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BANKING SECTOR REFORMS AND ECONOMIC GROWTH; EVIDENCE FROM NIGERIA

Adesanya Bayo, Obademi O. E

Department of Finance, University of Lagos, Nigeria

ABSTRACT

The study examines the effect of banking reforms on the economic growth of Nigeria from 1994 to 2014 using the ordinary least square method with an observation that the banking sector developments that were experienced in Nigeria`s economy at one point or the other had effect on the activities of the economy. However, this does not imply that the reforms in the banking sector are solely responsible for the sector being better off. In this study, an improvement in financial intermediation, monetary policy intervention, and consistent regulations was considered a necessary condition for stimulating investment, raising productive capacity and fostering economic growth. It is therefore recommended that there should be macroeconomic stability, as the activities in all other sectors affect this or is affected by it. Also there should be political and policy stability as this also affects the effective operation of the banking sector.

Keywords:

1.0 INTRODUCTION

The need for economic growth and development has been a prime objective of successive Nigerian governments. During the colonial era, the focus was on the provision of physical infrastructure in the belief that infrastructures development will catalyze private investments that will ultimately drive economic activities which will result in growth. After independence, government became more directly involved in promoting economic growth. The thinking this time was to nurture private entrepreneurs and mobilize the needed domestic resources for investment in some preferred sectors of the economy. This brought banks and their intermediation function into limelight in the economic history of Nigeria.

Banks as financial intermediaries are expected to provide avenues for people to save money not

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expended on consumption. It is from the savings they so accumulate that they are expected to extend credit facilities to entrepreneurs and other industrialists. Many of the banks that were in existence during the period pre-independence were of foreign ownership and did not share the vision of banks financing local enterprise. This exclusion of Nigerian entrepreneurs prompted the establishment of indigenous banks.

The initial indigenous banks were established to address perceived discrimination against Nigerian borrowers by foreign owned banks and the objective was to encourage local investors, support budding entrepreneurs and thereby engender economic growth. However, many of them evidently failed and according to the position held by Ezekiel (1997). Several reasons accounted for the high rate of failure of these early indigenous banks but the failure of these banks was due largely to the unregulated banking environment.

In order to check the incidence of failure among the banks and strengthen them to perform the growth function envisaged, the Central Bank of Nigeria (CBN) was established with the principal mandate of regulating the banking sector. From the rules, guidelines policies and statements issued by the CBN, it was clear that the agency sought to promote the contributions of banks to economic growth. Its guidelines, such as those prioritizing credit to the agriculture and manufacturing sectors as (The Agricultural Credit Guarantee Fund Scheme {ACGFS}- 1978 and Microfinance Fund {2005}), and policies like deregulation {1986} and consolidation {2004}, were all aimed at positioning the banks as drivers of economic growth. Several reforms were also put in place at different times, the primary objective of reforms and subsequent consolidation exercise was to increase the size of the banks based on the belief that with increased size these banks would become stronger, resilient to shocks and capable of funding the real sector and, by extension, enhancing economic growth.

Banking sector reforms have been a regular feature of the Nigerian financial system. The reforms have evolved in response to the challenges posed by developments in the system such as systemic crisis, globalization, technological innovation, and financial crisis. The reforms often seek to act proactively to strengthen the system, prevent systemic crisis, strengthen the market mechanism, and ethical standards Banking sector reforms in Nigeria dates back to 1952 when the Banking Ordinance was enacted. The deregulation of banking in 1986 provided the impetus for the Structural Adjustment Programme.

The 1986 reform saw a policy shift from direct control to a market based banking system, especially as regards monetary management, risk management and asset holding capabilities of the institutions. A number of other reforms followed including the consolidation policy in banking 2005 and the sensitivity analysis introduced by the Central Bank Governor in 2009

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necessitated conducting stress test on banks. The various reforms have also tried to address the perceived shrinking in the system, remove rigidities in the system of credit and control and achieve positive real interest rates and greater efficiency by the market operators in the intermediation process.

1.1 STATEMENT OF THE PROBLEM

The perceived underperformance of the real sector and the larger economy despite the series of reforms have put a question mark on the relevance of the reforms introduced in the past going by the fact that the main aim of banking sector reforms was to develop a diversified, efficient and competitive banking system with the purpose of improving the distribution efficiency of funds through operational flexibility, financial viability and intensification of institution. It then calls to question the validity of the supply leading hypothesis of the relationship between finance and economic growth in an emerging market.

Going by the fact that reform measures were instigated and sequenced to develop a conducive environment for banks to overcome externalities through managing the structure of interest rates, an apt pre-emption through reserve requirements and credit distribution to all sectors. The need to understand the causal link between reforms and economic growth is imperative. Series of interest rate deregulation has been a significant constituent of the reform process which has conveyed superior efficiency to resource distribution as well as increasing the capital base of equity capital contribution by the common investors is also a major feature.

However, the major problem being investigated in this study is on the long and short run causal impact the banking sector reforms carried out in the last thirteen years on growth from an empirical perspective. Here, comparisons of reforms carried out before now and those done currently to actually determine the true state of Nigeria’s banking sector and how far it has helped in the economic development of the nation is being investigated. It is widely believed that the ineffectiveness of the reforms is evident as the underfunding of the real sector of the economy, inadequate policy framework for financial development, weak regulatory supervision in a highly liberalized financial environment allowing banks become over confident, audacious, less transparent and less accountable in the handling of their diverse portfolios of services. Is this true in the Nigerian context?

1.2 OBJECTIVES OF THE STUDY

The broad objective of this study is to investigate banking sector reforms in Nigeria and its impact on the growth of the economy while the specific objectives however are:

1. To examine the relevance of banking sector reforms as a mechanism for economic growth in Nigeria.

2. To examine how banking sector reforms have affected real sector financing in the Nigerian economy.

3. To ascertain the relationship between banking reforms, real sector financing and economic growth in Nigeria.

1.3 RESEARCH HYPOTHESIS

Hypothesis One

H0: Banking sector reforms so far in Nigeria have no significant impact on economic growth.
H1: Banking sector reforms so far in Nigeria have significant impact on economic growth.

Hypothesis Two

H0: Banking sector reforms in Nigeria have no positive impact on real sector financing.
H1: Banking sector reforms in Nigeria have positive impacts on real sector financing.

Hypothesis Three

H0: There is a positive relationship between banking sector reforms, real sector financing and economic growth in Nigeria.
H1: There is no positive relationship between banking reforms, real sector financing and economic growth in Nigeria.

2.0 REVIEW OF LITERATURE AND THEORETICAL FRAMEWORK

Theoretical propositions on banking sector and economic growth relationship is traceable to the earlier Schumpeterian hypothesis which is categorized into supply• leading and demand following hypotheses. While supply-leading hypothesis suggested that financial institutions serve as a useful tool for increasing the productive capacity of the economy, the latter assumed banks as not a direct cause for economic growth, rather the growth of the real sector increases demand for financial services which stimulates the financial sector. Thus, "where enterprise leads, finance follows" (Schumpeter, 1934).

According to Coricelli (2008) it is widely accepted that financial development is a

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multidimensional concept which constitutes an important mechanism for a long-run economic growth. The supply leading proposition tend to affirm that efficient allocation of savings through the identification and the extension of credit to entrepreneurs with the best chance of successfully implementing innovative products and production process increases national output and hence accelerates economic growth in the long-run as also made evident by the theoretical evidence established by Goldsmith (1969), Shaw (1973), McKinnon (1973) in their works which theorized that finance is a very essential and prime requirement for both short and long-run economic growth.

More recently, several theoretical and empirical studies further strive to investigate the validity of the theoretical assertions on finance and economic growth. These includes the works of Levine (2002), and Afangideh (2006), they all opined that a big, liquid and a well-functioning financial market can accelerate and foster economic growth and profit incentives, enhance corporate governance and facilitate risk management. They further expressed that each of these financial functions affect economic growth through capital accumulation and technological innovation. Their argument is further supported by Coricelli (2008), who confirmed financial sector as a 'shock absorber' to economic growth and theorized that the underdevelopment of the financial sector is one of the reasons why poorer countries tend to show much larger falls in output than more advanced countries. Alternative views on the link between private sector credit and economic growth focus on the key function of financial sector in saving-investment-growth relationship.

These according to Azigkpono (2003) includes acting as an effective conduit, first, for channeling funds from surplus to deficit unit by mobilizing resources and ensuring an efficient transformation of funds into real productive capital and financial intermediation transform maturity of the portfolio savers and investors, while producing sufficient liquidity to the system as the need arises. The specific role of bank credit to private sector in stimulating economic growth is more obvious in in developing countries in that bank credit to private sector is the most important source of financing for firms, especially in situations where capital markets are not fully developed.

Bank credit is one of the important aspects of financial intermediation that provide funds to economic entities that can put them to the most productive investment. There is a consensus in several literatures that credit availability enables firms to undertake investments that they could not have otherwise made out of their own funds. They further demonstrated the macroeconomic impact of higher credit availability; as credit availability increases, consumption and investment demand also increases, and this will raise the level of output and employment.

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Talking about banking sector reforms and economic growth, Obademi (2013) posited that banking sector reforms, if well articulated and sequenced engenders financial inclusiveness which in turn enhances increased productivity, increased income and consequently economic growth.

Existing finance literatures provide support for the argument that countries with better/efficient financial systems grow faster while inefficient financial systems bear the risk of bank failure. In a review of finance literature, the study opined that better functioning financial systems ease the external financing constraints that impede firm and industrial expansion. Banks accept deposit from individuals and institutions thus transferring funds from the surplus sector to the deficit sector of the economy. (Mishkin, 2007). Though they are subject to certain regulations by the regulatory authorities, financial intermediaries still determine the rules for allocating funds, and as such they play a significant role in determining the type of investment activities, the level of job creation and the distribution of income hence to achieve this, banking reforms are carried out. Transaction costs are also believed to decline with the emergence of financial institutions. It is widely accepted that they assist in collecting and processing information about investment opportunities more efficiently and at lesser cost than what obtains under the barter system. Thus economies of scale enjoyed with the existence of banks. This action reduces the cost of investment. In essence, a low financial development distorts growth and increases the cost of financial transaction. Asymmetric information between borrowers and lenders which causes adverse selection and moral hazard often prevent market adjustment from operating between demand and supply through the price mechanism. However banks are able to minimize these risks through screening and monitoring of potential customers.

According to Gross (2001), financial intermediaries determine the allocation of capital by diminishing (but not totally eliminating) the level of risk through information gathering and special contract design. This implies that banks make use of the imperfect nature of the market to determine who to allocate funds to. In essence, one of the activities of financial institutions involves intermediating between the surplus and the deficit sector of the economy. The availability of credit function positively allows the fruition of this role and is also important for the growth of the economy. In Nigeria, banking sector reforms have taken the form of institutional and regulatory approaches resulting in the liberalization of ownership structure, interest rate, ease for granting credit to lenders etc.

3.0 RESEARCH METHODOLOGY

A critical variable- output of banking sector reforms and impact on economic growth in Nigeria - which is expected to capture the impact of banking sector on the GDP in Nigeria - has been

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selected as the dependent variable of the model specified for this study. The explanatory variables include bank's credit available to the private sector, cash reserve ratio, interest rate, size of banking sector capital and inflation rate. These independent variables are expected to explain the systematic variables in the dependent variable over the period covered by this study.

The model used in this study is crafted with an eye on the Ordinary Least Square (OLS) regression techniques. In doing this, attention has been given to the multi-variable case (which leads to the multiple regression model). The multiple regression model deals with the multivariable case, where a given variable, Yt, is explained by a set of independent value, Xt's thus:

$$Yt = a0 + a1\ X\ 1t + a2\ X\ 2t + \ldots\ldots\ldots\ldots\ldots + an\ X\ nt + ut \ldots\ldots\ldots \quad (3.1)$$

Where Yt= Dependent Variable

Xt's= Independent (Explanatory) Variables

Ut= Stochastic (Error) Term.

Multiple regression models are usually estimated by the OLS regression techniques. This is a statistical method that obtains estimates or linear equation by minimizing the sum of squares of the residuals. Given the above argument, the functional form of the model specified for this study is given as:

$$RGDP = f\ (M2, CRR, CPS, IRM, IR) \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots(3.2)$$

This can be written as

$$RGDP = \beta 0 + \beta 1\ M2 + \beta 2\ CRR + \beta 3\ CPS + \beta 4\ IRM + \beta 5\ IR + Ut \ldots\ldots \quad (3.3)$$

Where

RGDP	=	Real Gross Domestic Product
M2	=	Money Supply
CRR	=	Cash Reserve Ratio

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CPS = Credit to the Private Sector

IRM = Interest Rate Margin

IR = Inflation Rate

4.0 DATA PRESENTATION

Secondary data sourced exclusively from the Central Bank of Nigeria, the Federal Office of Statistics (FOS), and the International Monetary Fund (IMF) as presented shows the data for the afore-mentioned variables, which covers the period 1994 to 2014.

YEAR	RGDP (000)	IR (%)	IRM (%)	CRR (%)	CPS (%)	M2 (N "M)
1994	945.557	76.6	7.5	8.0	31.7	266,944.9
1995	2,008.56	51.4	7.0	8.0	48.0	318,763.5
1996	2,799.64	14.3	6.5	8.0	23.9	370,333.5
1997	2,906.63	10.2	10.2	8.0	23.9	429,731.3
1998	2,816.41	11.9	10.0	8.0	27.3	525,637.8
1999	3,312.24	0.2	7.0	8.0	29.2	699,733.7
2000	4,717.33	14.5	9.5	8.5	30.9	1,036,079.5
2001	4,909.53	16.4	8.0	9.0	43.5	1,315,869.1
2002	7,128.20	12.1	8.0	9.5	19.7	1,599,494.6
2003	8,742.65	23.8	6.5	9.5	27.1	1,985,191.8
2004	11,673.60	10.0	6.0	9.5	26.6	2,263,587.9
2005	14,735.32	11.5	7.0	10.0	29.3	2,814,846.1
2006	18,702.79	8.5	7.0	5.0	28.2	4,027,901.7
2007	20,874.17	6.5	6.2	8.0	96.8	5,809,826.5
2008	24,552.78	15.1	3.8	2.0	72.0	9,166,835.3
2009	25,102.94	13.9	6.0	4.0	77.3	1,0780,627.1

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2010	37,754.44	11.7	11.0	4.0	84.2	11,525,530.3
2011	37,754.44	10.3	10.0	8.0	85.0	12,436,823.8
2012	43,141.16	11.9	8.5	8.0	67.9	1,4075,786.9
2013	48,254.38	9.5	8.6	50.0	71.1	1,8190,346.8
2014	48,254.38	7.9	13.0	50.0	70.5	18,890,046.7

PRESENTATION OF EMPIRICAL RESULTS

INDEPENDENT VARIABLE	COEFFICIENTS	T STATISTICS	P VALUE
(Constant) RGDP	--	1.092	0.292
IR	-0.048	-1.070	0.302
IRM	0.024	0.501	0.624
CRR	-0.103	-1.569	0.138
CPS	-0.031	-0.390	0.702
M2	1.047	10.236	0.000

R	R^2	Adjusted R Square	R Square Change	F Change	df1	Durbin-Watson	F	Sig.
.987	.973	.965	.973	109.835	5	1.195	109.835	.000

4.1 TEST OF HYPOTHESIS

From the above, t calculated for M2 is 10.236 and IRM is 0.501 while the t table at 5% level of significance is 3.250 and 2.015 respectively. Since the t calc > t table, we reject the null hypothesis and accept the alternative hypothesis. Thus money supply as a predictor of economic growth with a P Value 0.000.

Following the decision criteria below; Reject H0 if tcalc > t 0.05

Reject H0 if Pvalue > 0.05

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Therefore we fail to reject the null hypothesis.

4.2 DISCUSSION OF RESULT

The result of the hypothesis tested reveal that the probability of the significant level is 0.000 which was less than 0.05 ($p<0.05$). This implies that the p-value is statistically significant. The unit root test, Collinearity test and Durbin-Watson test were used for the empirical examination. The result is such that the stationarity of all the variables has been established which is a pre-requisite for the co-integration test. The co-integration test indicates the existence of co-integrating equation at 5% significance level, showing that long run relationship exist among the variables. The high coefficient of multiple determinations (R2) in the over-parameterized model and parsimonious model and the coefficient of the lagged error correction term suggest that banking reforms has a significant effect on economic growth. The banking reform index in the study explains a greater proportion in changes in economic growth.

The study confirms that the relationship between the variables of interest was to a large extent significant and positive. It revealed that the relationship was significantly different from zero. It indicates that there was a significant and positive relationship between banking sector reforms and economic growth in Nigeria.

5.0 CONCLUSION AND RECOMMENDATIONS

Following the results of our empirical investigation it can be inferred that periodic banking sector reforms constitutes the bedrock for accelerating and sustaining economic growth and development of any nation. In this sense, all the stakeholders (including the three-tires of government in Nigeria, banks and entrepreneurs) should design favorable and acceptable terms and conditions for the sectors' reform. Doing so will enable the much expected growth to take place in Nigeria, thereby serving to put the country in its rightful position.

Based on the empirical findings, it is necessary to make policy recommendations. It is hereby recommended that;

1. Regulatory and supervisory framework should be further strengthened to ensure stability and promote public confidence in the banking system.

2. Healthy competition among banks should be promoted. Their competition raises the deposit rate which encourages savings thereby increasing capital accumulation in the economy.

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3. The interest rate policy should be made to stimulate savings through high real deposit rates and lending rate made reasonable in order to encourage seeker of funds particularly investors to borrow to participate in productive activities.

4. The role of banks in providing credit to the private sector should be improved and the end-use of credit granted monitored to avoid non-performing loans and moral hazard.

APPENDIX

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics		
					R Square Change	F Change	df1
1	.987[a]	.973	.965	3092.96307	.973	109.835	5

Model	Change Statistics		Durbin-Watson
	df2	Sig. F Change	
1	15[a]	.000	1.195

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	3860.655	3536.456		1.092	.292
	IR	-46.972	43.898	-.048	-1.070	.302

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IRM	190.138	379.627	.024	.501	.624
CRR	-131.125	83.577	-.103	-1.569	.138
CPS	-20.144	51.632	-.031	-.390	.702
M2	.003	.000	1.047	10.236	.000

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