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TOPIC:

FINANCIAL DEVELOPMENT AND REAL GROWTH: DECIDING THE CHICKEN AND DETERMINING THE EGG

By

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FINANCIAL DEVELOPMENT AND REAL GROWTH: DECIDING THE CHICKEN AND DETERMINING THE EGG

An Inaugural Lecture Delivered at the University of Lagos Main Auditorium on Wednesday, 20th May, 2015

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There is a Divinity that Shapes our End:
Rough-Hew Them How We Would

By William Shakespeare
In
HAMLET

I returned to see under the sun that the
Swift do not win the race nor the mighty ones the battle…
Ecclesiastes 9:11

DEDICATION

To the Divinity That Made Me Win the Race.

1. Preamble

The Vice-Chancellor,
Deputy Vice-Chancellor (Academics & Research),
Deputy Vice-Chancellor (Management Services),
The Registrar,
The Bursar,
The Librarian,
The Provost College of Medicine,
The Dean Faculty of Business Administration,
Distinguished Academic Colleagues,
Distinguished Ladies and Gentlemen.

I consider it a great honour and a privilege to stand before you all to deliver this inaugural lecture today.

I finished higher school at The Queen School Ibadan, as the Best Graduating Student. This automatically earned me Federal Government Scholarship (Merit Award), which, though not applied for saw me through my University education.

After my first degree at the University of Ibadan, the Central Bank of Nigeria offered me an appointment, having completed the one year NYSC service with the Central Bank of Nigeria Kano, but I turned down the offer. Before I left for NYSC, UAC of Nigeria Plc as well as Unilever (formerly called Lever Brothers) had offered me appointment which I was to pick up after my service year. However I turned down these offers as I awaited University of Ibadan to complete its admission process for a master's program in Economics. While waiting I took up a teaching job with the then Oyo State Ministry of Education and was posted to Oshogbo Baptist Girls High School. I barely worked for two months before the admission came through, and I left Oshogbo for Ibadan. While on the program, University of Ibadan employed me as a Graduate Assistant. When I got married, I moved to Lagos to join my husband and I applied to the then National Bank of Nigeria, as well as the University of Lagos. Both institutions offered me appointment, but given my innate desire for knowledge and for passing over knowledge, I turned down National Bank's offer and came to the University of Lagos. One of the people who encouraged me to come to the University was Prof. Isaac Adalemo, a one-time Dean of the School of Postgraduate Studies and a one-time Deputy vice Chancellor, University of Lagos. I started off as an Assistant Lecturer and climbed the Academic ladder one step at a time. In the interval, I took three maternity leaves (in quick successions) as if in a hurry for it to be over with. I did not realise that motherhood is an aspect of life that can never be "over with", because the nurturing and mentoring of progeny continues throughout life.

Along the line, I found favour from my peers and my seniors. My then head of Department, Dr. Olasemi Akintola-Bello (now Professor) encouraged me to publish and I did. After about six years in the system (and having been through with maternity leaves) I got a study-leave to do a Ph.D. at the University of Ibadan. While there, I applied for a Ph.D. Research Grant from the African Economic Research Consortium (Nairobi, Kenya) which I got. The grant allowed me travel across the three African countries involved in my Ph.D. research work – Nigeria, Ghana, and Uganda. At the end of my Ph.D, I returned to the Department where I was promoted and immediately appointed the Ag. HOD.

2. Background

Causal relationships are so important because they allow us have understanding of how to reach our goals. They also allow us think-out and map-out strategies for uprooting hindrances on our way to the Promised Land.

How many of us want to blame a twelve year old girl who does not know that the intimate experience with that male classmate of hers is what causes a female to become a mother. Ignorance of causal relationships can be dangerous. No wonder the Holy Book says "my people perish for lack of knowledge" Hosea 4:6. I want to believe that this knowledge is in particular the knowledge of causal factors – causes of events, of phenomena of seasons and times of progress of stagnation, of retrogression, of advancement, what causes some parts of the world to experience cyclones, tsunamis, earthquakes etc.? What causes ill-health, sicknesses and diseases? What causes relationships to thrive, and what causes them to die? Answers to all these causal factors and causal relationships are important for "optimal-living" or what economists would call "maximum-welfare".

Someone once said the ultimate purpose of all economic policies is "to promote welfare", and it is implicitly assumed that the higher the growth of an economy the higher its level of welfare. Growth of an economy is usually measured by the growth rate of its output. If the major purpose of national leaders' pursuits is to improve the welfare of a people and we say this welfare is a function of growing output or growing economy, then the factors that make the output/economy grow become of utmost relevance.

As far as the time of Adam Smith (1776), the question of what causes real growth had been of interest to politicians, businessmen, government officials, economists, financial theorists, etc. The question came back with greater force during the early years of industrialization. Bagehot (1873) tried to provide an answer to this question by arguing that it is the financial system's development that initiates, propels and ensures economic growth.

He argued that the existence of well-functioning financial systems facilitated the mobilisation of huge capital for immense industrial works in England in the 19th century.

For the next forty years no one took Bagehot on (neither for nor against). However, by 1912, Schumpeter came up in support of Bagehot's position when he argued that efficient banking systems propel technological innovation. Schumpeter posits that an efficient banking system is able to identify and fund entrepreneurs who have the greatest chances of successfully implementing innovative products and production processes.

However, by 1952 Robinson came up with the idea that it is not the development of the financial system that initiates and propels growth of the real economy as Smith, Bagehot, and Schumpeter had argued. Rather it is enterprise that really precipitates growth and development in the financial sector. She argued that trade is actually the handmaid of industrialisation, that wherever it leads, finance follows.

Patrick by 1966 partially lent credence to this position when he argued that after a given level of economic growth, it is the real sector that propels growth in the financial sector by making demands of the financial system which in responding to the financial system is moved forward. He called this "demand-following finance". Patrick argued that when a strong impulse to invest is hampered by lack of finance then devices are invented to release the finance... and habits and institutions are developed.

Patrick's position however is a two phased issue. Patrick argued that while the real sector propels financial development at the higher stages of real growth and development, that indeed, at the earlier stages of development, it is actually the financial sector that propels and ginger growth in the real sector. It does this by providing upfront financial instruments, financial arrangement, and financial innovation that help the real sector access funds for financing technological innovation. Patrick called this type of financial system a "supply-leading" financial system.

McKinnon (1973) and Shaw (1973) came up with their financial liberalisation theory, wherein they agreed with Patrick concerning his "supply-leading" hypothesis and argued that whenever the financial system is free from the shackles of government regulation, then it certainly becomes a "supply-leading" system, providing impetus for real sector growth and development.

The question is, is it just that financial growth and development correlate with economic growth and development or is it that financial growth causes real economic growth and development or is it vice-versa? There is a difference between one variable moving in a given direction as another variable and one variable being the cause of the other. This issue has been a main focus of theories and empirics in financial economics and economic development theories i.e. trying to decipher whether the financial system promotes growth in the real economy, or the real economy promotes growth in the financial system and indeed beyond promotion, whether the one causes the other or vice-versa.

3. The Issues

Given our interest in real growth and development, based on the implicit assumption that real growth is the determinant of optional human welfare, then the issue of what factors determines real growth and development become quite germane.

However both theoretical and empirical evidence have failed to take one single unique direction. Indeed there have been several divergent views both in theory and in empiricism. In fact, there are times that empirical findings move in directly opposite directions. In the midst of this maze of theories and empiricism we have been interested over the years in what indeed is the real and authentic position of Nigeria with respect to the financial system development and the real growth.

Today we begin this lecture by first examining the theoretical foundations of the financial development versions real growth nexus, then we look at the general empirical finds and then zero in on the Nigerian situation and in particular our own contributions over the years. However first we begin by setting the boundary.

4. Delineating the Boundaries

In financial-economics theory, the term "financial system refers to a network of financial institutions/intermediaries, financial markets and financial instruments" (Adegbite, 2007; Levine, 1997; FitzGerald, 2006).

A financial intermediary is an institution that specialises in mobilising funds from fund-surplus units (savers and lenders) for onward allocation to fund-deficit units (investors and borrowers). Usually the intermediary will place a mark-up on the cost at which it mobilises funds while making it available to the investors and borrowers.

Financial intermediaries are divided into two broad categories: banks; and non-bank financial intermediaries. Non-bank financial intermediaries include Insurance Companies, Pension Funds, Unit Trusts, Mutual Funds, Stock Exchanges, Mortgage Institutions, etc.

The financial intermediary usually designs instruments for this fund mobilisation and allocation activity. These instruments are of various forms and of various life-spans. There are short-term instruments like bank deposits and there are long-term instruments as available on the stock exchange like equities, debentures, corporate bonds, etc.

The market for trading in financial instruments is called financial markets, not necessarily physical locations but networks for exchange of financial instruments.

A financial system is said to be developed the more the number and variety of financial institutions, markets and instruments available. When a financial system is disproportionately dominated by banks, or the main instrument is money, then that system is regarded as relatively undeveloped. In other words, a financial system that has various types of financial institutions - Banks, Pension Funds, Insurance Companies, Unit Trusts, Mutual Funds, Stock-Exchange, Discount Houses, etc. - is said to be more developed than one that has less variety. Similarly, when there are several financial instruments by which financial institutions can mobilise funds and allocate them the financial system is relatively more developed than the one with fewer instruments or fewer markets.

The size of the financial system in an economy is usually measured by the value of the total assets of the financial intermediaries relative to the gross output or income of that economy. This size is measured using other indices and is also called "financial-depth" or "financial deepening". Other indices include the ratio of liquid liabilities of the financial intermediaries to gross domestic product.

The liquid liabilities include currency, demand deposits and interest bearing liabilities of both the banks and non-bank financial institutions.

There are other things about the financial system that we also measure. We measure, for instance, the liquidity of the financial system, the extent of diversification of the financial structure, etc.

What about real growth and development? Real growth refers to the growth of the non-financial sectors of the economy – the agricultural sector, the industrial sector, the commercial and services sector, etc. Growth here is usually measured by the output of these other sectors. Output in these sectors (i.e. production of goods and non-financial services) affect the quality of life of a people. In fact there is an implicit assumption of a linear and proportionate relationship between output in the real sectors and society's welfare. Hence whatever increases real output is assumed to increase welfare, and since the ultimate purpose of all economic policies is to maximize welfare – then whatever increases real output is of concern to economists and financial theorists.

It follows logically therefore that if industrialisation leads to phenomenal increase in real output (i.e. output of goods and non-financial services) then whatever factors make for industrialisation is of interest to development economists. If innovation is a precursor of industrialisation then whatever factors encourage and promote innovation is critical to maximisation of welfare.

It is important to note that while output growth is important, there is the belief today that beyond output growth, for there to be development the content of the output is important and so is its distribution. For instance, if the output is made up largely of arms and armaments, the output may be growing but the quality of life may not improve hence there is no development. Similarly, the distribution of the output among the population is also of interest. A situation where only 10% of the population corner 95% of the output and the remaining 90% scramble for the remaining 5% does not ensure development, as majority may still be living in poverty. What happens to the quality of life-access to food, portable water, good roads, health facilities, good education, freedom, etc. are critical to development. In other words, there can be output growth without development. However for our purposes today we are going to assume that output growth goes hand in hand with development, so we use the terms real growth and development as if they automatically occur together. Hence we take it that a country with a higher level of output is more developed than one with a lower level. If the USA has a higher output level than Nigeria, we assume automatically that it is more developed than Nigeria.

5. Functions of the Financial System

A relevant question at this juncture is what are the functions of a financial system? There are five basic functions identified in literature. These are: (i) Saving Mobilization (ii) Capital Allocation (iii) Risk Pooling, risk diversification and sharing (iv) Facilitation of trade and specialisation (v) Monitoring and control of entrepreneurs/ managers. We take a look at each of these briefly.

i. Savings Mobilisation

The financial intermediaries, by offering to pay savers for their funds, are able to pool available savings in the economy. Given their reputation, owners of funds find it easier to release their savings to the financial institutions than to individuals they probably do not know too well. What is more, in the absence of financial intermediaries to pool available funds within the economy (and in a globalising world even savings outside the country can also be pooled) a lot of beautiful projects will die even before they are born, or in the process of being executed.

ii. Capital Allocation

Having pooled the funds within the economy, the financial intermediaries allocate them based on superior objective analysis to areas of need. Given that the financial institutions are dealing with other people's funds, and funds that the owners will request for anytime, it becomes mandatory that such funds are not allocated based on sentiments or emotions but based on hard facts. There are issues of whether the investor/borrower is capable of executing the project he wants to use the fund for efficiently, there is the question of the level of returns that will come from that particular project relative to other projects. There is also the issue of the credibility of the investor/borrower, whether he will repay the fund or abscond. All of these factors are taken into consideration by the financial intermediary before allocating the available fund. Hence, capital allocation is way better with the existence of financial intermediaries than without them.

iii. Risk Pooling, Diversification and Sharing

A situation where a single–saver pours all his life's savings into the hands of a single investor who wants to produce a new invention can be quite risky. For instance, the project execution may fail or the investor may not return the funds obtained. This single saver would have lost all. However, in the presence of financial intermediaries who have pooled the funds from several fund-owners, and also distributed the pooled funds among several projects/investments, the risk is pooled, shared and diversified, such that at the end of the day the risk per saver is reduced. This is an extremely critical function that makes the existence of financial institutions a *sine-quo-non* for the real sector. In fact some researchers have maintained that many of the innovations that were executed in the era of industrialisation in 18^{th} century Europe had indeed been designed long before the industrialisation age but had to wait until the financial system came to take its rightful place of financing technological innovations.

iv. Facilitation of Trade and Specialisation

The financial system, by providing funds for the producer on the one hand, and also making credit available to the consumer, promotes trade on a phenomenal level. Increasing trade implies increasing specialisation and hence increasing output. Production that would have been constrained by unavailability of funds or the size of needed funds can be carried out because the financial intermediary can make the funds available.

Similarly, buyers who would have been constrained by non-availability of funds (either wholesalers or retailers) now have access to the type of facility (loan, advance, etc.) needed to assist them purchase what they require. The result of facilitating trade is that the more trading is done the more specialization is required to increase output. So by their existence and provision of a payments-system the financial institutions promote trade, specialisation and output growth phenomenally.

v. Monitoring and Controlling of Entrepreneurs and Managers

Financial institutions do not release their funds to an investor and go to sleep, because the funds ultimately belong to other people. It becomes a moral duty (and in many countries a legal duty) that they watch over the use of the funds to ensure that owners can get their funds back as at when desired. So financial institutions (in particular in Germany and Japan) monitor conscientiously how the investor is utilizing the funds; how the investor is executing the project for which the fund was committed, etc. This serious oversight function of the financial intermediary plays a tremendous role in ensuring that firms – the major investors in any economy - utilise available resources judiciously, prudently and circumspectly.

6. Factors That Make it Expedient for The Financial System To Perform Its Functions

There are frictions in the system that makes room for the financial system to find a place of relevance in an economy. In a world of perfect information and zero transactions costs where there are no frictions in the system, financial institutions would probably not be needed, or relevant. However three factors make the existence of financial intermediaries expedient and relevant, and these are

(i) Existence of Transactions Costs

(ii) Existence of Information Asymmetry

(iii) Existence of Liquidity Risks

i. Existence of Transactions Costs

In a world where there are no transactions costs, a would-be-investor can run-around and source funds directly from savers no matter how widely scattered such savers may be. In reality however, it will involve tremendous cost for an investor to run-round the nook and cranny of Nigeria seeking savers who have funds and are willing to release such funds into his own kind of business/project (Adegbite, 2007; Afolabi, 2003). If he learns that one such saver is in Kaduna and another is in Ado-Ekiti and the investor is in Abeokuta, the cost of effecting the transaction of raising the needed fund can itself stifle his enthusiasm and possibly kill the project too. So the existence of costs which the presence of financial intermediaries helps to mitigate constitutes a first-order justification for the existence of financial intermediaries, markets and instruments.

ii. Existence of Information Asymmetries

One of the major justifications for the existence of financial intermediaries is their ability to correct information asymmetries. A would-be-investor who has no information as to who and who have surplus funds that they are willing to release, and also would- be – savers who also do not know who and who need their own excess funds for some project/investment, will result in potential projects/ investment being unexecuted. As investment is hampered so will output growth and welfare be hindered.

Even when an individual saver gets to know an investor who needs funds and releases funds to the investor, how does he monitor to ensure that his fund is being judiciously utilised? The information he gets from the investor may be massaged. However with financial intermediaries, almost all the information asymmetries are corrected for. Savers can confidently place their savings in the financial institution (conscious that the institution has a reputation to protect).

The investor can place his plans on the table and the financial institution often has people with requisite skills to assess the plan/project. Even in monitoring, the financial intermediary can do it much better than the individual saver.

iii. Existence of Liquidity Risks

A third justification for the existence of financial intermediaries and financial markets as well as financial instruments is the existence of liquidity risk. Liquidity risk involves fund-owners not wanting to part with their funds for too long a time. They want to have access to their funds readily, especially in times of emergencies. If a single saver ties all his funds up in a single investment with a single investor then he runs the risk of illiquidity for a long period of time. However with financial intermediaries who have appropriate financial instruments the saver/lender can easily turn back the instrument he is holding into purchasing power at little or no loss in value. For instance, if the saver is holding equity in the capital market, he can sell all or part on the stock exchange whenever the need for liquidity arises. If he is holding his fund in a fixed account with a bank he can write to request that he needs all or part of the money (giving the number of days' notice as required by law). However he does not remain illiquid for too long. Mitigating the risk of illiquidity is a major attraction of the financial system and justification for its existence.

7. From The Financial System To The Real Economy: Transmission Channels

Two basic transmission channels of the activities in the financial system to the real sectors have been identified in literature. These transmission channels are:

- Capital Accumulation Channel
- Technological Innovation Channel

i. Capital Accumulation Channel

Economic theory makes it clear that in equilibrium, actual investment has to be equal to savings i.e. $S(r) = I\ (r_1\ MEC)$

where S is Saving; r_1 is rate of interest, I is investment and MEC is = Marginal Efficiency of Capital.

In other words, a country cannot invest more funds than it has as savings (either the one pooled within the domestic economy or, in a globalizing world, both the one pooled locally and those of other countries attracted as capital inflow). However starting with the domestic economy, the existence of financial institutions helps to increase savings rate. This is achieved first as a result of the greater confidence savers have in the financial intermediaries than in individual investors (whose antecedents savers may not know). Second is that given the savers desire for liquidity which the financial system assures – (either we are considering the banks or the securities markets) savers can access their funds in part or in whole as they desire whenever the need arises. All these interact together to make it easier for the financial system to increase savings rate. The higher the savings rate the higher the investment rate is expected to be ('a-priori'). Great investment results in greater capital accumulation, both of physical capital and also of human capital (whenever the investor is also interested in investing in human capital).

ii. Technological Innovation Channel

Given the expertise available to banks and other financial institutions, they are able to objectively assess innovative projects and provide funds appropriately. Indeed it is said that majority of the innovative projects executed during the early years of industrialisation in Europe were not just designed at the time of their execution. They had been designed years before, but lack of funds in quantum needed for their execution kept them at bay. With the development of the financial system, especially the stock market that enables savers release their funds and yet access them when the need arises, while the firm or investor still continues to use the fund, greatly helped technological innovation. A saver for instance who buys equity in the stock market can get all of his money back simply by selling his stock at the stock exchange. While he pulls out his funds, another saver takes his place, so that the company is not forced to stop the execution of the project mid-way.

So by mitigating liquidity risk, by efficient analysis of projects and their success- probability, by (in the case of banks) monitoring the management of the firm (even the stock market monitors the firm in its own way, by insisting on Annual Reports), the financial system promotes technological innovation.

8. Determinants of Performance of the Financial System

There are three different characteristics of the financial system that determine how well it is able to impact real growth. The characteristics are (according to FitzGerald (2006):

- The Level of Financial Intermediation
- The Efficiency of Financial Intermediation
- The Composition of Financial Intermediation

i. The Level of Financial Intermediation

This has to do with the depth of the financial system or its size as measured by several indices. Some of the indices for measurement of level, size or depth of financial intermediation include:

- Ratio of financial system's assets to gross domestic output
- Ratio of financial system's liabilities to gross domestic product.

In measuring actual penetration to the private sector, size is measured by

- Claims of the financial intermediaries on the private sector, relative to the gross domestic product.

When we are considering a largely banking system then we are considering

- Ratio of bank credit to the private sector relative to the gross domestic product.
- The ratio of bank credit to the private sector relative to total credit in the system.

The higher any of these size indices are the higher the impact of the financial system on the real economy is expected to be. When the financial system is larger, it is able to mobilize funds among diverse groups (the poor, the not so poor, the wealthy and the outstandingly wealthy); and also mobilise from different geographical settings in a country with their different resources-base. For example, in Nigeria funds can be mobilised from the largely agricultural workers in Benue State, to the largely oil and gas workers in Rivers and Cross-Rivers State to the basically commercial people (traders) in Lagos State, etc. Such diversification of savers and savings diversifies risk, makes the financial system more resilient and more able to deliver. What is more – the bigger the financial system, the more externalities it is able to generate – a positive externality is economies of scale. Economies of scale has the benefit of reducing per unit cost of financial services.

ii. The Efficiency of Financial Intermediation

The efficiency of financial intermediation has to do with the quality of financial services. Such quality varies depending on several variables. Where workers in the financial system (e.g. bank-staff) lack requisite skills-set, there will be problem. First analysis of projects for funding will not be thorough. Secondly, the financial system may not be able to cross information asymmetric hurdles. The financial system may not be able to provide appropriate oversight on borrowers of funds (the investors). What is more – in the face of imperfect competition (especially where the financial system has an oligopolistic structure) the financial system may produce sub-optimal levels of financing and inefficient capital allocation. Efficiency of financial intermediation is measured using several indices e.g. ratio of credit to private sector relative to credit to the entire economy.

iii. The Composition of the Financial Intermediaries
This composition is known as the **"Financial Structure"**. In addition to banks, there are financial intermediaries known as Non-Bank Financial Intermediaries. This category includes Pension Funds, Insurance Companies, Mortgage Finance Institutions, Mutual Funds, Unit Trusts, Stock Exchange etc. Even where the banks run from giving long-term finance, (if they have only mobilised short-term funds) the Pension Funds and Insurance Companies can make such long-term funds available in a well-diversified financial system.

If the stock exchange can mobilise funds to firms but cannot take rigorous control over the management, this can affect the impact of the financial system on the corporate world and hence on the real sector. If the financial system is made up largely of banks that would not release their funds to firms "and go to bed", but will rigorously monitor the activities of the firms, as done in Germany and Japan - (Patrick 1966) then this will also decide impact of the financial system on the real sector.

So in the end the extent to which the financial system impacts the real economy is a function of the level of financial intermediation, the efficiency of the system as well as the composition of the financial intermediaries. There is a continuing debate as to whether a particular composition (i.e. a particular financial structure) is more prone to producing positive impact on real growth than other structures.

9. Is There Any Flow From The Real Sector to The Financial Sector?

Indeed Robinson (1952) argued that the relationship of financial system and the real economy is one whereby activities in the real economy actually precipitate and propel financial growth and development. It is argued that as the real economy grows, it makes some demand on the financial sector which as the financial system responds to, it grows and develops. Robinson maintained that the "financial system is the handmaiden of enterprise".

In a similar manner, Patrick (1966) argued that the nature of the demand for financial services will depend on the growth of real output both in the agricultural sector as well as in other traditional and subsistence sectors. The more rapid the growth of enterprise, the greater will be its demand on the financial sector. First because as the enterprise grows, its own funds (retained earnings) will likely not be enough to fund sufficient expansion of that enterprise, hence the need for other people's saving which the financial intermediaries pool and provide for firms. Second in situation where different enterprises are growing at different rates, intervention to redirect resources from the slow-growth enterprises and industries to the high-growth ones for maximization of output and welfare must take place. The situation then places a demand on the financial intermediaries, to do this re-direction job. This redirection job ensures re-allocation of resources to their most efficient uses.

In sum, as a **consequence** of real economic growth, financial markets develop, widen, and become more perfect thus increasing the opportunities for acquiring liquidity and for reducing risk which in turn feeds back as stimulant to real growth, and to greater demand for financial institutions, instruments and markets.

10. The Evidence

In the words of Levine 1997 and I quote... "Although conclusions must be stated hesitantly and with ample qualifications the preponderance of theoretical reasoning and empirical evidence suggests a positive, first-order relationship between financial development and economic growth".

Beginning with Adam Smith (1776) (the so called father of Economics) who posits that real growth is only made possible as a result of activities of the financial system. Smith argued that the ease by which investors can raise funds in a developed financial system eases production, and helps specialization. Specialization itself aids innovation because it is in the process of repeated "doing" of a given task that one develops the relevant skill(s) for that task. Also in the process of thinking about a given function again and again one begins to create or "invent" new methods of "doing". In like manner, Bagehot (1873) argued that the financial system ignited industrialisation in the early part of the 19th century by mobilising funds in unusually "big form" for industry. Schumpeter (1912) agreed with Smith and Bagehot that indeed the activities of financial intermediaries, (in particular banks) of accessing and deciding the direction of movement of funds for investment purposes greatly spur technological innovation.

Schumpeter insisted that banks are able to carry out more objective analysis than individual savers looking for projects in which to put their funds. What is more – the banks and indeed all the financial intermediaries are able to overcome the problem of asymmetric information better than individual savers, hence the financial institutions can better identify innovative products and production processes that have high probability of successful execution. Hicks (1969) agreed with this position and argued that the development of the capital markets which mitigate the risk of liquidity strongly provided impetus for the industrial revolution in England.

Gurley and Shaw (1955), Tobin (1965) McKinnon (1973) all concluded from their researches that indeed financial development promotes real growth. However, McKinnon

1973 and Shaw (1973) added another dimension to the debate by arguing that it is not all the time that financial sector development is exogenous to real growth. They argued that over time and across space, there are situations where it is the real sector that propels financial growth (the so called demand – following hypothesis). They argue that the structure of the financial system and the quality of its services are affected by economic activity and technological innovation.

Unlike this first school of thought, Robinson (1952) insists that it is the real sector that actually initiates and propels development in the financial sector through its demand for products and services hitherto unknown to the finance world. In the process of satisfying the real sector, the financial sector becomes financially innovative and begins to grow. Others who share this position include Friedman and Schwartz (1963), Hugh Patrick (1966), Demetriades and Hussein (1996).

McKinnon (1973) and Shaw (1973) rested on the two sides of the divide; maintaining that at the early stages of real growth and development, it is the financial sector that takes the initiative producing upfront instruments and institutions that help the real sector grow. This is the so called **Supply-Leading** financial system. These financial economists cited that examples of Germany and Japan where the bankers literally pull-up enterprise and entrepreneurs.

After a given level of real growth and development, according to McKinnon (1973) and Shaw (1973), the real economy begins to forge ahead of the financial system. The only growth and development observable in the financial system at this stage is the one brought about as a result of the demand of enterprise, of the real sector for certain financial products, services and institutions. This is the so called **Demand-following financial system**.

Goldsmith (1969), in his study of thirty five countries for a period of over one hundred years, concluded that there is a significant positive relationship between the financial system and real growth. The financial system development he measured by the size of the financial system relative to total output (GDP). He proxied the size of the financial system by the ratio of total financial assets to GDP. Goldsmith's study was however silent on causality.

King and Levine (1993) studied eighty countries over a thirty year period and used other indices of financial development. For instance they used the ratio of total claims of the financial institutions to the private sector relative to the GDP, to find out how much the private sector is really benefitting and growing from activities of the financial sector. They found out that "the initial level of financial development is a good predictor of subsequent rates of economic growth, of physical capital accumulation and of productivity growth". It is important to note that for King and Levine there were other measures of real growth other than growth in output. Such other measures include rate of capital accumulation and rate of growth of productivity. There were several country case-studies. For example, Rondo Cameron et-al (1967) studied the case of England for a period of almost 100 years (1750-1844). They also studied France, Belgium, Germany and Japan and concluded that for all the countries, the banking system played a positive growth-inducing role.

In his own study, FitzGerald (2006) maintained that the impact the financial system would have on the real economy depends on what stage of real development the country was. Also he argued that which aspect of financial intermediation will affect growth the most will also depend on the stage of real growth and development.

He maintained that at lower levels of development, the size of the financial system known as financial depth will almost invariably have the largest impact on real growth. While as the economy progresses, it is the efficiency of the financial system or the composition of the system (financial structure) that will likely impact real growth the most.

His position seems to be supported by the study of Andres et al. (1999) and Leahy et al. (2001) who studied the economics of countries that cut across the development divide (i.e. while some were developed, industrial countries others were developing countries). These researchers found that there was a significant positive and robust relationship between the size of the financial system (i.e. financial depth) and the real economy for the developing countries. They however could not find such a relationship for the developed countries.

Greenwood and Jovannovic (1990) found that financial intermediation has a positive effect on long-run real growth of the economies studied. Their conclusions were affirmed by Bencivenga and Smith in their 1991 study and also by Pagano (1993).

The transmission from the financial system to real economic growth takes place through the mechanisms of efficient debt intermediation (especially as provided by the stock market) which in turn promotes investment and raises output, according to Luinted and Khan (1999). Levine and Zervos (1996) had earlier found that the stock market is extremely crucial to the efficiency with which the financial system performs its role and impact the real economy. Levine and Zervos had insisted that in the absence of the stock market (a reflection of low level financial development) investment shrinks. However, given that the stock market mitigates liquidity risks and idiosyncratic risks, the market propels growth. Other researchers who emphasized the importance of the stock market as a critical factor in financial development that helps the financial sector propel real growth are Greenwood and Smith (1997);

Atje and Jovanorich (1997). That financial development is a necessary ingredient of real growth and development is a conclusion reached also by Arestis et al. (2002), Christopoulos and Tsionas (2004), and Acaravci et al (2007).

Calderon and Liu (2003) identify three stages in the finance development and real growth nexus. In the first stage, the financial system development allows a broadening of the base for economic or real growth to take off. In the second stage there is a mutual or symbiotic relationship with growth and development in the financial sector feeding growth in the real sector, while the real sector is itself feeding back the financial sector, so that a bi-causality exists between them. In third stage, the financial sector takes the level again in a Patrick (1966) form of supply-leading finance.

Rousseau and Sylla (1999) in their study of the American economy for a period of 60 years (1790-1850) found a strong support for finance-led growth. In their 2009 study, Ahmed and Malik examined the relationship between financial sector development and real growth and development for 34 years (1970-2003) and concluded that financial development affects per capita income positively through its effects on efficient resources mobilisation and allocation.

Authors like De Gregorio and Guidotti studied the Latin American countries over a period of 36 years (1950-1985) and found financial development (measured by financial size) to be negatively correlated with real growth in the 1970s and 1980s. They attributed this performance to financial liberalisation in that period; when interest rates rose through the roofs and deposit insurance created moral hazard problems for the banking system.

11. What About The Effects of Financial Liberalization In Helping The Financial System Initiate Real Growth?

One debate the Mckinnon and Shaw hypothesis ignited is the fact that for a financial system to be able to play its growth inducing role efficiently and effectively, it must be free from shackles imposed by government regulation. They insisted that government regulations which, among others usually include:

i. placing of ceilings on interest rates (both deposit rates and lending rates)
ii. administratively directing credit
iii. requiring unduly high levels required reserves.

place a lot of burden on the financial system making the system inefficient and ineffective. They argue that, when interest rates are fixed, they fail to perform the function of savings - mobilisation. Indeed, administratively fixed interest rates lead to low and sometimes negative real rates of interest which discourage savings. Investment is possible in the face of pooled savings and the lower the level of pooled savings the lower the level of investment. So that at the end of the day government's attempt to keep interest rates low in order for investors to access funds easily, becomes counterproductive.

Secondly, administratively directed credit to supposedly preferred sectors of the economy (like agriculture and housing) can also be counterproductive. This is so because administratively directed credit increases the risk-exposure of financial institutions without compensating for the higher risk. This situation usually leads to moral hazard, as many recipients of funds in such situations default.

Thirdly, when required reserves are high there is undue high liquidity which the financial institutions cannot access and this limits the amount of credit they can create thereby hampering their credit allocation function.

This kind of financial system is termed **repressed** and it is the position of McKinnon and Shaw that when a financial system is freed of such regulation (i.e. deregulated or liberalised) it becomes better-able to fulfil its role and promote real growth and development.

Subsequent research work thereafter focused on whether the financial system is repressed or liberalised and what had been the effects of this on real growth. The results of research work on financial liberalization have been mixed. While some have found financial liberalisation to promote real growth, others have insisted that financial liberalization especially in the developing countries have led to financial instability, financial crises and massive bank failures.

De Gregorio and Guidotti (1995) in their study of twelve Latin American countries find that the removal of regulation as a result of liberalisation (which made entry into the financial sector easy for financial entrepreneurs) as well as the existence of deposit insurance, resulted in unwarranted credit expansion. The end result was a high level of bank credit relative to GDP, but this correlated negatively with real growth. In fact the result of the high growth rate of credit was banking crises. Mosley (1999) in his study of four African countries – Uganda, Kenya, Lesotho and Malawi found that though the financial assets of the banks increased in the era of financial liberalisation, the access of small and medium enterprises to credit did not increase. In the rural areas, the access of borrowers to the increased fund did not increase because of lack of collateral on the part of the borrowers.

However unlike these set of researches, the Marle Bark (1989) study as well as those of Fry (1997) and Ghani (1992) found that increasing real rates of interest by increasing nominal rates of interest in the era of liberalisation actually raised the real rates of growth in countries studied.

(2006), Odedokun (1996); Christopoulos and Tsionas (2004); others have found real growth and development to Granger –cause financial development – Lucas (1988), Stern (1989), Chandavarker (1992), Gurgay et al. (2007), and Shanoushi et al. (2008). Yet others as in the case of the chicken and the egg have found causality to be bi-directional – Levine (1997), Luintell and Khan (1999) Demetriades and Andrianeva (2003) Hendroyiannis and Loho (2005), Munnale and Eng (2002), Prodham (2009).

Infact, an interesting study is that of Akinlo and Egbetunde (2010) who studied 10 Sub-Saharan African countries and found different directions of causality using the same methodology for each country studied. They found that financial development Granger-Causes real growth in four of the countries while, it is real growth that Granger-Causes financial development in one country and for the remaining five countries causality is bi-directional. Similarly, Esso (2010) found that the financial system development Granger causes real growth in three of the countries studied while real growth Granger-causes financial development in one country, and for the remaining two countries he found bi-directional causality.

13. The Results of Empirics Concerning Nigeria

In spite of the low level of interest rates, the financial system seemed not to be able to mobilise sufficient savings to finance desired investment. In fact by the second half of the 1980s Nigeria's position worsened as shown by the poverty index which revealed that more than 70% of Nigerians lived below the poverty line (i.e. live on less than USA $1 a day). The country also had an excruciating external debt burden, the financing of which had led to neglect of basic infrastructures of good roads, hospitals, schools, electricity, etc. So the government was in dire need of what to do to arrest the situation.

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The government at the urging of the International Monetary Fund (IMF) and the World Bank (WB) came up with reform measures which basically aimed at freeing the financial system from shackles of overregulation and generally liberalising the whole economy. The reform measures involved rolling back government, and giving the private sector more voice and more power. So by the last quarter of 1986, the Nigerian government introduced liberalisation measures to free the financial system and give the private sector more leverage.

There have been several research output on the issue of financial development and real growth and development as it pertains to Nigeria. As have been the results of global research, the results of empirics concerning Nigeria have been mixed. While a number of studies have found the financial system to impact positively and significantly the real sectors of the economy, others have found real sector growth to predate and to initiate financial sector growth.

For instance Oyejide (1986), Ndebbio (2004), Akinlo and Akinlo (2007), Adegbite (2004, 2005), Adegbite and Oke (2008), Ogwumike and Afangideh (2008), Ogwumike and Salisu (2012), Olofin and Afangiden (2009), Nkoro and Uko (2013) found a positive correlation between financial system development and real growth, in a way that it is the financial system that initiates and promotes growth in the real sector.

On the other hand, some studies found that the financial sector has not enhanced real growth – Nzotta and Okereke (2009), and Nnanna (2004).

However, the works of Odeniran and Udeaja (2010), Osuji and Chigbu (2012), Andu and Okumoko (2013), and Kolapo and Adaramola (2011) have concluded that there is indeed a symbiotic relationship between these two main segments of any economy: the financial sector and real system.

That indeed the relationship is that of the chicken and the egg seems obvious in the assertion of models of causality between financial development and economic growth, though theoretically elegant seems irrelevant as it is obvious in principle that financial development and economic growth are symbiotically linked.

A typical study on causality is the work of Ogwumike and Salisu (2012) wherein they employed the Bound Test Approach to test whether there is any correlation between financial development and economic growth. They used the VAR Granger Causality Test to test for causality. They employed the real GDP as proxy for real or economic growth and employed several indices of financial development. They distinguished between the period of financial regulation and that of financial liberalisation, capturing the period when the system was not liberalised by a Dummy. Their regression equation is as shown below.

$$RGDP_t = f(\mathbf{BDL, CPS, RDR, INV, SMC}) \qquad (1)$$

Where:
RGDP = Real Gross Domestic Product
BDL = Bank Deposit Liability
CPS = Credit to the Private Sector
RDR = Real Discount Rate
INV = Investment
SMC = Stock Market Capitalization

$$RGDP_t = f(\mathbf{BDL, CPS, RDR, INV, SMC, DUM}) \qquad (2)$$

$$InRGDP_t = \beta_o + \beta_1 InBDL_t + \beta_2 InCPS_t + \beta_3 RDR_t + \beta_4 InINV_t + \beta_5 InSMC_t + \beta_6 DUM_t + \mu \qquad (3)$$

$$InRGDP > 0, \quad InCPS > 0, \quad RDR > 0, \quad InINV > 0, \quad and \quad InSMC > 0$$

[illegible]

Ogwumike and Salisu went ahead to specify their autoregressive distribution lag as shown below

$$bdl_t = \sum_{j=1}^{p}\gamma_{1j}\, bdl_{t-j} + \sum_{j=1}^{p}\gamma_{2j}\, rgdp_{t-j} + \sum_{j=1}^{p}\gamma_{3j}\, cps_{t-j} + \sum_{j=1}^{p}\gamma_{4j}\, rdr_{t-j} + \sum_{j=1}^{p}\gamma_{5j}\, inv_{t-j} + \sum_{j=1}^{p}\gamma_{6j}\, smc_{t-j} + \varepsilon_{1t} \ldots\ldots\ldots(6)$$

$$rgdp_t = \sum_{j=1}^{p}\beta_{1j}\, rgdp_{t-j} + \sum_{j=1}^{p}\beta_{2j}\, bdl_{t-j} + \sum_{j=1}^{p}\beta_{3j}\, cps_{t-j} + \sum_{j=1}^{p}\beta_{4j}\, rdr_{t-j} + \sum_{j=1}^{p}\beta_{5j}\, inv_{t-j} + \sum_{j=1}^{p}\beta_{6j}\, smc_{t-j} + \varepsilon_{2t} \cdots$$

$$cps_t = \sum_{j=1}^{p}\alpha_{1j}\, cps_{t-j} + \sum_{j=1}^{p}\alpha_{2j}\, rgdp_{t-j} + \sum_{j=1}^{p}\alpha_{3j}\, bdl_{t-j} - \sum_{j=1}^{p}\alpha_{4j}\, rdr_{t-j} + \sum_{j=1}^{p}\alpha_{5j}\, inv_{t-j} + \sum_{j=1}^{p}\alpha_{6j}\, smc_{t-j} + \varepsilon_{3t} \ldots\ldots(3)$$

$$rdr_t = \sum_{j=1}^{p}\theta_{1j}\, rdr_{t-j} + \sum_{j=1}^{p}\theta_{2j}\, rgdp_{t-j} + \sum_{j=1}^{p}\theta_{3j}\, bdl_{t-j} + \sum_{j=1}^{p}\theta_{4j}\, cps_{t-j} - \sum_{j=1}^{p}\theta_{5j}\, inv_{t-j} + \sum_{j=1}^{p}\theta_{6j}\, smc_{t-j} - \varepsilon_{4t} \ldots\ldots$$

$$inv_t = \sum_{j=1}^{p}\sigma_{1j}\, inv_{t-j} + \sum_{j=1}^{p}\sigma_{2j}\, rgdp_{t-j} + \sum_{j=1}^{p}\sigma_{3j}\, bdl_{t-j} + \sum_{j=1}^{p}\sigma_{4j}\, cps_{t-j} + \sum_{j=1}^{p}\sigma_{5j}\, rdr_{t-j} + \sum_{j=1}^{p}\sigma_{6j}\, smc_{t-j} + \varepsilon_{5t} \cdots$$

$$smc_t = \sum_{j=1}^{p}\varphi_{1j}\, inv_{t-j} + \sum_{j=1}^{p}\varphi_{2j}\, rgdp_{t-j} + \sum_{j=1}^{p}\varphi_{3j}\, bdl_{t-j} + \sum_{j=1}^{p}\varphi_{4j}\, cps_{t-j} + \sum_{j=1}^{p}\varphi_{5j}\, rdr_{t-j} + \sum_{j=1}^{p}\varphi_{6j}\, smc_{t-j} + \varepsilon_{6t} \cdots$$

In the end they found that causality runs from the financial system development to real growth.

14. Is There Any Evidence of Financial Repression in Nigeria?

Nigeria's financial system in the era of regulation (i.e. up to 1986) fitted perfectly the McKinnon and Shaw model of a Repressed Financial System.

Most of the features identified by McKinnon and Shaw (1973) as being manifestation of financial repression were actually present in the Nigerian economy up till 1986.

These features are:

- Regulated interest rates
- Direct Credit allocation
- Placement of ceilings on growth rates of credit
- High barriers to entry both for the banking and the non-bank financial intermediaries
- Unduly high reserve requirements
- Submission of foreign exchange proceeds by all exporters to the government through the Central Bank of Nigeria
- Fixing of the exchange rate by administrative frat
- Prohibition of banks from taking equity positions in enterprises
- Restriction of movement on the Capital Account

- Making it mandatory for banks to open up rural branches (1977) whether they were commercially viable or not.

Adegbite (2003) tried to provide the rationale for the several regulatory measures put in place by government for the financial services sector. She argued that the government believed it was its responsibility to provide basic physical and social infrastructure such as hospitals and schools, and therefore needed cheap funds to do so. Keeping interest rates low means that government could access credit from the financial system (in particular from the banking sector) cheaply. As part of playing its role as overseer of maximum welfare for the people, government believed it has a social contract requiring it to ensure the flow of funds into industries and sectors not commercially viable but socially desirable, hence the use of direct credit control. In those days, two sectors that were usually unattractive to the financial intermediaries (in particular banks) but were considered priority sectors by the Nigerian government were agriculture and housing.

In this era however, government also put in place public banks with the express purpose of sponsoring priority sectors especially in providing long-term finance-Adegbite (2004). Such public banks for provision of long-term finance include – the Nigerian Industrial Development (NIDB), the Nigerian Agricultural and Cooperative Bank (NACB), the Nigerian Bank for Commerce and Industry. These banks were later reorganised to produce the Bank of Industries (BOI) and the Bank of Agriculture respectively.

The federal government also encouraged the opening of a securities market by the opening of the Lagos Stock Exchange by a few individuals in the early 1960s.

15. What About The Issue of Financial Reforms (Financial Liberalisation)?

Beginning from the last quarter of 1986, the federal government of Nigeria started a series of financial reforms meant to liberalise the financial system and indeed the whole economy in order to make the financial system more efficient and more effective.

Beginning with exchange rate liberalization in September 1986, by February 1987, interest rates were uncapped. The major reasons for freeing interest rates were to:

i. enable the financial institutions (in particular banks) mobilise more savings;
ii. provoke higher level of capital inflows as domestic financial assets become internationally more competitive; and
iii. be able to finance development related investments (which tend by their nature to be heavy, requiring large funds).

In addition to freeing interest rates, other reform measures put in place between 1986 and 1990 included:

a. easing of entry requirements of financial institutions, in particular banks (known as free entry, free exit rule)
b. introduction of several new types of financial institutions to widen the financial base and alter the financial structure. Other forms of financial institutions introduced in these early years of financial liberalisation included – Bureaux-de-change, People's Bank, Community banks (these last two were designed specifically for providing micro credit in order to ensure inclusive growth), Urban Development Bank (now Bank of Infrastructure), etc.
c. establishment of a Deposit Insurance Scheme, created in 1988 but which started operations in 1989. The Nigeria Deposit Insurance Corporation (NDIC) was created to promote savings – mobilisation by providing insurance protection to savers – in particular

to small savers (whose deposits research have shown tend to be more stable)

d. use of market instruments to direct credit

e. granting liberty to banks to take equity position in non-financial enterprises

f. altering the capital funds adequacy ratio from 1:12 to 1:10 between adjusted capital funds and total loans and advances.

g. raising the minimum capital base from N0.02 bill (or N20 mill) to N2.00 bill (or N2000 mill) for commercial banks and that of merchant banks was from N0.04 bill to N2.00 bill

Indeed, by 2001 the concept of Universal Banking was introduced to make the banks more relevant, more efficient and more effective as banks became a "one-shop-for-all" business. Under universal banking, a bank can combine commercial banking business with merchant banking, as well as, insurance and stock broking businesses.

16. What Were the Expectations From the Early Reform Measures?

According to Adegbite (2003, 2004, and 2005) the expectations with respect to uncapping interest rates included the attainments of equilibrium interest rates. Given the fact that in a free market (i.e. where forces of demand and supply prevail) the interest rate can find its equilibrium level. Equilibrium interest rate will encourage savings. Given that in equilibrium, realised savings is supposed to equal realised investment then it follows logically that as realised savings increase realised investment will also increase.

When government no longer directed credit administratively (by insisting on what percentage of banks' loan-portfolios must go to specific sectors), then credit can move based on where its value marginal product is highest. If the economy can get the highest value for credit from

Telecommunication, there is no point forcing the credit into agriculture. Credit mobility based on value marginal productivity (or marginal efficiency of capital) ensures that financial resources are more efficiently allocated and utilised.

In the face of efficient allocation and utilization of credit, the chances of loan default are minimised. It follows logically that the lower the incidence of bad loans, which helps improve the stability of the banking system in particular and of the financial system in general the more robust the system would be.

The free entry, free exit rule for financial institutions (in particular banks) was expected to bring in more players into the financial system (i.e – more financial entrepreneurs). The more the financial institutions on-board, the greater the degree of competition is expected to be. In the face of larger number of players, collusive arrangements to oppress consumers of financial products are expected to reduce. Competition generally is believed to promote efficiency. It is also the case that the free entry free exit rule was expected to keep financial institutions' managers on their toes as free exit implies freedom for the financial institutions to die.

Allowing for financial institutions (in particular banks) to take equity position in non-financial enterprises was expected to promote greater interest and involvement of the financial institutions in enterprises. Such greater involvement is supposed to promote innovation and technological progress – Patrick (1966), Goldsmith (1969, Levine (1997).

17. What Have Been the Results of the Early Reform Measures?

In 1999, Omole and Falokun carried out a study to find out the effect of interest rate liberalisation on one segment of the financial system (the stock market). They found that the rising interest rate attendant on freeing the rate of interest led to a reduction in debt capital in the capital structure of firms as debt became more expensive relative to equity. Government's reduction of tax on corporate profits also made equity cheaper than debt. Overall they found that financial liberalisation has raised the cost of production of quoted companies in Nigeria, especially in the face of liberalised exchange rates.

Ikhide and Alawode (2001) similarly attempted to find out the effects of liberalisation measures on the financial system. They concluded that the financial reforms led to increased systemic risk. Such increased systemic risk led to the collapse of 21 banks at a go in 1995. They blamed this not so much on the liberalisation measures but on the lack of sequencing of the measures. They argued that there was need to have prepared the macroeconomic base before introducing the measures. They contended that what the government should have done first was to have pursued the attainment of macroeconomic stability, dampen inflationary pressures especially by reducing fiscal recklessness. The regulatory framework should also have been reinforced and prudential bank supervision put in place before liberalising interest rates, exchange rates, capital mobility, entry exit into the financial system etc.

Kayode and Odusola (2004) maintained that the financial reforms led to "bugging" in the system. Bugging is a situation whereby the borrower (upfront) has made up his mind that he not going to pay back. So that ab-initio the loan was already "bad" even before it was taken.

Hence, massive loan default that followed liberalisation. The "buggers" were able to get away with it, first because of the poor legal system, (that takes ages to prosecute a case) secondly because of lack of credit bureaus-where banks could check upfront the history of an intending borrower.

Umoh (1997) acknowledged that the high rate of expansion of financial institutions in the system following the free exit rule led to spreading the limited skilled manpower thin among the several institutions and supplementing with inexperienced hands. For banks for instance number of banks increased from 41 in 1986 to 120 by 1992 an increase of about 200 percent in less than 10 years.

Using inexperienced hands led to unprofessional banking practices which meant trouble for the financial intermediaries e.g. granting loans without collateral, or without perfecting the collateral. In the face of higher interest rates the projects that promised higher returns were selected but more often than not they were unduly risk projects (which failed eventually) hence adverse selection. Such adverse selection was made possible because of information asymmetries. In the presence of deposit insurance, banks were leaping before looking, confident that NDIC would bail them out – hence the problem of moral hazard.

Prior to Omole and Falokun (1999) and Ikhide and Alawode (2001), the Central Bank of Nigeria and the Nigeria Deposit Insurance Corporation in 1995 tried to investigate the effects of these early reform measures on the financial system. They found that the liberalisation measures had engendered **distress** in the financial system. What is distress? Distress, according to the CBN/NDIC (1995), is a situation where a financial intermediary cannot meet its day-to-day cash withdrawal obligations (i.e. it is illiquid) or when a financial institution's net worth becomes negative (i.e. it is insolvent); or both (i.e. illiquid and insolvent). When such illiquidity or insolvency or both is rampant in the financial system, then the whole financial system is said to be distressed.

THE CBN/NDIC concluded their investigation by saying that there is actually financial system's distress, which they attributed to the following factors

(i) Capital inadequacy;
(ii) Poor asset quality;
(iii) Unduly high level of competition;
(iv) Adverse Selection and Moral Hazard;
(v) Poor Management (especially of family-owned banks); and
(vi) Unfavourable policy and regulatory environment among others.

Such conclusions led to further reform measures to correct the perceived challenges in the system. Another factor that called for a second round of reforms was the Medium Term Development Plan (NEEDS) that the Federal Government introduced in 2003, to guide the economy for the next four years (2003-2007). NEEDs is the acronym for National Economic Empowerment and Development Strategy. Financing needs required the following of the financial system:

i. a deepening of the Financial System both in terms of asset volume and value and in terms of diversity of intermediaries.
ii. a change in the structure of credit from being public sector biased to being private sector biased.
iii. enhancement of the capital base of financial institutions.
iv. improvement in the quality of financial institutions' assets. (Adegbite, 2005).

Given the need to finance NEEDS over the period 2003-2007, and the challenges posed by systemic risk and distress in the financial system, then another round of reforms were introduced into the financial system by the Federal Government through the Central Bank of Nigeria. So by mid-2004 the then governor of the Central Bank of Nigeria, Professor Charles Soludo, announced some new reform measures billed to take full effects from December 2005. Below we look at the second round of reform measures.

18. Second Round of Financial Reform Measures

As discussed in the previous section liberalising the interest rates led to rising nominal rates of interest. By 2003 lending rates on the average was about 22%. This rate of interest was discouraging to investors in the productive sectors. The only group that was ready to borrow at this rate were the traders, who imported and sold the imports locally, as well as speculators. This trend was fast taking the country to what has been termed a "Casino Economy". A casino economy is one that cannot boast of any heavy industries, on that is mainly involved in distributive trade, what the local people will call "Ka-ra, Ka-ta" economy. The danger here is that such an economy neither promotes production, capital accumulation nor economic development.

The banking and financial system in general was more prone to holding short term liabilities and therefore lending largely for short term purposes. There was need for the financial system in particular banks to create financial contracts or financial instruments that could be used to pool long-term funds.

Secondly there was need as discussed in section 16 for the financial intermediaries generally and the banks in particular to have a more solid **capital base** to be able to weather financial storms. There was also need for more **stable deposit base**. The reform measures announced by the CBN Governor (Charles Soludo) on 6th July 2004 required that,

(1) All banks recapitalize from a minimum capital base of N2 billion to N25 billion.

(2) All community banks to re-apply for licenses as Microfinance Banks.

(3) In fulfilment of (1) above, banks were free to approach the stock market and issue fresh equity, or to employ the Mergers and Acquisition strategy.

The recapitalization was to take effect from December of 2005.

The purposes of this new reform measure were:

(a) to promote soundness and stability in the Nigerian financial system.

(b) To ensure enhanced efficiency in the system

(c) To place Nigeria's banking system in regional and global context.

(d) To ensure the development of inclusive financial system where the urban poor and the rural majority can access financial resources.

19. What Were The Expectations and the Fears from the Second Round Financial Reform Measures.

Among others, the expectations from the second round of reform measures especially from bank recapitalisation and consolidation were the following:

First, that when the banks become bigger. They can diversify both from the asset side and from the liability side. They can also diversify geographically (having branch networks along the whole country's landscape thereby benefiting from the specialization in each part of the country) and they can diversify along the **product – space**.

Increasing diversification is expected to reduce the risk and improve the risk-return trade-off, which is expected to ensure increasing return. Also in the face of mergers and acquisitions implicit in the second round of reform measures, there is expected to be improvement in the "skills – set" of bank staff, as new owners and new management are expected to lay-off inept staff and retain only competent ones. Further, a wave of mergers and acquisition compels current management to adopt the best management practices so as not to be swept off.

Given the big size of the new banks, they can afford to create/purchase new tools of financial engineering, new delivery methods etc. The reform made room for weak banks to go under (through mergers and acquisitions) thereby reducing the risk level of the industry.

As a result of the consolidation reforms, banks were expected to enjoy both **economies of scale** and **economies** of **scope.** Economies of scale reduce per unit cost of financial operations the larger the size of operations. Economies of scope reduce the joint cost of producing two complimentary outputs relative to the combined costs of producing each one separately. E.g. where a bank is allowed to provide insurance services, provide stock brokerage services, it will probably utilize the same building, basically the same management staff (adjusting a little for the "skills-set") and at the end of the day, lower the cost, than if each firm was different and operating independently.

There were however fears about these new measures. Some of these fears were, as the banks get bigger the banking sector may become unduly concentrated. This may lead to collusion among the banks, less competition and anti-consumer practices (Adegbite & Adaramola, 2006). This may lead to higher prices and poorer services. Also the bigger the bank, the greater the tendency to increase risk-taking through increased leverage and off-balance sheet operations.

While economies of scale may lead to reducing per unit cost, that is only one side of the coin. A quick flip at the other side of the coin will reveal that beyond a given threshold, economies of scale can turn to diseconomies of scale (when a firm becomes a big bureaucracy, difficult to run efficiently).

Another fear of the effect of consolidation is that unfettered banks in search of profits will probably not be too willing to finance agriculture and manufacturing (two industries critical to long-run growth but whose short-run returns can be very low). While rate of return tend to be high in services sector (e.g. Telecommunication, Commerce), they tend to be low in agriculture and manufacturing-two industries that are growth propellers. Re-arranging banks' portfolios to meaningfully accommodate such priority sectors was considered a challenge.

20. Aftermath of Second Round of Financial Reforms

The aftermath of the second round of financial reforms was a shrinking in the number of banks from 89 to 25 by December, 2005 and later to 24. While some of the banks raised additional equity in the stock market (increasing stock market activity) others merged or acquired each other. However, there were eleven (11) banks that could not raise N25 billion, neither did they find other banks willing to buy them over or to merge with them. So the licenses of these 11 banks were revoked by the CBN.

In the short run, it was like the expectation of government to develop a resilient competitive and dynamic banking system that supports and contributes positively to the growth of the economy had been achieved. However, with time, serious problems manifested. First some banks used depositors' money to grant loans to those purchasing equity. This led to asset/liability mismatch (i.e. using short – term funds to finance long-term investment). This posed a great threat to depositors' funds. For some merging banks, the merger itself posed integration risk as the merging parties had poor understanding of "adopted risks".

Given their size, some banks became reckless, having loan exposure either to a single customer or to a single sector visitation to the Expanded Discount Window. To assist these, banks the CBN injected N420 billion as subordinated loan. That five out of the twenty four banks in Nigeria were distressed, whose deposits make up about 30 per cent of aggregate deposit in the Nigerian banking system was a testimony to the fact that there was significant systemic risk.

By October 2009, the CBN/NDIC team was able to identify three additional insolvent banks i.e. Bank PHB, Spring Bank and Equatorial Trust Bank. As with the first five insolvent banks the CBN pumped a total of N200 billion into these banks as subordinated loan.

As a result of this distress in the financial system, the government through the Central Bank had to come out with another set of financial reform measures to save the Nigerian Financial System, deepen it and make it more resilient.

21. The Third Series of Financial Sector Reforms

The third series of financial sector reforms were far reaching in that they touched almost every aspect of the banking system

i. First the Universal banking template was discarded. Rather than a single bank functioning as a commercial bank, as well as a merchant bank and sometimes as an insurance company as well as a stockbroker, the reforms measures required each bank to make up its mind what it really wants to be. So a commercial bank is no longer allowed to function as a merchant bank. Each bank was to reapply for new license. Three classes of banking licenses were introduced commercial, merchant or specialised and development banking. The specialised category could be microfinance banking, mortgage banking or non-interest banking.

ii. Each bank has to determine its domain of operation – Regional (i.e covering only a specific region in Nigeria) visitation to the Expanded Discount Window. To assist these, banks the CBN injected N420 billion as subordinated loan. That five out of the twenty four banks in Nigeria were distressed, whose deposits make up about 30 per cent of aggregate deposit in the Nigerian banking system was a testimony to the fact that there was significant systemic risk.

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or national or international. In applying for fresh license each bank must specify its intended domain of operation.

iii. The Central bank set varying capitalization requirement for each banking category. For commercial banks interested in obtaining regional license minimum paid-up capital is N10 billion while for those interested in national license it is N25 billion and those who desire to have international license, the minimum paid up capital is N50 billion. It is interesting to note that, among those who applied for the International Commercial banking license were – First Bank of Nigeria Plc, Guaranty Trust Bank Plc, and United Bank for Africa (UBA) Plc. This reform was to take effect from 2011 and seems to be a fundamental reversal of the 2004 consolidation policy.

iv. Every bank must adopt the International Financial Reporting Standard (IFRS), by the end of year 2012; while all banks must adopt the January to December accounting year.

v. To improve corporate governance, the reform measure insists it is no longer acceptable for the Managing Director/Chief Executive Officer of a bank to at the same time be the Chairman of the board of directors.

vi. Still on Corporate governance, the reform measure requires a Managing Director of a bank not to serve for more than a maximum of 10 years at one-go i.e. 5 year term each, for two consecutive terms. The purpose of this reform measure is to avoid a situation where a chief executive officer begins to run the bank as a personal business rather than as a publicly held corporation where management is accountable to shareholders.

vii. An Asset Management Company was to be set up to take away toxic assets (non-performing loans) from the books of banks who run into distress. The importance of AMCON is that once it has cleansed up a bank by taking over its toxic assets, then the bank can have relief of funding pressures, and investors as well as depositors can have more confidence in the bank and in its future.

viii. A cash-lite policy was also put in place to reduce the amount of cash transactions in the system. There were three basic reasons for this policy. First the cost of producing cash (currency and coins) has become exorbitant – estimated to be about N200 billion as of 2011. Secondly a lot of robberies was effected in an attempt to steal cash, so the security implication of a largely cash-economy was serious. Thirdly, is an attempt to make Nigeria comply with the best global practices, alternative electronic payments systems were encouraged. A pilot scheme of the cashless program was put in place from 2012 covering Lagos, and extended by 2013 to Abia, Ogun, Anambra, Kano and Rivers States.

In all it can be safely concluded that the reform measures of 2009 / 2010 had four objectives. The first is to enhance the quality of banks and of banking, the second is to establish financial stability, third, to allow a healthy evolution of the financial sector and lastly to ensure that the financial system plays its real-growth – enhancing role in the Nigerian economy.

22. When All is Said and Done

Ayadi, Adegbite and Ayadi in their 2008 study on the reform measures (financial and non-financial) (popularly known as Structural Adjustment Program), the Financial Sector and Economic Prosperity came to an interesting conclusion. First we employed six different measures of the size of the Nigerian financial system; the size of a financial system measures the financial depth and is an indication of financial growth. Among the six measures of size were the ratio of deposit money banks' assets to the gross domestic product of the country (GDP), the ratio of the liquid liabilities of the entire financial system to the GDP, and the ratio of the deposit money banks assets to the Central Bank's assets.

Secondly we measured the efficiency of the Nigerian financial system i.e efficiency of financial intermediation using two indices – the ratio of credit by deposit money banks to the private sector relative to the GDP, and the ratio of both banks and Non-Banks financial institutions credit to the private sector relative to the GDP. The emphasis was on the credit to private sector because it has been argued in the literature that credit to the public sector tends to be largely unproductive because government's borrowing is usually used to finance over bloated bureaucracy. whereas credit to the private sector is for productive investment. Hence, a measure of the efficiency of financial intermediation is to see how much of credit actually goes into the private sector.

Thirdly we measured the liquidity of the Nigerian financial system usually represented by capital market activities. We know that one basic function of the financial system is to be able to impart liquidity to savers, so that while they are ready to release their funds for long-term projects, in case of sudden need for liquidity they can be sure they can access their money back. This kind of liquidity is what the stock market provides which allows enterprises enjoy the use of long-term funds without disruptions as savers can always sell their financial securities to obtain instant liquidity while the firm continues with the use of the fund. We measured liquidity using three indices – these are the ratio of stock market capitalisation to GDP, second the ratio of total value of stock traded to GDP, and lastly stock market turnover to GDP.

In measuring economic growth we used the growth rate of real per capita income and found that **there has been no consistent relationship between the financial sector**

development and real growth. For instance while in the immediate-run after liberalization (i.e. first five years) the size index rose, by six to ten years down the line (1993 – 1997) the index of size dropped, only to pick up later in the 1990s. This is understandable because by the mid – 1990s there was distress in the financial system caused by a whole array of factors (see Ojo J.A.T. (2010); Ogunleye G.A. 2010). However from the late 1990s, the size index started to rise. This rise possibly reflects the fact that government has put in place measures to control financial sector business especially banking business. Examples of such measures include the Bank and Other Financial Institutions Act, (BOFIA), the setting up of Financial Services Regulation Coordinating Committee (FSRCC) (a body meant to harmonise supervisory standards in the financial services sector).

As for the measure of activity or efficiency of financial intermediation, it was discovered that immediately following the reforms, the activity index fell. This implies that the level of funding of private enterprises by the financial system dropped in the immediate run following liberalization measures. This is understandable given that the liberalisation measure cut across every sector of the economy, so that as the private sector firms faced rising rates of interest from financial institutions they also faced higher exchange rates (in the exchange markets). Many small and medium enterprises could not afford to import necessary intermediate products at the new exchange rates, and could not afford to borrow at the new interest rates. However, when the dust had settled by the late 1990s, the activity measure picked-up. As for the liquidity measure (i.e. measure of activity in the stock market) it was poor up till 2003. However from 2004 after the second round of financial sector reforms which made it mandatory for all banks to recapitalise, even insurance companies were also to recapitalize, then activities in the stock market picked up. We found overall that the performance of the stock market as a measure of financial development was at best moderate.

Ehimere and Adegbite (2015) in trying to measure the efficiency of banks since the second round of financial reforms came to the conclusion that there is a high level of inefficiency in banking operations. Such level of inefficiency is a deterrent to the banking sector's ability to impact real growth positively.

Interestingly, Ogwumike and Salisu (2012) found a consistently positive impact of the financial sector on real development and indeed found causality to be unidirectional from the financial sector to real growth, so did Odedokun (1996). Others have found causality to run from real growth to financial development in a unidirectional manner – Shanoushi et al (2008), Lucas (1988) yet others have found causality to be bidirectional Akinlo and Egbetunde 2010.

The implication of all these when all is said and done is that the issue of the causal relationship between the financial system and the real economy is far from being settled. While intuition suggests that the relationship should be one of bidirectional causality, like the egg and the chicken, hard empirics is producing different results from country to country, even within the same country. The debate still rages on. However there are some lessons that policy makers, financial theorists, development economists etc. have learnt from all of these, and next we go to the lessons.

23. Lessons of Experience

There has been tremendous research output on the financial development versus real growth nexus but there has not been one single universally accepted conclusion. However, there is a reasonable degree of consensus about some aspects of the relationship. First, that there is a high degree of significant and positive correlation between financial development and real growth. That whenever the financial sector is getting more deepened and widened, the tendency is to see the real economy grow. Also, that as the economy grows the tendency is for the financial sector to show signs of improved development. However, there have been research outputs whose results seem to go contrary to these consensuses.

Besides, on the issue of causality while some have said there is unidirectional causality from financial development to real growth others have insisted that causality is unidirectional from real growth to financial development and yet others say it is bi-directional causality. However, some things have come out clearly:

i. Outside of financial development there are other factors that affect real growth. In fact Levine (1997) has insisted that it is **analytically difficult** and perhaps **reckless** to attribute differences in real growth rates of countries to differences in the level of development of their financial systems **alone**. For instance while saving is crucial to investment, non-interest-rate variables like demography, pension provision, funding of health and education, ownership structure of corporations etc. all affect savings and saving's rate and hence all affect investment and real growth whether the financial system is liberal or repressed, stagnant or growing.
ii. That liberalising the financial system leads to real growth may be true but it probably requires that some basic conditions be met.
    a. There must be macroeconomic stability.
    b. There must be adequate financial system supervision in particular bank supervision.
    c. The financial system supervisory agencies must have **supervisory capacity.**
iii. Fiscal recklessness and continually changing prices as well as policy summersaults are anathemic to financial

development as well as to real growth and development.

iv. There must be consistency between monetary policy and exchange rate policy. This ensures that inflation induced real exchange rate development is avoided.

v. The legal framework is crucial to financial development and real growth. A situation of "bugging", where borrowers have made up their minds upfront not to repay (Kayode & Odusola, 2004), is only possible where the legal framework is weak and such borrowers know that they can get away with it.

A sound legal framework is crucial for financial liberalisation to succeed, it is also crucial for the real sector (enterprises) to operate with maximum efficiency. Poor legal system can constitute hindrance to enterprise in several different ways and hence to real growth.

24. Where Do We Go From Here?

The weight of evidence **seems to be** that financial development promotes real growth and development. However the factors that have made this growth enhancing role difficult for the financial sector must be addressed.

First: is the government competing with the private sector for funds in the system thereby crowding out the private enterprises? Banks too prefer to lend to the public sector for two basic reasons: the public sector seems a safer sector to lend to, with lower risk of default; also, lending to government and its agencies implies lower cost of loan administration. But when government crowds out the private sector, the credit may not transform to increased investment, given that research has shown that the content of public spending tend to be largely unproductive. A lot of government borrowing from the banking system is usually spent to maintain an over bloated bureaucracy. Indeed when the lending to the public sector is productive the level of employment generated is low, making lending to the private sector the preferred option.

Second, there is the need for financial institutions in general and banks in particular to develop a more stable deposit base. It is said that household savings tend to be more stable. So rather than engage young girls and ask them to run after millionaires (a practice that the CBN has legislated against), the focus should be on how to design financial instruments attractive to households, so as to be able to pull household savings.

Three, in dealing with the plague of loan-default that causes financial system to experience systemic crises from time to time, and causes even indices of financial development to fall, there are quite a number of things that must be done. One such is that there should be a value-reorientation programme, which emphasizes the importance of honesty, integrity and probity. Then sanctions must be designed against dishonest practices both on the part of staff of financial institutions and their customers. Creating sanctions is not enough but executing them is primal, hence the legal framework must make it easy to persecute loan defaulters and other insider – abusers.

Fourth, to ensure that the pool of funds is sufficiently diversified thereby taking care of the savers' fear of risk, the financial intermediaries need to create more financial contracts (i.e. financial instruments). A more diversified deposit base is a cushion against financial instability.

Fifth, one of the things that drive rates of interest through the roofs, forcing banks to be caught in adverse–selection of projects is the existence of leakages in the system and of information asymmetries, which banks try to make room for by raising interest rates. However higher rates of interest become counter-productive after a given threshold, so there must be a benchmarking for interest rates probably to be provided by the regulator (the CBN).

Six, Government fiscal rascality can be a problem to the system, leading to consistently higher rates of interest. Fiscal rascality on the part of government must be watched and must be nipped in the bud.

Mr. Vice-Chancellor sir, in conclusion, I wish to ask: is it the chicken that causes the egg to be or the egg that causes the chicken to be? Your answer is as good as mine.

APPRECIATION

Mr. Vice-Chancellor Sir, I now wish to acknowledge and appreciate all those who in one way or another impacted my life and helped me on this journey. Sir if I were to attempt to list all the names here I would need time sufficient for another Inaugural Lecture.

However I wouldn't like to tax your patience. Be that as it may, I have to acknowledge some people here and wish to begin with my biological father and end with my loving heavenly father.

My profound gratitude therefore goes to my father Elijah Kolade Akinlade of Aibo Quarters, Aiyetoro, Yewa in Ogun State. This is the first opportunity I have to pay tribute to him, since his demise in March 2012 at the age of Eighty-eight (88), so permit me to dwell more on my late father.

Indeed I have not seen till date any man that I can compare with my dad. For 58 years of being together I never saw my father angry once; he was always cool, calm, unruffled and in control. A great sacrificer, he usually will go out of his way to help others, even at great expense to himself. I never saw him ruffled, I never saw him lose his composure, except when I lost my only sister in a ghastly motor accident on the Lagos/Ibadan expressway – I saw my dad weep. Outside of that episode, he was always in great peace and great calm, quiet and reserved.

With only Standard Three formal education, my father wrote books that others wrote Ph.D theses on, books that Professors researched and wrote papers and journal articles on. He was a creative Writer of Detective Fiction genre. As far back as 1975, University of Ibadan Linguistics Department was using some of his books in their Yoruba Classes.

Among his **sixty two (62)** works are:

- Owo Te Amookunsika
- Asenibanidaro
- Aja to Nlepa Ekun
- Sangba Foand Co-Authored with D. O. Fagunwa
- Asayan Itan Some of his English works include
- Chaka the Zulu
- A Land Without Beggars

A great man who set me on the path of academic greatness by filling our homes with books, I wish you were alive to see this day. Continue to rest in perfect peace.

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