Sequencing Capital Account Liberalization

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The increased integration of international financial markets provides both opportunities for economic growth as well as challenges for macroeconomic management in developing countries. By liberalizing their capital accounts, developing country economies stand a better chance of leveraging resources from the international capital market for investment and growth, and also enable their domestic investors to diversify their portfolio of investments. Capital account liberalization is, however, not without its challenges. Recent financial crises in some emerging market economies highlight the need for an appropriate sequencing of liberalization policies. Country experiences indicate the need for macroeconomic stabilization, current account liberalization, liberalization of the financial sector and effective prudential financial sector regulation as preconditions for successful opening of the capital account. This paper focuses on the case of Nigeria and examines whether, following the successful implementation of the recent reform program, appropriate policies are now in place for effective capital account liberalization. We conclude that there is no simple answer as to the sequencing process partly because the preconditions are not cast in absolutist terms. Similarly, reforms are a process rather an event suggesting that a gradualist approach to liberalization is needed as Nigeria's economic reforms are consolidated. Ultimately, the major benefits of capital account liberalization in Nigeria may result not from its direct effect on GDP growth, but instead, by promoting various collateral benefits such as strengthened domestic institutions, improved financial supervision, and greater macroeconomic discipline.

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I. Introduction

The increased integration of international financial markets has been one of the most notable developments of the past two decades. The rise in international capital flows to developing countries has been particularly significant, and spurred by demand for developing country debt and equities which have become increasingly attractive to international investors[1]. Aggregate net resource flows to developing countries increased nearly fourfold from $62 billion in 1985, to $227 billion in 1995; and further doubled to about $443 billion in 2005 (World Bank, 2006). There is considerable debate in the literature on the benefits of capital account liberalization. By liberalizing their capital accounts, developing countries could improve access to international capital needed for investment and growth, and also enable domestic investors to diversify their portfolio investments. The experiences of some emerging economies however provide lessons on potential risks associated with capital account liberalization, such as overheating of the domestic economy and asset price inflation. Effective macroeconomic management is needed if developing countries are to benefit from international capital flows, while minimizing its undesirable side effects.

This paper examines the case of Nigeria, and assesses whether appropriate policies are now in place for successful capital account liberalization. Our focus here is on the pace and sequencing of liberalization. In this paper, capital account liberalization is defined as the removal of prohibitions on transactions in the capital and financial accounts of the balance of payments. It includes the removal of exchange and other controls which may hinder the movement of international capital, either as foreign direct investments or short-term portfolio capital.

The remainder of this paper is organized as follows. Section 2 examines the theoretical literature on the benefits of capital account liberalization and briefly summarizes some empirical results on the relationship between capital account liberalization and growth. Section 3 presents some principles of

[1] *For example, net private flows (debt + equity) more than tripled in the past five years, from $154 billion in 2001 to about $491 billion in 2005 (World Bank, 2006).*

successful capital account liberalization, while section 4 reviews some country experiences to draw lessons on appropriate sequencing of capital account liberalization. Section 5 reviews Nigeria's recent economic reforms and examines whether appropriate policies are in place to support capital account liberalization. Section 6 provides a summary of previous arguments and outlines future challenges for Nigerian policymakers on the sequencing of capital account liberalization. The paper is concluded in section 7.

II. Some Current Literature on Capital Account Liberalization

II.1 Review of the Theoretical Literature

There are two main schools of thought in the theoretical debate on the benefits of the capital market liberalization. The first hypothesis is based on an "efficient market" argument, whereas a second school of thought argues that "information asymmetry" hinders the efficient operation of global financial markets.

The 'efficient market' view is derived from neoclassical arguments of allocative efficiency, and may be summarized in five parts as follows. First, it is argued that states should focus on maximizing their GNP (i.e. net income of their citizens), and not solely their GDP (i.e. the output of the country). Liberalizing their financial markets therefore supports a more efficient allocation of international capital, provides outlets for investments, and enables domestic economic agents to obtain the highest possible returns on their investments, even if abroad[2]. Second, open capital markets benefit a country by providing opportunities for inter-temporal trade and cross-border diversification of investment portfolios. Inter-temporal trade enables countries to borrow in times of low incomes, and to repay when incomes are higher,

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[2]*For example, according to Cooper (1999), the McKinsey Global Institute noted that South Korean entrepreneurs had access to more favorable investment opportunities abroad, compared to investing in major domestic industries which provided slightly lower returns. In such an instance, restricting export of South Korean capital would result in lower national income, and even further, may discourage domestic savings.*

thereby achieving consumption smoothing[3]. By allowing portfolio diversification, capital mobility provides risk-sharing, and enables countries and firms to reduce their exposure to local shocks by spreading their investments in various markets[4].

Third, for middle-income and developing countries which tend to be net importers of global capital, liberalization of their capital accounts permits an inflow of international capital. Such funds are needed to support investments, finance trade, and enhance growth. Fourth, capital account liberalization will result in a global competition for funds which will encourage states to improve their domestic business climates for investments. In an environment with global capital mobility, states will be rewarded (with increased capital flows) for ensuring macroeconomic discipline, improving their domestic investment climates, and obtaining favorable international credit ratings[5]. Finally, it is argued that it is increasingly difficult to enforce restrictions on capital mobility- a good example being the high levels of capital flight from developing countries. Therefore, from an efficiency viewpoint the mere costs of policing the implementation of capital controls are likely to outweigh the intended benefits of monitoring, and result in significant distortions and welfare losses. In addition to the above arguments, membership of the IMF obliges countries under Article I (IV) the "…establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade".

A slightly contrasting view, based on "information asymmetry" theory, argues that financial markets are heavily dependent on access to information, which may be unequally available to economic agents (Stiglitz, 2000). Information asymmetry results in various problems due to moral hazard behavior (e.g.

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[3]*Essentially countries run current account deficits with capital account surpluses in one period, and then run capital account deficits in subsequent periods.*

[4]*Even for countries as a whole, such capital flows are beneficial in equilibrating temporary imbalances in their current accounts (Cooper, 1999).*

[5]*More generally, a number of 'pull' factors are believed to assist in attracting foreign capital including, prevailing investment climate, credit ratings, secondary market prices of sovereign debt, domestic rates of return, and interest rate differentials between domestic and foreign markets.*

banks financing low quality projects because international funds are available), and adverse selection problems (e.g. where it is difficult to distinguish between good and bad investment opportunities). The existence of such distortions suggests that efficiency arguments may have limitations in financial market liberalization.

In addition, financial markets sometimes tend to behave erratically, resulting in "herding" or "bandwagon" behavior by speculators[6]. International capital flows can sometimes be pro-cyclical, and exacerbate instability in emerging market economies. For example, there are many instances where capital account liberalization tends to spur the flow of short-term portfolio capital ('hot money') which tends to be highly reversible compared with more long-term foreign direct investments (Stiglitz, 2000). The information asymmetry school of thought argues for limitations on capital mobility, and a strengthening of regulatory institutions to oversee international capital flows. In summary, the concern is centered on the risk of domestic financial crises, as well as increased vulnerability to instability in international markets.

Besides these two main theories, a third argument in support of capital account liberalization has recently been proposed by Kose, Prasad, Rogoff and Wei (2006). Kose, *et al* acknowledge that capital account liberalization may provide the benefits of GDP growth and reduced consumption volatility as suggested by the 'efficient markets' argument above. However, they further argue that increased financial integration could provide additional 'collateral benefits' to liberalizing countries. In particular, the process of capital account liberalization could serve as a catalyst in providing various 'collateral benefits' to liberalizing countries such as fostering financial market and institutional development, promoting better financial supervision, and improving macroeconomic discipline. We find this view proposed by Kose, *et al* to be particularly useful in assessing the potential benefits of capital account liberalization for Nigeria.

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[6] *See Bikhchandani and Sharma (2001) for a recent review of herding in financial markets.*

Review of the Empirical Literature

In the empirical literature, studies which assess the impact of capital account liberalization on economic performance have provided inconclusive results. Two major types of measures are found in the empirical literature: *de jure* (or rules-based measures) and *de facto* measures (Kose, *et al*., 2006). *De jure* measures often construct indices based on IMF data published in the Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER)[7]. *De facto* measures however rely on relevant economic variables to construct an index of capital account liberalization. For example, such measures estimate openness by examining disparities between national savings rate and investment rates, second, by looking at differences in onshore-offshore interest rates, and third, by using the ratio of actual capital inflows and outflows to GDP (see for example, Kraay, *et al*., 2002). It is important to note that *de jure* measures typically indicate the presence or absence of controls, but not the level of *intensity* of these restrictions[8]. This consideration is particularly important for recently reforming countries where it is clear that progress is being made but the policies have not yet been fully consolidated. The international financial institutions such as the IMF, that develop and use openness measures for policy design would need to go deeper by refining these measures.

Most empirical work estimates the impact of capital account liberalization on other growth variables such as level of schooling, investments, and level of GDP. Results point to modest positive gains attained for capital account

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[7]For example, Quinn (1997) constructs indices which reflect the intensity of capital account liberalization based on AREAER descriptions. Scores from 0-2, increasing in steps of 0.5, are assigned for various economies. A score of 0 indicates that capital flows are forbidden, 0.5 indicates that there are capital controls or severe restrictions, 1.0 and 1.5 indicate various forms of tax-like restriction, whereas a score of 2.0 indicates that flows are completely free of any restrictions.

[8]Thus, we can assess the current level of openness of Nigeria's capital account based on its current AREAER classifications. According to the recent AREAER report (IMF, 2006), Nigeria maintains restrictions on 6 out of 11 categories of capital account transactions. There are controls for transactions related to: capital market securities, money market instruments, commercial credits, liquidation of direct investment and personal capital movements. There are no restrictions on: direct investments, collective investment securities, derivatives and other instruments, financial credits, guarantees, sureties, and other financial backup facilities, and real estate transactions. We can therefore calculate Nigeria's score simply as 6/11 or estimate a more detailed score based on the actual descriptions above.

openness particularly for developed and middle-income countries, but with minimal gains for low-income countries[9]. Recent research by the IMF similarly finds no strong relationship between capital account liberalization and growth, although it stresses the importance of strong intermediary institutions in ensuring the benefits of openness (Prasad, *et al*, 2003). Capital account liberalization is however still viewed as a desirable option for most developing countries, but with greater emphasis placed on the sequencing and speed of reforms (Johnston, 1998; Eichengreen, *et al*, 1998). In the next section, we consider some principles of appropriate sequencing of capital account liberalization, and subsequently examine some country case studies.

III. Sequencing Capital Account Liberalization

It is important to note here that the debate on capital account liberalization is an evolving one. In 1997, for example, a committee set up by the Fund came up with a recommendation for its Article in this respect to be amended from a wholesale promotion of liberalization to one which would "…enable the IMF promote the *orderly liberalization* of capital movements" although the amendment eventually did not happen. Following the Asian crisis of the late 1990s, the focus of the debate shifted from the merit of capital account liberalization, to the preconditions for successful liberalization, i.e. policy sequencing. On balance, there is widespread acceptance among economists that successful capital account liberalization should be preceded by: macroeconomic stabilization; domestic financial sector reform; current account liberalization; and prudential regulation of the financial sector (Fischer and Reisen, 1994; McKinnon, 1993; Johnston, 1998). Each of these factors is examined briefly below.

Macroeconomic stabilization and fiscal adjustment are viewed as the first essential step for successful capital account liberalization. This is particularly important as there is the likelihood of the loss of monetary autonomy with a

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[9] *See for example, Quinn (1997) and Edwards (2001).*

fully liberalized capital account[10]. Fiscal control is therefore needed to accommodate any adverse effects of capital movements. Stabilization must therefore be achieved prior to the reform, to ensure that more expansionary fiscal policies could be utilized to accommodate any contractionary shocks due to liberalization of the capital account (Fischer and Reisen, 1994).

Domestic financial sector reform is also needed prior to liberalization, particularly when there are instances of financial repression. This could involve a range of policies such as high reserve ratios and liquidity requirements, legal ceilings on interest rates and credit expansion, and restrictions on lending portfolios by banks. Financial repression is undesirable as it reduces incentives for savings, and results in the misallocation of capital to inefficient and unproductive activities. In such an environment, where the authorities set real domestic interest rates at a low level, capital account liberalization may result in significant capital outflows and result in a balance-of-payment crisis. It is also argued that without financial sector reform, removal of capital controls could result in a case of immiserizing external borrowing. In such an environment, capital inflows are misallocated, so that the social rates of return on investments are lower than the costs of funds, leaving domestic citizens worse off.

Current account liberalization is also conventionally viewed as a precondition for successful capital account liberalization (Edwards, 1984; McKinnon, 1973, 1993). Current account liberalization in this regard encompasses both reduction of tariffs, as well as the removal of restrictions on payments for current account transactions. When capital controls are removed, capital inflows are likely, resulting in the possibility of a real exchange rate appreciation. An appreciated real exchange rate may be undesirable as it may harm competitiveness and reduce demand for domestic exports. Successful trade liberalization is however often accompanied with some depreciation of the real exchange rate - in order to stimulate exports and dampen domestic

[10] *Resulting from the so-called trilemma or Impossible Trinity that 'it is impossible to achieve the following three desirable goals simultaneously: exchange rate stability, capital market integration and monetary autonomy. Any pair of goals is achievable ... but requires abandoning the third.' (Joshi, 2003:2)*

demand for imports induced by tariff reduction[11]. Trade liberalization is therefore essential to counteract the likelihood of a real exchange appreciation resulting from the removal of capital controls. It is therefore advisable to pursue liberalization of the current (trade) account first, followed by a gradual relaxation of restrictions on the capital account[12].

Finally, successful opening of the capital account also requires strengthening of domestic institutions and prudential financial sector regulation. Such prudential practices are needed to ensure soundness of domestic financial institutions, effective risk management, and protect investors. Specific policies may include improving regulation and supervision, promoting competition in the financial sector to ensure efficient allocation of resources, introducing legal and accounting best practices to address systemic risks, and removing bad loans from the balance sheets of banks (Agenor and Montiel, 1999).

IV. Lessons from Country Case Studies

The recent experiences of some emerging market economies provide instructive lessons on the sequencing and impact of capital account liberalization. In this section, we summarize the experiences of Chile, Korea, Indonesia and Thailand as presented by Johnston, *et al* (1997)[13].

For Chile, reform of the financial sector was conducted prior to capital account liberalization. The authorities focused on a restructuring of the banking system, implementation of trade reforms, and liberalization of exchange rates. Institutions tasked with financial regulation and supervision were also strengthened. The country adopted a gradual approach in liberalizing the capital account, by initially permitting inflows of direct and portfolio investments, and subsequently, relaxing restrictions on capital outflows during

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[11] See Agenor and Montiel, 1999: 703-10 for a review of empirical evidence on this issue.
[12] Besides its effect on the real exchange rate, others have argued that liberalizing the capital account in the presence of restrictive trade policies will only tend to amplify existing distortions in the domestic economy (see Edwards and van Wijnbergen, 1986).
[13] Covering the period 1985-96, and in the case of Thailand, for the period stretching from 1985 up to the 1997 currency crisis

the reform process. Similarly, Korea pursued a gradual and sequenced liberalization program. Financial sector reforms, trade reforms and exchange rate reforms were conducted, while the government focused on ensuring current account surpluses. Capital account transactions were gradually liberalized as the authorities relaxed restrictions on capital inflows and outflows.

In contrast, in the case of Indonesia, capital account liberalization facilitated reform of domestic financial institutions. Authorities focused on growth of the real non-oil sector, and relaxed restrictions on direct investment flows. Various financial and monetary policy reforms were subsequently carried out to improve the functioning of the domestic financial system. Portfolio capital inflows were finally liberalized in 1989, but have been subject to close supervision by the authorities. Capital outflows were liberalized at an early stage of the reform process, while capital inflows (particularly portfolio investments) were liberalized much later and gradually. As a result of its relatively stronger fundamentals, Indonesia initially managed the regional currency crises in June 1997 somewhat better than its neighbours. However, speculative pressure on the Indonesian rupiah grew in July 1997, and prompted the central bank to abandon its managed exchange rate regime.

Finally, in the case of Thailand an uncoordinated approach to capital account liberalization with weak institutions resulted in a financial crisis. As part of an export-led growth strategy, trade and industrial policy reforms were carried out, while capital inflows were liberalized to attract foreign investments. Capital outflows were only gradually liberalized. Moreover, despite an initial reform of the banking sector in 1985, the financial sector remained weak, and many banks had an over-exposure to property sector by the mid-1990s. Inadequate supervision of the financial sector, coupled with large current account deficit, rising inflation and high interest rates, precipitated a sudden reversal of capital inflows and resulted in a currency crisis in 1997.

The country case studies broadly illustrate the need for a properly sequenced approach to capital account liberalization and stress the importance of developing strong domestic financial institutions. In Chile and Korea, a

gradual and proper sequencing of capital account liberalization was conducted, whereas in the case of Indonesia an initial opening of the capital account supported the development and strengthening of the domestic financial system. The experience of Thailand, in particular, highlights the need for strong domestic institutions to support the process of capital account liberalization.

V. Implications for Nigeria

The foregoing discussion has surveyed the theoretical and empirical literature on the potential benefits and risks of capital account liberalization. In this section, we consider whether the appropriate preconditions and complementary policies are now in place for a successful liberalization of Nigeria's capital account. Nigeria currently maintains some restrictions on its capital account transactions[14]. In this section, we examine at what stage during the current economic reforms is it appropriate for the authorities to consider full liberalization of Nigeria's capital account. To conduct our assessment, we examine recent progress in Nigeria on each of the preconditions discussed earlier in section 3.

Macroeconomic Stabilization

There is evidence that Nigeria had one of the most volatile economies in the past two decades (World Bank, 2003). A pro-cyclical expenditure pattern and persistent fiscal deficits often resulted in high inflation and low growth in the economy. Macroeconomic stabilization and fiscal adjustment were therefore needed in Nigeria, not only in the context of facilitating an opening of the capital account, but more broadly to support growth.

Recent economic policies have emphasized macroeconomic stabilization as a central component of the reform agenda. To improve the management of oil revenues, a benchmark price for oil was introduced in the government budget. Despite recent high oil prices, prudent benchmark prices of $25, $30, and $35

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[14] *See footnote 2 under the section on review of empirical literature*

per barrel were adopted for government budgets in 2004, 2005, and 2006, respectively; the 2007 budget currently under consideration by the National Assembly is based on $40 per barrel. These are significantly lower than the actual prices, making it easier to maintain monetary stability. The use of the fiscal rule has delinked government expenditures from oil revenues, and reduced the pro-cyclicality of government fiscal activities.

Government fiscal balance has improved considerably from previous deficits (of about 3.5 percent of GDP) to a consolidated fiscal surplus of about 10 percent of GDP in 2004, and 11 percent of GDP in 2005. Recent improvements in monetary policy have also strengthened macroeconomic stability in the Nigerian economy. Monetary targets have been achieved, and inflation reduced. The 12-month average inflation rate to July 2006 had declined to about 13.5 percent. Interest rates have also gradually declined with prime lending rates averaging about 16.5 percent in the first quarter of 2006 (CBN, 2006). The improved fiscal discipline of the government, and improved macroeconomic environment resulted in the negotiation of a successful debt relief package for Nigeria[15], as well as the country's first ever sovereign credit rating[16].

Current Account Liberalization

Prior to the tariff reform, Nigeria maintained a complex tariff structure, comprised of about 19 bands (with 5146 lines at the HS-8 digit level); and with tariffs ranging from 2.5 percent to 150 percent. For most of the post-independence period, Nigeria's trade regime was viewed as complex, protectionist and opaque (WTO, 2005). Following the structural adjustment programme (SAP) in 1986, a seven-year tariff schedule was adopted, which significantly reduced tariff averages. A subsequent revision of the tariff structure in 1995 further reduced average tariffs and simplified the tariff structure. Despite these revisions, however, the tariff regime was still largely

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[15] *As a result of the debt relief package, Nigeria successfully exited the Paris Club, and reduced its external debt burden from $35 billion to $5 billion.*

[16] *Both Fitch and S&P assigned Nigeria a sovereign credit rating of BB- with a stable outlook. This places the country's debt rating at par with other emerging economies such as Brazil, Turkey, Venezuela and Vietnam.*

viewed as opaque and complex. Since 1978, the government had introduced policies on import prohibitions, which provided for an outright ban on selected products, which were viewed as strategic for the economy, or in response to complaints from manufacturing sector. The ad hoc use of import prohibitions as well as other upward tariff revisions greatly reduced the predictability of the tariff regime, as actual tariffs applied at the ports often deviated from published tariffs.

As part of the recent economic reform program, Nigeria liberalized its current account, by embarking on a comprehensive trade liberalization program aimed at creating an open trading environment. The goal was to revise the previous tariff structure, and adopt the Common External Tariff (CET) as proposed by ECOWAS. Under the new ECOWAS tariff structure, Nigeria has adopted a four-band arrangement, with duty rates of 0, 5, 10, and 20 percent for capital goods, raw materials, intermediate products, and finished goods, respectively. Consequently, the simple (unweighted) average tariff has declined from about 25 per cent to 17 per cent. A temporary 50 per cent band exists but to be phased out by end-2007 while existing import bans are also to be eliminated progressively. Trade liberalization reforms have simplified the tariff structure in line with the government's objective of reducing uncertainty and unpredictability in the country's trade policy regime (NPC, 2004)[17]. But here again, the question arises as to what 'level' of trade liberalization is deemed adequate to support successful capital account liberalization.

Domestic Financial Sector Reform

Although there is widespread evidence that an efficient financial sector is important for long-run economic growth, implementing such reforms has been difficult in Nigeria in the past. The financial system was repressed prior to the structural adjustment program (SAP) that was introduced in 1986, as evidenced by the negative real interest rates of that period (Table 1). Even during the period of SAP, ceilings on interest rates were occasionally

[17] *See Chapter 7 of NPC (2004), the National Economic Empowerment and Development Strategy (NEEDS).*

reintroduced[18]. In this regard, market-based reforms were proposed to ensure that the 'true' cost of capital would be achieved and, thus, ensure a more efficient allocation of resources. However, initial attempts at financial liberalization in Nigeria yielded poor results. A poorly supervised and inefficient financial sector, weak institutions and poor governance created opportunities for arbitrage, patronage, and rent-seeking behavior[19]. The reform of the foreign exchange market during the SAP (discussed below) illustrates this point.

Prior to the reforms of the late 1980s, foreign exchange sales in Nigeria were highly controlled, and rationed by use of import licenses. In 1986, the foreign exchange market was liberalized, with the Central Bank adopting a two-tiered structure for the provision of foreign exchange. A first window operated at a fixed exchange rate, to provide foreign currency for government transaction such as debt servicing and financing foreign missions. A second, auction-based window was established (i.e. the Second-tier Foreign Exchange Market, SFEM), which provided access to foreign exchange to licensed dealers. The previous fixed exchange rate regime (which was determined by the authorities) was also relaxed in favor of a floating exchange rate regime. Bureaux-de-change were also permitted to operate beginning in 1989, and an informal parallel market also existed for foreign exchange trading. Between 1986 and 1993, the authorities tried out various foreign exchange auction mechanisms.

Large premiums existed in the foreign exchange market, and the multi-tiered market provided opportunities for arbitrage and rentier practices (Table 2). With the relaxation of rules for bank establishment in 1987, the number of financial institutions in the country grew rapidly, with the number of banks

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[18]Interest rate controls were initially removed in 1987, and spurred the gradual increase of nominal lending rates by financial institutions (see Table 1 below). Controls were briefly reintroduced in 1991 when a poorly managed reform program had led to the development of several distressed banks, and the diversion of capital to other unproductive activities. Interest rate controls were however abandoned in 1992, but with a stipulation for a 5 percent spread between cost of funds and lending rates (see Ikhide et al, 2002).

[19]A broader survey of Nigeria's financial liberalization under the Structural Adjustment Program (SAP) is provided by Lewis et al, 1997; Okogu, 1992; 1999; and Ikhide et al, 2002.

increasing from 41 in 1986 to 120 in 1993 (Lewis, *et al*, 1997). There is evidence that many new small banks as well as the elite with access to political offices could obtain foreign currency at low (official) prices, and reap substantial returns by re-selling in the bureaux de change or parallel market[20]. This inefficiency in the foreign exchange market was compounded by weak regulation of financial institutions, and by the early 1990s, there was widespread concern about the rising systemic risk in the Nigerian banking sector (Lewis, *et al*, 1997; Ikhide, *et al*, 2002). A complete liberalization of Nigeria's capital account in the presence of such internal distortions was likely to exacerbate risks in the existing financial system.

[20] *To obtain the extent of this distortion, it is worth noting that the World Bank estimated that the indirect subsidy arising from the spread between official and market rates amounted to $500 million in 1990 alone (Okogu, 1999).*

Table 1: Nigeria: Lending and Deposit Rates (1975-2005)

Year	Nominal Deposit Rate	Nominal Lending Rate	Inflation Rate	Real Deposit Rate	Real Lending Rate
1975	3.00	6.25	42.85	-39.85	-36.60
1976	2.67	6.50	20.00	-17.33	-13.50
1977	2.83	6.00	16.66	-13.83	-10.66
1978	4.15	6.75	21.42	-17.27	-14.67
1979	4.47	7.79	5.88	-1.41	1.91
1980	5.27	8.43	11.11	-5.84	-2.68
1981	5.72	8.92	25.00	-19.28	-16.08
1982	7.60	9.54	4.00	3.60	5.54
1983	7.41	9.98	26.92	-19.51	-16.94
1984	8.25	10.24	36.36	-28.11	-26.12
1985	9.12	9.43	8.88	0.24	0.55
1986	9.24	9.96	6.12	3.12	3.84
1987	13.09	13.96	9.61	3.48	4.35
1988	12.95	16.62	56.14	-43.19	-39.52
1989	14.68	20.44	50.56	-35.88	-30.12
1990	19.78	25.30	6.71	13.07	18.59
1991	14.92	20.04	13.28	1.64	6.76
1992	18.04	24.76	44.44	-26.40	-19.68
1993	23.42	31.65	57.69	-34.27	-26.04
1994	13.09	20.48	56.91	-43.82	-36.43
1995	13.53	20.23	72.71	-59.18	-52.48
1996	13.06	19.84	29.30	-16.24	-9.46
1997	7.17	17.80	8.19	-1.02	9.61
1998	10.11	18.18	10.29	-0.18	7.89
1999	12.81	20.29	6.67	6.14	13.62
2000	10.6	17.98	6.9	3.7	11.08
2001	10.2	18.29	18.9	-8.7	-0.61
2002	16.25	24.4	12.9	3.35	11.6
2003	13.86	20.48	14.0	-0.14	6.48
2004	12.9	19.15	15.0	-2.1	4.15
2005	10.23	17.85	17.9	-7.67	-0.05

Source: Ikhide et al (2002) for 1975-99 data; IMF/Central Bank of Nigeria for 2000-2005

Table 2: Nigeria's Foreign Exchange Market (₦/$), (1986-1994)

Year		Nominal Rate	Parallel Rate	Spread (%)
1989	Q1	7.40	10.51	42.03
1989	Q2	7.48	10.58	41.44
1989	Q3	7.25	10.30	42.07
1989	Q4	7.51	10.66	41.94
1990	Q1	7.90	9.48	20.00
1990	Q2	7.94	9.53	20.03
1990	Q3	7.96	9.55	19.97
1990	Q4	8.34	10.02	20.14
1991	Q1	9.43	12.99	37.75
1991	Q2	9.47	13.05	37.80
1991	Q3	10.95	15.09	37.81
1991	Q4	9.87	13.60	37.79
1992	Q1	12.49	18.23	45.96
1992	Q2	18.57	19.44	4.68
1992	Q3	18.85	20.81	10.40
1992	Q4	19.59	22.84	16.59
1993	Q1	22.28	28.19	26.53
1993	Q2	22.22	34.86	56.89
1993	Q3	21.89	37.65	72.00
1993	Q4	21.89	43.91	100.59
1994	Q1	21.89	49.73	127.18
1994	Q2	21.89	50.43	130.38
1994	Q3	21.89	66.91	205.66
1994	Q4	21.89	81.02	270.12

Source: Okogu (1999)

More recently, financial sector reform has also been a major component of Government's economic reforms. In the past, the Nigerian financial sector had been weak in supporting economic development due to its fragmented nature and the weak capital base of banks. To reform the sector, the Central Bank of Nigeria (CBN) launched a bank consolidation program in mid-2004 in which all deposit money banks were required to raise their minimum capital base from about N5 billion to N25 billion by the end of 2005. Banks failing to meet

these new requirements were expected to merge, or else have their licenses revoked. During the consolidation process, the number of banks in Nigeria was reduced from 89 to 25, largely as a result of mergers and acquisitions. In the process of meeting the new capital requirements, banks raised the equivalent of about $3 billion from capital markets, and attracted about $652 million of FDI into the Nigerian banking sector. A similar reform is also being carried out for the insurance sector.

Foreign exchange markets have also been liberalized, with the government adopting a wholesale auction format which merged the previous retail Dutch Auction System and the interbank market for foreign exchange. The official exchange rate has remained stable, while the previous parallel market premium was eliminated by mid-2006. Indeed, as shown in Table 3, the spread between the two rates has narrowed in line with the progress of the economic reforms.

The recent bank consolidation reforms in the financial sector, liberalization of interest rates, and convergence of exchange rates must be viewed as the beginnings of an improved financial sector. These reforms would need to be consolidated in the coming years to ensure the development of a strong financial sector. Closely linked to the subject of financial repression has been the history of inadequate prudential supervision in the Nigerian banking sector which is the focus of the next section.

Prudential Regulation of the Financial Sector

Following financial liberalization in 1986, there was a rapid growth in financial institutions, with the number of banks tripling to about 120 by 1992. Various other financial institutions such as mortgage, insurance and brokerage houses also expanded, spurred by opportunities in retail trade, foreign exchange trading, and urban real estate (Lewis, *et al,* 1997).

Regulatory oversight however did not keep pace with the rapid growth of financial institutions in the late 1980s and 1990s. The Nigerian Deposit Insurance Corporation (NDIC) was established in 1989, while the CBN

Decree (No 24 of 1991) and the Banks and Other Financial Institutions Decree (BOFID, No 25 of 1991) were enacted[21]. Yet weak supervision of the sector remained. There is evidence that many banks had poor balance sheets and made limited lending to the private sector, and engaged predominantly in other short-term arbitrage activities. By 1993, it was estimated that about half of the licensed banks were distressed.

Since 2003, various prudential practices have also been adopted by the Nigerian authorities to support the development of sound domestic financial institutions, to promote effective risk management, and to protect investors. Weak regulatory oversight had fostered the growth of several weak and distressed banks in the 1980s and 1990s.

[21] *Replacing the CBN Act of 1958 (as amended) and the Banking Decree of 1969 (as amended)*

Table 3: Nigeria's Foreign Exchange Market (1999-2006)

	Official rate	Parallel market rate	Spread (%)
1999Q1	86.69	93.82	8.22
1999Q2	93.25	100.50	7.77
1999Q3	94.88	102.68	8.22
1999Q4	96.64	101.10	4.61
2000Q1	100.05	105.47	5.41
2000Q2	100.98	105.50	4.48
2000Q3	103.66	114.41	10.36
2000Q4	104.02	119.98	15.34
2001Q1	110.64	125.13	13.10
2001Q2	113.26	136.14	20.20
2001Q3	111.71	134.73	20.61
2001Q4	112.28	134.02	19.37
2002Q1	115.33	137.59	19.30
2002Q2	117.95	136.10	15.39
2002Q3	125.14	137.16	9.61
2002Q4	126.69	138.51	9.33
2003Q1	127.30	138.57	8.85
2003Q2	127.91	139.02	8.69
2003Q3	128.10	140.50	9.68
2003Q4	134.62	147.51	9.58
2004Q1	135.25	143.12	5.82
2004Q2	133.08	138.92	4.39
2004Q3	132.82	139.95	5.37
2004Q4	132.87	139.52	5.01
2005Q1	132.85	139.10	4.70
2005Q2	132.85	139.10	4.70
2005Q3	131.44	145.19	10.46
2005Q4	129.31	143.62	11.07
2006Q1	128.23	145.35	13.35
2006Q2	127.19	141.27	11.07
2006Q3	127.06	129.75	2.12
2006Q4	127.01	128.64	1.28

Source: Central Bank of Nigeria

Against this backdrop, recent improvements in supervision by the CBN are noteworthy. The Central Bank's supervisory powers are being strengthened, with a migration from a prudential supervision system to a risk-based approach within the framework of the Basel-II Accord. Capacity-building programs to support the development of central bank officials in various risk assessment tools have been organized as well as the upgrading of supervision software used by the authorities. A new Draft Corporate Governance Code of Conduct is being developed to oversee activities of stakeholders in the financial sector. Finally, as a precautionary measure, Government is also developing contingency plans to ensure the smooth handling of merger breakdowns if they occur in the future.

The Central Bank implemented various measures to ensure a smooth liquidation of banks which failed to meet the new capitalization requirements. Appropriate legislation-under the Nigeria Deposit Insurance Corporation (NDIC) Act-also provides a comprehensive framework for addressing the case of private depositors who may be affected by the liquidation process.

At present, the CBN has presented drafts of the CBN Act as well as the BOFI Act Amendment Bill to the National Assembly. Successful passage of these Bills would grant the Central Bank greater autonomy in performing its oversight functions of domestic financial institutions.

VI. Time for Capital Account Liberalization in Nigeria?

In the light of the above discussion, the question that policymakers will have to deal with is not whether, but how to introduce capital account liberalization. It is a logical and inescapable step for a reforming economy with ambition to optimize its engagement with the international financial markets. Recent developments indicate that Nigeria has made significant progress towards meeting the prerequisites for liberalizing the capital account. These include progress in fiscal consolidation, reforms in the domestic financial system, including strengthening regulatory institutions, and providing an appropriate framework for the effective utilization of international capital flows. The sequencing signposts-macroeconomic stabilization, current account

liberalization, financial sector reform and prudential supervision of the banking sector-are acknowledged to have improved in Nigeria since the reforms.

However, it begs two questions: firstly, has the "improvement" gone far enough to satisfy the requirements for liberalization and how much more "improvement" is needed to reach the desired level of comfort? Secondly, given the evidence of poor management of the past two decades, can it be taken for granted that the reforms have sufficiently taken root to warrant full capital account liberalization? The questions are related, and the answer would appear to be that a longer period of sustained economic management and reforms, including of institutions, may be needed before comprehensive opening of the financial account. In this context, the adoption of appropriate legislation, such as the Fiscal Responsibility Bill, the amended Central Bank Act, and the BOFI Act, would help by ensuring the institutionalization of prudent fiscal, monetary and banking sector policies.

In relation to the economic policy and management of the past twenty years, the recent economic reforms signal an initial recovery and convalescence period for the Nigerian economy. In this vein, an additional period of sustained economic reforms and growth is still needed, which would signal long-term recovery of the economy, and the maturity of the institutions needed to support the challenges of managing unfettered international capital flows. By maintaining the current course of economic reforms, and introducing appropriate legislation to support the reforms, Nigeria would improve institutional and regulatory capacity of its financial sector, thereby enabling the country to further integrate its financial sector into global markets. As argued by Kose, *et al* (2006), the major benefits of capital account liberalization to developing countries may be obtained not from its direct contribution to increased GDP growth or reduced consumption volatility, but instead by providing a set of 'collateral benefits'. In the case of Nigeria, given a history of weak economic management, the actual process leading to further opening of the capital account could engender greater institutional development, improved financial supervision, and greater macroeconomic discipline.

Another factor worthy of consideration is that a resource-dependent, emerging economy like Nigeria may require extra caution in moving towards capital account liberalization precisely because it has one less degree of freedom: oil revenue is exogenous to the economy. The present favorable fiscal and monetary aggregates (good fiscal balance, excess crude oil revenue savings, large and rising level of international reserves, etc.) though attributable primarily to prudent management, have occurred against the backdrop of a favorable external environment. The strong performance of the international oil market has shifted the terms of trade strongly in favor of the Nigerian economy. Policymaking in respect of any factors that could have a bearing on any of the four sequencing signposts must be considered realistically. In this context, the present high oil price regime cannot be taken for granted for the purpose of planning. If, for example, the price were to revert back to its long-run average of about $27 per barrel, the present strong fiscal position could be threatened and the CBN will have to let the naira depreciate or risk losing international reserves. Under such a scenario, if the capital account is already liberalized, there could be speculative attacks on the naira, and there could also be reverse capital flows, particularly as “hot money” moves out. Hence, an analysis of the sequencing of capital account liberalization in a resource-dependent economy requires careful consideration, probably with more stringent requirements. Such economies need to achieve a higher degree of fiscal, monetary, structural and institutional consolidation than other economies before opening up the capital account.

VII. Conclusion

Nigeria's recent economic reforms have set the country on a path of recovery, including meeting the basic prerequisites for capital account liberalization. However, these need to be deepened and sustained for a while, including underpinning the reforms through legislation, before moving to full liberalization. This is even more important in the case of an oil-dependent economy such as Nigeria's which may be susceptible to large external terms-of-trade shocks. Overall, the process of preparing for capital account liberalization in Nigeria could provide 'collateral benefits', and spur the strengthening of the domestic institutions, greater macroeconomic discipline, and improved financial supervision.

Going forward, further research is needed to support policymaking as Nigeria considers its options for capital account liberalization in the future. While a number of authors have reviewed liberalization of the Nigerian financial sector in the 1980s and 1990s (see, for example, Lewis, *et al*, 1997; Ikhide, *et al*, 2002), few have systematically evaluated the options for capital account liberalization. Three areas of research could help improve our understanding in this regard. First, given the available data for Nigeria in the past three decades, it may be valuable to quantify the extent of capital account restrictiveness in each year (for example, based on Nigeria's AREAER descriptions), and examine its impact on portfolio and FDI inflows into the country. In the light of the importance of institutions, a second, and more forward-looking research exercise, may be to develop an *institutional quality* index for Nigeria's financial sector, which tracks its performance over time. Based on qualitative information, this index could be constructed for financial sector institutions in Nigeria (as well as other countries) for the past two decades, and updated annually. Such an exercise could enable policymakers to effectively benchmark Nigeria's *institutional* performance against other emerging market economies. Finally, some research on the specific depth of reform needed for a resource-dependent economy like Nigeria's could shed some light on the timing of capital account liberalization.

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