Review of Reforming Financial Systems: A Focus on Nigerian Economic Development

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Abstract:
Unique besides utmost thought-provoking debates of modern history is whether financial development affects economic growth or a consequence of economic activity. There are for-going reforms in the sector in Nigeria, therefore the expediency of a look in the need for reforms in Nigeria. A fact as to know how reforms are curbing the traditional handicaps of the financial sector is thus minimized in Nigeria. Modalities put in place to enhance banks’ corporate governance and internal systems suggests that the predictions for the financial sector to accomplish cost-effectively and pragmatically, whereas decreasing volatility in the system. The study takes on an analytical appraisal methodology for its exploration. The study consequently, proposes that the existing transformations remain appraised besides unrelenting in a methodical routine, for suitable focusing of funds for speculation as well as dynamic resolutions. Exertions ought to be concerted on the relationships of the region with tutoring financial statement then wherever monetary improvement seems too pathetic. Moreover, innovation of the financial sector regarding mechanisms had better be the crucial focus for the ruling classes. A counter-factual criticism instrument has a duty to also be incorporated in the financial sector aimed at correcting the financial prolific province.

Keywords: Financial Liberalization, Financial Policy, Reforming, Economic Development, Stock Market.

Introduction
Financial sector reforms started in Nigeria in conjunction with the deregulation of interest rates in August 1987. Subsequently, comprehensive policy measures as well as the leasing of new banks, restructuring of the money market and a change from intended to unintended monetary controls have remained accepted. The outcomes from the implementation of the restructuring have remained unsatisfactory, however. Bank liquidation, high inflation besides extremely high interest rates have developed conjoint sensations in the economy. For more than two decades after independence, the Nigerian financial system was suppressed, as demonstrated by ceilings on interest rates and credit expansion,
selective credit policies, high reserve requirements, and restriction on entry into the banking industry. This situation inhibited the functioning of the financial system and especially constrained its ability to mobilize savings and facilitate productive investment. In 1987, the authorities commenced an extensive reform of the financial system as part of a structural adjustment programme (SAP). (Refer to Table 1 for a summary of Nigeria's declining macroeconomic indicators.) Reforms involved liberalizing interest and exchange rates, promoting a market-based system of credit allocation, enhancing competition and efficiency in the financial system, and strengthening the regulatory and supervisory framework.

A financial sector plays a transformational and catalytic role in fostering socio-economic growth and development. In other words, a well-functioning financial sector, strengthened by sound financial sector policies, legislations and regulations, is a sine qua non for promoting financial market access for all, and also achieving inclusiveness as one of the top priorities of African governments, within its increasingly dynamic socio-economic and political landscape, which is characterized by jobless growth. However, across and within developed, emerging and developing countries, there are significant disparities in the development of the financial sector. More specifically, empirical evidence from several African countries indicates that the financial industry in Africa is substantially less developed when compared to those in the developed world 11. In the developed countries' financial industry, financial information is symmetric, and allocated efficiency is continually being targeted in order to facilitate risk management, and also offer to savers and investors alternative options for diversifying their investment portfolios. Due to the fact that Nigeria’s financial institutions and structures are weak, Nigeria continues to struggle with how to make its financial sector more efficient and responsive to the needs of the real sector – agriculture, manufacturing and services, et cetera.

Against the background of the number of financial sector reforms that have been implemented in most African countries in the past four decades, there have been increasing successes in the liberalization of money markets, restructuring of existing banks, enhanced recognition of informal finance, introduction of measures to encourage development of capital markets and private banking systems; and the liberalization of interest rates and prices. This is important given that lack of adequate access to financial services is often a critical element underlying persistent income inequality, as well as slower economic growth (Beck, Demirgüç-Kunt, and Levine (2007), Beck, Levine, and Loayza (2000), Demirgüç-Kunt and Levine (2009), Klapper, Laeven, and Rajan (2006) and World Bank (2012)). For instance, more than 1.5 billion women worldwide remain largely outside the formal financial systems (Demirgüç-Kunt and Klapper 2012).

The implementation of financial reforms in Nigeria has raised academic interest in two related areas:

- The proper timing of financial reforms within the overall adjustment programme.
- The appropriate sequencing of financial reform policies.

These subjects are now of specific distress for the operation of financial restructurings have been complemented by adjustable rates of inflation and an upsurge in the volume of problem banks. There are worries that these undesirable phenomena may have arisen from the improper timing and wrong sequencing of the Nigerian reform policies. This study thus focuses on the timing and sequencing of the reforms. Even though a proportion of research has dwelt on the impact of general economic reform on specific sectors of the Nigerian economy, surprisingly, not much has been done to examine the timing and sequencing of reforms.
Problems of Development and Expansion of the Stock Market

Over the past four decades there has been a gradual worldwide shift, though specific countries may vary, in financial systems from government ownership towards private ownership of financial services (Mody and Abiad 2003). The three main factors Mody & Abiad identified in current literature that influence financial reforms include ‘shock’ events (for example, economic crisis or shifts in global finance), ‘learning’ or gaining knowledge that leads to reconsideration of policy, and a country’s current government’s ideology (Ahmed and Suardi 2009; Mody and Abiad 2003). Even when those three factors are taken into account, reforms are more likely to be implemented when there is moderate liberalization (Mody and Abiad 2003). However, once a reform is implemented, its reversal is rare (Mody and Abiad 2003).

In the past thirty years, many countries in Sub-Saharan Africa liberalized their financial sectors as part of structural adjustment to become more economically developed (Misati and Nyamongo 2012). But even after increased liberalization, financial systems in Africa are still among the least developed in the world (Allen, Otchere, and Senbet 2011). In Africa, there is limited access to savings accounts, restrictions on credit access, and high interest rates compared to the rest of the world (Gulde et al. 2006). In many regions, cash is still the primarily form of financial transaction (Guide and Pattillo 2006; Gulde et al. 2006). Poor financial systems, such as the ones just described, can inhibit growth and prevent poverty eradication (Gulde et al. 2006). On the whole, Africa is the least economically developed continent in the world (Allen, Otchere, and Senbet 2011). However, there is great variation within the continent with, for example, oil producing countries having relatively high GDPs (Allen, Otchere, and Senbet 2011; Guide and Pattillo 2006; Gulde et al. 2006).

Banks play a large role in many African countries’ financial systems. Banks in Africa are not as efficient as they are in other areas of the world and have relatively high operating costs (Gulde et al. 2006). One of the main problems with banks is that even after increased liberalization, they still prefer to loan to large, familiar, low-risk clients (Kabango and Paloni 2011). So, large, established businesses are more likely to obtain credit and benefit from financial liberalization than smallholders (Domheher and Abdulai 2012; Kabango and Paloni 2011).

Poor household credit access is another issue in African financial systems, that can result in limited technology usage and lower productivity (Allen, Otchere, and Senbet 2011; Domheher and Abdulai 2012). When poor households have access to credit, they are able to participate in the economy, obtain an education, and protect themselves from economic shocks (Gulde et al. 2006). However, barriers to credit access exist - these include poor property rights and securing collateral (Gulde et al. 2006). Borrowers may also find barriers such as physical bank access and bank costs, for example minimum required deposits (Gulde et al. 2006).

Personal characteristics can also influence the likelihood of obtaining a loan. For instance, younger and older age groups were more credit constrained than middle age groups (Papias and Ganesan 2010). Educated households were more likely to access credit (Papias and Ganesan 2010). Marital status is theorized to show stability and trustworthiness; therefore married individuals are more likely to be accepted for a loan (Papias and Ganesan 2010). The further households are physically away from financial institutions, the less likely they will be able to access credit (Papias and Ganesan 2010).

Physical distance to financial institutions may be a problem for many small-scale farmers since; there is a lack of rural banking resources (Papias and Ganesan 2010). For example, a study in Rwanda showed that agriculture is over 40% of GDP, yet less than 5% of credit available goes towards agriculture (Papias and Ganesan 2010). The overall share of loans to the agricultural sector has dropped (Gulde et al. 2006). The individuals who do borrow in rural areas have relatively high incomes, whereas lower income individuals access credit informally from
markets that do not involve institutions (Papias and Ganesan 2010). The political economy of smallholder agriculture is important to understand because a vast majority of poor people are small scale farmers (Birner and Resnick 2010).

An increasingly popular and successful method of credit access for smallholders is microfinance. Although high growth is occurring in the microfinance sector, it however remains significantly smaller than banking institutions, with only an average of 2.5% of the population partaking in this type of financial service (Gulde et al. 2006). Microfinance involves short period, small loans that are targeted towards poor individuals who cannot usually access credit or other financial services (Allen, Otchere, and Senbet 2011; Gulde et al. 2006; Hartarska and Nadolyanyak 2007; Idolor 2012). The borrower then pays back the loan in small sums (Arun 2005). Even though some microfinance institutions (MFI) can struggle from low profits (Gulde et al. 2006), MFIs typically have high transaction costs and interest rates for administration and potential risk (Hardy, Holden, and Prokopenko 2003). Since MFIs tend to have high operation costs they tend to be located in urban areas, making rural access difficult (Allen, Otchere, and Senbet 2011; Gulde et al. 2006). They are operated by various organizations, such as NGOs or governments (Allen, Otchere, and Senbet 2011), and offer financial services such as savings accounts, credit, and development projects (Gulde et al. 2006). Aside from finance, MFIs can also offer other beneficial services to clients, such as training (Hardy, Holden, and Prokopenko 2003). This type of financial service attempts to fill gaps left by other financial institutions (Hardy, Holden, and Prokopenko 2003). The clients may have previously faced barriers when trying to access a loan elsewhere, such as collateral or personal finance (Hardy, Holden, and Prokopenko 2003). Through encouraging economic participation, MFIs can help contribute to GDP growth (Allen, Otchere, and Senbet 2011).

Microfinance could be beneficial to smallholder farmers who often lack collateral and have difficulties finding financial services elsewhere (Domeher and Abdulai 2012; Jama and Pizarro 2008). Collateral gives the borrower an incentive not to default and acts to compensate for potential weak financial characteristics (Domeher and Abdulai 2012). For banks, conflict over property titles/deeds is expensive and time consuming, so land registration means the borrower can easily use their land as collateral (Domeher and Abdulai 2012).

Other alternatives to collateral include group/cooperative loans where the group is held responsible for each individual’s loan, creating social pressure to pay back the sum borrowed (Hardy, Holden, and Prokopenko 2003; Idolor 2012; Jama and Pizarro 2008). Income or a third-party co-sign are other options, but asymmetry may make this method of obtaining a loan more difficult (Domeher and Abdulai 2012). Credit rationing is a result of asymmetry (Papias and Ganesan 2010). Since there is a lack of credit records in many developing countries, information asymmetry deepens (Domeher and Abdulai 2012).

Overall, access to financial services is important, especially for smallholders. Access to finance can be used to fight poverty by helping low income households control their own future and allow them to contribute to the economy (Idolor 2012). For example, farmers can use credit to purchase tools and supplies to increase productivity (Allen, Otchere, and Senbet 2011). Smallholder access to credit has the potential to reduce poverty (Jama and Pizarro 2008). To help create an accessible financial system the government needs to encourage financial institutions in rural regions, build up infrastructure to narrow the distance between rural households and their financial institutions, and to build capacity among staff of institutions as well as borrowing households (Papias and Ganesan 2010).

However, certain regulations probably do have the effect of retarding the development and expansion of the stock market. Prime example are the capital repatriation legislation strongly limiting the amount of profit foreign investors can take out of a country, existence of restrictions on investing directly, restriction on
foreign broker participation, entry restrictions on investments banking and brokering that not rational or that encourage rent seeking, and the failure to ensure that regulations are transparent and evenly applied. Changing such regulations has potential costs as well benefits and should be undertaken carefully. There are other significant problems with relying too strongly on stock markets as a development strategy.

First, stock markets lead to substantial foreign investor influence over domestic company operations. In developing country, a large percentage of shares of listed companies are usually foreign-owned. Second, stock markets can lead to short term speculation that can dominate trading and distort the decision making of managers, often inducing a short time horizon. Third, relatedly, hot money that flows in and out of a country to speculate in markets can produce wide currency swings and destabilize the economy. Many questions remain regarding the role of financial intermediation in general, and stock markets in particular, in economic development. This is sure to be an active area of policy discussion in the years ahead, (Smith, 2005).

**Literature Review**

It took the seminal works of McKinnon (1973) and Shaw (1973) to highlight the adverse effects of “financial suppression” on economic development. Financial suppression refers to the distortion of domestic financial markets through measures such as ceilings on interest rates and credit expansion, selective allocation of credit, and high reserve requirements. McKinnon and Shaw pointed out that such misguided policies have damaged the economies of many developing countries by reducing savings and encouraging investment in inefficient and unproductive activities. The standard recommendation is then that positive real interest rates be established on deposits and loans by eliminating interest rate and credit ceilings, stopping selective credit allocation, and lowering reserve requirements. The true scarcity price of capital could then be “seen” by savers and investors, leading to improved allocated efficiency and faster output growth. These recommendations have been implemented in several developing countries but with mixed results. While some studies have reported that certain countries experienced higher savings and investment following liberalization (see Fry, 1978; de Melo, 1986; Kharkhate, 1988), others have chronicled disasters in other economies that undertook financial liberalization (Diaz-Alejandro, 1985; Corbo and de Melo, 1985; Barandiaran, 1987; Atiyas, 1989; Larrain, 1989). Countries in the latter category experienced considerable macroeconomic instability, massive capital outflows and widespread bank failures following financial liberalization.

Dornbusch and Reynoso (1993) also underscored the importance of attaining macroeconomic stability prior to financial liberalization. They noted that high and unstable inflation often increases the demand for financial liberalization, but this might trigger further increases in inflation especially if fiscal deficits are large and the exchange rate is deprecating rapidly. As the government finances its deficits through money creation, the higher interest rates resulting from financial liberalization would reduce government revenue from money creation; with a given budget, this induces further increases in inflation. The recommendation is therefore that fiscal deficits be substantially reduced and the exchange rate stabilized before financial liberalization is embarked upon. Thus, Dornbusch and Reynoso (1993: 85) conclude that for Latin America, after a decade of financial instability, The path that will return the region to rapid long-run growth is awesomely orthodox: realistic exchange rates, balanced budgets, and a favourable investment climate.

Thus they emphasize a return to orthodoxy—stabilization policies as a prerequisite for successful financial reform policies. The issue of sequencing stabilization policies vis-a-vis structural adjustment policies has received a lot of attention in recent times. Smith and Spooner (1992) identified a number of reasons why stabilization measures are expected to precede supply-side measures in adjustment programmes. First, it is argued that the results of
supply-side measures take time to be realized. Without demand restraints, the initial increase in balance of payments deficit that accompanies demand-side measures may become explosive and uncontainable, especially where there is a constraint on external inflows. Second, stabilization measures are required to bring about a substantial improvement of the balance of payments. This is made possible by a drastic depreciation of the exchange rate to promote exports in order to provide funds for the importation of essential imports. In order to sustain the exchange rate adjustment, appropriate monetary, financial and income policies have to be put in place as a prerequisite to the expansionary supply-side policies. Third, to enhance the growth of savings and hence investment, it is necessary to control inflation. The initial impact of devaluation and restrictive monetary policies is in most cases an increase in the level of prices (Crockett, 1981; Porter and Ranney, 1982). More often than not, when these policies are combined with huge fiscal deficits, which are inevitably financed by borrowing from the central banks, the result is quite destabilizing. Chapple (1990) dwelt on the timing of financial liberalization within an overall adjustment programme. He outlined an economic liberalization framework with the following sequence:

1. Reduce fiscal deficits
2. Liberalize the financial system
3. Liberalize the trade account
4. Liberalize the capital account

According to Chapple, financial liberalization can only be successful if implemented after monetary stability has been attained. In developing countries, fiscal deficits constitute the major source of monetary expansion. Hence, particular attention should be paid to achieving a significant reduction in the size of the public sector deficit prior to the introduction of a financial liberalization programme. Chapple further argued that unless this is done, liberalizing interest rates in an unstable macroeconomic environment would lead to explosive increases in both deposit and loan rates. It is only after monetary stability has been achieved and financial reforms are well under way that the trade and capital accounts can be liberalized, in that order. Financial reforms and banking crises Attempts to link banking crises to financial sector reforms have met with a number of controversies. It is quite easy to enumerate reform measures and instances of crises in the system, but a lot of caution is required here in establishing causality.

Financial Liberalization, Real Interest Rates, Savings, and Investment

The restraint of credits to a few large borrowers, together with the widespread of the existence of high inflation, growing budget deficits, and negative real interest rates, led to a serious credit crunch among developing countries during the 1980s. The global recessions of 1981-1982 and 1987 exposed the frailty of many development bank loans so that by the end of decade, almost half of these banks were reporting more than 50% or more of their loans in arrears and other quarter had delinquency rates in excess of 25%. With real interest rates on the savings deposits in the negative and expectations of continued inflation and exchange rates devaluation contributing to substantial capital flight, is not surprising that few individuals were willing to save, (Michael & Stephen, 2011).

In addition, commercial banks and other financial intermediaries were subject to numerous lending restrictions and faced mandatory interest-rate ceilings on loanable funds at levels well below market clearing rates. These artificial interest rate ceilings were often set by government seeking to finance their budget deficits through the sale of low-interest bonds to private commercial banks. These banks in turn had to resort to rationing the available credit beyond the normal credit rationing observed in developed economies as a response to adverse selection (Michael & Stephen, 2011).
Loanable Funds

Figure 1 shows the impact of binding nominal interest rate ceiling at below the market-clearing levels. With the interest rate ceiling at $r_-$, which is below the market clearing equilibrium rate $r_E$, the demand for loanable funds, $L_2$, greatly exceeds the available supply, $L_1$. This excess demand leads to a need to ration the limited supply – a phenomenon known as financial repression because investment is limited or repressed by shortage of savings, which in turn results from administered real interest rates below what would occur in a market setting. In the absence of outright corruption in the allocation of $L_1$ loanable funds, most commercial banks choose to allocate the available credit to a few large borrowers so as to minimize the administrative overhead costs as a proportion of the total costs of lending. Thus the net effect of government controls over lending rates is that even fewer loans will be allocated to small investors. Banks can cover additional administrative costs and the added risks of smaller loans only by charging higher interest rates. Hence small farmers and urban entrepreneurs have no recourse but to seek finance from the unorganized money market, where as we see from the diagram, they are willing to pay above-money market-clearing rates of $r_U$ (Michael & Stephen, 2011).

One of the suggested solutions to the problem is to liberalize the financial sector by allowing nominal interest rates to rise to market clearing levels. This would cause real interest rates to rise to positive levels and thus remove the explicit interest rates subsidy accorded to preferred borrowers (rent seekers) who are powerful enough to gain access to the rationed credit. Higher real rates should also generate more domestic saving and investment and permit some borrowers to shift from the unorganized to the organized credit market. The World Bank cites evidence from countries such as Thailand, Turkey, and Kenya, where the liberalization of interest rates generated more savings and investment. However, evidence of the effect of financial reform in Chile during the 1970s revealed many shortcomings of the process. These included the acquisition of numerous banks by large conglomerates, or grupos, who used their new financial resources to buy recently privatized firms or expand their own companies. When many of their firms faced financial losses, these grupos had to resort to additional funding to avoid bankruptcy. This made the Chilean financial system particularly vulnerable when the debt crisis struck in the 1980s, (Morduch, 2000).

Reform and liberalization of the systematized money sector is therefore no solution for the financial systems of developing nations. The early success of South Korea and Taiwan (and before them, Japan) with financial systems that exhibited many of the attributes of repression demonstrates that judicious and selective government intervention can be a stimulus to industrial development. Although there is evidence that the abolition of substantial interest rate distortions can promote greater saving and more rapid economic growth, financial reforms must always be accompanied by other more direct measures to make sure that more farmers and investors have access to needed credit. Furthermore, careful supervision of the banking and financial sectors is needed to prevent undue concentration by local elites. As already pointed out, getting prices right is only one step, albeit an important one, in making development serve the
needs of the forgotten majority, (Morduch, 1999).

**Financial Policy and the Role of Market**

In an effort to identify how these governments can work effectively within the context of liberalized financial markets, the 2001 Nobel Laureate Joseph Stieglitz and his coauthors isolated seven major market failures that imply a potential role for state intervention. His basic argument is that financial markets are distinctly different from other markets; that market failures are likely to be more pervasive in these markets and that much of the rational for liberalizing financial market is based neither on a sound economic understanding of how these markets work nor on the potential scope for government intervention. These seven market failures Stieglitz and colleagues identified and that are likely to be of particular relevance to developing countries are the following:

**The unrestricted respectable environment of checking financial institutions:** investors need information about the solvency and management of financial institutions. Like other forms of information, checking is an unrestricted good – everyone who places savings in a certain financial institution would benefit from knowing that the institution was prospering or close to insolvency. But like other unrestricted goods in free-market economies, there is an undersupply of information, and consequently, risk-averse savers withhold their funds. The net result is fewer resources allocated through these institutions.

**Externalities of monitoring, collection and lending:** benefits are often incurred by lenders who learn about the viability of potential projects from the monitoring, collection and lending decision of other lenders. Investors can also benefit from information generated by other investors on the quality of different financial institutions. Like other positive (or negative) externalities, the market provides too little evidence, and resources are under-allocated or over-allocated.

**Externalities of market interference:** in the absence of government insurance (whether or not explicit policy has been issued), the failure of one major financial institution can cause a run on the entire banking system and lead to long term disruptions of the overall financial systems.

**Omitted and inadequate market:** in most developing countries, market for insurance against a variety of financial (bank failure) or physical (e.g. crop failure) hazards are omitted. The basic problem is that information is inadequate and expensive to attain, so a developing-country government has an imperative role in reducing these hazards. It can, for example, force membership in insurance programs or require financial institutions as well as borrowers to disclose information about their assets, responsibilities and credit worthiness.

**Inadequate antagonism:** antagonism in the financial sector of most developing countries is extremely limited, meaning that prospective debtors unusually face only a small number of suppliers of loanable funds, many of which are reluctant or incapable to lodge new and unfamiliar customers. This is particularly through of small borrowers in the informal urban and rural sectors.

**Inefficiency of competitive markets in the financial sector:** theoretically, for perfectly competitively markets to function efficiently, financial market must be complete (without uninsured risks) and information must be exogenous (freely available to all and not influenced by any one participants’ action in the market). Clearly, there are special advantages to individuals or entities with privileged information in financial markets in developing countries and risk insurance is difficult, if not impossible, to obtain. As a result, unfettered financial markets may not allocate capital to its most profitable uses, and there can be substantial deviations between social and private returns to alternative investment projects. In such cases, direct government intervention-for example, by restricting certain kinds of loans and encouraging others-may partly or completely offset these imbalances.
Uneducated financiers: contrary to the doctrine of consumer sovereignty, with its assumption of perfect knowledge, many financiers in developing countries lack both the facts and applicable means to acquire it in developing order to make rational investment decisions. Here again, governments can impose financial disclosure requirements on firms listed on the differences between simple and compound interest rates or of the nature of penalties for early withdrawals of savings.

In each of these seven instances, Stiglitz and his coauthors maintain, government have a suitable role to play in regulating financial institutions, creating new institutions to fill gaps in the kinds of credit provided by private institutions (e.g., micro loans to small farmers and tradespeople), providing consumer protection, bank solvency, encouraging fair competition, and ultimately improving the financial resources and promoting the financial economic stability. As in other areas of economic development, critical issue for financial policy is not about free market versus government intervention but rather about how both an work together (along with the NGO sector) to meet the urgent need of poor people (Smith, 2005).

Financial Sector Reforms

A peculiar feature of the reform program in Nigeria is the associated inconsistency in policy implementation. The financial sector in Nigeria is dominated by the banking sector, especially the commercial banking. The deposit money banks (DMBs’) accounts for 93.0 per cent of non-central assets in 2000 (World Bank, 2000) and 94.0 and 95.2 per cent of the aggregate financial savings in 2002 and 2003, respectively as well as above 60.0 per cent of the stock market capitalization (Note 4). Commercial banking started in 1892 with the establishment of the first banking firm, Standard Bank of Nigeria Ltd (now First Bank). Since then, the number of commercial banks has exploded. Thus, an understanding of the structural changes in the financial sector as a whole is of great importance to all stakeholders; as it would help in designing appropriate legislation to enhance competition.

The Nigerian banking system has undergone remarkable changes over the years, in terms of the number of institutions, ownership structure, as well as depth and breadth of operations. These changes have been influenced largely by challenges posed by deregulation of the financial sector, globalization of operations, technological innovations and adoption of supervisory and prudential requirements that conform to international standards.

Impact on the Nigerian Economy

The main impact of the crisis on the Nigerian economy was the collapse of commodity prices, especially the fall in oil revenue, reducing the government ability to carry out some of its financial obligations. Also, the declining capital inflow in the economy vis-à-vis de-accumulation of foreign reserves and attendant pressure on Nigerian exchange rate was another impact. There has been also limited foreign trade finance by banks due to low liquidity and dry-up of credit line. Foreign investors fled Nigerian capital market in droves, causing huge downturn in the capital market. This divestiture brought about tightness and possible second round effects on the balance sheet of banks by increasing provision for bad debt and decrease in profitability. A presidential Steering Committee on Global Economic Crisis was set up in January 16, 2009 to look into the crisis and proffer how the country will ameliorate the unpleasant effect on the Nigerian populace. The government previously set up a Presidential Advisory Team on capital market in August, 2008 to deliberate on measures to reverse the declining fortunes of the Nigerian Capital Market. The Security and Exchange Commission (NSC) and other capital market stakeholders reduced their fees by 50.0 per cent. NSC also reviewed trading rules and regulations. 1.0 per cent maximum downward limit on daily price movement and 5.0 per cent on upward movement, and this has been harmonized to 5.0 per cent either way from end-October 2008. On the other hand, the CBN complimented the efforts of NSC by reducing the Monetary Policy Rate (MPR) from 10.25 per cent to 9.25 percent; the Bank also reduced Cash
Reserve Requirement (CRR) from 4.0 per cent to 2.0 per cent, reduction of liquidity ration from 40.0 per cent to 30.0 per cent. Banks were also directed to restructure their margin loan up to 2009. Lending facilities to banks by the CBN were expanded up to 360 days. Expanded Discount Widow (EDW) facility was also introduced and liquidity mopping-up since September 2008.

However, the Bank has discontinued with the EDW operations, and guaranteed all the loans within the inter-transactions at the money market.

Some Findings of the Debate on the Role of Stock Market

Recent years have witnessed enormous growth in developing countries’ stock markets. This has had costs as well as benefits for development. It has increased volatility in the economy as funds has flowed in from abroad and even more dramatically flooded out. In this section, we take a look at stock markets in developing countries and consider some proposed policies to get the most benefits from these markets. We also consider some of the limitations of depending too heavily on stock markets as an engine of growth (Pitt, 2002).

Some studies have suggested that stock market development can play a highly constructive role in encouraging growth. These studies show that greater past stock market development (measures by either past capitalization or turnover in relation to GDP) predict faster subsequent economic growth, even after other variables known to influence growth, such as the rate of investment and education, are accounted for. Even more striking, both banking and stock market development were found to have independent positive effects on growth, suggesting that each plays a somewhat different role in the economy.

A correlation between stock market development and growth would be expected by many theories, including the view that finance follows industry. Therefore, industrial growth and stock market growth would occur together, but in that case, stock market growth would merely reflect the growth of the real sector. The fact that there is a faster growth after greater stock market development has already been realized is suggestive of causality but is not conclusive. This is because past financial depth is correlated with future depth: Countries that had well developed stock in the past usually do in the future as. So the correlation between growth and past depth could really be driven by a third factor, such as the protection of private property and the rule of law. However, the results suggest that stock markets have a role to play. Moreover, we can expect that stock markets promote the more general availability of liquidity and that risk diversification services, may serve to motivate entrepreneurs who may later go public, and provide incentives for managerial performance that makes it easier for firms to raise capital in any form (Ghatak & Timothy, 1995).

Issues, Challenges and Prospects

The Nigerian financial system is vulnerable to a number of risks, and there are serious concerns about the soundness and stability of the banking system. The Nigerian anti-money-laundering (AML) legal framework and enforcement is also considered inadequate, making the system vulnerable to financial abuse. Inefficiencies, such as delays and backlogs, in administration of justice by courts are also major impediments to the smooth functioning of the financial system.

On the part of banks, the challenges are enormous. We recognize that banks and their owners are primarily in business to make profit, and we are conscious of the need not to jeopardize this key driving motivation for innovation and entrepreneurship. However, we all know that banking system occupies a unique position in every economy and that is why it often attracts more than a casual regulatory attention. Our industry in the 21st century must have a moral face and live up to some modicum of social responsibility. Capitalism must have a social face and a human soul to be sustainable. This is the lesson of world history. It is in this context that we view with serious concern the
spate of frauds, ethical misconduct, falsification of returns by the banks to the Central Bank, unprofessional use of female staff in some banks in the name of ‘marketing’ and ‘sourcing of funds’, etc. Collectively, we can stop these misconducts and give the system a new face.

One of the most central economic policy challenges is to strike a balance between stability and reform in the financial sector. Clearly, there is no single "right" place on this continuum. Ultimately, the issue is about balancing the economic, financial, and social costs in the short term to medium term with potential gains in the long term. Allowing problems in the financial sector to fester may preserve stability in the short run, but could lead to pronounced distress and higher costs later on. At a minimum, sufficient progress has to be made to avoid deepening existing vulnerabilities, while building the capacity to manage financial distress when and if it occurs in the future.

Secondly, a key challenge will be to develop a credit culture. With the stock of non-performing loans already high, it is crucial to avoid a further build-up. This goal is interdependent with developing a credit culture and with improvements in corporate governance and sustaining economic growth. Fostering a credit culture and better governance, in turn, hinge on a reliable legal framework, supportive of private sector activity.

Thirdly, a closely related task is to resolve the stock of distressed debt in the economy. In essence, distressed debt is the counterpart to a portion of the capital stock and enterprises that need to be restructured or written off and closed. Once these restructurings and write-offs take place, resources - currently locked up would be freed up to finance new investment and consumption opportunities.

Fourthly, in the longer term, the financial sector needs to adapt to a new economic environment. The Nigerian economy is becoming increasingly market-oriented and opening up to foreign competition amongst others. The financial sector in particular may have to compete for creditworthy borrowers and skilled banking personnel. As flexibility is introduced into the exchange and interest rates over time, financial institutions would have to become adept at pricing credit risks and managing market risks.

Fifthly, another long term challenge is to deepen capital markets in order to diversify the sources of investment financing. Greater equity financing can help transform the ownership structure of the economy, attract strategic investors capable of restructuring their firms, and bolster market discipline. As with bank lending, the efficiency of equity financing would be a function of the quality of investment decisions made by investors and their ability to monitor and manage firms under their ownership through effective accounting, disclosure, and governance standards. Capital markets would also provide opportunities for risk diversification by investors, whose savings are still primarily invested in low-yielding bank deposits or in shares on the relatively undeveloped stock market.

Conclusion and Recommendations

It makes no sense to actively develop stock markets unless certain prerequisites are met: First, one needs macro-stability; investors will not invest in equity without it. Second, policy credibility is needed. How will policy makers keep the economy stabilized and how will they react in a financial crisis to prevent a meltdown? And third, one needs a domestic-firm base, there is no point in opening a stock market if there are few firms in which outside investors would wish to take an equity stake.

Given that these prerequisites are in place, it is reasonable to wonder why a country would need to promote stock markets; wouldn’t these markets develop as a result of market forces? One rational for a public policy promoting the development of stock market could be to balance the effective tilt toward debt finance implicit in policy to date (for example, public deposit insurance, while clearly necessary functions like an interest subsidy which tilts the playing field away from equity market). Although evidence of spillovers or other special benefits for the promotion of stock market development
is probably not enough to make a case for public subsidies to create and expand stock markets, in many countries’ policy-makers may conclude that the evidence is compelling enough to eliminate bias, explicit or implicit, that has operated against the stock market in the past (Ghatak & Timothy, 1995).

Furthermore, the first type of stock market development policy could be termed barrier removal. Rather than promoting stock market directly, let alone subsidizing their development, this strategy would remove other impediments, generating stock market development on its own. In practice, this usually entails certain forms of deregulation. Carefulness should be observed here because, as perceived previously, many regulations were put in place not necessarily because there was government failure but because of genuine market failure in the monetary sector. If some regulations responding to market failure are removed, others may have to be established in their place.

The study cautiously identifies a wrong sequencing process as a major factor in the poor performance of the financial sector reforms, but agrees that a lot more research needs to be done in this area.

References


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