks.
- to allocate resources,
- to monitor manager and exert corporate control,
- to mobilize savings, and
- to facilitate the exchange of goods and services.

He in addition posit the following as pattern of financial development;

- "financial intermediaries get larger as measured by the total assets or liabilities of financial intermediaries relative to GDP;
- bank grew relative to the Central Bank in allocating

credits;

- non-banks - such as Insurance companies, investment banks, finance companies and private pension funds grows in importance; and
- stock markets became larger, as measured by markets capitalization relative to GDP, and more liquid, as measured by trading relative GDP, and capitalization, and stock price variability"[7].

He concludes "I believe that we will not have a sufficient understanding of long-run economic growth until we understand the evolution and functioning of financial systems"[8]. He further stressed that conclusion about financial development and long-run economic growth has an important corollary; although financial panics and recession are critically important issues, the finance - growth link goes beyond the relationship between finance and shorter term fluctuations.

Yaviz and Hecter (1993) on their own present a simulation model (applied to Uruguay and implemented in Javelin) that permits analysis of the interaction between a financial system and the economic environment in which it operates. This model allows the user to compute and project the indicators necessary to monitor the performance of a financial institution and to examine how those indicators respond to economic change.

Boray and Sierra developed a tool that uses a time series that shows developing trend lines. The model requires an adequate level

of detail and consistency of content, interpretation, and presentation of the financial and economic data, plus an adequate grouping of banks to ensure that comparisons are between like entities. According to them, "the model should be useful to financial analysts" that need to plan and forecast for growth and profits of a financial institution, or a group of them, and that are interested in capturing the linkages with the macro-economy in a fully consistent framework. It should also be valuable to economists interested in assessing the viability of the financial system, and in particular in assessing the impact of financial restructuring"[9].

Oyejide (1994)'s argument on the relationship between economic growth and financial deepening is along the same line of argument by Ross Levine (1996) as stated above. He stressed the symbiotic relationship between financial deepening and economic growth.

He said "the theoretical insights about the two way relationship between financial deepening and economic growth have generated several empirically observed patterns of finance - growth linkages".[10]. He said that this linkage pattern offers some lessons for a developing country such as Nigeria which badly need some way of digging itself out of a deep economic "hole". As prerequisite for financial and economic growth recovery in the context of contemporary Nigeria, Oyejide suggests that financial reforms policies that liberalize financial market should ultimately enhance economic growth. But that the magnitude of their effectiveness would depend on the existence of a viable borrowing

class, i.e a large group of credit worthy borrowers who are not discouraged by the prevailing premium for external finance. Thus, financial reforms and market liberalization would be more effective if they were accompanied by other policies that directly stimulate real sector growth and enhance overall macro-economic stability.

Oyejide's suggestion is in consonance with Mckinnon - Shaw and Fry's approach (or the "monetarist's position). When the financial system/market was deregulated in Nigeria during the era of Structural Adjustment Programme (SAP) in 1987, this reforms were not accompanied by other policies that directly stimulate real sector growth and enhanced overall macro-economic stability in the country. The new reforms, (liberalization) merely enhanced growth in the commercial sector of the economy. They were phenomenal hike in lending rates by banks coupled with a short term - repayments of loans. Therefore, investors were compelled to invest in the commercial sector where quick turnover could be achieved, to the detriment of the real sector development. Hence, the economy depend on commission received from the expatriate firms in the mining sector, and the commercial sector blossom to the neglect of the real sector growth. The result of this phenomenon is the current economic crisis which Nigeria is plunged in.

Finally, Oyejide stressed that confidence, absence of disruptions and relative certainty are obviously necessary for the functioning of a financial system. And that when confidence breakdown, disruption occurs and general uncertainties prevails, financial markets and transaction contracts, and, in the process,

they shrink rather than facilitating real sector economic activities. And hence, if the public confidence are eroded in the financial system, a sustained crisis is ensued. It is on this ground, that the Federal Government of Nigeria in recent time decided to take a series of measures to restore sanity to the country's financial crisis. Failed Bank Decree were enacted and adequate machinery were put in place to restore public confidence on the Nigeria's financial sector. So far, evidences have proved that a lot of success have been achieved to some extent in the country's financial sector.

Review of empirical literatures as above shows evidences that financial deepening is an important factor in growth process in modern economies, both developed and underdeveloped. That a repressed financial system negatively affects growth process. And so, a financial deepened economy is to a large extent, a growing economy. This presupposes that there is a symbiotic relationship between financial deepening and economic growth. No wonder, Nigeria Government in recognition of this fact, decided to take steps to strengthen and redeem her already "distressed" banks off from total collapse in recent time.

## 2.4 EMPIRICAL STUDIES

John (1996) investigated the relationship between economic growth and financial deepening in developing economies. Using the Granger Causality test for twenty two (22) developing economies. The result suggest that for eight (8) of the twenty-two (22)

countries, financial deepening and economic growth appears to be determined contemporaneously; that is, the null hypothesis is rejected in both directions. That financial deepening promotes economic growth is supported in five cases at 5% level of significance (the Philippines, the Dominican Republic, El-Salvador, Jamaica and Malaysia) and a further two cases (Nepal and Thailand) at 10% level of significance; that is, in these cases there is evidence of unidirectional Causality from financial deepening to economic growth. His result further shows that the structuralist's position was supported in the case of Mexico only, where negative unidirectional Causality from financial deepening to growth is detected.

John's investigation also shows that unidirectional Causality from economic growth to financial deepening was indicated in four countries at 5% level of significance i.e. (Myammar, Peru, Uruguay and Korea) and in a further two countries at 10% level (Guatemala and Paraguay). In two countries (Jamaica and Venezuela) there appear to be feed back effects between financial deepening and economic growth the result further shows.

Mark and Andrew (1991) attempted to establish a broad empirical characterization of the relationship between financial depth and real Per Capital Income. They examined correlation between the (log of the) level of (real per capital dollar income), and the (log of the) ratio of credits to GDP. They found a strong evidence of a positive correlation; countries with higher income have deeper financial system. Again, they stressed that their work

is mainly descriptive, so that the causal interpretation of their findings was unclear.

Gertler and Ross in their empirical work, the coefficients are estimated in a simple regression of the log of the ratio of credits (or quasi-money) on a constant and the log of real per capita income measured in American Dollars. In a bench-mark result, the slopes are positive and significant in both economic and statistical terms. They estimated that a one per cent increase in the ratio of private credits to GDP of 0.42%; the comparable increase in the ratio of quasi-money to GDP is similar; 0.56%. Their results also shows that the intercept of both equations are significantly negative at conventional significant levels. Their results is also true in virtually all perturbations of the basic equations and it is quite robust to a variety of perturbations of the basic framework.

Generally Gertler and Ross's findings of a positive relationship between real income and the credit/income ratio is robust with one exception. And this could be found when they take the first differences of the data, they find a strong negative relationship between the variables of interest rate.

In a cross country studies, Goldsmith (1969) uses the value of financial intermediary assets divided by GDP to gauge financial development under the assumption that the size of the financial system is positively correlated with the provision and quality of financial services. Using data on 35 countries from 1960 to 1963 He finds;

(1) "... a rough parallelism can be observed between economic and financial development if periods of several decades are considered", and

(2) "... there are even indicators in the few countries for which the data are available that periods of more rapid economic growth have been accompanied, though not without exception, by an above average rate of financial development"[11]

Goldsmith's work however, has several weaknesses;

(a) the investigation involves limited observation on only 35 countries;

(b) it does not systematically control for other factors influencing economic growth;

(c) it does not examine whether financial development is associated with productivity growth and capital accumulation;

(d) the size of financial intermediaries may not accurately measure the functioning of the financial system; and

(e) the close association between the size of the financial system and economic growth does not identify the direction of causuality.

In order to address some of these weaknesses, a number of researchers have taken steps in recent times, for example King and Levine (1993, a,b,c) study 80 countries over the period 1960 - 1989, systematically control for other factors affecting long-run growth, examine the capital accumulation and productivity growth channels, construct additional measures of the level of financial development to predicts long-run economic growth, capital

accumulation, and productivity growth. They use four measures of "the level of financial development" to more precisely measure the functioning of the financial system than Goldsmith's size measure. The first measure, DEPTH, measures the size of financial intermediaries and equals liquid liabilities of the financial system (currency plus demand and interest bearing liabilities of banks and non-banks financial intermediaries) divided by GDP. This shows that citizens of richest countries held about two thirds of a year's income in liquid assets in formal financial intermediaries, while citizens of the poorest countries held only a quarter of a year's income in liquid assets. This investigation shows that there is a strong correlation between real per capita GDP and DEPTH. The second measure of financial development, BANK, measures the degree to which the Central Bank versus commercial banks are allocating credits. BANK equals the ratio of bank credit divided by bank credits plus Central Bank domestic assets. The intuition underlying this measure is that banks are more likely to provide the five financial functions than Central banks. And that BANK is greater than 90 percent in the richest quartile countries. In contrast commercial banks and Central banks allocates about the same amount of credits in the poorest quartile of countries. The third and forth measures partially address concerns about the allocation of credits. The third measures, PRIVATE, equals the ratio of credits allocated to private enterprises to total domestic credits (excluding credit to banks). The forth measure, PRIVY, equals credit to private enterprises divided by GDP. The

assumption underlying these measure is that financial systems that allocate more credit to private firms are more engaged in researching firms, exerting corporate control, providing risk management services, mobilising savings, and facilitating transactions than financial system that simply fund credit to the government or state own enterprises. This study shows that there is a positive, statistically significant correlation between real per capita GDP and the extent to which loans are directed to the private sector.

King and Levine (1993) then asses the strength of the relationship between each of these four indicators of the level of financial development averaged over the 1960-1989 period, and find three growth indicators also averaged over the 1960-1989 period. The three growth indicators are as follows:

(1) the average rate of real per capita GDP growth,

(2) the average rate of growth in capital stock per person, and

(3) total productivity growth, which is a "slow residual" defined as real per capital GDP growth minus (0.3) times the growth rate of capital stock. In other words, if F(i) represent the value of the ith indicator of financial development (DEPTH, BANK, PRIVY, PRIVATE) average over the period 1960-1989. G(i) represents the value of jth growth indicator (per capita GDP growth, per capital stock-growth, or productivity growth) averaged over the period 1960-1989, and x represents a matrix of conditioning information to control for other factors associated with economic growth (e.g. income per capita,

education, political stability, indicators of exchange rate, trade, fiscal and monetary policy), then the following twelve (12) [illegible] are run on a cross section of 77 countries;

$$G(j) = \alpha + \beta F(i) + FX + f \quad \ldots\ldots\ldots\ldots (10)$$

King and Levine posit that there is a strong positive relationship between each of the four financial development indicators, F(i), and the three growth indicators (G(j), long run real per capita growth rates, capital accumulation and pr[illegible]ty growth. Their test shows that not only are all the financial development coefficients, $\beta$,s statistically significantly, but that the size of the coefficients, imply an e[illegible]cally important relationship.

Finally, King and Levine's results, plus those from more sophisticated time series studies, suggest that the initial level of financial development is a good predictor of subsequent rates of economic growth, physical, capital accumulation, and economic efficiency improvements over the next 30 years even after controlling for income, education, political stability, and measures of monetary, trade and fiscal policy.

The model for this study has, to some extent taken care of some of the limitation cited on Goldsmith's work (Goldsmith 1969), which King and Levine tried to address. Goldsmith's investigation is carried out for cross country's study, but this research work basically utilize a stationery time series data on the relationship between financial deepening and economic growth in Nigeria only. The areas of studies for the two differs, therefore, some of the

weaknesses of Goldsmith's work may not be very relevant to this work. Nevertheless, the research model has systematically controlled other factors that influence economic growth apart from financial deepening. It is expected that the normally distributed error term (or the disturbance term) in equation 2,3,4 and 6 in the models has taken care of this. The study has also examined whether financial development is associated with productivity and capital accumulation. The emphasis of this work is not concerned with the size of the financial intermediaries as measures of the functioning of the financial system, but rather on the causuality test between financial deepening and economic growth in Nigeria. Hence, the adoption of the Granger techniques in testing the causality between the two variables using the auto-regressive time series model (i.e. equation 4 and 6 respectively). Although, the model does not take care of the various financial measures or indicators (DEPTH, BANK, PRIVY, PRIVATE), a more realistic measure were be adopted to gauge for financial deepening (e.g. total deposits/liabilities of banks and non-bank financial system divided by GDP). The results of the various tests were then used for analysis of the research.

However, it is important to note that less or nothing perse, is done empirically on the relationship between financial deepening and economic growth, using the Nigerian data. Oyejide (1994) merely looked at the Nigeria's financial system and economic growth replicated Gertler and Rose (1991)'s result that a fairly robust empirical finding is that a one percent increase in real per capital income is typically associated with approximately with a

1.5 percent increase in various financial deepening measures. He did not test this result empirically using the Nigerian data to ascertain the true relationship between financial deepening and economic growth in Nigeria. His work is more of descriptive analysis than quantitative.

This research has therefore looked at the relationship between financial deepening and economic growth using the quantitative techniques on the Nigeria data to ascertain the true relationship between the two variables. Although, empirical robust evidences were found by researchers the world over of the two way causality running between financial deepening and growth, this study has shown empirically, using the Nigeria's data of the true relationship between the variables using the appropriate econometric tools to know if the results would correspond with earlier research findings. Hence, this research work is the first of its kind using the Nigeria's data and has therefore provide a good material for references by subsequent researchers.

## 2.5 FOOTNOTE

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Chapter 3

# 3.0 AN OVERVIEW OF THE ECONOMY

## 3.1 TRENDS IN THE NIGERIAN ECONOMIC GROWTH

The Nigerian economic growth exhibits an unstable and long-run declining character since independence even to the contemporal time. Arguing along the line of the "vent for surplus thesis" the pre-independence Nigerian economic growth was predominantly influenced by the opening of the economy to international trade by the influx of the Western imperialist on the Nigerian shore.

It was argued that in the pre-colonial era, the Nigerian economy was undiversified, mainly agricultural activities which was essentially a subsistence one. And as such, there was no challenge for growth. But with the influx of Western culture there was the opening up of the economy to international trade. International trade then provided the market for the agricultural products. The peasant farmers responded by the increased demand to expand their resources and thereby increasing agricultural output. Hence, production was no longer for subsistence but for exports. And as a result of this development specialisation became visible. People started moving from the agricultural sector in the rural areas to the urban centres for trading and other commercial activities. The economy became more diversified, a shift from agricultural sector to other sectors, such as mining, transportation, insurance, banking, just to mention a few. The immediate result of this is the accumulation of investible surplus which provided the impetus for development, and as such, the economy became more dynamic and

diversified.

The above thesis provide an understanding of the Nigerian pre-independence economic growth. The Nigerian economic growth in the independence era was essentially dominated by the growth in the agricultural sector. The economy generated a lot of income from the exports of agricultural produce such as groundnuts, cocoa, coffee, palm produce, etc. The country depended solely on the agricultural sector, even after independence, until the discovery of oil deposits in a commercial quantities in the 70's.

One important issue to know about the Nigerian economic growth is that it exhibit an unstable and long-run declining character, especially since independence. Five distinct phases can be detected in our growth circle. The economy growth was relatively low, but dynamic in the 1960s, but Show an exponetial trend in 1970s and collapse by the beginning of the 1980s (Dike E., 19991). This of course depicts the feature of an economy whose growth is hinged on raw material extraction and exports. Phase one Span 1960-1966. The growth performance of the economy during this time, was a carryover from the colonial period when agriculture production dominated Nigerian gross domestic product (GDP), though industry was expanding its base that is the import substitution type. Phase two constitutes the Biafran Civil War (1967-1969). This period exhibit a trough in GDP expansion due to the dilapidation of some important infrastructures resulting from the civil war. The 1970's through 1980 mark the emergence and expansion of the "oil economy" proper. The entire period can be

splitted into two distinct phases. Phase three therefore is 1970-1973, which constitutes the period of post-civil war reconstruction, the beginning of the collapse of agriculture and inception of oil based economic dynamic proper. Phase four, 1974-1980 depicts the Nigeria's golden age of oil'. Finally, phase five, 1981-85 is characterised by the collapse of the oil economy due to the fall in the price of crude oil in the world market, and the inception into the open of the on going economic crisis (Enwere D. 1991).

For the period, 1960-1985, existing GDP growth estimates range between 2% and 4%, which shows an unstable growth, besides, the growth tempo has shown a long-run declining trend, Several factors have been identified for the long-term growth performance of the economy as observed here. Some of these factors identified in recent economic literatures for long-term growth performance of the less developed countries, among others includes; (a) domestic saving capacity; (b) structure and dynamics of human capital formation, which represent the pace of technological changes (c) demographic dynamics, (d) export performance; and (e) the external debt burden. It is postulated that growth in variables (a), (b) and (d) enhances long term growth performance; in contrast, growth in (c) and (e) undermines that process.

An empirical analysis conducted by Enwere Dike (1991) on the Nigerian GDP growth rate as a function of the above variables between 1960-1985, and 1970-1985, on Nigeria data shows that export growth stands out as the major factor propelling Nigerian economic

growth as other variables mostly shows negative coefficients. In the 1970-1985 period, a 10% point increase in export growth rate tended to boost the capita GOP growth rate by 7.1% points. On the other hand, harassing external debt and deficiencies on human capital formation have constituted the major impediments to the long-run growth of the economy.

He further pointed out that the negative growth rates in GOP of the early 1980s are traced largely to the collapse in capital investment, underlaid by rising external debt burden and overall drop in efficiency of factor utilization. In the 1970s, he said, "the high growth rates in GDP were almost entirely generated by equally high growth rates in investment and employment"[1].

Capital accumulation (expansion in Capital Stock and employment) and economic growth are associated often by economists. But if that process was not accompanied by technological progress, as seems the case in Nigeria economic growth, the economy would in the long-run experience a movement towards the "stationary" State.

In a nutshell therefore, factors identified as limiting the process of economic growth in Nigeria are; low domestic Saving Capacity; low level of technology; high population growth rates; and the rising external debt burdens. The low domestic saving capacity can be traced from the failures of the Nigerian financial system to effectively perform its role of financial intermediation in the economy.

## 3.2 GROWTH OF FINANCIAL INSTITUTIONS IN NIGERIA

As a catalyst in the process of economic growth and development, the Nigerian financial system has become increasingly deep, broad and sophisticated. Over the last few decades, it has undergone remarkable changes in terms of number and ownership structure of its institutions, the depth and breath of the markets and the sophistication of the regulatory framework within which the system operates.

The growth of the Nigerian financial system can be better appreciated along its regulatory framework. Now, what is a financial system of a country?

An economy's financial system is the framwork within which capital formation take place through the intermediation of financial institutions. A typical financial system is made up of a network of banks and non-bank financial institutions including financial markets on one part and the regulatory body on the other.

The Nigerian financial system comprises the Central Bank of Nigeria (CBN) the Federal Ministry of Finance (FMF) the Nigerian Deposit Insurance Corporation (NDIC), the banking sector and the non-bank financial institutions. The banking sector consists of the Commercial and the Merchant Banks as well as the development financial institutions. The non-bank financial institutions include finance houses, insurance companies, pension funds and mortgage institutions. Others are the Securities and Exchange Commission (SEC), the Nigerian Stock Exchange (NSE), Stock brokers, registrars and discount houses.

The growth and development of the Nigerian financial system, especially the banking system has been very rapid interms of number and structures. The commercial banking is relatively old and well known business in Nigeria. As far as 1912, the year of the establishment of the West African Currency Board, an expatriate bank, the Bank of British West Africa (now Standard Bank of West Africa) was already in existence. The Hisotry of Commerical banking as we know today, therefore goes back at least sixty years.

Until about the end of the thirties, the business of commercial banking (which was the first financial institution to develope in Nigeria) in Nigeria was in the hands of the expatriate banks - the Bank of British West Africa and Barclary Bank Domician, Colonial and Over-seas. The first indegenous bank - National Bank of Nigeria Limited - was established in 1933. This was followed by the appearance of other indigenous banks; the Agbonmagbe Bank (now Wema Bank) in 1945, the Nigerian Penny Bank, the African Continental Bank, all of which were formed in 1947. In 1949, another expatriate bank, the British and French Bank was established in the Country.

The present financial structure had its roots in the 1950s following the promulgation of the banking Ordinance in 1952 and the establishment of the Central Bank of Nigeria in 1958, Both developments resulted from the adoption of the recommendation of the Paton inquiry Panel established in 1948 by the Colonial administration to examine the causes of massive bank failures experienced during that period. That was the first attempt made to

review the nation's financial system.

The establishment of the Central Bank of Nigeria and the attainments of political independence in 1960 enabled some conscious attempts to be made to develop some formal financial markets - the money market in 1960 and the Lagos Stock Exchange in 1961. The first ten years of independence witnessed the central bank at work, initiating, executing and monitoring monetary and banking policies in conjunction with the Federal Ministry of Finance. During this time, the banking system was dominated by commercial banks which were predominantly foreign owned. The major features of the banks were branch banking, conservative banking postures, urban banking orientation and risk-aversion. The first monetary circular was issued in 1969 whilst a new comprehensive banking decree was also promulgated the same year to serve a guidelines for establishing and conducting banking business in Nigeria.

In the mid 1970s, the nation was awash with petro-dollar. However, the conservative posture of a large number of existing financial institutions, coupled with inadequate financial infrastrustrures, prompted government to set up a committee to review the nation's financial system having realised the important role the system can play in the real development of the country. In this regard, attempt has been made to examine the two major committees set up by the government in 1976 and 1986 to review the nation's financial system and their implementation to underscore the growth and development of the Nigerian financial system.

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THE 1976 FINANCIAL SYSTEM REVIEW

The Financial System Review Committee otherwise known as the Okigbo Panel was formerly inaugurated on April 1976 with the following terms of reference;

- to examine the adequately, relevance or otherwise of the instructions in and the structure of the financial system to meet the needs of the economy for rapid development:

- to examine the organisational and ownership structures of institution in the system, evaluate their liability in the context of the stated preamble, the economy's future domestic and international requirements, and development trends;
- to study operational needs in the system with particular reference to promotional activities of the financial institutions generally, and
- to make recommendations on their findings.

The committee in its report recommended the following objectives for the Nigerian financial system viz: that the system should;

- fascilitate the effective management of the economy;
- provide non-inflationary support for the economy;
- achieve greater mobilisation of savings and its efficient and effective channeling;
- effectively sustain the indigenisation ot ownership, control and management of the economy;

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- assist in achieving significant transformation of the rural sector; and
- assist in achieving greater inter-linkages in agriculture, commerce and industry.

Amongst its many recommendations, the Federal Government accepted the following to be implemented;

- the establishment of A security and Exchange Commission.
- the establishment of the Nigerian Stock Exchange with branches in Lagos, Kaduna and Port-Harcourt;
- State and local governments as well as state-owned corporations to be encouraged to float their bonds in the securities markets.
- as part of the effort to improve the monetary management advisory functions of the Central bank, all financial institutions are required to make returns of financial statistics to the Central Bank of Nigeria;
- setting up more commercial bank branches in the rural areas of the country;
- A comprehensive programme for training and manpower development in the banking system;
- strenghtening of the banking legislation to reflect the distinction in practice between commercial and merchant banks; and
- Increased banking supervision and regulation to encourage specialisation of financial institutions.

The implementation of the above recommendation took immediate

effect though in phased stages. However, following the collapse of the international oil market in mid-1982, the economy began to nose-dose with consequential negative impacts on the financial system. By the end of 1985, it became evident that the economy had to be restructured in order to overcome monumental problems such as those posed by low economic growth, unemployment, the debt burden and the fundamental imbalance in the structure of production and consumption.

## THE 1986 REFORM OF THE FINANCIAL SYSTEM

The 1986 reform of the financial sector was part of an overall structural adjustment programme of the whole economy expectedly, the financial sector was given a place of pride in the implementation of the intergrated policies of the reform. In the main, the objectives were to emphasis price mechanism as means of strenghtening government demand management policies; encourage a realistic exchange rate for the naira; replace administrative controls with market forces; and attempt to rationalise public enterprises.

From 1986 through 1993, the reforms cut accross all subsectors of the financial system. The first was the deregulation of the foreign exchange market. The movement towards an appropriate pricing of foreign exchange based on the demand and supply situation was first made through the establishment of a second-tier foreign exchange market on September 29th, 1986 (Peter N. Umoh, 1995). Prior to that time, the government controlled the exchange

rate over a period of time. The rate was generally believed to have over-valued the main and consequently, the demand for foreign exchange to import soared. Between 1986 and 1993, several variations of the floating exchange rate mechanisms were tried in the management of the market. These included the two tier regimes, the Dutch auction system and the inter-bank system which was introduced on March 5, 1992. Another new dimension was the introduction and licensing of bureaux de change in 1991. This was done to accord legal recognition to small dealers in foreign exchange and provide free a ccess to foreign exchange by small buyers.

Another remarkable aspect of the reform was the deregulation of interest rates in August, 1987,. With this singular action, banks were given free hand in determining their deposit and lending rates according to market forces. However, at various times between 1986 and 1993, the monetary authorities in a bid to stem abuses and unnecessary high interest rates, capped the spread between deposit and lending rates.

Also, as part of the reform package, there was deliberate effort to encourage the emergences of new institutions both into the banking and non-banking sectors of the financial system. In the banking sub-sector the procedure for licensing new banks was eased to stimulate the growth of banks. To provide banking services to the poor and others who had no access to the conventional banks, two innovative banking sub-system were created, the people's Bank of Nigeria and the Community Banks in 1989 and 1990, respectively.

In the non-banking financial sub-sector, new institutions such as finance companies and primary mortgage institutions were established to top the opportunities occasioned by the deregulation of the financial system.

Quite a sizable number of companies had their shares floated on the stock exchange as a result of either government privatization of estwhile government corporations or the existence of the second-tier market with less stringent conditions than the first-tier market and consequently, the number of stock brokerage firms, investment advisers and of stock exchanges nationwide increased.

Concurrently as these institutional developments were taking place, new supervisory, regulatory and legislative arrangements aimed at strengthening the financial system and most especially, promoting safe and sound banking practices were introduced. Notably in 1988, government, through the promulgation of Decree No 22, established the Nigeria Deposit Insurance Corporation to insure depositors' fund and enhance banking supervision. In 1990, the central bank of Nigeria issued some directives to banks aimed at enhancing their capital base and professionalism in bank lending as well as provisioning for non-performing credits. The last constituted the prudential regulation which was a landmark, especially as regards income and loss recognition in the Nigerian banking industry. To crown it all, the Central Bank Decree No 24 of 1991 and the Banks and other Financial Institution (BOFI) Decree No 25 of 1991 were promulgated to strenghten the foundation for an

efficient and sound financial sector. The laws became necessary, firstly because of the need to consolidate and harmonize the numerous amendments to the exisiting banking laws. Secondly, the new laws constituted an important component of the broader programme of financial sector reforms aimed at promoting competition and efficiency in the country's financial system.

The other subsectors of the system were equally subjected to new regulations and negulatory bodies. For instance the National Board for Community Banks was established to regulate the community banks whilst the Federal Mortgage Bank of Nigeria also changed role to that of regulator of primary mortgage institutions. Regulation of finance companies was done by both the Central Bank and the Security and EXchange Commission. And within the insurance sub-sector, the National Insurance Supevisory Board was created as an additional supervisory body of the industry.

Lastly, we considered the monetary and credit management under the reform. From the inception of the reform in 1986, the need to curb excessive bank credit expansion of the economy (and most especially to government) was recognised in order to maintain an appropriate monetary growth which could ensure stability in both the domestic and external sectors of the economy. To this end, the permissible rate of increase in licensed bank's loans and advance was generally reduced over the years of the reform except in 1988 when there was the need to stimulate growth and reduce unemployment. Inaddition direct credit ceilings, a series of indirect measurers to control banks' ability to extending new

credit were applied. These measures included of the naira counterpart of outstanding external payment arears; mopping of excess liquidity through the issuance of stabilization securities since October, 1990; increases in commercial banks' cash ratio requirement and introduction of the same requirement for merchant banks; transfers of public sector accounts from the commercial and merchant banks to the Central Bank in May-June 1989; and the prohibition of commercial and merchant banks from adopting foreign guarrantees and or foreign currency deposits as collateral for domestic loans denominated in naira.

At the begining of September, 1992, the indirect method of credit and monetary control recieved a boost with the selective lifting of credit ceiling for healthy banks.

The implementations of both the 1976 and 1986 Nigeria Financial Reviews brought about a remarkable changes and progress in the growth and development of the country's financial system. The 1976 financial system review was the first and so far the only comprehensive effort at the reform of the financial system. The implementation of the recommendation of the committee that were created by government no doubt improved the financial system considerably.

In the money market, the committee recommended the extension of banking offices and banking credit to the rural areas where the majority of our people reside. The recommendation was implemented through the Rural Banking Scheme (RBS) introduced by the Central Bank of Nigeria in 1977. Although the Rural Banking Scheme had its

problems between 1977 and 1989, rural bank branches grew from 13 to 756 indicating an average yearly growth rate of about 76 per cent (Peter N. Umoh (1995). Unfortunately however, the same cannot be said of credit to the rural communities in which the branches operated.

The recommendations calling for the strenghtening of banking regulation and supervision led to a number of changes in the Central Bank of Nigeria including multiple Deputy Governors (DGs) as opposed to one Director General, in addition to increased attension and protect depositors that the Nigerian Deposit insurance corporation was established in 1988 to complement the Central Bank's efforts in this regard.

The Committee called for a clear distinction between the operations of the commercial and merchant banks and lamented the unwillingness of the latter to extend medium to long-term credit for development. Consequently, the Central Bank of Nigeria in implementing the recommendation stipulated yearly, the maximum levels of short-term credit to be extended by merchant banks. While such stipulations may have been met on paper, the truth is that merchant banks as before the committee report implementation have been operating like commercial banks at the short-term end of the market.

The implementation of other recommendations of the committee in the money market brought about serious breakthroughs in the operations and functioning of the markets.

In the capital market, the capital Issues Commission was replaced with the newly established Securities and Exchange Commission with wider powers, whilst the Nigerian Stock Exchange (NSE) was created with branches in Port Harcourt and Kaduna to replace the Lagos Stock Exchange against the recommendation of the committee to creat three competing exchanges that would share basic information about the market. The indigenisation of estwhile foreign companies through the Nigerian Stock Exchange increased substantially the size and depth of the capital market. However, state and local governments were unable or unwilling to use the Nigerian Stock Exchange to float debt instruments as recommended by the committee unitl the 1980s when a few state governments floated development bonds. So far, no significant interest has been shown by local government to utilise the market to raise development.

On the otherhands, the implementation of the financial reform of 1986 brought about a phenomenal growth in the Nigerian financial system, especially, the banking subsector. The growth of the financial system during this period results from the deregulation of the interest rate, the exchange rate market as well as the financial -institutions as a whole which was the major policy thrust of the reform. In the financial markets, money, the tradable commodity has its price adjusted according to market forces. Such adjustment was of course reflected in interest rate loan (interest rate) adjusted favourably, banks took advantage of this to make abnormal profits due to the hike in interest rate occasioned by the deregulation. As a result of this scenario,

investors were turned to invest in the banking system. In the same vein, the deregulation of the foreign exchange market was lucrative to the banking system. Hence, the era of "new generation" banks came into being. These banks essentially were established majorly for foreign exchange transactions with little or no interest in the traditional roles of supply of credits. The implication of this development in the financial system is the financial repression in recent times.

The proponents of financial reforms argue that financial repression, which is a symptom of tight control of the financial system by government, would give way to financial deepening whenever such economy is subjected to reforms based on the forces of supply and demand. It is argued that more firms would come into the industry thereby increasing the choice options for consumers of financial services. Furthermore, improved, efficient, and competitive services are expected to result from such reforms. All markets within the system are also expected to clear at appropriate market determined rates without undue waste of resources. Finanly, the overall financial intermediation index of an economy undergoing reform is expected to improve considerably. Given this background, Appendix 1 shows some sellected indicators of the financial system when the reforms started and when it peaked.

As showed in Appendix 1, the ratios of financial Assets/GDP and M2/GDP increased from a low level of 0.8 and 0.4 in 1986 to 2.95 and 1.9 as at the end of 1993 respectively. These shows that more Nigerians were holding financial assets. Secondly, the use of

quasi-money was gaining large support amongst Nigerians. The sabstantial increase in both savings and time deposits were as a result of the reforms.

On institutional banking, there was a substantial increase in the number and type of firms in the system. Commercial banks increased to sixty-six from twenty-nine, merchants banks totalled fifty-four, branches of People's Banks of Nigeria stood at 271, primary mortgage institutions numbered 252, whilst community banks which were non-existents in the pre-reform period numbered 874, all at the end of 1993. In the non-bank financial sub-sector, similar increase were witnessed; stock brokerage firms increased to 140 from twenty-two, finance companies totalled 310 and the stock exchanges also doubled to six. Insurance Companies were also not left out, from seventy-two in 1986, the number shot up to 121 as at the end of 1992. The adoption of indirect method of menetary control through the use of open market operation (OMO) had given birth to a new set of financial institutions - the Discount Houses which, as at the end of 1993, numbered three, several new financial services, product, and instruments were introduced by these competing institutions, whilst the use of old ones were greatly enhanced.

In the securities markets, activities in both the primary market as well as the secondary market have been on the upward trend. Several companies which had earlier been unable to meet the stringent conditions of the first-tier market had their shares

listed in the second-tier market. Furthermore, transactions in the stock exchange went up significantly.

In 1986, the stock exchanges had a total transactions of 22,718 worth N495.6m. By 1993, this had increased to 40,938 transactions with a value of N804.4m (NDIC Quarterly REview, Volume 5, Number 3, September, 1993)P.39). Even though this was still low compared with what was obtainable in the developed economies, the difference between the two periods was significant. Two new financial markets were created as a result of the reform - the Foreign Exchange Market, and Inter-bank Market. From the above analysis therefore, one can conveniently conclude that there was evidence of financial deepening which came as a result of the reforms of the Nigerian financial sector from 1986.

## 3.3 CRISIS IN THE NIGERIAN FINANCIAL SYSTEM (ECONOMIC CRISIS AND BANK PORTFOLIO BEHAVIOURS)

The incidence of crisis in the financial system is not a monopoly of Nigeria alone, it occurs in various economies of the world although the gravity of the problem and the mode of handling it differs from country to country.

Nigeria have been buffeted with serious economic crisis and the financial service sector is not an exception. Incidence of crisis in the Nigeria financial system is not a recent development, but date back to the pre-independence era. As already stated in the previous section that while modern commercial banking commenced in Nigeria in 1892, indigenous commercial banking commenced only in the late 1920s. Financial distress became highly noticeable among the Nigerian indigenous banks as early as mid 1940s. With time,

the colonial authorities realised that the absence of banking regulation was largely responsible for this financial distress. Consequently, the banking ordinance of 1952 was enacted. Folowing the implementation of 1952 Banking Ordinance, by 1954, 21 of the 25 indigenous banks had collapsed. The Major causes of the collapse of these banks were inadequacy of capital, inexperienced management, over-lending due to the main to nationalism, and intense competition from the already established foreign owned banks. The colonial assessment was that the forces behind thier distress were internal. Therefore, they were allowed to fail without any attempt to give them intensive care.

With the benefit of hindsight, the goal of promoting indigenous banking development would have been better served, if financial and technical assistance had been provided to those banks. Thus, upgrading their managements through merger and acquisitions or by outright management take-over, could have been combined with the provision of financial support to prevent their collapse. But since the promotion of indigenous banking could not, morally, have been the objective of a colonial government, the problems of the distressed banks were viewed as purely the result of their internal weaknesses.

It was generally believed that the absence of safety regulation prior to 1952 that created rooms for financial distress in Nigeria. It was on this note that the Central Bank of Nigeria (CBN), was established in 1959, following the enactment of the (CBN) Central Bank of Nigeria ACt of 1958. Since its

establishment, it has been a prime mover in the Nigerian financial sector. It has acted positively to accelerate financial development in Nigeria.

Since 1960, the Central Bank of Nigeria has widened the money market established and deepened the capital market, and promoted the establishment of development banks. With the Banking DEcree of 1969, it was more able to compel the banks to perform some developmental functions. It engineered and serviced the indigenisation of the Nigerian banking industry. Thus, the period between 1960-1986 witnessed increase economic and safety regulations. But the economic regulations appeared to have exceeded their desirable limits by mid 1970's, while safety regulations were becoming inadequate.

In particular, the oil boom had created new consumption habits and a culture of corruption has embraced the Nigerian society. Corruption reduces the effectiveness of controls. Consequently, economic regulations on banks that were earlier appropriate became undesirable because of the pervasive corruption. As the oil boom waned in mid 1970's the inappropriatness of Central Bank of Nigeria's directed credit programme, credit ceilings, rural banking programme, regulated interest and exchange rates, and restricted bank licensing e.t.c. became clearer with the passage of time. These policies discouraged competition in banking, reduced profitability while increasing risk and encouraged fraud in banking. Hence, bank crisis heightened again.

In 1973, National Bank of Nigeria (NBN), one of the indigenous

bank then recorded a serious illiquidity problem. The Central Bank of Nigeria initiated a move for the federal government to take it over but later settled for a change in the Managing Director combined with financial support. Commenting on the rehabilitation effort of the national bank of Nigeria limited, Eghodagbe says, "At the climax of this liquidity crisis for NBN in 1973, CBN, actually initiated a move for the federal government to take it over. In November, 1973 a NICON facility of N7 million was restored. Its clearing facilities were raised to a limit of N10 million per month for the next one year. As part of the measures to save the bank, a new expatriate Managing Director for NBN was appointed in November, 1973. The federal government of Nigeria eventually bailed out NBN with a loan of =N30 million in 1974 repayable over 10 years..... The NBN was revived and it paid all its indebtedness to CBN..... it succeeded in reviving the bank which fully repaid the loan within 3 years."[2]

In spite of the efforts of the federal government to bail out the National Bank of Nigeria Limited from total collapse, the bank in less than a decade eventually collapsed completely due to the internal weaknesses of the banking industry; fraud, forgeries, fraudulent lending, violation of authority limits, etc.

The incidence of bank failures became more pronounced since the introduction of the structural Adjustment Programme (SAP) in 1986, and the deregulation of the financial system in 1987. Since that time, there has been a phenomenal increase in the number and type of financial institutions leading to stiff competetion in the

industry. This development led to many non-bank finance companies to offer services previously reserved for licensed banks as well as engaging in some unethical banking behaviours and services. In addition, the banking system was also buffeted by adverse economic forces including foreign debt problems of government, large fiscal deficits, high inflation and slow growth.

The result of these forces has been the emergence of serious distress in the banking system which reached a crisis state in May, 1989 after the withdrawal of treasury funds from the licensed banks. At the end of 1992, the number of banks which the Central Bank of Nigeria and the Nigeria Deposit Insurance corporation classified as technically insolvent or distressed rose from 8 as at the end of 1991 to 16 as at the end of 1992. They may well be many more banks at the same period on the margin of distress whose activities are being closely monitored by the central bank of Nigeria and the Nigeria Deposit Insurance Corporation.

In 1994, the Central Bank of Nigeria closed some bank, and non bank institutions which were terminally distressed as part of the efforts aimed at strenghtening the financial system as a whole. These comprised three merchant banks, one commercial bank and 20 finance companies. Distress in the financial system in general increased further in 1994 in terms of the number of institutions regarded as distressed as well as the individual financial conditions affected institutions. For Commercial and Merchant banks, the number of institutions in distress rose from 10 to 42, excluding the 4 banks that were closed during the year.

The scenario of bank failures continues over the years till today. Early this year, the federal government mandated the Central Bank of Nigeria and the Nigeria Deposit Insurance Corporation to liquidate 26 banks which could not meet the recapitalisation automatum given in the last year's budget, as well as those under severe distress.

To conclude this aspect, it is important to look at the Nigerian Bank's portfolio behaviour and liquidity levels.

At any time, monetary and fiscal authorities in any economy set target levels for inflation rate, extenal payments balances (balance of payments or exchange rates) and ouput growth, among others. The attainment of these goals would require that monetary variables (money supply, domestic credits, etc) and fiscal variables (e.g fiscal deficit, expenditures mix, etc) be kept at some levels compatible with the target level for the basic economic indices. Consequently, the desirable level of liquidity is predetermined and is monitored by the regulatory and supervisory authorities. When the actual liquidity exceeds this predetermined level, the liquidity is said to be excess liquidity in an economy, monetary instruments are tightened to put liquidity under control.

In Nigeria, tightening monetary instruments in recent years, have come in form of the issuance of stabilization securities (SS) compulsorily to banks, raising the Minimum Rediscount Rates (MRR), engaging in open market operations (OMO) and raising the Cash Reserve Requirement (CRR). Of all these, the issuance of SS appears to be the major instruments that the monetary authorities

have relied on most, at least in the last five years or so.

Underlying this conventional wisdom is the belief that the existence of excess liquidity in the banking system would further support and finance additional aggregate demand for goods and services, thereby worsening inflation and external balances. While this foundation might be appropriate for a properly functioning banking system, it might be inappropriate for a system on want of confidence or in financial distress that had been occasioned largely by rampant loan defaults and the existence of large nonperforming loan portfilio. Similarly, it might be inappropriate for a banking ystem witnessing frequent policy reversals, unstable and unpredictable economic programmes. Also, it might be inappropriate in a system where basic credit information on potential borrowers are scarce or very expensive.

When some banks are failing or have failed as a result of loan repayment defaults, others still operating are bound to be more cautious in giving credits. The results is credit crunch for sectors where defaults are most rampant which are often the productive sectors or the small scale firms with thin accounting records. As banks are relunctant to lend, they acquire more of liquid and safe assets but with lower rate of return. Consequently, banks' liquidity grow to which the regulatory authority respond, typically, by issuing additional stabilization securities which are often in excess of the banks' free reserves. As banks try to replinish the lost reserves through deposit mobilisation, more stabilization securities are issued and a snow

ball process that saw deposit rate rising, and at the end of the day, the financial system was in distress.

It is important to note that when bank's liquidity level is high as a result of their reluntant to lend, tightening monetary instruments would serve no useful purpose. Rather, monetary authorities should encourage and give teeth to banks' loan recovery efforts and do everything within their power to discourage debtors from reneging. They should also encourage banks to monitor their credits, such that debtors are not encouraged to default, let alone banks being reluctant to give credits. The introduction of the prudential guidelines and their strict enforcement would encourage regular credit reviews that are capable of improving portfolio quality of banks.

Another important issue on the bank portfolio behaviour is the foreign exchange transactions. As a result of the deregulation policy following the adoption of the structural Adjustment Programme (SAP) in 1986, many banks were established mainly for foreign exchange transactions. These "new generation banks" were reluctant to give out credits to the productive sector of the economy, and as such banks vaults are denominated in foreign currencies. They merely use their deposits assets to bid for foreign exchange auction weekly at the interbank foreign exchange market (IFEM). Worsestill, after obtaining these foreign exchange market at a cheaper official rates, they in turn resell same at a high rate in the parallel foreign exchange market. This was highly profitable to them, and hence neglected the traditional role of

supply of credits to the productive sector of the economy.

With the passage of time, with the coming of a new administration, coupled with the change in policy, the interbank foreign exchange market (IFEM) and the second-tier foreign exchange market (SFEM) were abolished. The resultant effect is the collapse of banks and non-bank financial institutions since the foreign exchange business was no longer profitable. This development was not palatable to the economy. Banks' major role is to bridge the gap between the surplus and the deficit sector of the economy, thereby mobilising fund for capital investment which is the engine of growth and development of the economy. On the contrary, Nigerian banks in recent time were only concerned with the quickest way of maximising profit regardless of its effects to the productive sector of the economy. Growth and development of a country's financial system is synonymous to the overall growth and development of the economy. In other words, financial deepening is expected to accelerate growth in the productive sector of the economy. But in the context of Nigeria, the reverse is the case.

Since 1990 when the Nigerian structural Adjustment Programme derailed, accusing fingers have been pointed at the banks for worsening the Nigerian economic crisis. However, it is always forgotten that the banks can only prosper if the economy is prosperious. Similarly, the economy can only be prosperious if our banks are in good health.

Two areas banks are commonly blamed concern their portfolio behaviours in the credit and foreign exchange markets. In the

credit market, they are blamed for not giving enough credit to the productive sectors and for charging high interest rates. However, these so-called high interest rates are economic rates that take due account of high loan defaults that is rampant in our economy the economic and political uncertainties of our time, high inflation, high credit information costs and the need to remain in profitable business. The volume of credits given to certain sectors are equally influenced by these same considerations.

## 3.4 CAUSES OF BANK FAILURES IN NIGERIA

The distress in the Nigerian banking system is a manifestation of a complex set of inter-related problems which emanate from a number of factors. Although, there seems to be an emerging world wide concensus that the quality of management makes the difference between sound and unsound banks, other factors are known to cause banking distress in Nigeria and elsewhere. Attempt will be made to look at some of these factors as it affects the Nigerian environment. These include economic downturn, inhibitive policy environment, inadequate capital, impact of deregulation, and ownership structure/pervasive influences. Some of these factors which are examined in turn are endogenous to the banking system while others could be regarded as exogenous.

### 3.4.1 ECONOMIC DOWNTURN

The adverse economic condition since the mid-1981 has been characterised by high inflation, depreciating value of the naira, large fiscal deficits, heavy external debt overhang, high

unemployment and slow growth. Arising from this stress in the economy many borrowers, both corporate bodies and individuals as well as government at all levels, are unable to service their loans thereby making many financial institutions to come under severe distress. The macroeconomic reforms introduced in 1986 also took its toll on the external value of the naira which was then believed to be over-valued. A massive depreciation that followed shot up foreign manufacturing input costs leading to greater domestic capacity under-utilization and reduced ability of corporate borrowers to repay their loans and advances. These problems greatly impaired the quality of banks' assets as non-performing assets became unbearable and turned out to be huge burden on many banks. The financial intermediation role of these banks have been heavily impaired while our macroeconomic activities have seriously slowed down.

### 3.4.2 INHIBITIVE POLICY ENVIRONMENT

Prior to the introduction of the Structural Adjustment Programme in 1986, our financial system could be described simply as highly regulated. Some of the regulations, though occassionally desirable, had no doubt contributed to the strains in the financial system. Banks were subjected to substantial restriction, or their products and activities. These restrictions had, to a reasonable extent limited some bank's ability to adapt to changing market conditions under the new dispensation in a deregulated environment.

Among these interventions and controls were ceilings on credit

expansion and interest rates as well as restrictions on entry into the banking industry. Another major intervention was the restriction often placed on bank's portfolio selection. Many of the banks were forced to perform developmental roles such as provision of subsidized credit to priority sectors and public enterprises for which some of them well illequipped, and therefore they suffered financial problems. One of the effects of these policies was the large number of weak banks, particularly among the first generation banks.

Tnaddition, several measures were introduced in order to sanitize the operations of banks in a deregulated environment which adversely affected some of them. Among such policy measures were the prudential guidelines, statement of accounting standards for banks and the use of stablization securities by the Central Bank of Nigeria to mop up excess liquidity in the system. The adoption of these measures, though sometimes, imperative, exposed many weak banks and threatened them with insolvency. Some banks which had earlier posted fat profits started to post heavy losses resulting in insolvency. The use of stabilization securities to mop up excess liquidity also pushed some marginal banks to illiquidity. In extreme cases of illiquidity there was near panic as some of the banks were unable to meet depositors' demand. Consequently, the banks embarked upon distress borrowing in the interbank market at exorbitant rates.

3.4.3 INADEQACY OF CAPITAL

One principal function of capital in many bank is to serve as

the means by which losses may be absorbed. Capital provides a cushion to withstand abnomal losses not covered by current earnings, thus enabling the bank to regain equilibrum and re-establish a normal earnings pattern. Unfortunately, a good number of the country's banks are grossly undercapitalized. This situation could partly be attributed to the fact that many of the banks were established with very little capital. This problem of inadequate capital has been further accentuated by the huge amount of non-performing loans which has eroded the capital base of many banks.

### 3.4.4 THE PROBLEMS OF MANAGEMENT

Poor management often results in exessive risk-taking through high operating expenses, inadequate administration of loan portfolio, an overly aggressive growth policy to attract deposits, interest rate speculation coupled with other instances of poor judgement that result in stress for their banks. Many of the banks have poor credit policies, and in cases where good policies are in place, such are never implemented faithfully. Also, some of the banks' management teams are often characterised by instability of tenure of the directors and key management staff especially in state government - owned banks while the private banks, particularly the new generation banks, are characterised by board room quards, insider abuse, frauds, and forgeries, weak internal control system as well as occasional contravention of well intended statutory regulations. All these have contributed in no small way

to banks' poor health in Nigeria.

### 3.4.5 IMPACT OF DEREGULATION

The macroeconomic reforms in the country have had negative impact on the health of some banks, particularly those that had hitherto enjoyed some implicit subsidy. The deregulation has brought about increased competition and innovations accompanied by noticeable traces of strains in the industry. Banking institutions that do not have the management expertise to survive in an increasingly complex, volatile and competitive market suffer adversely in a deregulated environment.

### 3.4.6 OWNERSHIP STRUCTURE/PERVASIVE INFLUENCES

Owner's direct intervention, most especially in government controlled bank, in the internal managementg of the banks has contributed to the financial distress in some of the banks. In the privately controlled banks, the prevalence of board room quarels and insider abuse are pernicous cankerworms causing distress in some of them. In some of the banks under liquidation, the main causes of their failure had been due to insiders abuse and financial malpractices. For example, about 80 percent of the non-performing loans in the liquidated banks were granted to a few directors before the banks' demise. Besides, most of the government, controlled banks are often treated as political banks. In most cases, the board and key management staff of these banks change as frequently as changes occur in the administration of the

governments controlling such banks. The result is, apart from the appointment of incompetent hands or sycophants, there will be inconsistent policies as what one board did, the succeeding one, for political reasons, would overturn with reckless abandon.

The present administration is however determined to use the provisions of the promulgated Decree No.18 of 1994 on Failed Banks (Recovery of Debts) and Malpractices in Banks to bring to book those responsible for the distressed condition of banks. The tribunals which have been constituted under the Decree will also try bad debtors and recover such debts from them. The activities of this tribunal have been success story since it commenced its duties. Millions of naira has been recovered through the Failed Bank (Recovery of debt) and Malpractice Tribunal, and this has restored sanity to the Nigerian financial system in recent times. No wonder the Abacha's administration has been praised in no small way by many Nigerians in its efforts to sanitize the country's financial system which was at the verge of collapse in the early 90s.

## 3.5 EFFECT OF BANK FAILURES ON THE NIGERIAN ECONOMY

The systemic bank failure would do an untold damage to the fragile economy to the extent that the economy might not recover from it easily. Infact, the adverse effect of bank failures on the Nigerian economy is now visible to all and sundry even to layman on the streets. It therefore suffice every purposeful planning person to sound a note of warning that massive liquidation of banks, if

not well managed, would have far reaching implications for the banking system in particular and the economy in general.

Going down the memory lane, the origin of banks in Nigeria saw the collapse of indigenous banks as rapidly as they were established. As already revealed in the past section, between 1952-1954, twenty one out of twenty five indigenous banks that were established failed within the period. In the words of Ebhodaghe,

"The attitude of Nigerian bankers, which bordered on reckless use of depositors fund, inexperienced and poorly qualified management staff at the helm of affairs of indigenous banks, undercapitalisation, overtrading with available resources, politicisation and absence of regulation especially as there was no central bank, all combined to cause the mass failures of indigenous banks in the country during the period"[3].

The banks' problem were compounded by the attitude of Nigerian borrowers who would not want to honour their contractual loan obligations to their banks even when they had the means to pay. The traumatic experience of the failures linger long as depositors lost their funds and public confidence in the industry was eroded espacially in banks owned and managed by Nigerians. This experience partly explained the lull in the establishment of banks in Nigeria until the oil boom of the mid-1970.

All these negative culture and influences are now being repeated in the Nigerian banking system today as noted earlier.

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Board and Management of banks are known to indulge in insiders abuse, empire building, arbitrage opportunities and rent-seeking activities, quarels on access to privileges and perquisites of office rather than on charting profitable and growth oriented plans for their banks. With the proliferation of banks, the executive capacity in the industry is over-stretched to the extent that the gravity of technical manpower has become very low. Banks now violate regulations and falsify returns to the authorities just to cover up their atrocities. Many bankers are selfish as they are not improving on their banks' capital but instead help themselves to same. At the same time, many borrowers are not willing to repay debts owed to banks even when they are known to have the means to do so. Many of them feels that the terms are their own share of the so called "national cake". Bank licensing are often granted to men of questionable characters despite the official investigation, they are however given clean reports. These short-comings should be taken note of in subsequent bank licensing in Nigeria.

The major adverse effects of bank failures in Nigeria are as follows:

### 3.5.1 EROSION OF PUBLIC CONFIDENC

Banking business is built on trust and confidence but once these are betrayed, they are not easily returned. When there is an erosion of public confidence on banks as a result of the constant failures due to poor management, it impaired the ability of the system to mobilise fund from the public in form of deposits to

finance investment. And as such banks will no longer be able to play their role of financial intermediation effectively. The loss of public confidence would lead to many other adverse effects.

### 3.5.2 BANK RUNS AND CONTAGION

With the erosion of public confidence and the fear that bank failures would spread, there would be bank runs and would no doubt further worsen the condition of the already depressed economy.

### 3.5.3 DEMONETIZATION

Following the loss of confidence and bank runs, there would be massive portfolio shift to safes assets such as foreign currencies, treasury bills and certificate and non-monetary assets as well as capital flight.

### 3.5.4 EFFECTS ON BANKING CULTURE

Equally related to demonetization is the negative implication for the banking culture. The habit of banking in Nigeria is poor already in the country and bank failures would only exacerbate the situation. Statistics shows that currency outside banks exceed the demand deposits component as it accounted for 52.6 percent of total money supply at the end of 1994. This indeed, was the first time in the history of the economy that such happened. The loss of public confidence on the Nigerian banks caused many Nigerians to safe their money outside the banking system. Most wealthy class keeps their resources in liquid form in their houses.

### 3.5.5 EFFECT ON THE PAYMENT SYSTEM

Effective and efficient payment system in any country is achieved when the banking system is sound. With bank failures, the payment system would become precarious as the link between the real and the financial sector, including international settlements, would be greatly impaired. This will hinder the intermediation role of the banks and of course, the development of the country.

### 3.5.6 CREDIT MARKET

The ability of a bank to extend new lending depends on its health condition. The healthy ones would similarly be constrained from generating credit for fear of such facilities becoming deliquent. If credits are extended at all, they are likely to be a short term mainly to finance commerce and the purchase of foreign exchange. The effect of these would be to further crowd out the productive sectors of manufacturing and agriculture from the credit market, as the case in the country in recent time. If the economy is to be revived, the productive sectors must be galvanised.

### 3.5.7 EFFECT ON INVESTMENT IN THE BANKING SECTOR

Investment in the banking sector is often considered lucrative. With bank failures, investors lose their investments. Investors would no longer be encouraged to make further investment in the industry, rather there would be deinvestment from the sector generally. This problem would be compounded by low profitability for the remaining banks as loss of confidence in them would

jeopardise their patronage and earnings.

### 3.5.8 EFFECT ON FAILURE RESOLUTION COSTS

The cost of resolutions of failed or distress banks is high. The more the delay in regulatory intervention to address the problem of distress in the banking system, the higher the failure resolution costs. According to Ebhodaghe's finding in recent times, he claimed for example, that the six hitherto state owned banks taken over by the Central bank of Nigeria and the Nigerian Deposit Insurance Corporation in 1994 would have required about =N4.5 billion in 1993 to restructure as against =N6.2 billion. The high cost of distress resolution has a significant fiscal and monetary implications as tax payers, through the government, would be required to contribute a substaintial proportion of the funds required for the resolution of failed banks eventually.

### 3.5.9 MACROECONOMIC IMPLICATIONS

In circumstances, where the capacity of banks to perform their traditional role of financial intermediation is impaired, the real sector of the economy would be adversely affected. Bank loans would not flow to the sector with the result that national product would fall while unemployment and prices would rise with bank failures, development would be hampered because the stability of the economy is inextricably linked with the stability of the banking system. It was on this note that the Abacha's administration in pursuit of the policy of sustainable growth and

development in recent times that conscious steps were taken to stenghten the financial service industry from total collapse.

We are quite well aware of the success on this sector so far since the inauguration and implementation of the Failed Bank Decree and Malpractice of 1994, as the ochestrated achievement of the Abacha's administration.

This research therefore has captureed the linkage pattern between financial deepening and economic growth variable to underscore the signifance of finance to growth performance of the Nigerian economy.

## 3.6 RELATIONSHIP BETWEEN ECONOMIC GROWTH AND FINANCIAL DEVELOPMENT

The relationship between economic growth and financial deepening present a two way linkage pattern. In otherwords, there is a symbiotic relationship between financial deepening and economic growth the world over. A growing economy is associated with a growing financial system and on the otherhand, the reserse is the case, "Ceteris Paribus; These two way relationship pattern has been discussed in this section succintly using descriptive analysis and the quantitative or pragmatic approach was given in the next chapter to show empirically, the direction of causality between economic growth and financial deepening.

### 3.6.1 HOW FINANCE PROMOTE GROWTH

The voluntary existence of a given set of institutions and associated markets is, in itself, a clear indication that they are rendering some economically valuable services that "consumers" are

willing to pay for. It is easy therefore, to justify the existence of a financial system in accordance with this line of argument. Development economists have gone beyond this "last defence", however, they posit that the existence and evolution of financial institutions and markets constitute an important dimension of the process of economic growth. This implies that a set of definite roles can be assigned to the financial system in the growth process.

In general, the financial system enhances individual and group economic activities and thus promotes overall economic growth in the following ways;

PROVISION OF RELIABLE PAYMENT SERVICES;

As earlier stated, the banking system is central in the payment system of an economy. All transactions, both domestic and international are carried out in monetary term and payment within the system is greatly enhanced by an effective and efficient financial system. Development in the real sector depend to a large extent, on the general level of demand or patronage for its products. This in turn is enhanced by the payment system which is effective by a sound financial intermediaries.

MOBILISING SAVINGS;

The traditional role of the financial intermediaries is the mobilising of funds from the surplus units to finance investment in the deficit sectors. Effective savings is required in the process

of capital formation, which is the engine of growth in the real sectors. The financial system provides the linkage in the transmission mechanism between total money supply and gross domestic product. An increase in savings mobilised by the banking sectors lead to an increase in investment finance by bank loans, which have a multiplier effect on the level of output generation.

ALLOCATION OF CREDITS:

In line with the mobilisation of savings by the banking system, is the allocation of credits to priority sector of the economy. More often than not, the monetary authorities gives directives to the banks operating within the economy to allocate their credit portfolios to certain priority sectors, especially the real sectors such as the manufacturing and the agricultural sectors. In this direction, the financial system provides the impetus to growth processes.

ENABLES ECONOMIC AGENTS TO POOL, TRADE AND PRICE RISK

The financial system especially the banking sub-sector serves as gaurantors to the economic agents in terms of economic risks. A group of banks can form a consortium to finance a project with a very high capital base, and which returns is not immediate. This kind of credit facility is refered to as loan syndicate, a condition whereby a number of banks pool their resources together to finance a project that involved in a large risk. Such large risk-projects are often in the real sector such as manufacturing

and agriculture. For example, projects like the Ajaokuta Steel Complex and the Federal Agricultural Development Projects (ADPs) in Nigeria required a huge amount of capital that a single bank cannot finance at a stretch without having an adverse effect on its day to day running.

Broadly speaking, financial system efficiently mobilises and allocates societal savings, it promotes growth by raising the "financialised" savings rate, channeling savings into investment, enhancing the efficiency of capital accumulation and by increasing the "financialised" saving rate, the finacial system helps to reduce the level of societal savings held in the form of unproductive liquid assets. In another corollary, financial system promotes growth through this specific mechanism by helping society to economise on holding of non-performing assets (e.g cash under the pillow) so that a greater proportion of societal resources can be held in the form of higher perfoming (or income earning) assets.

Tnaddition, the financial system also help in promoting growth by ensuring efficient transfers of resources between savers and investors by providing information about loan projects and monitorning the project in which depositor's fund are invested. The evaluation and monitoring of projects is not important only for depositors whose funds are channel to specific investment through financial intermediaries, it does also promote more efficient management of firms whose operational performance is subjected to this "external" review. This activity also goes hand in hand

usually with that of liquidity by issuing liabilities that are safe and short-term and entering arrangements to provide loans on short notice. Liquidity in this wise helps to improve production efficiency by reducing the need for efficient forms of self insurance.

In another dimension, financial intermediaries provide insurance to risk-averse savers and investors in the process of pooling individual savings and enabling investors to hold diversified portfolio whose varrying liquidity characteristics serves as protection against a premature liquidation of capital of firms in which they invest.

In summary therefore, financial system makes significant contribution to the process and magnitude of economic growth in several key ways;

- it improves the efficiency of resources mobilization by pooling a myrial of individual savings;
- it provides a more efficient allocation of these savings into investment outlets than individual savers can accomplish on their own;
- it increases the function of societal resources devoted to interest yielding assets and long run investment which in turn augument economic growth;
- it reduces risks faced by firms in their production processes by providing liquidity and capital;
- it enables investors improve their portfolio diversification by providing insurance and project

monitoring information ; and

- it reduces firms to operate more effciently by monitoring loan projects and by offering financial protection against premature liquidition of their capital.

The above mentioned roles of financial intermediaries underscores the fact that financial deepening make significant contribution to overall economic growth.

### 3.6.2 HOW ECONOMIC GROWTH ENHANCES FINANCIAL DEEPENING

The direction of causality between financial deepening and economic growth often questions, the "leading lagging" sector typology and of course, raises the "chiken and egg" (which come first?) issue.

It is evidently clear that growth in the financial system depend to a large extent on the overall growth of an economy. It can be succintly argued that financial development is a "child birth" of growth and development of an economy. Financial institutions mobilises savings and allocate credit; the larger and wealthier an economy is, the greater should be, the value of resources that can be mobilised and invested. This shows that the size and growth of the sector influence the size of the corresponding financial system. In line with this idea, Oyejide write;

"... the influence of the real sector on the financial system goes beyond this; as an economy develops many different types

of financial (bank and non-bank) intermediaries crop up to offer borrowers and lenders a wide range and variety of financial services."[4]

What this does implies is that innovations and expansion of financial services can be largely demand-driven, the moment the economy develop sufficiently to cross a certain threshhold of modern "banking habit". This demand-driven nature of most financial services further implies that real sector economic growth influences the range and types of financial services found in an economy by making their provision both profitable and affordable, subject to the constraints imposed by regulatory policy.

Looking at an illustrative example of a growth-cycle of business firm will help to "drive home" the linkage proper and their key elements. At the beginning, the business firm starts basically as an idea couple with the vision, enthusiasm, and energy of its founders. Usually, it has little else, only limited financial resources and collaterisable assets. The vision of its founders has little marked value and thus, the firm has a low net worth. But to grow, it need resources.

The firm in this case must rely heavily on internal funds as a means of financing its investment and growth since it lack an adequate net worth (on collateral assets) to attract external finance. At this stage, it can be said that the firm 's external finance premium is very high.

On the other hand, if the firm was able to dramatically raise its net-worth over time, that is, it is able to accumulate

substantial financial and physical assets through its operation, it has the chance of obtaining external finance through banks become better. That is to say that its external finance premium falls as its net-worth improves. Additioanl development and growth beyond this point enhances its net worth even more and enable the firm to tap external finance through direct credit, a cheaper form of external finance than bank credits.

This simple illustrative example generally unfold the fact that as an economy developed, its economic agents tend to evolve from self-finance to external finance since real sector growth tend to reduce the premium attached to external finance. As the economy grow further, financial deepening is stimulated in terms of the development of institutions and market for direct credit facilities.

Finally, it is important to note that the theoretical insight about the two way relationship between financial deepening and economic growth have generated several empirical observed pattern as earlier stated, of finance - growth linkages. These patternm of course offer some lessons for a developing country as ours in search of economic break-through. That is why attempt has been made in this research to show empirical evidence on the direction of causality between financial deepening and economic growth using the Nigerian data. The next chapter (chapter four) is totally devoted to this task.

To summary, the structure of the financial system affects growth as the following empirical linkage pattern imply;

- faster growing countries tend to have larger deposit banks' assets to Central Bank assets than slower growing countries;
- faster growing countries tend to have larger ratios of deposit banks' assets to GDP than slower growing countries;

And on the other hand, the allocation of credits by the financial system has important implications for economic growth. In particular, empirical findings indicate that;

- Countries with faster growth rates tend to have financial system that allocates a larger proportion of total credits to the private sector; and
- the share of credit allocated to the private sector by the financial system is positively and significantly correlated with both the investment and the effeiciency of investment.

3.7 FOOT NOTES

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2. J. U. Ebhodaghe, " Bank Rehabilitation, the Nigerian experience" NDIC Quarterly, Volume 2, Number 3, September 1992, P 16.

3. J. U. Ebhodaghe, " Causes and environmental effect of bank failures in Nigeria" NDIC Quarterly, Volume 5, Number 3, September 1995, P 21.

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Chapter 4

# 4.0 MODEL SPECIFICATION, PRESENTATION AND ANALYSIS OF EMPIRICAL RESULTS

## 4.1 INTRODUCTION

In chapter three, a description of the two ways linkage pattern between financial deepening and economic growth was given. This chapter attempt to give an empirical analysis of the finance - growth relationship to establish the true relationship between the two variables in Nigeria within the period under review; 1975 - 1996.

As already stated in the previous chapters, there are two major school of thoughts in the understanding of finance - growth linkage pattern in developing economies. The Structuralists and the Monetarists positions. The Structuralist's are of the view that the structural rigidities within the developing economies inhibit the transmission mechanism of financial development to growth in output. Hence financial deepening interfere negatively to economic growth. On the other hand, the monetarists which is the same thing as the Mckinnon (1973), Shaw (1973) and Fry (1978) approach argued that frequent interference of Government in the financial markets hinder the development of the market in stimulating growth in output. Therefore, if the financial system is liberalised, it will deepen the financial markets, which in turn will contribute positively to economic growth (increase in GDP).

In this, four different regressions were run to show the relationship between the two variables in Nigeria and their direction of causality.

## 4.2 THE MODEL

The general functional relationship between financial deepening and economic growth is as follows;

$Y_t = F(FD_t)$ ..... (1)

where $Y_t$ is the real GDP; and $FD_t$ is the financial deepening variable, all at time, t. This shows that GDP is a function of FD. F symbolises mathematical notation for function. That is, $Y_t$ is a function of $FD_t$.

The first regression - 1975 - 1985 in stochastic form;

$Y_t = \alpha_0 + \alpha_1 FD_t + U_t$ ..... (2)

where $Y_t$ = real GDP at time, t.

$FD_t$ = financial deepening at time, t.

$U_t$ = the well behave normally distributed error term.

$\alpha_0$ and $\alpha_1$ are parameters to be estimated.

The second regression, 1986 - 1996 in stochastic form;

$Y_t = \alpha^1_0 t \; \alpha^1 FD_t + U^1_t$.....(3)

where

$Y_t$ and $FD_t$ are as above,

$U^1_t$ = the well behave normally distributed error term.

$\alpha^1_0$ and $\alpha^1_1$ are parameters to be estimated.

The third regression, 1975 - 1996 in stochastic form; which is an auto-regressive time series [illegible] is given thus;

$$Y_t = a_0 + \sum_{i=1}^{n} a_{i1} Y_{t-i} + \sum_{i=1}^{n} a_{i11} FD_{t-i} + U_t^{11} \ldots\ldots (4)$$

Where $Y_t$ and $FD_t$ are as above,

$U_t^{11}$ = the well behaved normally distributed error term.

$a_0$, $a^1_i$ & $a^{11}_i$, are parameters to be estimated.

The forth relationship between financial deepening and growth.

$FD_t = F(Y_t)$----------(5)

This shows that financial deepening is a function of economic growth, which is a reverse of equation 1. Now, the model in a stochastic form as equation (4) is as follows;

$$FD_t = \beta_0 - \sum_{i=1}^{n} \beta_{i1} FD_{t-i} + \sum_{i=1}^{n} \beta_i^{11} Y_{t-i} + U_t^{111} \quad \ldots\ldots(6)$$

where

$FD_t$ and $Y_t$ are as above

$U_t^{11}$ = the well behaved normally distributed error term.

$\Gamma_0$, $\Gamma_i^1$ and $\Gamma_i^{11}$ are parameters to be estimated.

Financial deepening is measured as the ratio of total bank deposits (Quasi money) to GDP (i.e. Currency is excluded from the definition since it is not intermediated through the banking system), and real output is measured by real GDP at 1985 prices.

The values of $w_0$, $w^1$, $\alpha_0$, and $\beta_0$, that is the intercepts of the models could either be positive or negative or even zero. On the other hand, the values of $w_1$, $w^1_i$, $\alpha^1_i$, $\alpha^{11}_i$ $\beta^1_i$ and $\beta_{11i}$, must be positive for the hypothesis to be significant. In other words, the coefficients of the financial deepening to growth or of growth to financial variables must be positive for the hypothesis to be significant. The error terms $U_t$, $U_t^1$, $U_t^{11}$ and $U_t^{111}$ take into account the influence of less important factors and the error of measurement of data (or the aggregation of data) for the various models.

F - statistics were be used to test the combined influence of the parameters in equation (2) and (3) to show the causality between financial deepening and economic growth. And student 't' statistics was also used to test the significance of the individual parameters of equation (2) and (3).

To implement the Granger Causality test, in equation (4) F-statistics was calculated under the null hypothesis that the coefficients of the lagged values of FD are jointly insignificant (i.e all $a^{II}_i = 0$). If the null hypothesis cannot be rejected then the possibility that changes in financial deepening causes changes in economic growth cannot be accepted. Given a finding that financial deepening causes growth, the sign of the effect can be checked by using the F - test of whether the sum of the financial deepening coefficients is positive or negative.

If the dependent variables of equation (4) are reversed then the opposite hypothesis that economic growth determines financial deepening can be tested in the same way. In this case, if the null hypothesis cannot be rejected then the possibility that economic growth Granger - causes financial deepening cannot be rejected. A common approach in Granger tests is to choose arbitrarily lag lengths for $a^{I}_i$ and $a^{II}_i$ in equation (4) or $B^{I}_i$ and $B^{II}_i$ in equation (5).

Finally, the final prediction errors of the coefficients and the coefficient of determination, $R^2$ were be calculated to show if the relationship between financial deepening and economic growth is impressive.

## 4.3 THE EMPIRICAL RESULTS AND THEIR IMPLICATIONS

The various hypothesis proposed for verifications were estimated using the data in the statistical appendices. In this section, the results of the estimates are provided and their implication discussed.

The first model estimated use the data in appendix III which is calculated from appendix II, that is, real GDP, $Y_t$ is regressed on financial deepening, $FD_t$. The following results were obtained.

$$Y_t = 142781.82 - 4418.94\ FD_t \quad \text{----------(11)}$$

$$(11.73) \quad (-23.85)$$

$R^2 = 062$, $F = 14.79$, $F^{cri} = 5.12$ and

$t^{crit} = 1.8$, $n = 11$ i.e 1975 - 1985.

In the result provided, t - ratio is in parenthesis. The estimate show a negative relationship between growth in output (real GDP) and the financial deepening variables. The $R^2$ value shows that about 62% growth in output is explained by financial deepening variable. the intercept, 142781.82 shows the level of output when the financial deepening variable is equal to zero. And the coefficient of $FD_t$, i.e. - 4418.94 shows the magnitude in growth in output of a percentage change in financial deepening variable. The F value, 14.79, test the significance of the regression parameters in explaining the changes in output. The F statistical test is highly significant, since the F critical, 5.12 is less than the F calculated (i.e. 14.79> 5.12).

The t- ratio is used to test the significance of the individual parameters in explaining the changes in output at a

given period of time. The parameters are significant since the estimated 't' values are both greater than critical 't' values.

The above results shows a robust evidence of a given perturbation in the two variables. Now, the problem lies in the sign of the relationship. It shows that financial deepening negatively influence growth in output, contrary to economic theory. The negative sign of the coefficient of the financial deepening variable in Nigeria can be justified in real term. The period between 1975 and 1985 witnessed a phenomenal growth in domestic output resulting from the petrol-dollars. Nigeria generated a huge amount of income from the exports of petroleum products which came into limelight in the early 70's. Evidence shows that over 70 percent (70%) of our Gross Domestic Product (GDP) are generated from the oil sector since the "oil boom" era even up-till the present time. 1975 fall into the period of the "oil boom" proper, so that the bulk of the domestic output (GDP) were generated from the oil sector. As already discussed in the previous chapter, development in the financial service industry was lull in the 70s and early 80s. The financial system was at its formative stage so that the total deposits mobilized was insignificant to finance investment at the same period. The implication of this was that as the GDP rise, the ratio of total bank deposit/liabilities to GDP continued to fall in real terms.

Therefore, the negative regression results between financial deepening and economic growth in Nigeria between 1975 - 1985 (period of regulation) is justifiable as the above analysis

reveals.

The second regression was estimated from data in appendices IV. That is, the period between 1986 to 1996, which is the period of deregulation of the Nigerian financial market. Just like the first regression, it is regressed against $FD_t$. The following results were obtained.

$$Y_t = \underset{(4.30)}{89317.59} - \underset{(-0.19)}{348.64}\ Fd_t \text{----------(12)}$$

$$R^2 = 0.004,\quad F = 0.037,\quad F^{crit.} = 5.12,$$

$$t^{crit.} = 1.8,\ n = 11 \text{ i.e } 1986 - 1996. \ ^{A}$$

In the result provided, t- ratio is in parenthesis. The estimate also show a negative relationship between growth in output (real GDP) and the financial deepening variable, just like equation (11) shows. The $R^2$ value shows that only about 0.4% growth in output is explained by financial deepening variable. The intercept in this case is less than that of equation (11). Also, the coefficient of $FD_t$ is less than that of equation (11) in absolute terms. Equations (11) and (12) provide the structural analysis of the period under review (i.e. 1971 - 1996). The essence of this is to show the effect of policy change on the parameter estimate of the model. That is, the effect of regulation and deregulation respectively.

It is expected that financial deepening variable should relate positively with economic growth variable, but the above results shows a negative relationship. The $R^2$ is not significant at all, since it is very low. The low value $R^2$ shows that the financial deepening is not an important variable that explains growth in

output in Nigeria. Other important variables that influence economic growth in Nigeria must have been excluded. Both $F^1$ test and $t^1$ test are not significant in explaining changes in the Gross Domestic Product (GDP) in Nigeria between (1986 - 1996). Although, the coefficient of the financial deepening variable between (1986 - 1996) is less than that of the first period (1975 - 1986) it is not significant statistically.

Now, the question is, why is financial deepening variable not significant in explaining growth in GDP in Nigeria despite the phenomenal growth in financial markets resulting from the deregulation of the market since 1987? There were increases in types and number of financial institution in Nigeria as a result of the Structural Adjustment Programme (SAP), embarked by the Government at that time. Banks and non-bank financial institutions were able to mobilise savings from the surplus sectors to finance investment and thereby induce growth. Why then is the coefficient of financial deepening variable negative, and even not significant to explain changes in real growth? The answer to these questions are not far-fetched. There are number of factors responsible for this, ranging from banks's portfolio behaviours and the incessant failures or distresses in financial institutions in Nigeria in recent times.

As already discussed in previous chapters, banks's portfolio behaviours inhibits the process of financial intermediation in Nigeria. The bank's portfolio are denominated in excess liquidity due to their refusal to offer credits to important sector of the

economy, as well as foreign currencies as a result of the high profit generated from the Parallel Foreign Exchange Market in operation then. In human geography, there is a postulate that human beings take the shortest route when taking a walk. This appears to be true of all human activities. Man likes convenience in its transactions that it also wants it at the cheapest cost. This is true of Nigeria banks in respect to foreign exchange transaction. Banks acquire foreign exchange cheaply at the official market rates and resell some of it at the Parallel Market at substantial premium. This led to the neglect of real sector development as banks were not ready to make credits available to the sector, hence, the negative regression coefficient between financial deepening variable and economic growth in Nigeria.

Another important factor limiting the process of financial intermediation in Nigeria is the incidence of financial distress among Nigeria banks. The immediate result of this urgly situation is the erosion of public confidence on the Nigerian banks. When banks are liquidated and proper resolution procedures are not put in place, people's deposits in banks will be lost completely, as experienced in recent times. Therefore, people were no longer interested to deposit their excess funds in banks, and as such the ratio of total bank liabilities (Quasi-money) to nominal GDP continue to fall as the latter increases.

At this junction, it is therefore discernible from the above point, why financial deepening variable in Nigeria is not significant in explaining changes in real output as the above

result revealed.

The third and the fourth regression is designed to implement the so-called "Granger Causality" tests, between financial deepening and ecoomic growth in Nigeria. That is, to test the research hypothesis proper.

To test the first research hypothesis that financial deepening interferes with growth in positive way, the data on Appendice (V) was used to produce the following result from the Granger causality techniques,choosing the lagged length,n, equals to two years.

$$Y_t = 68820.23 + 0.58Y_{t-1} - 0.15Y_{t-2} + 898.10FD_{t-1} - 2400.01FD_{t-2} \quad --(13)$$

(1.91) (2.64) (-0.71) (0.64) (-1.56)

$R^2 = 0.58$, $F = 5.96$.

In the result provided, t ratios are in parenthesis. To implement the Granger Causality test, in equation 13, F statistics was calculated under the null hypothesis that the coefficients of the lagged values of the explanatory variables are jointly insignificant;

i.e, $H_0$ ; $a_i^1 = 0$

$H_1$ ; $a_i \neq 0$

At 5% level of significance. That is the critical region is $V_1$, $V_2$ $F^{0.05}$, while $V_1$ and $V_2$ are the various degrees of freedom.

$V_1$, $V_2$ $F^{0.05} = 2.96$, and F statistics calculated = 5.96.

Now, the $F^C$ calculated is greater than the critical $F_C$ i.e 5.9672.96, therefore, we reject the null hypothesis and accept the alternative hypothesis, $H_1$, $a_i \neq 0$. That, the coefficients of the

explanatory variables are not equal to zero. This result shows that financial deepening interfere with growth process. But the direction or the sign of the effect of the Granger Causality test can be checked by using the F test of whether the sum of the financial deepening coefficients is positive or negative Statistical support for a positive effect indicates support for the Mckinnon - shaw - Fry approach (i.e the Monetarists position), while a negative effect would support the Structuralist view.

From the above result, the sum of coefficients of the explanatory variable is negative. That is, there was negative unidirectional causality from financial deepening to economic growth in Nigeria. This result therefore supports the structuralist view of the relationship between financial deepening and economic growth in Nigeria. Yes! Financial factors are important in stimulating growth in Nigeria, but this process is being hindered by the structural bottlenecks inherent in the Nigerian economy.

The second research hypothesis to be tested is the reverse of the first hypothesis which states that economic growth is depended on financial deepening variable. The second hypothesis therefore states that financial deepening is not depended on economic growth, as against the alternative hypothesis that it is depended on economic growth: i.e.

$H_0 \; ; \; \beta_i = 0$

$H_i \; ; \; \beta_i \neq 0$

To implement the above test therefore, the result of the estimated equation using the Granger techniques is obtained using the data on appendice (VI) as follows;

$$FD_t = 3.08 + 048FD_{t-i} + 0.26FD_{t-2} + 1.51Y_{t-1} - 1.71Y_{t-1} \text{--(14)}$$

(0.53) (2.08) (1.05) (10.421) (-0.47)

$R^2 = 0.61$, $F = 6.31$.

In the result provided, t ratios were in parenthesis.

As usual, to implement the Granger Causality test, F statistics was calculated under the null hypothesis that the coefficients of the lagged values of $Y_t$ (i.e the explanatory variable) are jointly insignificant.

Now from the above result, the F statistics calculated is equal to 6.31, while the critical F is only 2.96. Since F calculated is greater than the critical $F_1$ we reject the null hypothesis and accept the alternative hypothesis that the coefficients $B_i$ are jointly significant at 5% level of significance. The result shows that the financial deepening variable in Nigeria is greatly influenced by the growth in real Gross Domestic Product (GDP). The sum of the coefficients of equation (14) is positive, which shows a positive unidirectional causality from economic growth to financial deepening. That is, economic growth Granger cause financial deepening in Nigeria. This result shows that as the country experiences economic growth, its financial markets will become more deepened. This presupposes that a growing economy is associated with a growing financial system.

The results from the Granger causality test between financial

deepening and economic growth in Nigeria appear to be determined Contemporaneously; that is, the null hypothesis is rejected in both directions. This underscores the fact that there is a symbiotic relationship between financial deepening and economic growth in Nigeria.

Finally, it is important to note from the foregoing analysis that the research findings provide a roburst result as could be seen empirically in equation 11, 12, 13, and 14. Almost all the equations are significant except equation 12, in explaining the relationship between financial deepening and economic growth in Nigeria. The Central focus of this research work is to see the causality between financial deepening and economic growth in Nigeria. And this was carried out succintly by using the Granger techniques in equation 13 and 14 respectively. The result is highly significant. Equation 11 and 12 were merely employed to provide structural analysis of the period under review (ie 1975 - 1996). At this point, policy recommdndation can be made for policy makers based on the research's findings.

Chapter 5

# 5.0 SUMMARY, CONCLUSION AND RECOMMENDATIONS

## 5.1 SUMMARY OF THE STUDY

Attempt has been made in this study to identify bank failures as one of the major factor limiting the development process of Nigeria. A Cursory Survey of the "Scenario" between financial development and economic growth shows that financial factors have not been significant in explaining the growth performance of the economy due to some structural regidities within the economy that culminated into the failures of the financial service sector of the economy.

The study also attempt to show the basic opproaches in understanding the place of finance in growth performance among developing economies. That is, the monetarists position which was adopted by Mckinnon (eg 1973, 1991), Shaw (1973), and Fry (1978 or 88), otherwise known as the Mckinnon-Shaw-and Fry approach. This group have advanced the argument that a represed financial system interfaires with development because savings vehicles are underdeveloped, the returns on savings and investment are negative or unstable, and financial intermediaries do not allocate savings efficently among competing users. The second approach is known as the structuralist position on the other hand, was advanced by Ruffle (1984), Taylor (1983) and Van Wijnbergen (1983). They argued that banks can not intermediate funds efficiently in an economy taced with some structural bottlenecks identified as foreign exchange constrains, poor performance of the market

mechanism, socio-political problems etc.

A large number of empirical literatures on financial deepening and economic growth among developing economies gives a conflicting evidence. Some found no role for financial deepening in explaining per capita real GDP, Yao, (1976), while Fanyi and Saracoglu (1983) found a positive and significant relationship; and in a study combining time series and cross section data Jung (1986) found that developing contries were generally characterised by causality running from financial deepening and economic growth.

The study further shows the growth of the Nigerian economy since independence, the growth of the Nigerian financial system, the causes and effects of bank failures and the Nigerian banks' portfolio behaviour. The Nigerian post-independence growth rate has been characterised by a long-term declining trend. The factors identified as limiting this process are low capital formation, high level of unemployment debt burden, increased population demographic factor, rise in import, just to mention a few. The causes of bank failures include the economic downturn, inhibitive policy enviornment, inadequate capital, poor management, insider abuse, just to mention a few. The economic implication of bank failures includes the erosion of public confidence, effect on real sector development, effect on credit market, the cost of bank resolution and its effect on investment in the banking sector etc. All these factors led to a negative shift in the banks' porfolio behaviour that adversely affects the capacity of the Nigerian financial system to stimulate economic growth through its role as financial

intermediator in the economy.

It further shows that the various financial reforms of government since independence have not yielded any positive results. The 1976 financial system review brought about a positive response to the development of financial markets and the economy as a whole, until the collapse of the international oil market in 1981, after which the economy began to nose-dive with consequential negative impacts on the Nigerian financial system. On the other hand, the 1986 financial system reforms, which was part of an overall structural adjustment programme of the whole economy, merely led to a phenomenal increases in the structures and number of financial institutions whose basic focus of transactions centred on foreign exchange dealings. The result of a change in policy which affects the foreign exchange market negatively is the continous distresses and failures of these "new generations" banks whose asset base is very low.

The study finally shows that there is a symbiotic relationship between financial deepening and economic growth in Nigeria from the Granger causality test. The test shows that the causality between financial deepening and economic growth in Nigeria are determined Contemporaneously; that is , the null hypothesis in both directions are rejected. There is a negative undiredtional causality running from financial deepening to economic growth, and conversely there is a positive undirectional causality running from economic growth to financial deepening. In this regard, the structuralist's view is true of the case of Nigeria as negative unidirectional causality

runs from financial deepening and economic growth.

## 5.2 CONCLUSION

Financial factors are very important in the growth performance of an economy. A growing economy is synonymous with a growing financial sector. This presupposes that growth in the financial system is expected to stimulate real sector development, through financial intermediation. If this process is impaired, it means something must be wrong with the financial system. This necessitates that a drastic measure must be taken to restore sanity to such a financial sector so as to boasts the growth performance of the economy.

## 5.3 POLICY RECOMMENDATIONS

Having known the place of finance in economic development and the fact that the Nigerian financial system has failed completely in its role of stimulating the Nigerian economic growth, the study seek to give the following recommendations to policy makers to remedy or reduce the incidence of bank failures in Nigeria and to put the Nigerian banks on a sound financial footing;

i Policy makers must address the immediate problems of weak and insolvent banks, shortcoming in accounting, legal and regulatory frameworks,, and tax supervision and compliance. This restructuring exercise necessitates that the central bank of Nigeria (the overal regulatory body of the Nigerian financial system), must also stand ready to provide liquidity

support to viable banks. The central bank should not, however, provide long term financing to banks, nor should it be involved in commercial banking activities (as the case in recent times), as this will lead to increased costs and creates conflicts with the central bank's monetary policy objectives.

It is important to note that the broad objectives of bank restructuring programmes comprises of various measures aimed at improving bank performance - that is, restoring solvency and profitability and improving the banking system 's capacity to provide financial intermediation. But then, the success of bank restructuring programmes depended to a large extent on the efficiency and capability of the various regulatory bodies such as the central bank of Nigeria (the apex bank) and the Nigerian Deposit Insurance Coperation (NDIC) in handling the instruments of regulation available to them. Policy makers therefore, must ensure that the regulatory bodies are fully equipped to function properly.

ii. In addition to originating from exogenous, macro-economic shocks, banking problems often stem from deficient bank management and poor operational control, short-comings in regulatory and accounting frameworks related to inadequate management control, and distorted incentive schemes. To overcome those problems, authorities must employ a set of instruments, cost of which are modified versions of normal bank management tools and strategies.

Examples are the formation of specialised units to handle loan-collection, reconfigurations of core business, and use advisory and consulting services to improve specific aspects of bank operations. A situation where banking problems involve state banks, privatisation is also a standared approach to improving the eificiency of banking. Bond instruments - such as exchange bonds for non-performing loans and issuance of new equity are widely used by all countries. However, such expenditures do not always seem to be disclosed in the budget. In other words, they are part of the extra-budgetary allocations of government.

iii. To ensure banking confidence and financial stability which of course, is the essence of bank regulations, the following legal provisions must be maintained and complied with as already stated in the Nigerian banking laws;

(a) The regulatary bodies must ensure that no person is permitted to carry on banking business in Nigerian except it is a company duly incorporated in Nigeria under the company and Allied Matters (CAM) Decree No 1 of 1990 and in possession of a valied license issued under the banks and other financial institutions (BOFI) Decree. In other to protect the interest of depositors, section 40 of BOFI Decree disallows any person(s) or body corporate to solicit for any type of deposit from the public except is a duly licensed bank. This provision is necessary to prevent exploitation of the public by just any person(s) and or body corporate thus causing

financial instability in the economy. Unfortunately, experience has shown that the so called "Nigerian factors" has abused this procedures in the past. The policy makers must ensure that such "Nigerian factors" should be eliminated.

(b) The regulatory authorities must also ensure that banks maintain the minimum paid-up capital as specified in the BOFI Decree for all the financial institutions operating in the country';

(c) The monetary authorities must strictly ensure that banks operating in Nigeria maintains the minimum. Holding of Cash Reserves, specified Liquid Assets, Special Deposits and stabilization securities. All these assets are mainly used by monetary authorities as instruments of monetary policy by the Central Bank of Nigeria. These assets also cover normal fluctuations in deposits that may be experienced by banks;

(d) Since the major causes of bank failures in Nigeria is high rate of loan defaults or poor management of non-performing credits, the monetary authorities must ensure that the general lending and investment restrictions are complied with by the operating financial institutions in the country. As a general rule, the Central Bank of Nigeria is empowered to fix a ceiling on the volume of loans, advances and discounts that may be granted and/or outstanding at any time. By section 39 (5) of the CBN Decree, the Bank is empowered; "to require that all applications to loans exceeding such amount as the bank may specify shall be submitted by the bank to the bank (CBN)

for approval and no such loans shall be made without such approval"1. Apart from the general lending restrictions, there are other specific credit regulations. One of such regulation limits the loans and advances that can be made to a single borrower. For any licensed commercial bank, the limit is pegged at 20 per cent of the 'Shareholders' Fund impaired by losses and in case of a merchant bank not more than 50 percent of its shareholders' fund and also not impaired by losses (Rotimi W. O. 1995).

Loan to insiders which constitutes the major share of the total banks' loan defaults should be highly restricted if not cancelled. Loan to insiders includes credits to banks' shareholders, directors, executives, officers and their relations. More often, these loans are granted without necessary collateral securities in case of defaults, hence, the incessant failures/distresses of our banks. The policymakers must take adequate measures to eliminate such urgly situations by promulgating Decrees that will act as a deterrant effects on insider abuses. It was in recognition of this fact that the Federal Government promulgated the Failed Banks (Recovery of Debts and Financial Malpractices) Decred No. 18 of 1994, whose implementations broght an ochestrated "land mark" on the Abacha's administration. This brought a little sanity to the banking system in recent times. The government should therefore ensure that cases broght under the tribunal (Failed Bank Special Tribunal) are immediately tried and those found guilty are broght to book.

(e) Monetary authorities (the regulatory boides) must ensure prohibition of employment of certain persons, Inter-Directorship and Disqualifications and exclusion of certain individuals from Management of Banks. Management Constitutes the key factor that determines the success of any bank. The other factors such as capital adequacy, assets quality, ensuring growth and liquidity all hang on good management. Absence of good management automatically spells down for any bank; it could at the extreme situation lead to bank failure which jeopardizes banking confidence. Rank regulators therefore, must critically monitor and approve those they want to own and manage banks, their intergrity, sincerity, honesty, trustworthiness etc.

(f) Regulatory bodies must ensure that banks discloses their information by keeping proper book account with respct to all transaction. As regards the publication of annual accounts of banks, section 27 (1) of the BOFI Decree provides that "subject to the prior approval in writing of the bank (CBN), a bank shall, not later than 4 months after the end of its financial year,

(i) cause to be published in daily newspaper printed in and circulating in Nigeria and approved by the Central Bank of Nigeria;

(ii) exhibit in a conspicous position in each of its offices and branches in Nigeria; and

iii forward to the CBN, "Copies of the bank's balance sheet

and profit and loss account duly signed and containing the full and correct names of the directors of the bank"2.

Information disclosure by banks is basically designed to ensure that depositors, investors and the general public are adequately informed of a bank's performance/condition. These are necessary to creat the public Confidence on a particular bank.

(iv) Finally, from the empirical result of this research, the structuralist positions was supported ot a negative unidirectional causality running from financial deepening to economic growth in Nigeria, therefore, this research further recommend that policy makers must seek for measures to adopt in eliminating such structural bottlenecks that limits the process of financial intermediation in Nigeria. Such structural factors such as foreign exchange constrains, socio-political and economic reqidities, excruciating foreign debt burdens, to mention a few. These factors impaired the process of financial intermediations in Nigeria, hence limit the pace of economic growth in Nigeria.

If the above recommendations are strictly inbibed by the policy markers and fully implemented religiously, I supposed, financial deepening will enhance economic growth and development of the country.

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APPENDIX I

SELECTED INDICATOR OF FINANCIAL SECTOR IN NIGERIA BEFORE AND AFTER THE INTRODUCTION OF STRUCTURAL ADJUSTMENT PROGRAMME (SAP)

| INDICATORS | 1986 | 1993 |
|---|---|---|
| TOTAL FINANCIAL ASSETS | =N=54,562.6M | N297,352.5M |
| $M_1$ | =N=13,103.0M | N116,390.2M |
| $M_2$ | =N=74,592.7M | N192,458.6M |
| STOCK MARKER INDEX* | 103.8 | 269.4 |
| AGGREGTE FINANCIAL SAVINGS | =N=13,939.1M | =N=85,027.9M |
| TYPES AND NUMBER OF FINANCIAL INSTITUTIONS | | |
| - Commercial Banks | 29 | 66 |
| - Community Banks | 12 | 54 |
| - Merchant Banks | - | 874 |
| - Primary Mortgage Companies | 1 | 252 |
| - People's Bank Branches | - | 271 |
| - Stock Brokerage Forms | 22 | 140 |
| - Finance Companies | 2 | 310 |
| - Bureaux de change | - | 147** |
| - Insurance Companies | 72 | 121** |
| - Development Banks | 3 | 5 |
| - Stock Exchange | 3 | 6 |
| - Discount Houses | - | 3 |
| RATIOS *** | | |
| FINANCIAL ASSETS/GDP | $M_2$/GDP | |

SOURCES: NDIC Quarterly Journal, Volume 5, Number 3 September 1995, page 38.

* December 1984 = 100
** As at 1992
*** Calculated

APPENDIX II

SELECTED ECONOMIC INDICATORS IN NIGERIA IN MILLIONS =N=

| YEAR | CONSUMER PRICE INDEX AT 1985 - 100 | QUASI MONEY '=N=' MILLION | GDP AT MARKET PRICE '=N= MILLION |
|---|---|---|---|
| 1975 | 20.7 | 1,578.4 | 21,558.8 |
| 1976 | 25.6 | 1,985.9 | 27,297.5 |
| 1977 | 29.6 | 2,263.1 | 32,747.3 |
| 1978 | 34.5 | 2,609.8 | 36,083.6 |
| 1979 | 38.5 | 3,710.6 | 43,150.8 |
| 1980 | 42.3 | 5,170.6 | 50,848.6 |
| 1981 | 51.2 | 5,803.2 | 50,749.1 |
| 1982 | 55.1 | 6,845.4 | 51,709.2 |
| 1983 | 67.9 | 6,086.5 | 57,142.1 |
| 1984 | 94.8 | 9,396.4 | 63,609.1 |
| 1985 | 100.0 | 10,550.8 | 72,355.4 |
| 1986 | 105.4 | 11,487.7 | 73,061.9 |
| 1987 | 116.1 | 15,088.7 | 108,885.1 |
| 1988 | 181.2 | 21,631.7 | 145,243.3 |
| 1989 | 272.7 | 20,525.3 | 224,796.9 |
| 1990 | 293.2 | 27,699.0 | 260,636.7 |
| 1991 | 330.9 | 36,788.6 | 324,010.0 |
| 1992 | 478.4 | 53,111.2 | 549,808.8 |
| 1993 | 751.9 | 76,067.9 | 701,472.9 |
| 1994 | 1180.7 | 95,755.1 | 914,334.3 |
| 1995 | 2040.4 | 106,037.6 | 1,436,648.5 |
| 1996 | 2771.0 | 136.281.4 | 1,447,018.1 |

SOURCES: Central Bank of NIgeria Statistical Bulletin, Volume 6, Number 2, December 1995, page 7-144, and Central of Nigeria Annual; Report and Statement of Account 1996/97.

APPENDIX III

| YEAR | | |
|---|---|---|
| PERIOD | $Y_t$ | $FD_t$ |
| 1975 | 104,148.79 | 7.32 |
| 1976 | 106,630.86 | 7.28 |
| 1977 | 110,632.77 | 6.91 |
| 1978 | 104,590.15 | 7.23 |
| 1979 | 112,080.00 | 8.61 |
| 1980 | 120,209.46 | 10.17 |
| 1981 | 99.119.33 | 11.44 |
| 1982 | 93,846.10 | 13.24 |
| 1983 | 84.156.26 | 10.65 |
| 1984 | 67,097.15 | 14.77 |
| 1985 | 72,355.40 | 14.58 |

NOTE: $Y_t$ and $FD_t$ are calculated from Appendix II.

$Y_t$ = real GDP = $\frac{\text{Norminal GDP}}{\text{Price Index}} \times \frac{100}{1}$

$FD_t$ = Financial Deepening Variable = $\frac{\text{Quasi Money}}{\text{Norminal GDP}} \times \frac{100}{1}$

NORMINAL GDP = GDP AT CURRENT MARKET PRICE

APPENDIX IV

| PERIOD | $Y_t$ | $FD_t$ |
|---|---|---|
| 1986 | 69,318.69 | 15.72 |
| 1987 | 93,785.62 | 13.86 |
| 1988 | 80,156.35 | 14.89 |
| 1989 | 82,433.77 | 9.13 |
| 1990 | 88,893.83 | 10.62 |
| 1991 | 97,917.81 | 11.35 |
| 1992 | 114,926.59 | 9.66 |
| 1993 | 93,293.38 | 10.84 |
| 1994 | 77,440.02 | 10.47 |
| 1995 | 70,410.14 | 7.38 |
| 1996 | 70,918.35 | 9.42 |

$Y_t$ and $FD_t$ are as above.

# APPENDIX V

$$Y_t = a_0 + \sum_{i=1}^{n} a^1 Y_{t-i} + \sum_{i=1}^{n} a^{11} FD^{t-i} + U^{t111}$$

| PERIO | $Y_t$ | $Y_{t-1}$ | $Y_{t-2}$ | $FD_{t-1}$ | $FD_{t-2}$ |
|---|---|---|---|---|---|
| 1975 | 104,148.79 | 122,586.09 | 84,858.09 | 5.18 | 5.09 |
| 1976 | 106,630.86 | 104,148.79 | 122,586.36 | 7.32 | 5.18 |
| 977 | 110,632.77 | 106,630.89 | 104,148.79 | 7.28 | 7.32 |
| 1978 | 104,590.15 | 110,632.77 | 106,630.89 | 6.91 | 7.28 |
| 1979 | 112,080.00 | 104,590.15 | 110,632.77 | 7.23 | 6.91 |
| 1980 | 120,209.46 | 112,080.00 | 104,590.15 | 8.61 | 7.23 |
| 1981 | 99,119.33 | 120,209.46 | 112,080.00 | 10.17 | 8.61 |
| 1982 | 93,846.10 | 99,119.33 | 120,209.46 | 11.44 | 10.17 |
| 1983 | 84,156.26 | 93,846.10 | 99,119.33 | 13.24 | 11.44 |
| 1984 | 67,097.15 | 84,156.26 | 93,846.10 | 10.65 | 13.24 |
| 1985 | 72,355.40 | 67,097.15 | 84,156.26 | 14.77 | 10.65 |
| 1986 | 69,318.69 | 72,355.40 | 67,097.15 | 14.58 | 14.77 |
| 1987 | 93,785.62 | 69,318.69 | 72,355.40 | 15.72 | 14.58 |
| 1988 | 80,156.35 | 93,785.62 | 69,318.69 | 13.86 | 15.72 |
| 1989 | 82,433.77 | 80,156.35 | 93,785.62 | 14.89 | 13.86 |
| 1990 | 88,893.83 | 82,433.77 | 80,156.35 | 9.13 | 14.89 |
| 1991 | 97,917.81 | 88,893.83 | 82,433.77 | 10.62 | 9.13 |
| 1992 | 114,926.59 | 97,917.81 | 88,893.83 | 11.35 | 10.62 |
| 1993 | 93,293.38 | 114,929.59 | 97,917.81 | 9.66 | 11.35 |
| 1994 | 77,440.02 | 93,93.38 | 114,926.59 | 10.84 | 9.66 |
| 1995 | 76,410.14 | 77,440.02 | 93,293.38 | 10.47 | 10.84 |
| 1996 | 70,918.35 | 70,410.14 | 77,440.02 | 7.38 | 10.47 |

NOTE: $Y_t$ and $FD_t$ are as Appendix III & IV

$Y_{t-i}$ and $FD_{t-i}$ are lagged values of $Y_t$ and $FD_t$ respectively, where the lenght of lag is two years.

## APPENDIX VI

$$FD_t = \theta_0 + \sum_{i=1}^{n} \theta^1 FD^{t-i} + \sum_{i=1}^{n} \theta^{11} Y_{t-i} + U_{t1v}$$

| PERIOD | $FD_t$ | $FD_{t-1}$ | $FD_{t-2}$ | $Y_{t-1}$ | $Y_{t-2}$ |
|---|---|---|---|---|---|
| 1975 | 7.32 | 5.15 | 5.09 | 100,585.36 | 843,351.09 |
| 1976 | 7.28 | 7.32 | 5.18 | 104,148.79 | 122,586.36 |
| 1977 | 6.91 | 7.28 | 7.32 | 106,630.89 | 104,148.79 |
| 1978 | 7.23 | 6.91 | 7.28 | 110,632.77 | 106,630.89 |
| 1979 | 8.61 | 7.23 | 6.91 | 104,590.15 | 110,632.77 |
| 1980 | 10.17 | 8.61 | 7.23 | 112,080.00 | 104,590.15 |
| 1981 | 11.44 | 10.17 | 8.61 | 120,209.46 | 112,080.00 |
| 1982 | 13.24 | 11.44 | 10.17 | 99,119.33 | 120,209.46 |
| 1983 | 10.65 | 13.24 | 11.44 | 93,846.10 | 99,119.33 |
| 1984 | 14.77 | 10.65 | 13.24 | 84,156.26 | 93,846.10 |
| 1985 | 14.58 | 14.77 | 10.65 | 67,097.15 | 84,156.26 |
| 1986 | 15.72 | 14.58 | 14.77 | 72,355.40 | 67,097.15 |
| 1987 | 13.86 | 15.72 | 14.58 | 69,318.69 | 72,355.40 |
| 1988 | 14.89 | 13.86 | 15.72 | 93,785.62 | 69,318.69 |
| 1989 | 9.13 | 14.89 | 13.86 | 80,156.35 | 93,785.62 |
| 1990 | 10.62 | 9.13 | 14.89 | 82,433.77 | 80,156.35 |
| 1991 | 11.35 | 10.62 | 9.13 | 88,893.83 | 82,433.77 |
| 1992 | 9.66 | 11.35 | 10.62 | 97,917.81 | 88,893.83 |
| 1993 | 10.84 | 9.66 | 11.35 | 114,926.59 | 97,917.81 |
| 1994 | 10.47 | 10.84 | 9.66 | 93,293.38 | 114,926.59 |
| 1995 | 7.38 | 10.47 | 10.84 | 77,440.02 | 93,293.38 |
| 1996 | 9.42 | 7.38 | 10.47 | 70,410.14 | 77,440.02 |

NOTE: $FD_t$, $FD_{t-i}$ and $Y_{t-i}$ are as Appendix V.