

Financial systems of ghana and nigeria



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Since the idea of Adam Smith's invincible hands also known as invincible hand of the market, the allocative power of the market has been generally recognised. These ideas have been reinforced by the apparent failure of Keynesian theories of government intervention to stand the test of time. As a result of the adoption of SAP (Structural Adjustment programme) by most developing countries including Ghana and Nigerian which are my main concentration, the debate of liberalization versus intervention has been rekindled. The major area of concentration is if these developing countries (Ghana and Nigeria) with imperfect markets have benefitted from recent liberalization efforts in the structural adjustment programme.

Financial liberalization is usually an important component of a country's strategy for economic growth. In an old fashion way, financial liberalization, has come to be most universally linked with freeing of interest rates, but now financial liberalization is seen as a process involving a much broader set of measures geared toward the elimination of various restrictions on the financial sector, such as the removal of portfolio restrictions on the banking sector, the reform of the external sector, and also changes in the workings of the monetary policy

THE FINANCIAL SYSTEM OF GHANA AND NIGERIA.

A key stylised fact about financial systems in developing countries is that they are dominated by commercial banks (Fry, 1995, pp. 4-5; Rojas-Suairez and Weisbrod, 1995, pp. 4) Ghana and Nigeria's financial system consists of a large fragmented informal sector and formal sector. The formal sector is made up of central bank(Bank of Ghana and Central Bank of Nigeria) at the

apex, with 42 commercial banks for both countries; Nigeria (26) and Ghana (16), development banks (Nigeria, (5), Ghana (3) , and merchant banks (30 Nigeria), (Ghana, (10), insurance companies, stock exchange, building society, community banks. The structure of Nigeria's financial system will be explained below:

Regulatory Authorities: they regulate the Nigerian financial system, and they include Central Bank of Nigeria (CBN), the Federal Ministry of Finance (FMF), Federal Mortgage Bank of Nigeria (FMBN Nigeria Deposit Insurance Corporation (NDIC), Securities and Exchange Commission (SEC),), and the National Board for Community Banks (NBCB, National Insurance Commission (NIC). These regulatory authorities will be explained in detail below.

1. Federal Ministry of Finance: the role of this regulatory authority is to advise the Federal Government on its fiscal operation and make sure it follows whatever the central bank of Nigeria says concerning the monetary matters of the country.

2. FEDERAL MORTGAGE BANK OF NIGERIA (FMBN)

The role of the is to provide banking and advisory services, and also to undertake research activities pertaining to housing. After the adoption of the National Housing Policy in 1990, The FMBN is empowered to licence and control main mortgage institutions in Nigeria and act as the peak regulatory body for the mortgage finance industry.

3. The central bank of Nigeria

The central bank of Nigeria has the same responsibilities as the bank of Ghana. It was established by the central bank of Nigeria act of 1958 and commenced operation on July 1, 1959. Their major regulatory objective is to issue legal tender to the economy, banker of last resort, financial adviser to the government, enhance monetary stability and a good financial environment which will be of benefit to the country in the short and long run. the central bank of Nigeria's success is partly as a result of the rise in crude oil prices.

4. The Nigerian Deposit Insurance Corporation: Its role is to complement the supervisory and regulatory role of central bank of Nigeria (CBN). It has the right to examine the books and affairs of the insured banks in Nigeria and other deposit taking financial institutions.

ORIGIN OF FINANCIAL LIBERALIZATION IN NIGERIA

Nigeria's economy has always been dependent on oil prices since the early 1960's. As a result of the collapse of world oil prices and the reduction in the production of petroleum in the early 1980's, the nature of the country's economic and financial position became very weak and vulnerable. This led to recession and economic deterioration. The economy was characterised by shortages in its foreign exchange, debt crises, negative economic growth and high rates of unemployment, Indeed, beginning from 1982, and through 1984, the country had become saddled with negative trends in economic growth as indicated by the decline in the gross domestic product (GDP) (0.35% in 1982; -5.37% in 1983; and -5.18% in 1984), persistent current account and budget deficits, a huge number of uncompleted projects in the

public sector, factory closures, large-scale retrenchment, acute shortages of essential commodities and galloping inflation, (Odusola, 2001, p4). The government decided to carry out some short run stabilization measures, one of which was to foster employment through the creation of public sector jobs, this exerted more pressure on the budget, notwithstanding that, public sector employment grew by a further 18 per cent between 1981 and 1984. This policy promoted migration into cities, as the increases in government salaries during this period compared to that of the rural areas was more favourably. Urban migration and its attendant unemployment problems became even more pronounced in 1981 when the Government increased the minimum wage rate to the entry level salary of public sector employees. Urban unemployment increased significantly, from 2½ per cent in 1980 to 10 per cent in 1985, while rural unemployment rose from 4 per cent to 6 per cent over the same period. Real per capital income fell significantly as well, from US\$1, 010 in 1981 to US\$850 in 1985 (Odusola, 2001, Pp4). Nigeria financial sector was characterised by rigid exchange and interest rate controls, sartorial allocation of bank credit (Okpara, 2010, P54), the naira was overvalued, all of which made the economy more exposed to risk of default and practically led to distortions that resulted into low direct investment, which in turn led to financial repression. it will be discussed more in-depth below. Financial repression discouraged investment in information capital; it also discouraged savings mobilization, in the sense that it was not vigorously pursued. The financial system incurred a lot of cost in financial intermediation, and it was as a result of inactive liquidity and liability management and incentives to increase efficiency. Not only was Nigeria the only country going through this problem of financial repression,

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much of the twentieth century saw intensified financial repression (Caprio et al, 2001 p5), for example, Ecuador, Uruguay, Mexico, Ghana, Malawi, Tanzania etc, all had the problem of financial repression in their economy. As a result of the financial repression in the economy, the government decided to adopt a financial sector reform to help increase the countries economy. The programme they adopted was called Structural adjustment programme (SAP).

STRCTURAL ADJUSTMENT PROGRAMME IN GHANA AND NIGERIA.

The Ghanaian economy also went through the same problems as the Nigerian economy during the early 1980's. They had similar problems as the Nigerian economy; which include, high default rates, high rates of inflation, weakened confidence in the financial system. These affected the ability of the banks to perform their intermediation function properly (Acquaye and Sowa, 1999, p395). The major objectives of this SAP were, among others, to:

Restructure the economy in a way to reduce its dependence on oil as its main source of income.

Revitalise the financial sector by creating new institutions

Reduce fisal balance of payment problems

Promote non-inflationary economic growth.

The key policies designed to achieve these objective were:

The liberalization of the external trade and payments system-dismantling of price,

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trade and exchange controls;

Implementation of methods to encourage domestic production and expand the supply base of the economy;

The setting up of a Second-Tier Foreign Exchange Market (SFEM) as a mechanism of

realistic exchange rate.

The rationalization and restructuring of public sector enterprises and overhauling of

the public sector administrative structure.

Reinforcement of important and strong demand management policies;

More rationalisation and restructuring of tariffs in order to aid industrial diversification;

The elimination of price controls and commodity boards;

The key reforms that have already been implemented as part of the financial liberalization policies include;

Changing of the concept of a credit ceiling with OMO(Open market operation)

Promoting competition and efficiency in the financial system

Liberalizing interest rate, exchange rate, but in general the financial sector.

The financial sector reforms were thrown into crisis by the sequencing of reform measures and the lack of the necessary prerequisites for liberalization. Particularly, the deregulation of interest rate and the requirements for market entry led to the instability of the financial system. A series of corrective measures had to be adopted, raising questions of policy credibility (Aiyetey et al, 1997, P196).

THE STRUCTURAL ADJUSTMENT PROGRAMME: THEORETICAL BASIS

Virtually every sub Saharan African country including Nigeria and Ghana experienced major changes in the overall direction of the national economic policy in the early 1980's. These policy reforms were implemented as an integral part of the structural adjustment programmes (SAP) prescribed by the World Bank and the stabilization programme of the international monetary fund (IMF) (Olasupo, 2005, p 7). The structural adjustment programme had a lot of objectives, but the major objective of this reform programme was to correct the alleged distortions which made sustained economic growth and recovery in the economies difficult. Notwithstanding the general decision of the countries to undertake the adjustment programme, there has since the start of the 1990 decade, been wide ranging argument surrounding the theoretical paradigm underlying the SAP and their suitability to African countries. The first which is the unrequited orthodoxy; it emphasizes how well the adjusters have done in comparison to non adjusters. According to this perspective, the regime of restricted inward looking policies resulted in over protected industrial structure, balance of payment problems (Olasupo 2005, p10). They also contend that development problems will be solved by more adjustment not less, with this

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they concluded that sub-Saharan African countries experienced poor macroeconomic growth and performance relative to their South East Asian counterparts, because economies in the former were exposed to long term government intervention and restrictive macroeconomic and sectorial policies. The modified orthodoxy sees adjustment programmes in an economy as a necessary but not sufficient condition for development, because adjustment is only capable of stabilizing economies in the short term. This orthodoxy believes that other measures must be put in place for African development to occur in the medium and long term. A strong proponent of this approach puts it, "...the most significant shortcoming of current structural adjustment programs is the lack of logical linkage between the short-term objectives of attaining balance-of-payments equilibrium and improving allocative efficiency and the long-term objective of sustainable development..." Nguyuru Lipumba, (p. 9)

FINANCIAL LIBERALIZATION AND REPRESSION.

Financial liberalization is the process of breaking away from a state of financial repression. Financial repression has been most commonly associated with government fixing of interest rates and its adverse consequences on the financial sector as well as on the economy.

The term financial repression was originally coined by economists interested in less developed countries (LDCs) Gupta, 2004, Pp2. It originated in the works of Ronald I. McKinnon and Edward S. Shaw in the early 1970s, to describe a developing country's environment, defining it as the set of government legal restrictions preventing the financial intermediaries in the

economy from functioning at their full capacity level. The most common forms that this intervention takes are interest rate regulations, directed credit schemes, and high reserve ratios. The literature on financial repression stresses that because savings levels are sensitive to real interest rate, nominal interest rate controls; cumulative inflation reduces the amount of the national income.

The benefits of financial repression, as opposed to financial liberalization, are debated on several points Ozdemir & Erbil, (2008). In theory, it is believed that financial repression can make it better to control money supply in an economy and also control over interest rate which will induce investment. Another argument in favour of financial repression is that government controls on financial markets are needed for developing countries. In practice, financial repression appears to have yielded government revenue in the order of 2 % of GDP on average in samples of developing countries (Giovannini and de Melo, 1993; Fry et al. 1996, p. 36).

The main conviction of the advocates for financial repression is that the government knows better than the market. The repression mechanism works through the interest rate and the exchange rates. Therefore moving from financial repression to financial liberalization would require extra budgetary measures and could create budgetary problems, Like in the case of Nigeria in the early 1980's when the government sought to reduce unemployment in the urban areas and the outcome of this decision exerted more pressure on the budget.

Financial liberalization may increase the fiscal deficit and the cost to finance, as the government loses revenues and is forced to pay more market-based interest rates on its existing debt.

On the other hand, the most popular argument which favours financial liberalization is the rising growth effect by motivating savings and investment. Financial liberalization may increase the level of savings and improve the allocation of savings among potential investors. This will lead to the creation of more available funds and hence economic growth. Financial liberalization may decrease the cost of capital, but on the other hand, movements which cause the crises and macroeconomic instability may have a negative impact on economic growth Ozdemir and Erbil (2008). This debate highlights the need for further sound empirical evidence on the benefits of financial liberalization on economic growth, especially for small open economies of developing countries.

FINANCIAL LIBERALIZATION AND SAVINGS

The advocates of financial liberalization do not seek to induce savings, but to promote and increase the volume and efficiency of capital formation. While financial reform can affect saving through various potential channels, on the whole its net effect is ambiguous. (Schmidt- Hebbel and Serven, 2002, p2). Moreover saving is often considered beneficial for its financial dimensions. In open economies, raising national saving is a way to reduce the dependence on foreign saving, protecting the economy from external shocks. This is an important policy concern in a world of increasing financial integration. Together with a strong and well-capitalized financial system, saving

represents a form of self-insurance to reduce the economy's vulnerability to unexpected reversals of international capital flows. In this manner, saving can help reduce macroeconomic volatility, which empirically has been shown to hamper growth (Ramey and Ramey 1995; Fatás 2000).

Various researchers have shown some empirical evidence that although financial liberalization results in higher interest rate and financial deepening, it does not really lead to higher savings. In majority of countries, financial reforms are followed by declines in savings (Okereke, 2009).

Bandiera et al (2000) estimated an econometric relationship showing the private saving ratio as a function of the real interest rate and degree of openness as an index for financial liberalization, along with income, inflation and public savings. They analyze the experience of eight countries that underwent significant reforms in their financial systems, namely Chile, Ghana, Indonesia, Korea, Malaysia, Mexico, Turkey and Zimbabwe. For these countries they measured the effect of liberalization on the volume of aggregate savings, their results

Their results do not provide a clear answer on the impact of reforms on saving, as

the effect appears significantly negative in some cases (Korea and Mexico), positive in

some others (Greece and Turkey) and insignificant in the Indonesia, Malaysia, Zimbabwe, and Ghana. In a study similar to theirs i. e. (Bandiera et al), Loayza and Shanka(2000), used India as their country of observation,

and the savings rate from India and found out that financial reform has not changed the savings rate, but moved the composition of savings in India towards a higher share of durable goods.

Ostry and Levey (1995), in their findings maintained that financial development as a result of liberalization reduced savings. Bennett et al (2001), in their work, also found a negative significant effect on savings.

CONSEQUENCES OF FINANCIAL LIBERALIZATION

Policies that make an economy open to the rest of the world and they are needed for sustained economic growth. No country has achieved economic success, in terms of substantial increases in living standards for its people, without being open to rest of the world. Trade opening has been an important element in the economic success of East Asia, where the average import tariff has fallen from 30 percent to 10% over the past 20 years.

Opening up economies to global economy has been essential in enabling many developing countries to develop competitive advantages in different sectors of their economy. Countries that have opened their economies in recent years, for example India in 1991, have experienced faster growth rate and more poverty reduction, a proof is that following the economic reforms, the country began to develop a fast paced economic growth. India is the eleventh largest economy in the world

There are some negative effects experienced by countries or the world in general in terms of their reform policies that has outweighs the benefits of such reforms, this statement can be applied to the effects of financial

liberalization despite its benefits in terms of access to more capital inflows. Financial liberalization creates exposure to various kinds of risk and they include; a propensity to lead to financial internal and external financial crises, inadequate access to funds for small scale producers etc.

Many researchers have carried out empirical studies on financial liberalization on financial fragility of the economy, and their conclusion is that liberalization increases the fragility of the financial system. According to (Demirguc-kunt & detragiache), one of the reason why financial liberalization may lead to increased financial sector fragility is that the removal of interest rate ceilings and also the reduction of barriers to entry reduces bank franchise values, thus exacerbating moral hazards problems. The moral hazards problem is a special case of information asymmetry, a situation in which one party in a transaction has more information than another. Normally banks try to protect their franchise, and the risk of losing their franchise, but during a period of policy reform such as financial liberalization, where there is free entry in to the market or financial sector, so as a result of that there is more competition, this erodes franchise values. If the effort of reform does not incorporate adequate strengthening of the prudential regulations and supervision to realign incentives, lower franchise values are likely to lead to increased fragility (Stiglitz et al (2001)

Tornell et al (2003), in their studies, they said that financial liberalization is bad for growth because it leads to crises. Their empirical analysis shows that in countries with harsh credit market imperfections, financial liberalization leads to a more rapid growth but also a more higher incidence of crises. They also argued that liberalization leads to faster growth because it eases

financial constraints, but on one condition that this occurs if agents which are the government, investors and creditors take on credit risk which makes the economy fragile and prone to crisis.