

The Financial System And Economic Growth In The Context of Political Transition

by

T. Ademola Oyejide

Department of Economics, University of Ibadan

I. INTRODUCTION

Nigeria has been struggling with its worst experience of prolonged economic difficulties since the early 1980s. Attempts to deal with these difficulties have swung from one policy extreme to the other and yet the problems apparently continue to persist. The problems of economic recovery are probably also associated with Nigeria's apparently unending search for a generally acceptable and sustainable political system. The pursuit of profitable economic activities that generate overall aggregate growth and development is best promoted in the context of a stable political system that creates and sustains an appropriate "enabling environment". This implies that solutions to Nigeria's stagnation and even decline cannot be found except in the context of a simultaneous or prior resolution of the conflicts associated with its "political transition" and establishment of a durable political system.

The mandate of this paper is to examine "the roles of banks in economic recovery and political transition". It seems more appropriate, however, to think not just about banks but about the financial system as a whole, even though banks (of various types) constitute the most important single component of the financial system. The roles of the financial system in promoting economic growth, and the mechanisms through which these roles are accomplished, involve institutions, and their relationships, and hence call for the broader focus that this implies.

The issues and problems discussed in this paper are best addressed in a specific sequence. Thus, section II articulates how finance promotes growth; while the next section examines the other side of the coin, i.e. how economic growth in turn enhances the development of the financial system. A natural extension of the ideas discussed in sections II and III is provided in the next section which describes emerging patterns of linkages between financial development and economic growth.

Discussions of how finance and growth relate to and enhance each other typically assume the existence of a stable political arrangement that provides an enabling environment. Section V offers some thoughts on the linkages between finance and growth when the political environment is impaired. Some policy implications of this are discussed in the concluding section of this paper.

II. HOW FINANCE PROMOTES GROWTH

The voluntary existence of a given set of institutions and associated markets is, in itself, a clear indication that they are rendering some economically valuable services that "consumers" are willing to pay for. It is easy, therefore, to justify the existence of a financial

system in accordance with this line of argument. Development economists have gone beyond this “last line of defence”, however, they posit that the existence and evolution of financial institutions and markets constitute an important dimension of the process of economic growth. This implies that a set of definite roles can be assigned to the financial system in the growth process.

In general, the financial system enhances individual and group economic activities and thus promotes overall economic growth by:

- providing reliable payment services;
- mobilizing savings;
- allocating credit; and
- enabling economic agents to pool, trade and price risk.

To the extent that the financial system efficiently mobilizes and allocates societal savings, it promotes growth by raising the “financialized” savings rate, channelling savings into investment, enhancing the efficiency of capital accumulation and by eliminating costly disruptions to the investment and production process. In addition, by increasing the “financialized” savings rate, the financial system helps to reduce the fraction of societal savings held in the form of unproductive liquid assets. In other words, the financial system promotes growth through this specific mechanism by helping society to economise on holdings of non-performing assets (e.g. cash under the pillow) so that a greater proportion of societal resources can be held in the form of higher performing (or income-earning) assets.

The process of efficiently mobilizing savings and then allocating these savings across investment projects involves other growth-promoting dimensions. The financial system ensures more efficient transfer of resources between savers and investors by specializing in gathering information about loan projects and monitoring the projects in which depositors’ funds are invested. Scale economies largely explain why individual lenders must delegate this activity to financial intermediaries. The loan evaluation and project monitoring activity is not only important for depositors whose funds are channelled into specific investments through financial intermediaries; the activity also promotes more efficient management of firms whose operational performance is subjected to this “external” review. The activity of loan evaluation/project monitoring goes hand-in-hand, usually, with that of liquidity by issuing liabilities that are safe and short-term (possibly demandable) and by entering arrangements to provide loans on short notice (e.g. line of credit). Liquidity provision improves production efficiency by reducing the need for inefficient forms of self-insurance.

The financial system also provides insurance to risk-averse savers and investors in the process of pooling individual savings and enabling investors to hold a diversified portfolio whose varying liquidity characteristics serve as a protection against the premature liquidation of the capital of firms in which they invest.

In summary, financial intermediation makes significant contributions to the process and magnitude of economic growth in several key ways:

- it improves the efficiency of resource mobilization by pooling a myriad of individual savings;
- it provides a more efficient allocation of these savings into investment outlets than the individual savers can accomplish on their own;

- it increases the fraction of societal resources devoted to interest-yielding assets and long-run investment which, in turn, augment economic growth;
- it reduces risks faced by firms in their production processes by providing liquidity and capital;
- it enables investors improve their portfolio diversification by providing insurance and project monitoring information.
- it induces firms to operate more efficiently by monitoring loan projects and by offering financial protection against premature liquidation of their capital.

Clearly, to the extent that the financial system enhances the mobilization of resources, improves the allocation of capital and enhances the productivity of firms, it should make significant contributions to overall economic growth.

III. HOW ECONOMIC GROWTH ENHANCES FINANCIAL DEVELOPMENT

Financial development appears to accompany growth in the real sector. There is, in fact, a symbiotic (or two-way) relationship between finance and real sector growth which blurs the direction of causality, questions the "leading-lagging" sector typology and raises the "chicken and egg" (which comes first?) issue.

Some parts of the relationship between finance and growth are sufficiently obvious. Financial institutions mobilize savings and allocate credit. The larger and wealthier an economy is, the greater should be the volume of resources that can be mobilized and invested. In this simple way, it can be shown that the size and growth of the real sector influence the size of the corresponding financial system. But the influence of the real sector on the financial system goes beyond this; as an economy develops many different types of financial (bank and non-bank) intermediaries crop up to offer borrowers and lenders a wider range and variety of financial services. In other words, innovations in and expansion of financial services can be largely demand-driven; once an economy develops sufficiently to cross a certain threshold of modern "banking habit". The demand-driven nature of most financial services implies that real sector economic growth influences the range and types of financial services found in an economy by making their provision both profitable and affordable, subject to the constraints imposed by regulatory policy.

An illustrative example may, perhaps, more clearly demonstrate the linkages and their key elements. Think in terms of the growth-cycle of a business firm. At the beginning, it starts basically as an idea coupled with the vision, enthusiasm and energy of its founders. Usually, it has little else – only limited financial resources and collateralizable assets. The vision of its founders has little market value: and thus, the firm has a low net worth. But to grow, it needs resources.

This firm must rely heavily on internal funds as a means of financing its investment and growth since it lacks an adequate net worth (or collateral assets) to attract external finance. It can be said that, at this stage, the firm's external finance premium is very high.

If the firm succeeds in dramatically raising its net worth over time, i.e., if it is able to accumulate substantial financial and physical assets through its operations, its chances of

obtaining external financing through banks become much better. In other words, its external finance premium falls as its net worth improves. Further development and growth beyond this point enhance its net worth even more and enable the firm to tap external finance through direct credit, a cheaper form of external finance than bank credit.

A generalization which can be derived from this simple illustrative example is that as an economy develops its economic agents tend to evolve from self-finance to external finance since real sector growth tends to reduce the premium attached to external finance. Further economic growth stimulates financial development in terms of the development of institutions and markets for direct credit.

IV. FINANCE-GROWTH LINKAGE PATTERNS

The theoretical insights about the two-way relationship between financial development and economic growth have generated several empirically observed patterns of the finance-growth linkage. These patterns offer some lessons for a developing country such as Nigeria which badly needs some way of digging itself out of a deep economic "hole".

Many of the observed linkage patterns relate certain measures of financial system development to particular elements of real sector growth (Gertler and Rose 1991, Levine 1992, King and Levine 1992, and Ghani 1992) while the empirically derived patterns are based on the experience of a large number of developed and developing countries (including Nigeria). In general, the measures of financial deepening (or development) cover ratios of various monetary and credit aggregates to overall or aggregate income.

At the broadest level of generalization, empirical studies have established strong evidence of a positive correlation between the level of real per capita income and the ratio of credit to overall income. This implies that countries with higher incomes have deeper financial systems. It turns out also that history matters: the starting point and subsequent growth of the financial system are positively related to economic growth. Thus, countries that begin a period with larger financial system enjoy faster subsequent economic growth; while faster growing countries tend to have deeper financial systems.

The *structure* of the financial system affects growth, as the following empirical linkage patterns imply:

- faster growing countries tend to have larger ratios of deposit banks' assets to GDP than slower growing countries;
- faster growing countries tend to have larger deposit banks' assets to Central Bank assets than slower growing countries.

Finally, the allocation of credit by the financial system has important implications for economic growth. In particular, empirical findings indicate that:

- countries with faster growth rates tend to have financial systems that allocate a larger proportion of total credit to the private sector; and
- the share of credit allocated to the private sector by the financial system is positively and significantly correlated with both the investment rate and the efficiency of investment.

V. PRE-REQUISITES FOR FINANCIAL AND ECONOMIC RECOVERY

Given the two-way nature of the relationship between finance and growth, it would appear that one may not necessarily be used effectively as a lever for the other. The nature of the relationship also implies that a country may experience a virtuous cycle in which both the financial system and the real sector grow together in a mutually reinforcing way or a vicious cycle in which they both stagnate and decline. Neither of these could, of course, preclude overshooting in particular situations; i.e. adoption of liberalization may enhance the growth of the financial system over a period of time at a rate beyond that which can be sustained by the corresponding growth of the real sector. On the other hand, an export boom-induced rapid real sector growth may, for a while, leave the financial system lagging behind. But, in general, when the real sector is growing and there are no policy impediments (such as measures associated with financial repression), it is expected that the financial system will also grow. A fairly robust empirical finding is that a 1 per cent increase in real per capita income is typically associated with approximately a 1.5 per cent increase in the various financial deepening measures (Gertler and Rose, 1991, p. 35).

Financial reform policies that liberalize financial markets should ultimately enhance economic growth. But the magnitude of their effectiveness would depend on the existence of a viable borrowing class, i.e. a large group of credit-worthy borrowers who are not discouraged by the prevailing premium for external finance. Thus, financial reform and market liberalization would be more effective if they were accompanied by other policies that directly stimulate real sector growth and enhance overall macro-economic stability.

It is common knowledge, of course, that political stability provides an important background against which the behaviour of economic agents are influenced through different types of economic policies. The stable environment (including legal and contract-enforcement arrangements, general security and maintenance of law and order, etc.) provided by a generally accepted political arrangement constitutes the primordial pre-requisite for the interface of economic activities and policies designed to influence them.

Confidence, absence of disruptions and relative certainty are obviously necessary for the functioning of a financial system. When confidence breaks down, disruptions occur and general uncertainties prevail, financial markets and transactions contract and, in the process, they shrink rather than facilitate real sector economic activities. Hence political stability must be viewed as a pre-requisite for both sustainable economic growth and healthy development of the financial system.

VI. SOME POLICY IMPLICATIONS

When the discussions above are placed in the context of contemporary Nigeria, several policy implications can be drawn. One relates to the country's virtually unending experiments in political transition; the other relates to the place of the Central Bank in a growth-enhancing financial system and in a stable political arrangement.

It is not difficult to sketch the broad contours of a stable political arrangement. In spite of continued military involvement in government, it seems to be generally agreed that a democratic system of government is the ideal because it enhances transparency, accountability and good governance. In the Nigerian situation, a federal system of government also appears to be generally accepted as the best way of achieving "unity in diversity" given the

heterogeneity inherent in Nigeria's national make up. However, the Nigerian federation has evolved over the last 30 years in ways that have, unfortunately, sacrificed diversity on the altar of unity and, in the process, established a dangerously unbalanced federation made up of an all-powerful (and well-endowed) federal government surrounded by a large number of largely unviable "satellite" states. Given the very nature of this structure of government and its almost total dependence on a large non-tax revenue base, it has become increasingly impossible for the governed to demand accountability, transparency and good governance. Because of the substantial and apparently unrestricted powers and resources available at the centre, competition for the presidency has become a "do or die" battle. The structure of the current political system therefore has an in-built feature of permanent instability which no amount of "federal character" and *ad hoc* "settlement" can successfully eliminate. If anything, these "solutions" are likely to combine with the unending demands for more states to produce an even more centralized political arrangement serviced by mediocre rent-seekers.

The return to a more balanced federal system requires a drastic reduction in the powers, functions and resources of the federal government, a sharp reduction in the number of states (and local governments) so that this tier of government becomes much more autonomous, economically viable and thus constitute more effective centres of political power and economic growth. Such a restructuring would, incidentally, render the presidency less glamorous and substantially reduce its attraction as the ultimate political prize. More importantly, from the perspectives of economic management and growth, this political restructuring should drastically reduce the size of Nigeria's public sector and reduce the crowding-out of the private sector that has hindered rapid economic growth since the early 1970s.

An important component of this political restructuring has a bearing for the place of the Central Bank of Nigeria (CBN) in the financial system and the overall economy. Under current arrangements, the CBN is seen largely as an agency of the federal government. Thus, the federal government has progressively subverted the CBN's primary mandate of sustaining monetary and financial system stability as the CBN has been successfully tainted by the government's fiscal irresponsibility. Evidence of this abounds. Federal fiscal deficits as a percentage of GDP has remained unsustainably large through the 1980s to date (9.8% during 1990-92, 10.1% in 1992, 12.3% in 1993) with the CBN being the largest single source of their financing. In fact, the mandatory role of the CBN in fiscal deficit financing, its mandatory role in the underwriting of primary issues of government securities and the right of banks to rediscount their holdings of government securities with the CBN virtually make it impossible for the CBN either to conduct a rational monetary policy or to discipline a wayward and out-of-control federal government.

In a more balanced federation, the CBN should be viewed as a banker to each of the governments in the federation. The only way of doing this would be to be largely independent of each of them in a specific sense. This is to say that the CBN should maintain its primary mandate of promoting and protecting overall monetary and financial system stability and be relieved, entirely, of the obligation of mandatory provision of credit to any of the constituent governments of the federation. This reform would serve at least three important purposes; it would:

- signal the neutrality of a key agency that regulates overall economic activity in its relationship with the various governments in the federation;
- help to ensure that fiscal discipline and responsibility are maintained at all levels of government; and

- **prevent irresponsible fiscal behaviour by any of the constituent governments from impairing the monetary financial system stability that is so crucial to the unhindered pursuit of legitimate economic activities by all economic agents in the country.**

The current economic difficulties and the on-going struggle on “political transition” present both significant challenges and important opportunities. Innovative approaches, some of which may border on “thinking the unthinkable” are called for and deserve careful and serious consideration if the country is to successfully pull itself off the face of the cliff.

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