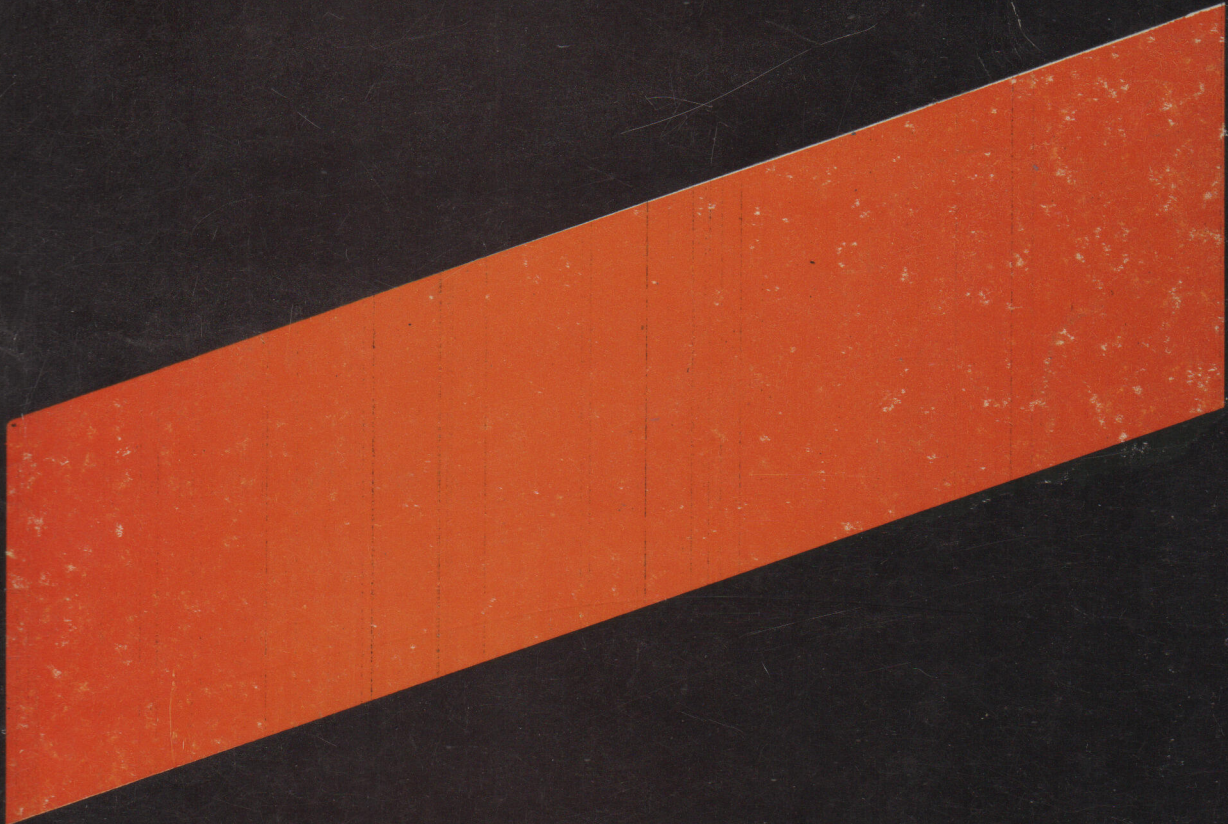


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THE MACRO-ECONOMIC INDICATORS: THE EVALUATION OF THE PERFORMANCES OF THE FINANCIAL SYSTEMS IN PROMOTING THE DEVELOPMENT OF THE NIGERIAN ECONOMY

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ABSTRACT

This study has analyzed major macro-economic indicators to evaluate the performance of the financial system against its role in promoting the development of the Nigerian economy. The results show that the high inflationary pressures under which the Nigerian financial system operates have hampered its effective performance. Also, the analysis has shown that the level of domestic savings which could have been transmitted into investment is relatively very low. High interest rates ushered in through deregulation attracted savings but in a manner detrimental to capital formation and accumulation thereby negatively affecting real growth, our conclusion is that the Nigerian financial system has probably been constrained by unstable and harsh economic and socio-political environment, besides some unfavourable policies. We have suggested measures aimed at addressing the issues.

Keywords: *Economic, Financial, Performance Interest, Savings, Inflation.*

INTRODUCTION

It has long been recognized that there is a direct link between economic development and the existence of an efficient and a highly developed financial system. In fact, history and process of industrialization in practically all the industrial countries of the world confirm this direct link and prove that an operational and highly functional financial system is a pre-condition for sustained industrial growth (Ajayi, 1984:1). Patrick (1966) posits that the contribution of the financial sector to development is a function of the quality and quantity of its services and the efficiency with which the services are provided. According to him, this would depend on how successful the sector is in building channels for the flow of financial operations, inculcating financial habits and discipline and developing human skills for carrying out complex financial operations. In Nigeria, however, the relevance and adequacy of the financial system has been called to question in that it does not contribute significantly to the structural economic transformation of the nation. Although there is a convergence of views that the role of the financial system is indispensable in the process of economic transformation, but the bone of contention is how the system should function to fulfill this role. Scholars have undertaken series of studies on the issue and prescriptions have been proffered. It is fair to say that the Nigerian financial system reforms which have been carried out through various prescriptions have led to changes in the overall size, structure, depth and the nature of competition, but the expected macroeconomic impacts on the domestic economy have been at best, minimal. The main objective of the paper is to examine the relevance and contributions of the financial system to the structural economic transformation in Nigeria. Following this section, section two highlights the theoretical framework and literature review on financial system. Section three analyzes the performance of the Nigerian Financial system in relation to the environment which it operates. Finally, section four gives the summary and conclusions.

THEORETICAL FRAMEWORK AND LITERATURE REVIEW

FINANCIAL SYSTEM DEFINED

This financial system refers to a set of rules and regulations and the aggregation of financial arrangements, institutions, agents, that interact with each other and the rest of the world to foster economic growth and development of a nation (Nzotta, 1999:119; Eke, 2000 and Ekezie, 1997:6). The financial system within an economy is described as a framework of financial intermediaries, financial markets, regulatory and supervisory bodies, the market participants and all instruments traded in the market. From the foregoing, the financial system is the prime mover in the process of economic transformation. It achieves this through the intermediation process which entails providing a medium of exchange necessary for specialization and the mobilization of savings from surplus to deficit economic units.

FINANCIAL SYSTEM AND ECONOMIC DEVELOPMENT

There is a convergence of views that the financial system of an economy (and by implication, the financial institutions) does matter significantly in economic development. Cameron (1972) stated that 'most scholars regard financial institutions as a passive factor'. In contrast, some authors argued that two factors are essential for economic development, namely -- the availability of entrepreneurs and financial institutions. Writers supporting this view include among others, the following: Mckinnon (1973), Shaw (1973), Cameron (1972) as well as Aldeman and Morris (1967). They all have differing emphasis on the relative impact that should be attributed to financial institutions in the process of structural economic transformation. Copeland and Weston (1980) asserted that the financial system has specific role to play in economic development. They identified the following roles as being performed by the system:

- (i) Allow the transfer of funds between borrowers and lenders. This intermediation role permits investors with insufficient wealth to take advantage of all their investment opportunities which yield higher rates of return than the market rates.
- (ii) Facilitate the separation of savings and investments which has positive impacts on economic growth and development. Separation makes it possible to overcome the unequal distribution of entrepreneurial opportunities and abilities among the population and also encourages division of labour and specialization.
- (iii) Encourage investments as investors are able to borrow funds and invest more than they would have done without financial institutions. The institutions are thus able to pool savings and direct them into viable investment.

For the financial sector to actively play the above stated roles, real interest rate must be positive (Mckinnon, 1973, and Fry, 1978). This would permit any amount invested to generate a positive rate of return at the end of the investment period. For instance, in a every simplified model, if X_0 naira is invested at period zero, end-of period value then will be denoted as rX_0 naira of interest plus repayment of principal, X_0 , where r is the rate of return. The future X_t of the initial investment X_0 can be expressed symbolically as:

$$X_t = X_0 + r X_0 \quad (1)$$

$$X_t = (1 + r) X_0 \quad (2)$$

when the rate of return is negative

$$X_t = (1 - r) X_0 \quad (3)$$

consequently

$$X_t < X_0 \quad (4)$$

which would discourage further investment.

The financial sector also requires basic infrastructure to operate. This would allow accurate, reliable and timely information to be disseminated to market operators. In many places, availability of efficient telecommunication networks and good road network is taken for granted but in Nigeria these and other key facilities are highly inadequate and grossly hamper the performance of the financial sector. Ghani (1992) provides evidence to the effect that the initial level of financial development is positively associated with a country's Gross Domestic Product (GDP) grow rate. A country that starts with a more developed financial system tends to grow faster because it can make more efficient use of resources. This is achieved through better evaluation and monitoring of firms, lower transaction costs for financial intermediation and externalities generated from information collected and processed in the financial markets. Levine (1992) constructed a model that captures the two-way nature of the relationship between financial and economic development and with different financial services. According to him, the level of financial development is a good predictor of future rates of economic growth, capital accumulation and technological change. He further argues that financial policies have important implications for the rate of economic growth, the level of financial development and the types of institutions providing financial services. It has been argued that financial development depends on real growth. Gurley et al (1967) posit that direct financing through financial institutions is more efficient than direct financing through the issuance of primary securities as claims against financial institutions are easier to liquidate. In their view, the prevalence of financial institutions leads to specialization and division between savings and investments which promote growth in quantity and variety of economic activities. Jhingan (1985:39) argued that capital formation is the 'main key' and strategic factor in the process of economic development. According to him, the process of capital formation is cumulative and self-feeding which involves three interdependent stages: (i) An increase in the volume of real savings which depends upon the will to save and the power to save; (ii) The existence of credit and financial institutions to mobilize and canalize these savings for converting them into investable funds; and (iii) The use of these savings for purposes of investment in capital goods which depends upon

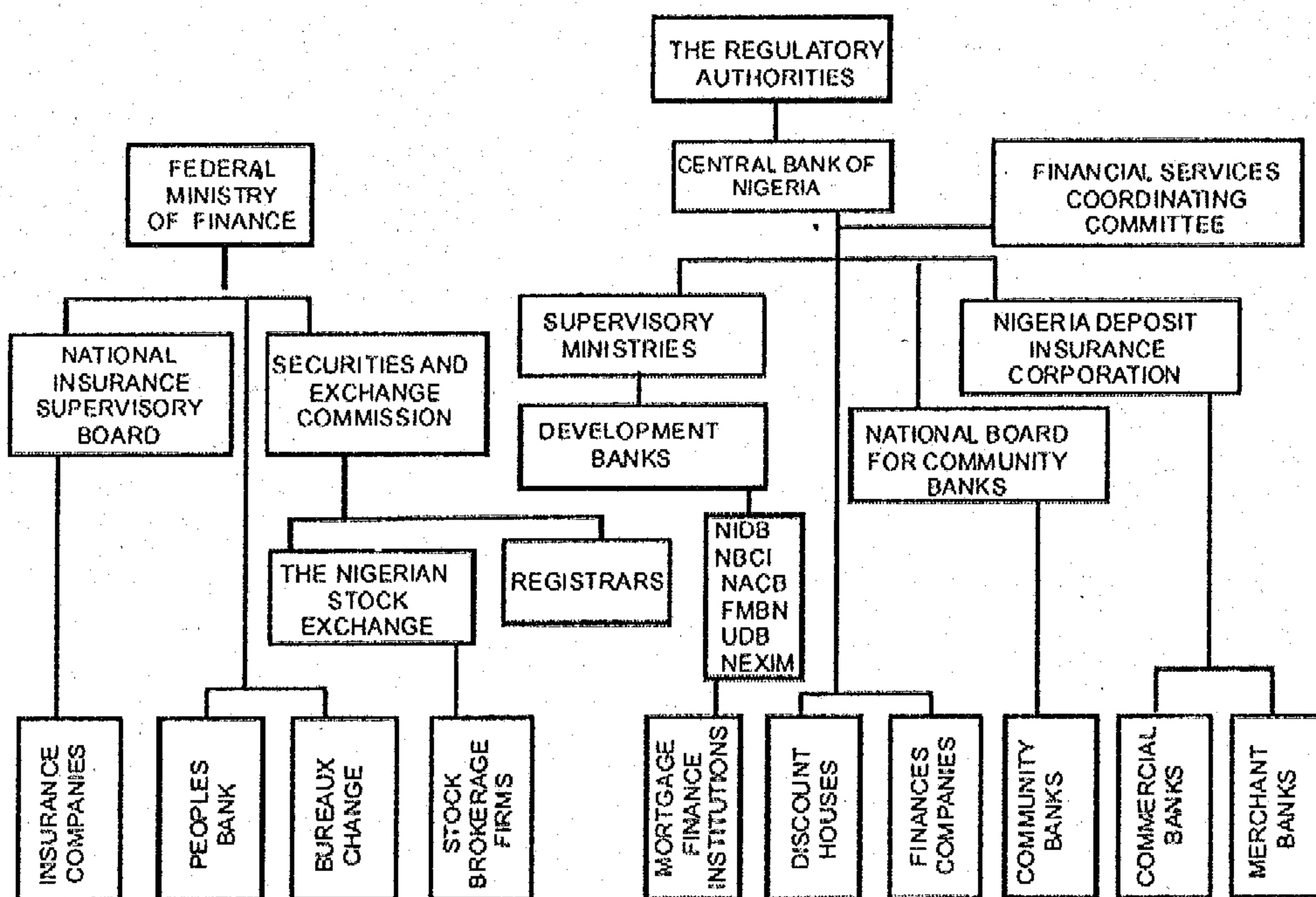
enterprise. Agu (1988) and Bhatia et al (1975:133) have outlined the role of the financial system in the savings – investment process and hence capital formation in the development process as follows:- In essence three main issues exist regarding the influence of financial intermediaries: first, their impact on growth of savings, especially on the household sector; second, their role in the financialisation of these savings (ie savings in the financial form); and third, their ability to ensure the most efficient transformation of mobilized funds into real capital. The role of the financial system in the savings – investment process has recently been associated with “Financial Repression Hypothesis Theory”. The theory which is usually associated with the established works of Cameron et al (1972), Mckinnon (1973), Shaw (1973) and Fry (1982, 19788), holds that the role of the financial system in the savings -- investment process would contribute most significantly to economic development and growth if the government authorities were not to interfere in the operations of the financial institutions. The proponents of this hypothesis argued that governmental controls of financial system impair capital formation and invariably economic growth, hence their advocate for a positive interest rate and financial liberalization.

THE NIGERIAN FINANCIAL SYSTEM

STRUCTURE OF THE NIGERIAN FINANCIAL SYSTEM

According to Olashore (1988:4), the structure of the Nigerian Financial System comprises financial institutions, financial instruments and financial markets and its role is to mobilize funds from the surplus spending units (savers) and channel them to the deficit spending units (investors) for profitable economic activities. Figure 1 below highlight this structure.

FIGURE 1
STRUCTURE OF THE NIGERIAN FINANCIAL SYSTEM



The figure consists of institutions and structures that have provided facilities for dealing in short-term monetary instruments and long-term market for handling stocks, debentures and other forms of long-term securities. The financial sector has evolved from one of partial dependence on foreign capital and expertise to locally-owned and organized business institutions which are now more market-oriented. All segments, particularly the banking sub-sector, have witnessed remarkable growth in the past two decades, though they have been undermined by the advent of distress which is currently ravaging the sector: consider, for instance that:

- (i) The regulatory/supervisory activities of the financial system are shared by the Central Bank of Nigeria (CBN) which is at the apex of the system, the Federal Ministry of Finance (FMF), the Nigeria Deposit Insurance Corporation (NDIC), the Securities and Exchange Commission (SEC), the Federal Mortgage Bank of Nigeria (FMBN), and the National Insurance Commission (NIC). With the promulgation of the CBN Decree No. 24 and Banks and Other Financial Institutions (BOFI) Decree

Macro-Economic Indicators: The Evaluation of the Performances of the Financial Systems in Promoting the Development of the Nigerian Economy

No. 25 of 1991, the CBN now has the sole responsibility for the formulation and execution of monetary policy in Nigeria, the power it hitherto shared with the Federal Ministry of Finance. The existence of several regulatory bodies for various segments of the financial system dictated the need for the establishment of the financial Services Regulation Coordinating Committee (FSRCC) to coordinate and harmonize set standards and supervisory efforts of these various apex regulatory bodies.

- (ii) Commercial and Merchant Bank, the most predominant, serve as money creating institutions and are expected to play vital roles in the development process. These banks generally accept deposits, provide loans and corporate finance, finance foreign trade, facilitate the transformation of the rural environment, and provide financial advisory services. They also serve as channels through which governments' monetary and credit policies are implemented. They are, however, beset by such problems as massive frauds, structural and organizational bottlenecks, and conflicting signals from the macroeconomic environment.
- (iii) Development banks in Nigerian Industrial Development Bank (NIDB), the Nigerian Agricultural and Cooperative Bank (NACB), the Nigerian Bank for Commerce and Industry (NBCI), the Federal Mortgage Bank of Nigeria (FMBN), Urban Development Bank of Nigeria Limited (UDBN) as well as the Nigerian Export – Import Bank (NEXIM). These banks provide medium to long-term credit facilities to the agricultural, industrial, commercial and other sectors of the economy. They are inundated with such problems as inadequate funding by the government, bad loans, and unfavourable interest rates.
- (iv) Non-bank financial intermediaries include finance and investment companies, discount houses, bureaux de change, insurance companies, as well as pension and provident funds. These institutions perform the role of financial intermediation by mobilizing and providing short to long-term funds to the various sectors of the Nigerian economy. They also sell securities or debt instruments to savers for funds which are subsequently channeled into viable investments. Their problems include the contagious effect of distress in the system, and the unfavourable changes in government policies in relation to their operations.
- (v) Specialized banks are the People's Bank of Nigeria (PBN) and the Community Banks (CBs). The PBN came into being in the country in 1989. The bank aims at improving the lot of the low income group by providing them facilities outside the regular norms and procedures operating in the conventional banking system. Community banking concept evolved in 1990. It is also a specialized bank whose operations and laws differ from the conventional banks. These banks are similar to Unit banks in the United States of America as they have no branch network. In recent times, all the specialized banks are experiencing continuous downturn trend in their activities due to distress in the system.

FINANCIAL SYSTEM PERFORMANCE IN NIGERIA

This subsection provides the empirical evidence which is used to evaluate the performance of the financial system against its role in contributing to structural economic transformation in Nigeria. The environment in which financial institutions operate constitutes an important factor in their performance. Generally, where the environment is conducive and supportive, financial institutions' performance is enhanced, but where the environment is largely unstable and harsh, performance is hampered. In Nigeria, the major environment under which the financial institutions operate could be broken down into economic, socio-political and regulatory environments. Major developments in the economic environment are reviewed against the performance of the financial system. Presented in Table 1 are some macro-economic indicators from 1995 to 1997. As evidenced in the Table, current inflation rates in Nigeria could be described as high and volatile. In 1995, the inflation rate was 72.8 per cent, it decreased substantially from 29.3 per cent in 1996 to 8.3 per cent in 1997. NDIC (1997) indicated that the inflation rate fell substantially principally because of controlled government expenditure, lightened liquidity coupled with the stability in the foreign exchange market, among other factors. According to the Corporation, the observed drop in the rate of inflation and the marginal improvement in the rate of growth of the FGD neither reflected in any significant improvement in the living conditions of many Nigerians nor did it have significant effects on purchasing power. The high rates of inflation in the country are no doubt traceable to fiscal deficits and unstable exchange rate of the naira, a trend which has negatively affected the efficiency of the financial markets in the Nigerian economy (Ariyo, 1998).

TABLE 1: SOME SELECTED MACRO-ECONOMIC INDICATORS

Variables	1995	1996	1997*
Real GDP (Growth Rate %)	2.2	3.25	3.77
Gross Domestic Savings As a proportion of GDP (%)	10.7	11.6	10.6
Gross Domestic Consumption Expenditure As a Proportion of GDP (%)	89.3	88.0	87.2
Manufacturing Capacity Utilisation (%)	29.3	32.5	33.0
Inflation Rate (%)	72.8	29.3	8.3
Net Domestic Credit (Growth Rate %)	12.4	5.0	-3.2
Credit To Private Sector	51.8	21.9	-55.2
Narrow Money (M1)	8.1	26.3	14.4
Broad Money (M2)	10.3	25.7	17.7
Current Account Balance (In Per Cent of GDP)	-5.6	2.8	-0.8
Overall Balance (In Per cent of GDP)	-3.1	-.07	-0.9
External Reserve (US\$Million)	1,441.0	4,074.7	7,700
External Debt Stock (In Per Cent of GDP)	32.64	28.0	27.04
GDP Per Capital (N)	1,073.6	1,090.7	1,081.3

Provisional

Source: NDIC 1997 Annual Report P, 1

We observe from Table 1 that the Gross Domestic Savings as a proportion of GDP (%) was 10.7 percent in 1995 (NDIC Annual Report, 1997). It then declined from 11.6 percent in 1996 to 10.6 per cent in 1997. This is a downward trend that is not associated with the dynamism observed in developing countries that are rapidly accumulating capital and in which saving ratios are of the magnitude of 20 and 30 per cent of GDP, (Fakiyesi, 1998, Nigeria saves only between 10 and 12 per cent of its GDP on the average). What is more worrisome is the fact that only about half of this low-level of savings is actually converted into investment. Development economists have argued that for development to take place, a country must save at least 27 per cent of her income and invest that much (Thirlwall, 1983). Fakiyesi (1998) provides evidence that between 1986 and 1989) (ie after the introduction of Structural Adjustment Programme), savings were consistently greater than investment. The trend which shows that, the country has been generating substantial savings – investment gap, even with very low levels of savings. The declining trend of savings/investment according to Goldsmith (1969) is a characteristic of an early state of economic development. Unlike the previous years, Net Credit to Government was 8.6 per cent in 1995. It is seen from Table 1 that the Credit to the government sector grew from 8.6 per cent in 1995 to 10.1 per cent in 1996. It then declined to about 55.0 per cent in 1997 which could be explained by the repayment of government of its long overdue debts to the banking sector and the enforcement of fiscal discipline by the government, among other factors. On the other hand, credit to the private sector improved tremendously. It grew from 21.9 per cent in 1996 to 37.9 per cent in 1997. The use of interest rates (lending, savings and rediscount rates) as a macroeconomic policy tool was not accorded the desired prominence until the commencement of SAP in 1986. Prior to this year, interest rates were administratively determined and kept low, probably below its equilibrium level Basari, (1996), with occasional adjustments as at when deemed fit by the relevant monetary authority. Such financial repression could not generate adequate domestic savings and investment required for financing the targets contained in the various National Development Plans. Hence, a deregulation of interest rates was considered necessary for the realization of the objectives of SAP Table 2 shows the level and structure of selected rates between 1980 and 1995. It is observed from the table that the interest rate rose steadily between 1987 and 1990, fell in 1991, rose again between 1992 and 1993 falling thereafter in 1994 and 1995. These movements clearly reflected government policy stance. The deregulation embarked upon in 1987 could not be pursued in a consistent manner, as the CBN found itself having to re-control the rates on several occasions. It became evident that the management of interest rates was marked by sharp and unanticipated policy reversals with serious distortionary impacts on the financial and real sectors. For instance, though the deregulation of interest rates was reported to have enhanced competition and efficiency in resource allocation among

Macro-Economic Indicators: The Evaluation of the Performances of the Financial Systems in Promoting the Development of the Nigerian Economy

financial institutions (Busari, 1996), it nevertheless did it at a high cost. Financial institutions had to offer higher saving rates to attract deposits and at the same time raised lending rates in order to maintain or improve their profit margin. This rise in interest rates attracted savings, but in a manner detrimental to capital formation and accumulation, thereby negatively affecting real growth.

SUMMARY AND CONCLUDING REMARKS

The history and process of industrialization in practically all the industrial Countries of the world confirm that there is a direct link between economic Development and the existence of an efficient and highly developed financial system. In Nigeria however, the relevance and adequacy of the financial system has been called to question, in that, over the years it has manifested inadequate structures for serving the development needs of the country. In this paper, we have therefore, been keen to examine the relevance and contribution of the financial system to structural economic transformation in Nigeria. We have presented some theoretical insight that captures the two-way nature of the relationship between the financial system and economic development. We have also analyzed major macro-economic indicators to evaluate the performance of the financial system. Against its role in contributing to structural economic transformation in Nigeria. Our findings suggest that the high and volatile rates of inflation under which the financial system operates have hampered the effective performance of the financial system over the years. The analysis shows that the average savings/ GDP ratio was 11 per cent, which could have been higher particularly when compared with developing countries that are rapidly accumulating capital. The findings have shown credit to the government sector has declined while credit to the private sector has improved significantly. In terms of interest rates, deregulation ushered in high interest rates which attracted saving but in a manner detrimental to capital formation and accumulation, thereby negatively affecting real growth. Our preliminary conclusion in this study is that the Nigeria financial System has probably been constrained by unstable and harsh economic and socio-political environment as well as some unfavorable policies. Eke (2000) has pointed out that for the Nigerian financial system to contribute meaningfully to the task of economic growth and development in the country, the following issues must be addressed:

- (i) developing a conducive macro-economic policy environment
- (ii) designing and implementing appropriate macro-economic policies
- (iii) articulating creative strategies for bringing about debt reduction;
- (iv) undertaking deregulatory measure affecting domestic financial market that would enhance efficiency liquidity and cost effectiveness so as to make market more attractive to foreign and investors; and
- (v) Putting in place in basic infrastructure such as availability of effective telecommunication networks and roads that would foster accurate, reliable and timely information to be disseminated to market participants.

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