FINANCIAL LIBERALISATION AND CAPITAL DEVELOPMENT: A THEORETICAL EVALUATION OF FINANCIAL REPRESSION AND STRUCTURAL REFORMS IN NIGERIA

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Abstract

The Theses examines some of the hypotheses advocated by some economists as the vital instrument toward economic growth and development. The works of Mckinnon, Shaw and the Neo-Structuralists were reviewed in great depth.

Following the postulations of the Mckinnon - Shaw school and the Neo-Structuralists models, the role of interest rate in particular in financial deepening and capital development became the centre piece of the study. In addition to that, is the demand for money, the effects of financial liberalisation and short run growth.

Attempts were made to provide a contrast on the arguments advocated by the Mckinnon - Shaw school with those of Taylor et al ie the Neo-Structuralists.
In support of the hypothesis that financial sector of an economy is important in its economic development, especially in a repressed economy, a thorough review of the Nigerian Financial System, Structure, Growth and Developments were provided in this thesis.

The thesis also provides an indepth review of the Nigerian structural adjustment programme (SAP) and the role of the International Monetary Fund (IMF),and the World Bank.

The objective of the dissertation, which provides the theme binding the chapters together, is a critical analysis of the operation of the structural adjustment programme for the financial sector, in the light of the theories of financial reform.

The grouping into chapters provided a detailed overview of the main schools in financial development theory and the Nigerian economy.
The thesis also relates to the dynamics of the demand and supply sides of the economy, the issues of foreign investment and policies and financial intermediation.
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Dedicated to my late beloved Grandmother

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Acronyms

ADB	African Development Bank
CBI	Confederation of British Industries
CBN	Central Bank of Nigeria
ECOWAS	Economic Community of West African States
EER	Effective Exchange Rate
GATT	General Agreement on Trade and Tariff
GDP	Gross Domestic Product
GNP	Gross National Product
IBRD	International Bank for Reconstruction and Development
ICM	International Capital Market
ICOR	Incremental Capital / Output Ratio
IMF	International Monetary Fund
IOCR	Incremental Output / Capital Ratio
JPE	Journal of Political Economy
JME	Journal of Monetary Economics
LDCs	Less Developed Countries
MFNs	Most Favoured Nations
OECD	Organisation for Economic Co-operation and Development
OLS	Ordinary Least Squares
REER	Real Effective Exchange Rate
S & D	Savings and Development Journal

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Chapter 1

LITERATURE REVIEW ON THE FINANCIAL REPRESSION

The seminal works by Mckinnon (1973) and Shaw (1973) both independently marked the take-off or trend of empirical research interest into the workings of financially repressed economies and the beneficial effects of financial liberalisation.

Chapter 1 deals with the general review of financial repression, while in chapters 2 to 4, I review the work of Mckinnon, Shaw and the Neo-structuralist. Chapter 5 deals with the structural adjustment and the Nigerian financial system. Chapter 6 is a consolidation of chapters 1 to 5 and review of "Order of Economic Liberalisation". Chapter 6 examines in detail some of the policy prescriptions such as exchange rate misalignment, quotas, GATT, and foreign exchange volatility which were all briefly mentioned in other chapters. Chapter 1 examines the available empirical evidence on the essential relations of what is now termed the financial repression paradigm [Dornbusch & Reynoso (1989)].

The Mckinnon - Shaw hypothesis is that a repressed financial system disrupts development in several ways ie; the savings channel are underdeveloped and the return on savings is negative or unstable and financial intermediaries that collect savings do not allocate them efficiently among competing uses. Firms are discouraged from investing because poor financial policies reduces the returns to investment or make them excessively unstable.
However, liberalisation on the financial sector from interest rate ceilings and other restrictions facilitates economic development and growth, because higher interest rates lead to increased savings and a more efficient allocation of capital.

The common features in the Mckinnon - Shaw models are illustrated in a diagram popularized by Maxwell J. Fry (1979, 1980, 1988, 1989). Saving, $S(Y_1)$ at income level Y_1 is a function of the real rate of interest, while F denotes financial repression

taken to consist of administratively determined nominal bank lending and deposit rates which hold the real rate of interest below the equilibrium level r_1 and actual investment limited to I_1 which is equal to the amount of saving receivable at the real interest rate r_1 (See Figure 1).

Raising the interest rate ceiling from F to F* ie r_1 to r_2 , raises saving and investment. It also rations out low yielding investments which are no longer profitable at the higher interest rate r_2. The level of income increases in this process and shifts the savings function to $S(Y_2)$. The Mckinnon - Shaw models policy prescription is to raise institutional interest rates and or to reduce the rate of inflation .

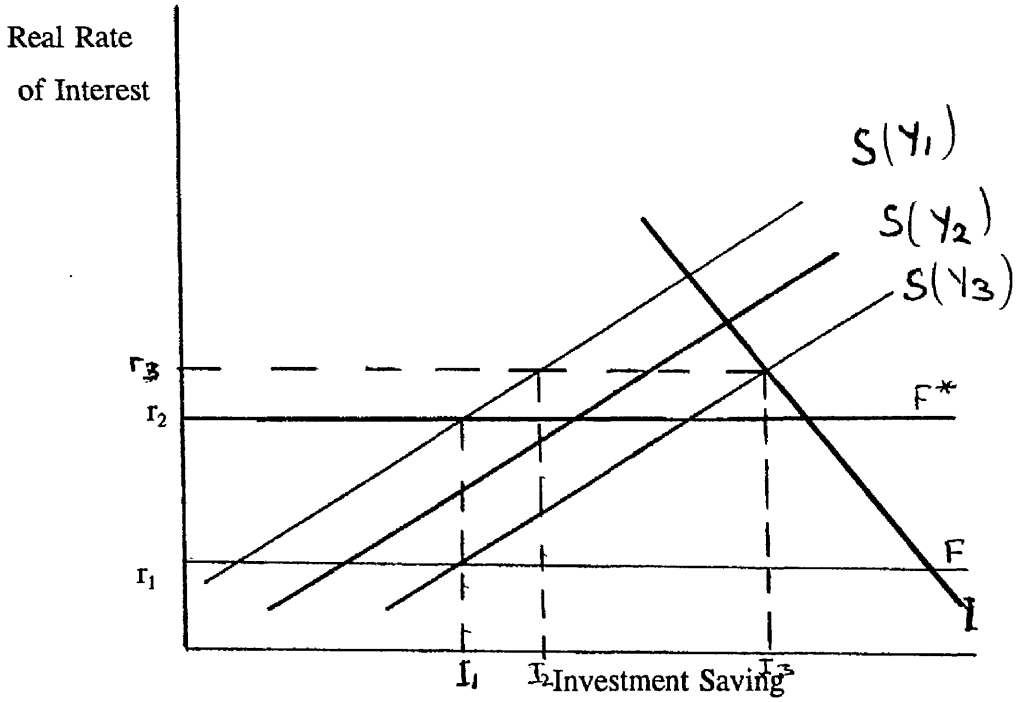

Figure 1. Saving and Investment Under Financial Repression

The optimal result therefore, is to eliminate entirely the interest rate ceilings so as to maximise investment and raise further the average efficiency of investment. This is indicated on fig.1 by the equilibrium at $S(Y_3)/I_3$ at r_3 and a higher level of income Y_3.

Before I proceed to review each model separately, I want to discuss briefly five sections survey studies relating to the impacts of interest rates on saving, financial intermediation, investment, economic growth and the demand for money. I will briefly discuss the studies on the impact of financial intermediation on economic growth and the available evidence as well as the assessment of the empirical support for the financial repression paradigm.

1. THE IMPACT OF INTEREST RATES AND SAVING

The hypothesis advanced is that financial liberalisation will develop positive real rates of interest which will equate the demand for and the supply of savings and lead to increased saving (Thorton 1991). Williamson (1968) carried out one of the earliest studies in this area by doing a cross section study of the determinants of personal saving for six Asian countries. He adopted the real rate of interest, permanent and transitory disposable income as explanatory variables in his equation to explain personal saving. The role of interest rate in his study offered little support in that, the interest rate elasticity of saving in five of the Six countries in the sample were negative. The regression coefficients were not statistically significant at the 5% level (t - statistic).

Gupta reported a mixed results in three Asian countries he studied, with personal saving in India responding positively to real rates of interest and per capita disposable income (Gupta 1970). He postulated (1984a) that increases in the interest rate would affect financial saving positively and physical saving negatively based on his study of twelve Asian countries.

He concluded that support for the Mckinnon - Shaw hypothesis was quite limited by reporting a positive and significant coefficient for the real interest rate in only four countries (Gupta 1984b).

Furthermore, he analyzed separately (Gupta 1987) countries from Asia and Latin America using a pooled cross-section and time series data for the period 1967 - 76. By regressing gross national saving on nominal interest rate, permanent income transitory income, expected rate of inflation, the financial intermediation ratio and inflation uncertainty variable, he found that financial conditions do not affect saving in Latin America but they did in Asia[1]. He then concluded that pooling across continents were inappropriate.

Fry, over a series of studies, found a fairly consistent support for a positive effect of real interest rates on savings, for example, Portugal and Turkey (Fry 1977 & 1978); by regressing the ratio of national saving to Gross National Product (GNP), on the growth rate of GNP, the foreign saving rate and the real deposit rate of interest, with both exhibiting positive and significant interest rate coefficient. Giovannini (1983) contested the stability of Fry's results by re-estimating the equation used by Fry, but for a later time and also he substituted the national saving with domestic saving variable and found the coefficient of real interest rate insignificant.

In De-Melo and Tybout (1986) study of Uruguay 1962 - 83, by regressing the ratio of gross domestic savings to GDP on real interest rate, the growth rate of real GDP and the ratio of foreign savings to GDP were found to be positive but not significant interest rate coefficient. Their restricted model using the data 1962 - 73, yielded a positive and highly significant interest rate coefficient. Perhaps this could be attributed to a greater shock in the economy between the period 1973 - 83 which caused the reported significant influence on the real interest rate. Rossi's (1986) examination of the liquidity constraints using a pooled time series and cross section data also found the real rate of interest[2], positive and significantly different from zero.

[1] .ie a positive and significant interest rate coefficient for Asia and insignificant for Latin America.

[2] ... defined as a time deposit rate of interest or foreign interest rate adjusted for inflation .

2. THE FINANCIAL INTERMEDIATION AND INTEREST RATES

Financial repression postulation is that, higher real rates of interest increase the incentives to save by means of bank deposits. Lanyi and Saracoglu (1983, p.28), provided evidence on the relationship between interest rates and the growth of the broad money supply in real terms in a cross - section study of twenty one countries for the period 1971-80. Their study concluded that, the data supports the argument that positive interest rate policies stimulates output growth and that this stimulus is transmitted mainly through the intermediation of financial asset accumulation. The question here is whether the increase in intermediation comes from the shift out of unproductive assets such as gold or if there is a diversion of funds from the curb market.

The answer may be that curb market could actually reduce total intermediation[3] because funds diverted from the curb to the formal market becomes subject to reserve requirements (this is discussed in detail in chapter 6). For example, Van Wijnbergen (1982) found that substitution between the curb market and the time deposits has a greater importance than substitution between currency and time deposits in his study of South Korea.

[3] Total intermediation can be defined as formal (official) banking system intermediation plus curb market intermediation.

3. THE INTEREST RATES AND INVESTMENT

The hypothesis presented by empirical research is that increased real interest rates raise the quantity and quality of investment. This is effected from two sources; first, higher rates increases the availability of domestic credit to finance investment (which can be viewed to be similar to the savings effect). The second potential source is through Mckinnon's (1973) hypothesis[4] of the complementarity of money and capital. Abe, Fry, Min, et al (1975), Fischer (1981) & Jao (1976) tested the complementarity hypothesis and found a positive and significant coefficient by including real money balance in the investment or savings function.

Another group also tested the complementarity hypothesis by including either an investment variable or a savings variable in the demand for money function. Their results were mixed, for example, Akhtar (1974) using the investment rate rejected the hypothesis in a study of Pakistan. In Harris (1979), only Taiwan out of five Asian countries supported the hypothesis.

Fry (1978) using the savings rate, found a negative and significant coefficient in a pooled time series study for ten Asian countries and rejected the hypothesis. Finally, Thorton (1989 & 1990) using a time series data for India and Nepal found a positive and significant coefficient for the savings rate in a demand for money balances in a savings function. Based on this result Thorton concluded that the complementarity hypothesis was relevant for the poorest countries.

[4] In this case, investment projects are lumpy and investors must accumulate their investment balances in the form of deposits until the required amount of principal is reached.

4. INTEREST RATES AND ECONOMIC GROWTH

The empirical postulation is that increased real rates of interest promote economic growth. Fry (1980) indicated that about half a percentage point in economic growth was forgone for every one percentage point by which the real rate of interest is set below its equilibrium level (this is expanded in chapter 6).

Lanyi and Saracoglu (1983) identified a positive and significant relationship between interest rates and the rate of growth of real GDP while Khatkhate (1988) results is the complete opposite. Finally, Gupta's (1984) results for twenty five Asian and Latin American countries were unfavourable but the results for India and Korea (1986), higher real interest rates raised economic growth.

5. IMPACT OF THE DEMAND FOR MONEY

Mckinnon[5] stressed the basic complementarity between money and physical capital wherein money was viewed ... as a conduit through which accumulation takes place. But in an empirical test of several Asian countries using a pooled time series data, Fry (1978), found little evidence to support Mckinnon's hypothesis and concluded that:

> "one would have to look a long way down the development ladder, to some of the world's least developed countries in a search for complementarity (p.474)".

Mckinnon's work is one of two catalytic pieces of work in financial development, the other being Shaw (1973). Both of them combined theoretical analysis and illustration of the malfunctioning of capital markets in developing economies.

A critical lesson from both works is that, at low real interest rates people would not want to hold much money or other financial assets. As a result, the financial system would not adequately be able to fulfil one of its primary functions of integrating capital and credit markets and equalising returns to investment. The hypothesis that

[5] Mckinnon (1973, p.60) Capital and Money in Economic Development.

money and capital are complementary was Mckinnon's explanation for the way in which real interest rates impact upon saving, investment and growth.

The hypothesis was based on two assumptions. The first is that, all economic units are restricted to self finance and that there are important indivisibilities in investment activities. The second is that potential investors must accumulate money balances before they can be able to invest. The indivisibility of investment implies that the demand for money will be larger, the greater the ratio of investment to total expenditure. Therefore, complementarity is expressed by the following demand for money function:

$$(M/P)^* = f(Y/P, I/Y, \pi, \dot{\imath}^e) \qquad (1)$$

where M = money stock

P = price level

Y = nominal income

I = gross investment

π = the nominal rate of interest on bank deposits and

$\dot{\imath}^e$ = expected rate of inflation

The money stock is broadly defined in the formulation because it represented the conduit between saving and investment, while complementarity is reflected by the sign of the partial derivative with respect to the ratio of investment to income i.e:

$$\delta(M/P) / \delta(I/Y) > 0$$

Fry indicated that the hypothesis rests on the assumption that investment opportunities are plentiful so that it is actually the supply of saving that is the binding constraint and not the demand for investible funds. This implies that domestic saving S^d, can be substituted for investment as the finance motive in the demand for money function. This is represented as :

$$(M/P)^* = f(Y/P, S^d/Y, \pi - \dot{\imath}^e) \qquad (2)$$

The reversibility of the complementarity relationship posses the main obstacle. The conditions of money supply has an impact on decisions to save and invest, therefore, it works both ways. The savings function can be specified to be determined simultaneously with the demand for money as:

$$(S^d/Y) = f(\ M/P,\ \delta(Y/P),\ S^f/Y,\ E/Y) \qquad (3)$$

where δ represents the growth rate of real income

S^f = foreign saving which also represents a substitute for domestic saving.

E = exports.

Testing for complementarity between money and capital in the finance motive for economic development, Thorton[6] made the demand for money a function of the saving ratio and simultaneously, saving was made a function of the real money balances. Using the 2SLS method of estimation, his results indicated a strong support for the Mckinnon hypothesis in both the demand for money and the saving function.

[6] Thornton, J. (1990), 'The demand for money in India : a test of Mckinnon's complementarity hypothesis'. S & D no2 1990, pp. 153 - 156.

6. FINANCIAL DEEPENING AND ECONOMIC GROWTH

The hypothesis is that financial deepening and economic growth are positively related. Jao (1976) estimation of sixty seven developing and developed countries indicated a support for a relationship between financial deepening and growth. Restricting his regression to developing countries alone, per capita real money balances showed a significant coefficient. A positive relationship between real GDP and the real supply of domestic credit was obtained by Tun Wai (1980) in a time series study of twelve developing countries. Similar results were also obtained by Lanyi and Saracoglu (1963) between the rate of growth GDP and the rate of growth of the broad money supply. Mckinnon, Shaw and others assumed that causation runs from financial intermediation to economic growth, but an earlier work by Patrick (1966)[7],

Fritz (1984) and Jung (1986), used Granger-type causality test to investigate the relationship between financial intermediation and economic growth. Fritz's result confirmed Patrick's hypothesis that financial intermediation causes economic growth at an early stage of development and the causation is reversed at a later stage, while Jung concluded for a moderate support for the supply-leading phenomenon in LDCs. Most of the evidence available provided a consistent support to the theoretical argument advanced by the Mckinnon - Shaw's view for example Fry[8]. Dornbusch and Reynoso (1989) called the evidence in support of the financial repression paradigm "episodic". They argued that financial repression is only important when financial instability becomes the dominant force in the economy.

What Dornbusch and Reynoso failed to consider is the potential for a shift to savings from purchase of gold, real estate and other inflation hedges that predominate under financial repression. Higher domestic interest rates can also reduce the flow of savings

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[7] Patrick, Hugh T. "Financial Development and Economic Growth in Underdeveloped Countries (1966 p64)..the direction changed in the course of economic development since as the process of real growth occurs , the supply - leading impetus gradually becomes important and the demand - following financial response becomes dominant.

[8] Maxwell Fry - Money , Interest and Banking in Economic Development .Baltimore : The Johns Hopkins university Press 1988 p154....The bulk of the empirical evidence is consistent with the Mckinnon-Shaw view that financial liberalization increases saving , improves the efficiency with which resources are allocated among alternative investment projects and therefore raises the rate of growth .

abroad, thereby increasing the amount available for domestic investment.
Most of the empirical work concentrated their emphasises on the marginal changes in financial conditions rather than discrete changes that result from a deliberate program of financial liberalisation. A few African countries of which Nigeria is now among them, have taken steps to liberalise their financial system. Since 1989, Nigeria has moved quite considerably towards full financial liberalisation.

Ajewole[9] (1989), provided a strong evidence for the relevance and workability of Mckinnon's model of money demand in Nigeria. He indicated that the real demand for money in Nigeria is considerably influenced by real income and return on physical assets. His test also indicated that the broad definition of money performs much better than the narrow definition in the specification of money demand function with respect to Nigeria. His paper finds that there is no significant difference in real money demand when expected and current (actual) income are used and interest rates does not significantly influence money demand in Nigeria, even though it is correctly signed. On this basis he concluded that the Mckinnon model is relevant and very much workable in the Nigerian economy.

Just as Diaz-Alejandro (1985) pointed out, reform programs in many countries achieved success, especially in Asian countries but the support for liberalisation has been called into question by the experience of a number of Latin American countries. Their experience suggests existence of many potential pitfalls for financial liberalisation programs and under certain conditions could lead to a worsening economic situation; more especially, since liberalisation gives money holders access to interest-bearing returns. This could add to public sector financing problems by reducing government revenue from money creation. Therefore, for financial liberalisation to succeed, the conditions must include other factors such as: price stability, fiscal discipline and policies credibility[10], realistic exchange rates, balanced budget and a conducive investment climate.

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[9] Joshua O . Ajewole - some evidence on demand for money in Nigeria A test of Mckinnon model of demand for money in developing economies . Savings & Development 1989 no.2 pp183 - 197.

[10] see Fry (1989 p26).

6.1 Summary

This chapter sets out the structure of the thesis. The seminal works of Mckinnon, Shaw and the Neo-Structuralist are outlined. It reviews the hypothesis that a repressed financial system disrupts development especially the savings channel and the financial intermediaries, leading to inefficient allocation of financial resources among competing uses.

The role of interest rates and saving in determining economic growth are important. Hence the postulation that financial liberalisation will develop positive real rates of interest which will equate the demand for and supply of savings, leading to increased saving.

The thesis examines the impact of financial intermediation and interest rates. Analyzing the hypotheses that higher real rates of interest increase the incentives to save by means of bank deposits, leads to a critical analysis of the curb market.

On investments, empirical research suggests that increased real interest rates raises the quantity and quality of investment. That is, higher rates increases the availability of domestic credit to finance investment, as well as through the complementarity of money and capital. There are still some concern as the support for liberalisation. This is because of many potential pitfalls for financial liberalisation, which under certain conditions could lead to a worsening economic situation.

Chapter 2

A REVIEW OF MCKINNON'S MONEY AND CAPITAL IN ECONOMIC DEVELOPMENT.

Mckinnon attempted to demonstrate the common features of capital market distortions, examination of existing monetary theory and adaptation of a fresh approach to the relation between money and physical capital in developing countries. The Theses aimed to show why liberalisation of financial markets is necessary and how to achieve it without necessarily incurring social and economic costs.

Although his analysis paid less attention to the economies of Africa, one can still relate it very much to the Nigerian economy[1]. The analysis suggests that as long as potential access to international trade remains free, successful development remains mainly on policy choices made by national authorities in the developing countries. However, the inadequate economic performance of many LDCs has been attributed to repressive economic policies that they pursued. For example, Nigerian interest rates policy has been a subject of controversy. They were controlled and regulated up to 1986 when the structural adjustment programme (SAP) was introduced[2].

Money and finance as governed by the banking system played a crucial role in Mckinnon's analysis. This is because of his concentration on the domestic capital market and the way by that market's operations are influenced by monetary and fiscal policies. The expansion of real stock of money[3] or its fall and high rate of taxation critically affects the relation between saving and income and the efficiency of

[1] socialist economies will be included in so far as they use prices to allocate resources in commodity and factor markets (Mckinnon 1973 p2) . note ..Nigeria is a capitalist economy .

[2] Bullion CBN Vol 15 no2 April / June 1991 p15.

[3] That is, the stock of money measured by its value in relation to the prices of goods and services .

investment; a phenomenon which is very apparent in Nigeria.

Keynesian and Monetarist theory has failed to explain the dominance of real money balances in the capital markets of developing countries[4]. The theories to treat real money balances and physical capital as substitutes for each other, a relation of complementarity better explains the data in certain circumstances.

Mckinnon developed an alternative monetary model, even though the theoretical approach lacks the completeness and elegance of either the short run Keynesian theory or the long run Monetary growth models, but suitable for explaining the relationship between monetary processes and capital accumulation in developing countries. This is of course to a certain extent depending on which policy is adopted in relation to inflation versus deflation, higher or lower rates of interest and growth or stagnation. Mckinnon assumed that adopting the appropriate strategies will lead to liberalisation of foreign trade and rationalisation of domestic taxes and expenditure policy. Successful liberalisation will in turn allow for radical restructuring[5], whereas, a correct policy towards the foreign exchange rate is necessary to secure control over the money supply.

Nigeria has now followed this doctrine of liberalisation - a complete overhaul and indeed a very radical outward looking restructuring of the capital market, with greater vigour since 1989. Although there is ample evidence of success, assessment of its success or failure still needs a little time.

The International Monetary Fund (IMF) and other international consortia of lenders from the industrialised economies has been a source of aid to Less Developing Countries (LDCs), in an attempt to liberalise foreign trade. Nigeria operated one of

[4] The theories of monetary and financial processes which assumed capital markets to be 'perfect' with a single ruling rate of interest, whilst underdevelopment is overwhelmingly fragmented in real rates of interest.

[5] of tariff, quotas and licensing restraints on foreign trade .

the most stringent exchange controls throughout the 1970s up to 1986. The policy led to a massive capital flight from the country, in an attempt to secure a better investment elsewhere as a consequence of the repressive interest rates policy followed by the authorities[6]. There are two prevalent views about the effect of liberalisation of the constricted foreign trade sector. The first is that liberalisation is taken as the removal of import controls and tariffs[7]. The second is that foreign aid and/or other external credits should come with liberalisation of foreign trade[8].

2.1 CAPITAL AND ECONOMIC FRAGMENTATION

Public intervention is generally viewed as pervasive and unsuccessful. The reason is due to the perception that a particular market or sector is malfunctioning and the authorities as a consequence are obliged to take action. This pressure for intervention is the result of severe fragmentation in the economy, which manifested in the form of distorted effective prices for land, labour, capital and produced commodities as well as unequal access to the same technologies.

Primary commodity exports enclaves in Nigeria were controlled by foreigners in the 19th and early 20th centuries and much of the population remained outside of the market economy. Indigenous entrepreneurs had little access to capital or advanced technologies and limited skilled labour. Hence, eradication of economic and political colonialism requires introduction of new industrial activities, manufacturing of goods previously imported and mobilisation of domestic factors of production. The authorities attempt to achieve this through manipulation of commodities prices and by intervening directly to help some individuals or sectors of the economy at the expense of others. These are usually through large subsidies by the government in the form of

[6] CBN Bullion April / June 1991 p15, Nigerian SAP p236 -237, Balabkin p9-10 . Nigerian 4th national development plan 1981 - 85 p.40 .

[7] Gradual liberalization -(i) essential producer & consumer goods (ii) essential consumer items ; ie , removal of protection first from domestic industries that are capable to withstand foreign competitions and then , the infant industries .

[8] Aimed to provide external financing for the increased imports that removal of controls seems to portend .

tariff protection, import licenses, tax concessions and low-cost bank finance; mainly to the small urban elites.

The income inequality did not help to induce high rates of saving and the authorities remained reluctant to reduce the disposable income of the rich investors whose unique access to investment opportunities is guaranteed by the web of official controls and the endemic fragmentation.

2.2 THE IMPACT OF LIBERALISATION AND CAPITAL MARKET

Liberalisation does not require intervention in commodity markets hence, an explicit policy for improving the operations of factor markets is necessary to persuade the authorities to cease intervening in the market. Mckinnon's main objection is not just the imperfections in factor markets but the use of Neo-classical approach of treating labour, land and capital symmetrically as primary factors,(1973 p.8).

He hypothesised that fragmentation in the capital market causes the misuse of labour and land, suppresses entrepreneurial development and condemns important sectors of the economy to inferior technologies. Discrepancies in the rates of return on some physical and financial assets causes some worthwhile investments to be forgone.

Development is not accumulation of homogeneous capital of uniform productivity. Hence, Mckinnon accused economic theorists and econometrician's of incorporating this into production functions and by so doing, most policy makers in LDCs held it implicitly and followed a strategy of maximising short run gross investment in virtually any form. In an attempt to develop a distinct alternative view of the role of capital, he defined economic development as:

> "the reduction of the great dispersion in social rates of return to existing and new investments under domestic entrepreneurial control".

By using the capital market in developed economies as an illustration, their success in monitoring the efficiency with which the existing capital stock is developed, by pursuing returns on physical and financial assets towards equality, thereby increasing

the average return. He argued that, economic development so defined is necessary and sufficient to generate high rates of saving and investment. The adoption of Best Practice Technologies and learning by doing.

However, arbitrary measures to introduce modern technology via tariffs or to increase the rate of accumulation by relying on foreign aid or domestic forced saving, will not necessarily lead to economic development. Therefore, there is a need for unification of capital market, which will increase the rates of return to domestic savers by widening exploitable investment opportunities and eliminating other forms of fragmentation.

2.3 FISHERIAN APPROACH

Mckinnon argued that, this approach is not suitable when dealing with capital market in LDCs, because the income categories are not well defined, nor are the processes of saving and investment specialised as in the advanced economies.

By adopting Irving Fishers approach to Impatience and Inter-temporal choice; as extended by Jack Hirchleifer, he provided a framework for viewing the way in which the capital constraint impinges on the decision making of entrepreneurs. Inter-temporal decision making depends upon 3 factors (maximisation of entrepreneurial utility): First is endowment or owned deplorable capital, second is productive or investment opportunity and the third is market opportunities for external lending or borrowing over time outside the entrepreneurs own enterprise. The resulting dispersion in real rates of return reflects the mis-allocation of existing capital and represses new accumulation.

Most Nigerian entrepreneurs with potential production opportunities lacks resources of their own. They have no access to external financing. Those with substantial endowments may lack internal production opportunities. Many have no external investment outlets at rates of return that accurately reflects the prevailing scarcity of capital.

The advantage of Fisherian approach is that it explains the individuality of each entrepreneur with own production opportunity which depends on specialised knowledge or expertise[9]. With availability of external financing, the need for public decision making in each sphere of economic activities is thus reduced, leaving only the problem of indivisibilities acting as a barrier to productive innovation. Without indivisibilties, self-financed capital accumulation-where saving and investment take place within the same firm, might well be sufficient for a slow diffusion of new technologies and a gradual reduction in the dispersion in rates of return within and between various enterprises.

Marginal innovative investment by poor but thrifty entrepreneurs would thrive because divisible investments could be financed directly by marginal reductions in current consumption. Given the constraint of self-financed, an entrepreneur can still decide on investment and consumption decisions that serve to allocate his capital over time. However, limitation to self finance biases investment strategy toward marginal variations within the traditional technology.

The Neo-Classical theory of technological diffusion and learning differs from this analysis of external financial constraints. The Neo-Classical approach assumed an existence of a perfect capital market which equalises all private rates of return, disregarding the importance of indivisibilities. It also assumed similar production opportunities for entrepreneurs. Imperfections in technological diffusion therefore requires a different approach as to external or extra market effects.

Mckinnon disagrees with Kenneth Arrow's suggestion

> "[the economic implications of learning by doing, Review of economic studies vol 29 June 1962 pp155 - 173] that learning by doing in an industry depends on the level of gross investment undertaken by individual firms and because of spill-overs, becomes socially beneficial, thus warranting subsidy to gross investment in high learning industries".

The view was based on the argument that traditional technologies coexist with modern ones and as such the authorities can determine which of the two has the highest rate

[9] Factors of production available to him/her : family labour land holdings and structures .

of return. He admitted that internal rate of return itself can attract enough resources to individual firm-households if an adequate capital market exists. In which case state subsidies can be used to encourage technical innovations in research and development. The essence of high rates of interest according to Mckinnon's view is that artificially low cost loans or subsidized credit programs may be unnecessary and unwise[10]. The availability of loans and high rates of interest for both lenders and borrowers introduces a beneficial dynamism for development, such as increase in net saving, investment and technical improvement. The policy of running a low or negative rates of interest on financial assets and limited loan availability may not accomplish these benefits[11]. This point is discussed further in Chapter 5.

The major set back of capital accumulation through self finance is uncertainty, which fragments the interest rate structure so that it no longer reflects the community or entity's collective time preference. Thus, the effect of risk is to lower the rate of interest on safe loans and at the same time raise the rate of interest on unsafe loans, hence offsetting the effects of bad debts or defaults in repayments.

In contrast to the fragmentation hypothesis, the existing theories of uncertainty assume that individual savers and investors are free to select whatever portfolios of physical and financial assets they choose. Which means that they can borrow and issue their own liabilities at a given rate of interest. James Tobin -(mean variance) and Kenneth J. Arrow -(state preference) explained the uncertainty phenomenon in their essays-liquidity preference as behaviour toward risks and the role of securities in the optimal allocation of risk bearing. The mean variance and state preference relates to the expected returns in holding an alternative physical and financial assets.

Tobin, in Optimal Monetary Growth [JPE Vol.76 July/Aug. 1968 p.854] indicated that risk - averters will hold safe assets with lower yields, while risk takers will hold high variance high return assets and may borrow or leverage themselves to do so.

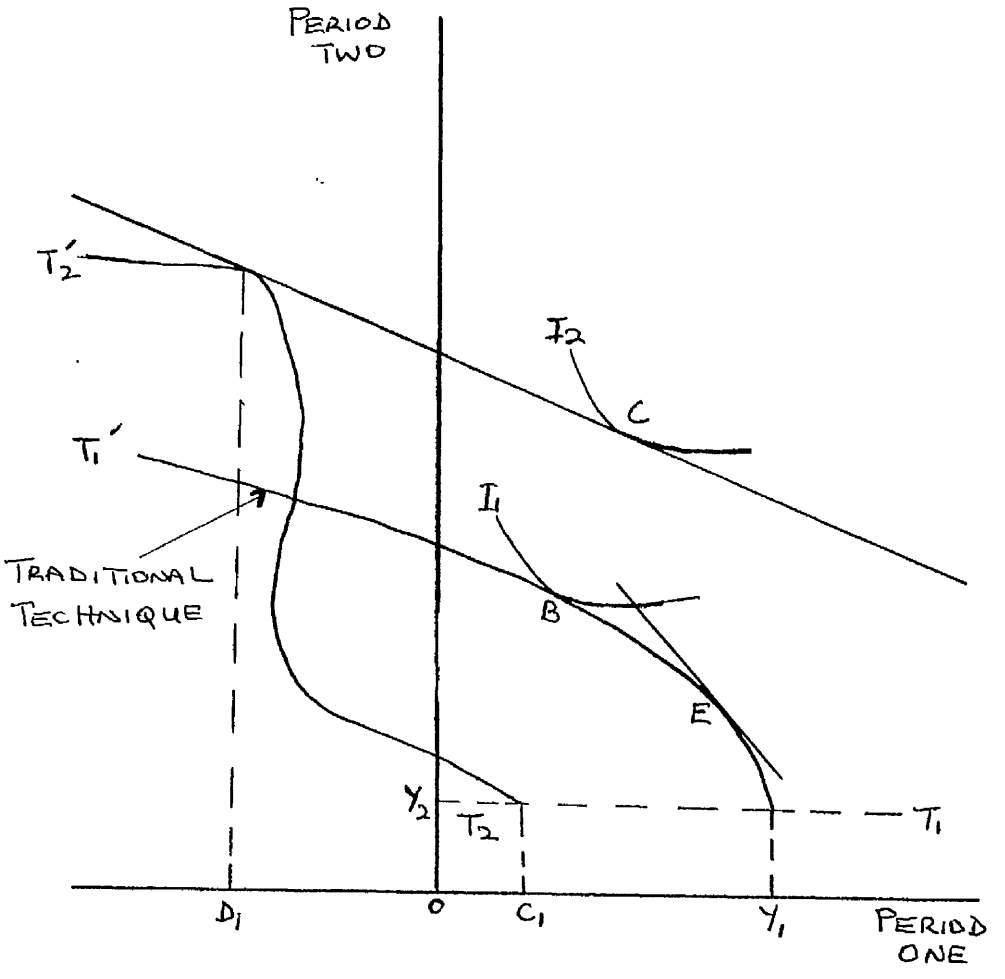
[10] Borrowing at a rate that exceeds the marginal rate of return under self financed investments .

[11] R. Reichel The macroeconomic impact of negative real interest rates in Nigeria , S & D 1991 no3 pp273 - 282

In developing countries, individuals and governments do not have a common menu of physical assets, with objectively defined probability distributions of rates of return. Therefore, investment and production opportunities will be highly differentiated.
The reason for the existence of subjective uncertainty among firms and households is that economic units are small, and it is difficult for outsiders to obtain reliable information if they contemplate obtaining a loan or to invest. LDCs have poor data on repayment and many units operate with little liquidity. Therefore leverage becomes a key consideration in assessing with this interpersonal uncertainty and imperfect information. Those firms that can obtain access to external financing will have their initial endowments as an essential form of collateral to ensure good performance. Thus, initial endowment and capacity to borrow are complimentary over a long range, while leverage is particularly limited for those with small endowments.
For Nigeria, finance is severely limiting the inter-temporal redistribution of enterpreneurial resources as well as collateral in demand for a quick visible payoff on the trickle of external finance that is provided [ie time and quantity dimension]. As a result of these constraints, the government have implicitly been influenced and responded by adopting a policy of Second-Best.

To summarise, Mckinnon essentially used the Two-Period Fisherian diagram to provide a graphic and technical account of how individuals may abstain from consumption (investment) in period one in order to argument their consumable output in period two. He also used it to demonstrate the problem of indivisibilities by assuming that internal investments within the firm can only be in the context of two distinct technologies; Traditional T1 T1' and Mechanised T2 T2' .

Figure 2.1: THE RELATION OF INVESTMENT TO THE CHOICE BETWEEN TRADITIONAL AND NEW TECHNIQUES.



The diagram provided a sketch of how consumption constraint and limited endowment lock the entrepreneur into an inferior technology at point B indicating that with access to external finance, entrepreneurs will break out of the traditional mode with higher production, using new technology [at D] and with much improved consumption at [C] given the rate of interest slope [DC]. The external finance will therefore allow for new investment [Y_1 D_1] in the new technology and increased consumption in period one, ie; from B to C, while the gain in private and social productivity permits him to repay the loan in period two.

2.4 THE INTERVENTION SYNDROME

Mckinnon attributed the intervention syndrome on public policies which circumvents domestic capital market as:

a. Tariff protection for infant industries: A technique commonly used by LDCs to implement the Import Substitution Strategy. He argued that only repayment of principal and interest without tariff protection would vindicate new industries, since early losses must be held to social account and also as learning has its own social opportunity costs. The fact is that, even with spin-offs from established firms optimal public policy will still need a functioning capital market for inter-temporal allocation in the learning phase and in the succeeding growth phases of the new industry.

b. Import licenses and financial leverage:

This has a number of merits to the affected firms such as the privilege to import at lower prices which enhances operating cash-flow of the firm, identifying exclusive right to import an essential commodity as an opportunity for the particular firm to obtain external financing more easily as well as force the restraint on leverage to relaxed. A major drawback to this, apart from the financial aspects is the bureaucratic inefficiencies it brings about and the monopolistic power which acts as the offsetting social cost for concentrating import licenses for essential inputs to a selected few industries so as to reduce fragmentation .

c. Corruption - While he did not conclude that corruption is endemic in LDCs, he did however, indicate that disequilibrium commodity prices arising from intervention is a likely outcome of corruption.

d. Diverting from microeconomic arguments in favour of assisting firms , restrictions on foreign trade tilt the whole structure of relative prices, reducing commodities in some areas as it raises some. The cheapening of capital goods therefore implies an acceptance of the doctrine of uniformly productive capital and a disregard of the need for rationalized inter-temporal and inter-entrepreneur allocations.

e. Most governments intentions has been to transfer the rural economic surplus which

may be in the form of redundant labour or of inferior savings to the industrial sector. Failure to create the appropriate financial mechanism which will induce agricultural savers to part with their surplus voluntarily at the posited high rates of return to be earned in industry.

f. With land serving as a crucial endowment, limited leverage increases the importance of initial endowments in defining production opportunities. Therefore, land reform or redistribution should be given a priority in an attempt to achieve equality in current and future incomes in agrarian economies. According to Mckinnon, egalitarianism motives can hardly be faulted when differences in landholding are extreme and nonagricultural production opportunities are severely limited for those without the necessary capital.

His views were based on the findings of Minhas on India's fragmentation [Minhas - rural poverty, land redistribution and development strategy: facts and policy, IBRD 1970], by advocating for land consolidation, motivated by irrigation or green revolution without waiting for government action, ie through purchase. The idea is that it will achieve the requisite external finance or internal liquidity, especially if there is a prohibition on the resale of land, giving the example of the (ejidos holders) Mexico land reform of the 1920's of such policy failure.

g. There is some kind of ambivalence in the treatment of foreign direct investment and commercial credit by the LDCs. Initially direct investments are accepted with tax concessions over a certain period and then followed by periods of xenophobia which includes the threat of nationalisation. Nigeria followed a similar policy in the 1960s through to the early 1970's, then came the indigenization exercise by the then Military government. When the civilian government was returned in 1979, they reversed the policy and throughout the 1980s both the central and state governments sort foreign direct investment by any means they can. This is discussed in greater details in chapter 5.

In the absence of domestic capital market, the use of foreign financial services

becomes very attractive, although the risk for foreign investors in the domestic economy may be very expensive, the domestic nationals do not see it in that way. Hence the formulation of the hypothesis that domestic entrepreneurs have investment opportunities but lack financing from outside their own enterprises to exploit these opportunities.

The pitfalls of reliance on direct foreign investments is the possibility of breaking the external financial constraint at the cost of relinquishing investment opportunities to the foreigners, therefore, forcing the government to intervene by introducing complicated bureaucratic controls. There is also the danger of returning to colonial economy where expatriates operate with freer access to external capital market in such a way as to deprive domestic entrepreneurial development.

2.5. THE IMPACT OF SELF FINANCE AND INCOME DISTRIBUTION

Self finance is defined as the investment within a particular enterprise of savings accumulated in that enterprise. Through public interventions constraints on external finance are relaxed by enriching the holder of a production opportunity or by making that opportunity appear to be more profitable so that the immediate cash-flow from it increased, for example, by raising output prices through tariffs or through subsidies.

The problem with using prices to generate cash-flows for investment is that it distorts their allocation functions in planning. Firms supported by government subsidies or import licenses or through increase in relative prices have their incomes increased irrespective of the level of efficiency and productivity. Changing the commodity terms of trade in favour of manufactured goods extracts forced saving elsewhere especially in rural areas, without compensation. The argument in favour of this policy is that the industrial sector may save more out of given incomes than do the rural people, so that the transfer increases total saving.

In contrast, self finance tilts the distribution of income towards the wealthy in urban areas, who already have some resources, hence a concentration of economic stratification while lucrative productive investment opportunities are forgone.

2.5.1 THE TAX - SUBSIDY SOLUTION AND THE THEORY OF THE SECOND BEST

Tariffs and other trade restrictions constraints the domestic price structure by differentiating it from the foreign prices through increases in the domestic prices of the protected commodities. Higher internal prices also causes inefficiency by unduly restricting consumption of its output in an attempt to stimulate production. Therefore, the proposition that a direct production subsidy, leaving price unchanged, is the "Best" technique for stimulating production to some predetermined level. Mckinnon used the word " Best" to describe a technique or a policy that achieve some preassigned goal with the least social cost to consumers and to other producers. Thus, tariff is the Second Best Strategy and could diminish welfare even if there were some economically legitimate reason for stimulating production in one industry at the expense of the others. A crucial factor in the liberalization process is the elimination of price distortions.

Since fragmentated economy faces severe fiscal constraints, financing a production subsidy by raising taxes generates its own distortion. Tariff on competing imports has the advantage of being fiscally sound in the sense that consumers of the output of the protected industry are effectively taxed to subsidize producers. However there are few problems with production subsidy. Capital constraints are not recognised as to allocation of resources and budgetary problems. There is biasness towards self finance in the protected industry. There is no recognition of the role an external financial structure in facilitating efficient decision making over time.

Fiscal policy can be very important and can fulfil some essential roles in using differentiated taxes and subsidies aimed at specific industries. Apart from macroeconomic stabilisation policies, the tax instrument of the government can be fully employed financing public goods, redistributing income and mobilising an economic surplus of revenues over current expenditure of capital formation.

2.6. MONEY AND THE PRICE LEVEL

On the nature of the financial structure in LDCs, Mckinnon gave an account of the observations by Raymond Goldsmith [1969 ch.1- 9 and June 1971 pp. 129 - 92]; that individual economic units issue relatively few primary securities as a proportion of saving, indicating the greater reliance placed on self finance by firms in LDCs in contrast to the industrialised economies.

Most of this limited flows of primary securities are obtained by the financial institutions rather than being placed directly with final savers. The liabilities of the monetary system - the central plus deposit banks, accounting for about two-thirds of all claims on intermediary financial institutions that are held by the public.
Modern financial sector consists of instead, indirect financial or intermediaries through which the monetary system operates. In the developed countries, there is a much wider spectrum of available financial assets of which some may be fairly close substitutes for money. Money acting as a legal medium of exchange is uniquely risky and default free for short term transaction.

Since creditors has limited knowledge of the repayment capability of potential debtors in LDCs, financial instruments other money can not easily be marketed. Therefore, money's role as a means of payment and its sanction by the state, greatly enhance its value as an instrument of private capital accumulation. But the usefulness of money as a financial instrument depends on the willingness of firms-households to hold it. However, over finite time intervals, no real financial asset is risk-less. The attractiveness of money depends on some combination of the percentage rate of inflation:

$$P = [\ \delta p / \delta t\ ]/p \qquad (1)$$

(proportional changes through time in the designated variable) the nominal interest rate on deposit d and the convenience of holding money, especially in demand deposits and currency. P is the comprehensive price index of goods in terms of money, while the real return on holding money is d - P*. The instruments of monetary policy open

to the authorities are the nominal interest rate on deposits d, and the rate of expansion in nominal cash balances $\dot{M}$. $\dot{P}$ and $\dot{P}^*$ are determined by using the interaction between the demand for and supply of money as the prime mover of the price level.

If the supply of nominal money rises faster than the demand for real balances, price inflation occurs. In contrast with Keynes, the divergence between ex-ante flows of investment and saving in other to establish an inflationary gap which can move the price level under conditions of full employment[12]. The demand for real balances will be positively linked to the rate of growth in real output, as well as being strongly influenced by the real return on holding money, with a possibility of rising more than output in times of rapid economic transformation. With $\dot{m}$ determining the actual and expected rate of change in the price level, the authorities can indirectly set the real return on money $d - \dot{p}^*$ at any level they considers to be socially desirable.

In terms of causality, it can be either way that is, the rate of price inflation as determined by $\dot{m}$ can affect the rate of growth of real output both in the short and in the long run. Therefore, monetary policy strongly affects private propensities to save and invest in the LDCs.[p.40]. That is, conditions that make M/P attractive to hold enhances rather than inhibit private incentives to accumulate physical capital. Conversely, large real money holdings are normally the result of the monetary systems maintaining a high and stable real return to the holders of money.

Mckinnon in conclusion to this complementary hypothesis about inflationary finance and deposit rates of interest for accelerating development, deviated from the usually accepted monetary theory. His reason for doing so was that, both the Neoclassical and Keynesian theories were designed for the mature (ie the developed or industrialised) economies with functioning capital markets and may be unsuitable if uncritically applied to the fragmented economies.

[12] Mckinnon (1973 p.39)

2.6.1 MCKINNON'S CRITIQUE OF THE PREVAILING MONETARY THEORY

The critique concentrated on the Neo classical theory because of their views of monetary and fiscal policy in determining the rate of capital accumulation and growth in real output, as well as the formation of prices and price expectation to the issue of nominal money. However, he did not assume that the Keynesian theory is the best alternative in dealing with the LDCs.

He was concerned about the Neo-Classical assumptions that; capital markets operates perfectly and costlessly to equate returns on all real and financial assets [other than money] with single real rate of interest. The assumption that inputs [including capital] and outputs are perfectly divisible with constant returns to scale, as well as the assumption of important transactions demand for money in avoiding the need for double coincidence of wants, that real money balances are socially costless to produce for satisfying the transactions motive.

2.6.2 SUBSTITUTION BETWEEN MONEY AND PHYSICAL CAPITAL

The "substitution effect" can be defined as an indication of the possibility that large real cash balances will inhibit the accumulation of physical capital in the private sector. Using the money demand function as an example;

where Y = aggregate real income

r = the real rate of return on physical capital and non-monetary financial assets.

The opportunity cost to wealth holders of holding money will be:

$$r - (d - \dot{p}^*) \qquad [1]$$

where $d - \dot{p}^*$ is the real return on money.

Therefore, the equilibrium demand for money will be:

$$[M/P]^D = H[Y , r , d - \dot{p}^*] \qquad [1.1]$$

where : $\delta H / \delta y > 0$, $\delta H / \delta r < 0$, and $\delta H / \delta(d - \dot{p}^*) > 0$.

The substitution effect between money and real capital in the Neo Classical Monetary Theory can be considered as follows:

The economic power of $\delta H / \delta r < 0$ is that, money is held because of its role as a medium of exchange, whereas capital is held for its own separable rate of return. An increase in r will cause individual asset holders to switch at the margin from money to more beneficial capital, hence forgoing some of the transactions advantage of using money. At the same time, an increase in the real return on holding money for a given Y and r reduces the demand for physical capital in the portfolio of private savers.

In his consideration of the substitution effect between money and aggregate investment for an economy on a balanced growth path, Mckinnon used the monetary growth model of Levhari and Patinkin (the Role of Money because it took into account the theories by Milton Friedman, Harry G. Johnson, James Tobin et al; in deriving the Neo-Classical investment function that holds in equilibrium growth. In his exposition, money is assumed to be an input into the aggregate production function. That is without entering private utility functions but affects welfare only through increasing flow of real goods and services available to individuals. In which case the aggregate production function can be written as:

$$Y = G (K , L , M/P) \qquad [2]$$

where; K = divisible physical capital of uniform productivity
[source of transaction demand for money];
M/P = the real stock pf money;
Y = real output quantity of goods and services;
L = Homogeneous labour input;

Therefore, if money is the productive social wealth such as physical capital, then increases in the real stock of money are a part of disposable income yD, where:

$$Y^D = Y + \delta(M/P) / dt = Y + (\dot{m} - \dot{p}) \qquad [3]$$

Note that the Neo-Classical assumption that savings function is arbitrarily specified

as a given fraction, $0 < s < 1$, of disposable income so that;

$$\delta K / \delta t = G (K, L, M/P) - (1 - s)Y^D \qquad [4]$$

Substituting equation [3] for Y^D , yields the investment function:

$$I = \delta K / \delta t = sY + (s - 1)(\dot{m} - \dot{p}) M/P \qquad [5]$$

Therefore, $s - 1 < 0$, and $\dot{m} - \dot{p} > 0$, or

$$(s - 1)(\dot{m} - \dot{p}) < 0 .$$

where I = aggregate annual flow of investment in physical capital

t = index of time

s = marginal propensity to save

Any increase in the demand for the real stock of money will reduce investment because in equation [5], the marginal propensity to save is less than unity, $s - 1 < 0$ and $\dot{m} - \dot{p} > 0$ because the rate of issue of nominal money is always greater than the rate of increase in the price level in growing economy. The substitution effect here is the same as that of the stationary model of asset choice, hence the propensity to save s, actual saving will be directed either to real money balances or to physical capital. If real return on money increases, hence more attractive to hold M/P at any given level of income, investment in physical capital would decline.

Note: Cash balances are not needed as a store of value in the context of the Neo-Classical model. The private propensity to save is often assumed to be invariant to the real return on holding money and as such is invariant to monetary policy.

On the contrary, cash balances are a valuable current input into production processes as a medium of exchange, for example, Levhari and Patinkin included M/P as an input like labour or capital in the aggregate production function. It is important that, the authorities wishing to encourage private investment exercises some degree of caution on policies that raises M/P, within the Neo-Classical model framework.

2.6.3 THE FULL - LIQUIDITY MONETARY POLICY

In the Neo-Classical model, governments were able to use the monetary and fiscal policy to maximise social welfare, by using the money supply M or its rate of change, $\dot{m}$, and controlling it through the issue of nominal money as a transfer payment to the private sector or in return for current services rendered by the private sector to the government.

An alternative is to increase the monetary system through loans to individuals or firms, even though the banking system is assumed to have no comparative advantage as a financial intermediary. Another form of instrument at the disposal of the authorities is the nominal interest rate on certain classes of time and savings deposits. The Nigerian government adopted this policy since the mid 1980s and has successfully intensified its use to the present time.

In contrast, fiscal policy is viewed primarily as a device for using public saving to control the rate of aggregate capital formation over the long run and to overcome this problem another assumption is required. It is assumed that, 'Fiscal Policy' can be used costlessly to adjust the aggregate rate of capital formation by running a public sector surplus or deficit to increase or reduce the stock of real capital. The condition of equilibrium in private portfolios can be described as :

$$(d - \dot{p}^*) + \text{convenience yield of money} = r. \quad [6]$$

The government can increase real cash balances by increasing the real return $d - \dot{p}^*$ and if d is close to zero, $\dot{m}$ can be set so as to achieve a steady Deflation ie $\dot{p} < 0$.

Raising the real return on holding money above r will not be necessary, because high portfolio changes from relatively illiquid nonmonetary wealth to highly liquid real money balances would occur once $d - \dot{p}^*$ approaches r. Therefore, optimal strategy for securing full monetary liquidity can be described as:

$$d - \dot{p}^* \qquad [7]$$

This implies that price deflation at rate r, the real return to capital ,is socially optimal if no formal deposit rate of interest is paid on holding of cash balances. The same principles applies if d = r when the price level is stable. The next step now is to consider the effect for real capital formation and growth and the possible effect of large expansion in M/P reducing investment in physical capital as a proportion of income due to the substitution effect.

Private saving can be directed towards maintaining the large monetary demand that full - liquidity rule seems to portray, especially if private saving is the only source of capital formation. Given the assumption about the costless use of fiscal policy to adjust aggregate rate of capital formation, the government can also use fiscal policy to increase public saving in order to compensate for substitution effect in private portfolios.

Maximisation is achieved when public plus private investment is adjusted so that the real rate of return on capital is equal to the rate of growth;

$$r = \dot{y} \qquad [8]$$

This implies that, full-liquidity rule provided the best optimisation within the Neo-Classical framework. Holding this optimisation to be true by combining equations [7] and [8] the nominal interest on deposits is zero, full-liquidity monetary policy [7] including keeping the nominal stock of money fixed, so that prices decline at the same rate at which income grows, will yield

$$\dot{Y} = d - \dot{p}^* = r \qquad [9]$$

That is, with $\dot{m} = 0$, if $d = 0$. It can be concluded therefore that, the banking - monetary system has no particular role to play in the process of capital accumulation, although they may appear to be doing so.

2.6.4 THE NEOCLASSICAL APPROACH AND THE BIAS TOWARD INFLATION

The postulation here is that, the Neoclassical model does not provide a perfect fit for the fragmented economies in selecting asset portfolios, as well as the non inclusion of issues of primary concern to the LDCs in formulation of economic policies. Some of the issues omitted includes:

1. Improvement on the quality of the capital stock by reducing dispersion in rates of return (ie, problem of Imperfect capital markets);
2. The optimal commitment of real resources to the monetary system; and
3. The nature of fiscal constraints on government in adjusting the aggregate rate of capital accumulation.

The omissions then lead to bias conclusions regarding:

[a] the substitution effect between real money balances and real capital accumulation;

[b] the independence from monetary policy of the private rate of saving, and the use of the inflation tax as an instrument to promote social saving;

[c] the dominance of the diminishing returns in capital accumulation; and

[d] the failure of the model to generate a determinate demand for money.

Policies based on the Neoclassical model tends to be inflation prone because it arguments real capital accumulation in two ways: first, by increasing public revenues from the inflation tax on cash balances. This can be deployed toward real capital accumulation within the public sector or through a functioning capital market.

The second is through the substitution effect where private savers are induced to acquire more real capital at the expense of real money with their rate of saving out of private disposable income remaining just about the same. This indicates that social saving rises as a proportion of the aggregate income. The opportunity cost of this inflation is the reduced productivity of the economy as a result of the decline in the input of real money balances. There is also the problem of establishing a determinate demand for real cash balances in which case, the transactions motive for holding money can not exist. A determinate demand for money requires imperfections in the capital market, with different risks of default and rates of return on physical and

financial assets.

2.7. THE DEMAND FOR MONEY IN ACCUMULATING CAPITAL

Mckinnon followed the Neoclassical assumption of outside fiat money like cash and excluding intermediations between savers and investors by banks or insurance companies. The analysis highlighted the lack of organised finance in LDCs and the inadequacy of government substitutes for financial processes.

Reversing the earlier Neoclassical assumptions, he assumed that all economic units are confined to self-finance. Greater emphasis was placed on the indivisibility in investment hence, making cash balances the only financial instrument available which can be accumulated and sold freely. These alternative assumptions meant that restraints on external borrowing constraints individual enterprises from undertaking discrete investments with the best practice technologies. The resulting consequence is a creation of wide divergence on rates of return on physical capital.

Another alternative assumption is that governments do not participate directly in capital accumulation through the tax expenditure process or by using seigniorage from money issue for capital formation. This implies that revenues are only used to finance current government consumption.

Complementarity between money and physical capital; (1973 pp.57 - 61); will depend to the extent the individual saver - investor relies on one mode or to the real return on holding money and the inconvenience of storing his own product. Therefore, if d - °p* rises, money will be used more and the less the inventories acts as an efficient store of value (see figure 2.2 below). The proposition used a time profile of the cash balance holdings of two typical firm households. Assuming income to be at a constant level but disbursement subject to indivisibilities, measured by the vertical drops which are also equal for both firms. Figure 2.2 indicates that average cash balance holdings are positively related to the propensity to investment (save) under the formal constraint that all investments are self-financed.

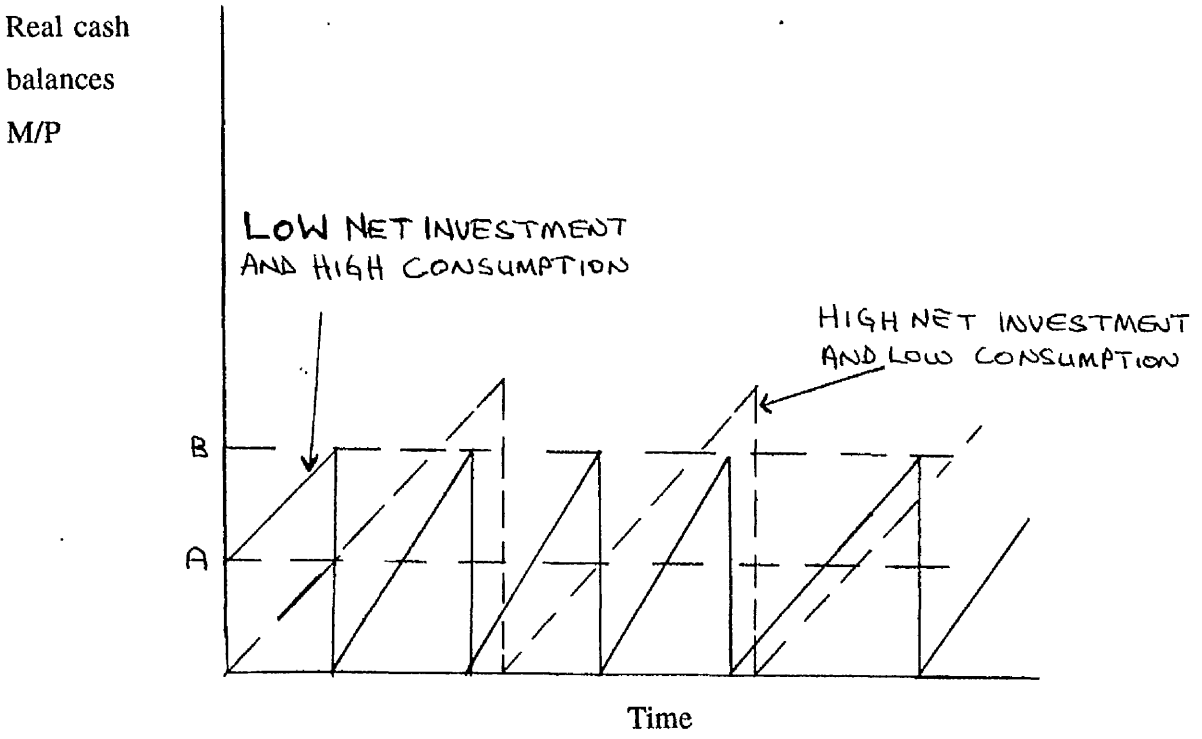


Figure 2.2 Alternative Time Profile of Holding Money for Consumption and Investment

Incorporating the time profile into a function with average demand to hold money such as points A and B on the diagram above will yield the determinants of the real stock of money M/P and the demand for it arising from capital accumulation:

$$(M/P) = L(Y, I/Y, d - \dot{p}^*) \qquad [7.1]$$

where the function L = investment / income ratio , I/Y;

Y = transaction motive for holding money (current income); and

$d - \dot{p}^*$ = the real return on holding money.

With the partial derivative of L being positive ie $\delta L/\delta[I/Y] > 0$ indicating complementarity between money and physical capital in fragmented economies. The assumption of a single real rate of return (opportunity cost of holding money) in this case will be misleading because the application of this conventional approach to LDCs is limited. Assuming $\tilde{r}$ = return to capital and there is an exogenous change in the economy such as removal of foreign trade restrictions, so that investment would increase as $\tilde{r}$ rises.

The new money demand function will therefore be:

$$(M/P)^{D} = L(Y, \tilde{r}, d - \dot{p}^*) \qquad [7.1]$$

where $\delta L / \delta y > 0$; $\delta L / \delta \tilde{r} > 0$; and $\delta L / \delta(d - \dot{p}^*) > 0$.

The complementarity relationship is represented by $\delta L / \delta \tilde{r} > 0$,
and in the Neoclassical model by $\delta H / \delta r < 0$.
Money and physical capital are treated as substitutable forms of wealth holding in the traditional portfolio while the process of accumulation takes place rather as a competing asset. The conditions of money supply has an impact on the decision to save and invest just like the Neoclassical model. This complementarity implies that as real return on holding money increases, so will self-financed investment over a significant range of investment opportunities.

The complementarity between money and physical capital for the investment function can therefore be represented as:

$$I/Y = F (\tilde{r}, d - \dot{p}^*)$$

where $\delta f / \delta \tilde{r} > 0$ and $\delta f / \delta (d - \dot{p}^*) <$ or > 0 representing the mixture of the 'conduit effect' of money and the traditional 'competing asset' effect between money and physical capital.

2.7.1 OPTIMIZATION WITHIN THE NEW MODEL

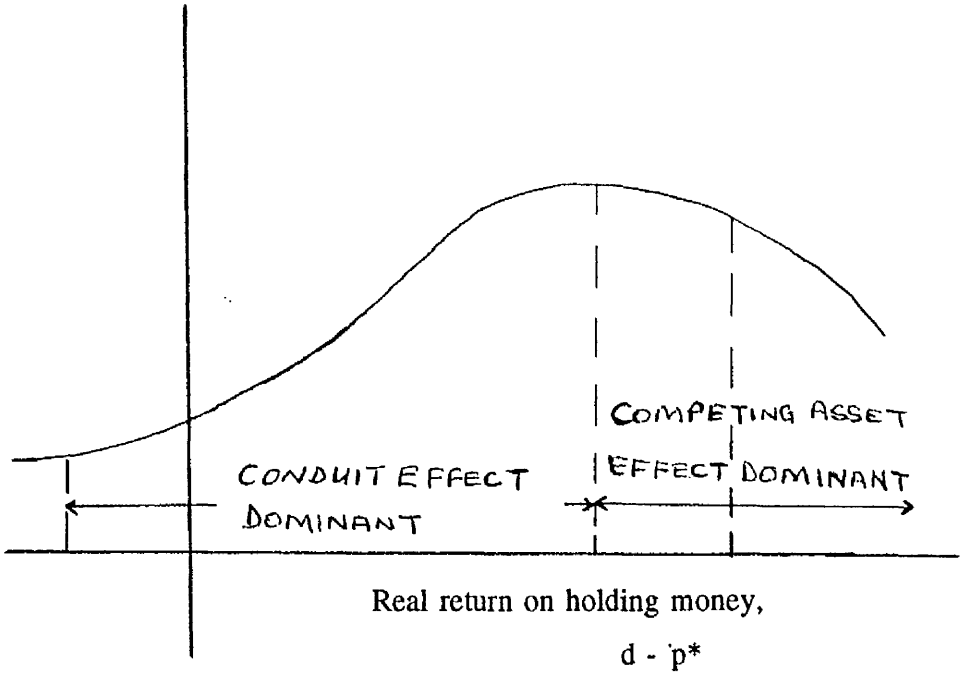


Figure 2.3 Effect of The Real Return on Holding Money on Self-Financed Investment

The return on money set by the authorities is measured on the horizontal axis and the interval AB represents the complementarity between M/P and I/Y because of the 'conduit effect'. When the returns on money is greater than B, the competing asset effect begins to reduce investment. Therefore, a return on money equals to B maximises the rate of self-financed investment which is the rate of returns the monetary authorities would desire in the absence of other avenues for capital accumulation.

The other argument in favour of the optimum level of the real return on holding money is that, it will be socially desirable to prevent investments whose internal rates of return are actually negative , even though such investments as store of value may be privately undertaken if $d - \dot{p}^* < 0$. That is money acting as a store of value or as an inflation hedge.

The competing asset effect can actively constrain social waste if the return on money is kept positive because individuals will not hold nonmonetary assets with a return less than that earn on highly liquid cash balances. This indicates that the quality of the

capital stock is directly and positively related to the real return on holding money, for example, Nigeria by adopting the IMF / World Bank textbook-stylised adjustment program, devalued the currency 'naira'.

The 'Knock-on-effect' on the currency immediately as a store of value diminishes automatically both domestically and abroad. An example of the extent to the fall in value, especially in 1990, can be seen by the total loss in confidence in the coin Kobo (equivalent to pence), where racketeers started buying the Kobo and smelting it, because the metal has more value than the monetary unit itself. If the rate of return on holding cash balances is higher, this smelting of the coins will not occur.

One important consequence of the devaluation is that it has caused greater poverty, making accumulation for lump sum investments impossible especially in terms of its purchasing power. Disinvestment in traditional techniques and planning for quantum investments in new technologies can only be undertaken if there is a higher return to the holders of cash balances.

The traditional preoccupation with diminishing returns from capital formation can be dispensed with when the nature of financial restraint on individual enterprises in LDCs are taken into account. For Mckinnon, the financial institutions definitely have an essential part to play in removing the obstacles that confine self-finance, pooled-savings and efficiency.

This monetary system model based on self - finance is limiting.
The return at point B could be lower than that earned on many potential investments that could be undertaken if banks were active lenders for example.

2.8 FINANCIAL REPRESSION AND INFLATION

The self finance assumption described the situation of developing countries with no operating capital market. Full liberalisation requires the confines of self finance and channelling of external funds to large and small investors who can earn high marginal and intra - marginal rates of return. Therefore, a case can be made for a more costly monetary system based on extensive bank lending to exploit more fully the ability of money and near monies to attract saving in an uncertain world. Financial repression can be said to have started a result of such action.

Bank credit remains a financial appendage of certain enclaves, exclusively licensed imports, large international corporations and various government deficits on current account frequently pre-empt the limited lending resources of the deposit banks. The inability of organised banks to penetrate the economic domain of the LDCs, in serving rural areas and small borrowers; leaves financing of the whole economy to the meagre resources of money lenders, pawn brokers and cooperatives.

One of the reasons for the low ratio of money to GNP can be attributed to the failure of banks to earn high equilibrium rates of return from their borrowers as shown by the low return to depositors. Another reason is that scarce capital is underpriced by the banks and not by the money lenders. Savers tend to respond to low returns by reducing their holdings of money and near monies, even below the social optimum. An increase in the efficiency of bank lending is therefore a necessary condition for enlarging the real size of the monetary system and for alleviating financial repression.

2.8.1 BANKING RESTRAINT AND ITS CONSEQUENCES FOR TRADITIONAL CREDIT MARKET

Organised banking was developed in the LDCs mainly to serve expatriates who were engaged in developing exports of raw materials during the colonial period (Mckinnon 1973 p.69, J. V. Lenin 1960 pp.144 - 54). The indigenous individuals in the colonies were depositors rather than borrowers and funds were channelled to banks controlled from overseas such as London, which then would reinvest funds with borrower whose collateral and reputations were known to overseas bankers.

With independence and the development of national banking in LDCs, the overseas colonisation of the banks disappeared and in its place a similar Neo-Colonial Banking system emerged. The mass of small farmers and indigenous urban industry remains financially repressed even though they own a significant proportion of the deposits on which the expansion of bank credits to the favoured enclaves are based. The poor farmers need capital to bridge the gap between the time when they grow or harvest their crops and when they actually market them. Only few agricultural loans were made by the organised banking system.

Facilities for holding deposits offers limited physical accessibility in rural areas and the rates of interest paid on deposits were low. This leaves the organised banking system to raise the cost of financing inventories of agricultural produce by making it high for traders and farmers and ensuring marked seasonal variations in grain prices. There is also the huge interest differentials between organised banking and informal rural credit in these LDCs[13].

Rural money lending and credits offers only a partial substitute to the organised bank finance [Charles Nisbet, Economic development and cultural change, vol.16 1967, pp.73 - 83]. Nisbet's survey of Chile traditional credit market indicated only about 30% use the state financial institutions. The organised banks have been free from competition and enjoys the yearly expropriation of monopoly profits, hence there is a skewed distribution of income. The interest rate ceiling may be due to attempts to regulate the monopoly power of the banking system.

The views expressed from the Chilean example were that monopolistic banking system with free interest rates use its power to maximise profits, regardless of the impact on aggregate economic activity. It was deemed to be essential to control interest rates to protect the public from the resulting unemployment.

[13] E. C. Eboh et al Saving and Development no.4 1991 pp.361 -371 . Nigerian village money lenders and their usurious interest rates : an analysis of intervening factors .
Mckinnon 1973 p.71.

2.8.2 POLICY RESPONSES TO FINANCIAL REPRESSION

The authorities can respond by extending the usury restrictions, that is, by using ceilings on interest rates charged by banks. The effect of such response is, it will lead to greater fragmentation in the returns to capital and more instability in prices, especially crops. The authorities may decide to allow money lending at high rates of interest but will attempt to mitigate some of its unfortunate social effects, like prohibiting pledging land as collateral, in order to prevent landless peasantry. The effect of such action is that access to finance will become more limited. Raising collateral for loans will become extremely difficult for the farmers to achieve, examples include, the Malaya land reservation and the Mexican ejidos[14].

The authorities may adopt price stabilisation policy like holding grain inventories and setting up crop prices. The effect is, pressure will be put to the government to set prices either too high in favour of the farmers or too low in favour of the urban pressure to keep the cost of wage goods down Public inventory and marketing control can cause expropriation and mis-allocation of credits and other agricultural inputs on non price basis.

2.9 MONETARY REFORM AND SUCCESSFUL FINANCIAL GROWTH

Mckinnon expressed the view that to criticise the monetary policies of the LDCs can only be justified if it can be shown that the financial repression observed is not endemic and that its release is within the control capabilities of monetary and fiscal authorities. He used Japan and Germany as an example of sustain monetary growth relative to GNP. The two countries showed how a fully developed monetary system can be approximated in a fast growing economy. The reality is that, this has not been the case with regard to the LDCs, in breaking the repression syndrome.

Some LDCs that had suffered from the consequences of financial repression, did make a remarkable policy shift toward increased real deposit and lending rates that favourably altered the future course of their economies, for example, Korea 1964 - 66,

[14] The Malayan Land Reservation Act - prevents money lenders (mainly the Chinese and the Indians) from gaining title to the land . The Mexican EJIDOS are land parcels which can not be resold .

Indonesia 1967 - 69 and Taiwan. These three countries are now in what is called 'financially transformed categories', even though their monetary system has not reached the same proportion of GNP as have those of Japan and Germany. Korea, Indonesia and Taiwan provided a perfect analysis of successful but nonorthodox programs for stabilising the price level.

Germany and Japan are particularly interesting in assessing sustained financial growth because in both; the banking system dominates the capital market and direct finance is less important than in other advanced economies.

In Nigeria, indirect finance through the banking system is still the dominant mode. The capital market remained fragmented with widely dispersed rates of return. There are still high dependence on self-finance and the household savings were tapped by the organised business sector, therefore, economic transformation becomes essential.

One would expect that economic development will require inter and intra-sectoral transfers of the same magnitude as those of post Second World War Germany and Japan. Instead, what is found in the LDCs is a maintenance of small and repressed monetary system, coupled with extensive reliance on various fiscal and other interventions in commodity and factor markets as a substitute for bank intermediation, a second best device.

Mckinnon remarked that the lesson learnt from those LDCs that has undertaken financial reform are:

(1) It is within the monetary and fiscal capabilities of the developing countries to use high nominal rates of interest and control over money supply to embark on a sharp changes in monetary policy away from repression and towards real financial growth;

(2) Stabilisation of the price level need not be accompanied by an economic depression if policy permits the banking system to play its intermediary role;

(3) High nominal rates of interest can be managed effectively to offset expected and experienced inflation, depending on inflation being progressively reduced to moderate levels;

(4) Optimal real rates of interest on deposits and loans for which capital scarce economies should strive, are surprisingly high but financial repression is not far away if monetary policy goes astray.

2.9.1 GROWTH AND SAVING

This analysis considers how growth itself increase the propensity to save out of aggregate income, especially when holdings of real money balances are high. An optimal monetary strategy will be one that weighs increased private investment against public seigniorage in determining how best to utilise the portfolio effect.

The Harrod-Domar model of equilibrium growth was used to illustrate the portfolio effect. The model assumed that saving was automatically transmitted into investment at a uniform rate of return, hence leaving out financial consideration. The output/capital ratio σ was constant and yielded the simple production function:

$$Y = \sigma K \qquad [1]$$

where Y = aggregate real output (income); and

K = the stock of physical capital;

Implicitly, the equation assumes that technical change is sufficiently labour augmenting. Thus, labour does not need to enter explicitly as a separate constraint on production. Within this financial approach to economic development, the output/capital ratio could rise when new investment is accompanied by suitable monetary expansion or investment could be subject to diminishing returns in the classical sense. The saving or investment propensity in the unmodified Harrod-Domar model is a fixed proportion of income S, which can be expressed as:

$$I = \delta K / \delta t = sY. \qquad [2]$$

where t is an index of time.

Substituting equation [1] into [2] we have:

$$\dot{Y} = \sigma s \qquad [3]$$

where $\dot{Y}$ is the equilibrium percentage rate of income growth.

Equation [3] result implies that the rate of growth is the product of the marginal output/capital ratio and the marginal propensity to save. Assuming the parameter p, be given exogenously to the Harrod-Domar model, representing these other variables in the function describing the propensity to save:

$$s = s(\dot{Y}, p) \qquad [4]$$

where $0 < s < 1$; $\delta s / \delta \dot{y} > 0$; and $\delta s / \delta p > 0$.

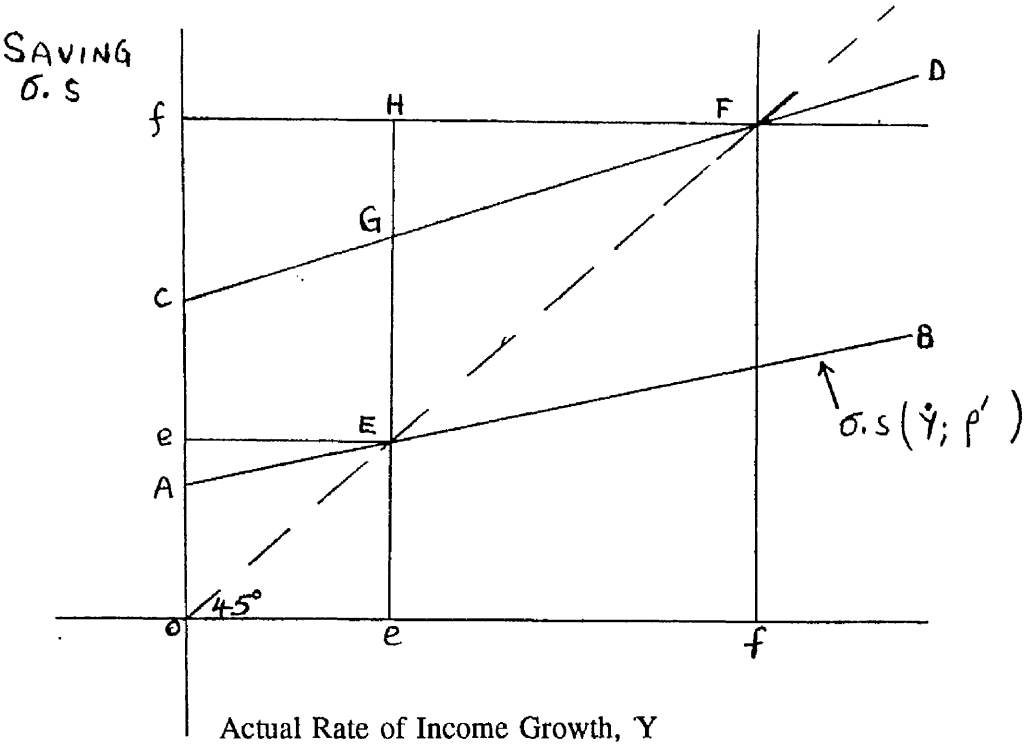
Equations 3 and 4 gives the equilibrium growth path for this variable saving version of the Harrod-Domar model, once p is given exogenously.

That is, $\dot{Y}$ is defined by the implicit equation:

$$\dot{Y} = \sigma.s(\dot{Y}, p) \qquad [5]$$

The effect is that, the quantity $\dot{Y}$ is now dependent on the portfolio effect of growth itself operating on intended saving. Figure 2.4 illustrates the solution for equation [5]. The horizontal axis is the actual rate of growth and the product of the intended or ex ante propensity to save. σ is plotted on the vertical axis and the equilibrium growth at the point where the two are equal which is represented by the 45° line. Assuming AB is equal to the variable saving propensity represented as an increasing function of $\dot{Y}$. Therefore, the intersection of AB at E is the equilibrium growth where the actual rate of growth in income generates the desired saving sufficient to support the investment necessary to maintain the rate E indefinitely.

Figure 2.4 THE PROPENSITY TO SAVE AND THE RATE OF INCOME G GROWTH



Considering the stability of this equilibrium position:

If actual growth were set at zero so as to eliminate the portfolio effect, then the propensity to save would still be positive and equal to OA. If this saving is successfully transmitted into net investment, the rate of growth would be driven upward. For equilibrium to exist at E, AB must be constrained to have a slope of less than unity, in order to prevent explosive growth in the context of the model.

$$\delta s / \delta Y < 1 / \sigma \qquad [6]$$

The objective for constructing this growth model is to show the consequences of a market change in financial policy of the kind observed in some less developed countries. It provided an economic insight into why a discrete improvement in monetary policy can have a sharp impact on observed growth and saving rates. It also helps in permitting rapidly growing economies like Japan to sustain an extraordinary high propensity to save over a long period of time.

2.9.2 FISCAL POLICY AND THE LIBERALISATION OF FOREIGN TRADE

Import tariffs, licenses and quotas all have contributed to the bureaucratic confusion and to the inordinate cheeping of some tradable commodities while creating undue scarcity of others. The strategy of industrialisation through import substitution has been disappointing. The endemic economic fragmentation and lack of generalised productivity growth have been aggravated.

Studies by the OECD and IBRD[15] both recognised that a substantial relaxation of import restrictions, coupled with a suitable devaluation in the exchange rate towards an equilibrium level is necessary to expand exports and overcome the shortages of foreign exchange that most LDCs seem to face. Dependence on the production and export of primary commodities has to eliminated as economic stagnation was overcome. Hence, a more vigorous domestic capital market centred on the monetary system, can be a more efficient path of economic development.

2.9.3 TAX NEUTRALITY AND EXPORT REVIVAL

Most LDCs have followed an extreme anti-protectionist policy in the export sector of their economies. Implicit taxation of export industries is usually much greater than the visible direct restraints on actual export flows. Keeping imports out reduces the effective demand for and consequently the price of foreign exchange relative to the domestic costs of labour, capital, intermediate inputs that producers of export products must pay.

Since exporters sell in foreign markets at this less favourable real exchange rate, they are caught in a profit squeeze, which reduces traditional exports and blocks new export development, especially manufactures. It is common practice in LDCs as well as many advanced, to give exporters of manufactures special access to central or commercial bank credit at low real rates of interest. As these low or negative rates are passed back to depositors,it contributes to repression.

[15] OECD - The Organisation for Economic Co-operation and Development . IBRD - The International Bank for Reconstruction and Development .

2.9.4 INDIRECT TAXATION AND THE PROBLEM OF REVENUE INELASTICITY

Developing countries rely heavily on a wide variety of indirect taxes that are not applied uniformly, for example, sales taxes, custom duties and stamp duties.
One of the adverse consequences of import substitution is that revenue from the indirect tax system has become less income-inelastic. As gross national product (GNP) grows, revenue from indirect taxes tends to grow less than proportionately and the problem is with the way it has been distorted to provide incentives for industrialisation to replace imports. In the past, most LDCs were producers of primary commodities only, which were mainly exported, hence tariffs on imported manufactures were the principal levies for raising revenue. In an attempt to try to achieve more progress in the structure, imports of consumer manufactures, especially luxuries goods were heavily taxed.

Growth brings with it a tendency toward budgetary deficits. Public saving does not keep pace and governments either allow more non-neutral small taxes to proliferate or turn to central banks for financing given the absence of capital markets for absorbing long term public debt. Excessive issue of nominal money can then cause inflation and a reduction in the real stock of money. Therefore, incorporating more revenue elasticity into a reformed tax system is necessary in order to avoid financial repression.

2.9.5 THE VALUE ADDED TAX

One way of maintaining revenue as income grows is by adopting a moderate uniform tariff on all imports. Although uniformity on tariff system for foreign trade would be a great improvement for most LDCs but it would not be a FIRST BEST solution because of inconsistencies with other taxes which remained.

However, introduction of uniform value added tax VAT can overcome the difficulties by combining the simplicity of a single ad-valorem levy on imports with generally neutral taxation of domestic and foreign commodities destined for final consumption. The problem here is how to administer the VAT in the absence of foreign trade.

The tax base of value added can be defined;

(1) From a tabulation of gross sales, the tax paying firm can subtract all supplies purchased including capital goods as well as raw materials and semi finished materials in calculating its tax base.

(2) The value of capital assets purchased can be disallowed and a depreciation allowance substituted. It will be an easy task for the tax assessor if the consumption version is adopted with a single rate.

Note; value added refers to the sum of wages, salaries, profits, interest and rents generated within the firm, which are all to be taxed at the same rate, and the tax collector does not have to know or estimate these individually. All to do is to verify the dollar value of the gross sales of the firm which is a relatively easy business statistics to obtain. The tax payer has to supply evidence of materials purchased from other firms that have already been taxed. The tax base is then is the difference between gross sales and the value of those inputs whose purchase from suppliers can be verified.

For an open economy, they would then chose whether the VAT should be applied on the "ORIGIN" principle or on the "DESTINATION" principle. The distinction of course lies in the form of the border-tax adjustments chosen to reconcile the taxation of imports and exports, with the VAT system imposed on the domestic goods. If the authorities chose the maintain neutrality with respect to foreign trade, imports entering the economy will not be taxed because of the symmetry between import and export taxes.

In the case of the LDCs, the origin principle for VAT will not be desirable. LDCs have a long history of levying taxes on imports at ports and border-crossing stations because of the relatively visibility and sophisticated nature of international trade. If imports and domestic output were to be taxed under the destination principle, neutrality would require that exports be exempted from VAT in order to avoid double taxation of foreign trade. Apart from the zero tax on the VAT by the final exporter, rebates would be given for taxes that had been paid earlier on supplies that were

purchased to ensure complete exemption of the product. Bias would be avoided if the VAT replaced import duties as a source of revenue and protective tariffs eliminated. It is not feasible or desirable, at least for the time being , in most LDCs to extend the tax to include the final retail stage of distribution, where collection of the tax would be costly and because of the large number of peddlers, vendors and very small merchants. Basic unprocessed foods are often exempted so that farmers are excused from legal tax liability in an attempt to ensure that food prices are kept low.

2.9.6 CONSUMER EXCISES

Since personal income taxation may be quite ineffective in LDCs there is a good case for continuing to tax consumer luxuries at different rates appropriate for each commodity in addition to the uniform VAT levy. In order to avoid unintended protection for domestic producers of consumer luxuries, countries should convert revenue tariffs to consumer excises, which will be collected by customs officials on imports but domestic producers of luxury goods would also become liable at the same rate with the tax collected at the factory gate .

This excise technique of taxing final consumers avoids bias foreign trade in the process of industrialisation and it also maintains or increases overall revenue elasticity as consumption and income grow. The degree of rate differentiation among individual consumption goods would depend on:

(1) The consequences for income distribution;

(2) The price elasticity of demand and the resulting revenue the government might expect;

(3) The enforcement problem;

(4) The historical level of the equivalent revenue tariff.

For consumer goods that are produced domestically as well as being imported , the conversion should be made in conjunction with a general removal of tariff and quotas on all imports. The resulting depreciation of the foreign exchange value of the domestic currency then tightens the burden on domestic industries as they adjust to losing their tariff protection and become liable for these consumer excises and the VAT.

2.10 THE TRANSITION: EXCHANGE RATE FLEXIBILITY AND THE ROLE OF FOREIGN CAPITAL

Despite the financial advice and support from the IMF, IBRD and other multinational lending consortia composed of creditors from the advanced countries to the LDCs. Some attempts have been made to secure liberalisation, both in foreign trade and domestic finance and fiscal policy. Substantial net inflows of foreign capital including stabilisation loans have been used frequently. Some policy changes towards greater liberalisation have been partial and short lived, while few countries succeeded on a sustained basis.

Mckinnon used an Alpha economy to illustrate the pitfalls in partial liberalisation with foreign capital. He concluded that a compromise solution between general liberalisation as promoted by the IMF and liberalisation that is confined to essentials may ultimately be worse than extreme. The protection and anti protection of such compromise or partial liberalisation can be further accentuated by an extraordinary inflow of foreign capital (Mckinnon 1973 p.158)

Note; the assumption is that his alpha's economy inflation has risen so that exchange rate pegged by central bank becomes overvalued, resulting in excess demand for foreign exchange leading to increased imports. Consequently, a fall in exports due to rising internal costs and a flight of short term capital as traders begin to anticipate a devaluation. To protect reserves, exchange controls are extended to intermediate products which in turn forces a slow down in domestic production. In addition to industrial recession, the flight of capital and the depletion of foreign exchange reserves makes it impossible for the government to continue to meet normal commercial debts of foreigners.

On his consideration of full liberalisation without foreign capital, Mckinnon constructed another paradigm, a Beta economy which uses political consensus to liberalise completely policies that are previously repressed. The focus is on the internal constraint rather than foreign capital. The government then increases its own saving by raising taxes and the prices of publicly dispensed services so as to reduce fiscal dependence on credit from the central bank. At the same time interest rates on

deposits and loans are increased in order to stimulate the flow of private savings through organised banking.

Monetary constraint are eliminated on internal capital accumulation through raising the real interest rate on deposits and stimulating investment of higher productivity and maintain the level of output. As long as all import substitution industries have their formal protection lowered simultaneously, the compensating devaluation in the foreign exchange ensures that no single producer faces unduly harsh or subsidised competition. The delicate internal employment reallocation may be offset by an unusually large inflow of foreign capital that inhibits the exchange rate from depreciating sufficiently. Aggregate imports then would start to rise above exports so that tradable goods sector as a whole be negatively protected.

Previously protected import-competing industries which faces a significant adjustment problem, could have their problems doubled by unusual inflow of competitive imports. The capital inflow could trigger a decline in overall domestic output because an increase in the production of exportable's need no longer counterbalance a reduced production of importable's. As it liberalises, the authorities would deliberately avoid the unusual injection of foreign capital, whether of stabilisation loan or suppliers credits. It would also avoid repayment problems.

2.10.1 MISALIGNED INTEREST RATES AND CAPITAL INFLOWS

Using a short term interest capital movements, such as trade credits, a sharp rise in domestic nominal rates of interest and the expectation of exchange rate stability in the near term, increases the propensity of nationals to hold bank deposits, instead of foreign currencies. The idea is that the willingness to hold bank deposits would prevent capital flight, once complex exchange controls and rules on export retention are removed. Nigeria has followed some or all the reform procedures discussed so far. The currency, which the IMF and the World Bank argued is overvalued has since been devalued up to 40% by March 1992, Financial Times (London March 16 1992). Interest rate has been deregulated and the government now contemplating floating the currency.

2.10.3 RESTRICTING INFLOWS OF SHORT-TERM CAPITAL

Given the complexity of the gliding parity for aligning foreign and domestic interest rates during liberalisation, some governments may find it too difficult to handle. Careful calculation of the division of exchange rate adjustment between the initial discrete devaluation and the magnitude and duration which foreign trade had been repressed and the speed to which inflationary expectations are to be dampened together with changes in nominal rate of interest.

There is strong tendency to restrict the use of short-term capital during liberalisation, especially supplier credits for imports, as a supplement to exchange rate policy. The LDCs can dismantle official regulatory devices set up for the express purpose of encouraging the use of foreign short term finance. Apart from the rejection of stabilisation loans and other government to government aid, the authorities may restrict the purchase of domestic financial assets by foreigners and sharply limit the trade credit that importers are permitted to accept.

The distinction between normal and abnormal commercial credits on imports are difficult to assess because of the various insurance programs for export credits on the part of the advanced economies. Fortunately such extraordinary measures will fade as financial liberalisation dampens domestic inflationary expectations and domestic nominal rates of interest can be reduced.

2.10.4 SUMMARY

The analysis of financial development by Mckinnon challenged the case for low controlled interest rates and financial repression. The hypothesis advocated is for financial liberalisation and development as growth enhancing economic policies. This contrasts the monetary models of Keynes, the Keynesians and the Neo-Structuralist. Mckinnon's postulation is that essential assumptions in these paradigms are erroneous in the context of developing countries.

Mckinnon provides a theoretical framework for analyzing the role of financial development in the process of economic growth. He proposes an alternative model in which real balances are complements to, rather than substitutes, for tangible investment.

Mckinnon formalised a complementarity hypothesis based on complementarity between money and physical capital. Complementarity is reflected in the demand for money function expressed as:

$$M/P = f(Y, I/Y, d - \pi^e)$$

where M is the money stock including saving/time deposits, demand/sight deposits and currency in circulation (M2). P is the price level, Y is the real gross national product (GNP), I/Y represents the ratio of gross investment to GNP, while $d - \pi^e$ is the real deposit rate of interest (d is nominal deposit rate and π^e is the expected inflation rate). Complementarity works in both ways: the conditions of money supply have a first order impact on decisions to save and invest. Thus, the complementarity can be expressed as an investment function of the form :

$$I/Y = f(r^t, d - \pi^e) \qquad [4.1]$$

where r^t is the average return to physical capital whilst, the partial derivatives of complementarity is:

$$\frac{\delta(M/P)}{\delta(I/Y)} > 0 \; ; \; \frac{\delta(I/Y)}{\delta(d - \pi^e)} > 0.$$

Mckinnon however, adopted the Tobin approach in developing a model based on commodity or outside money, which is money issued as loans to the government and not therefore available to finance private sector investment. Thus, if all financial

institution liabilities consists of outside money, their assets must be entirely government bonds or gold, in which case the financial institutions do not intermediate between private savers and investors.

For selective credit policies to work, financial markets must be kept segmented and restricted. Selective or sectoral credit policies are common components of financial restriction. The techniques used to reduce the costs of financing government deficits can also be used to encourage private investments. Interest rates on loans for such approved investment are subsidised. Successful financial restriction is exemplified by a higher proportion of funds from the financial system being transferred to the public sector and by three effects on the demand for money:

[1] A rightward shift in the function;

[2] A higher income elasticity; and

[3] A lower cost elasticity

A successful financial restriction makes income velocity of circulation low and falling, allowing for a greater public sector deficit to be financed at a given rate of inflation and a given level of nominal interest rates.

In the financial development model by Mckinnon, he emphasises the dispersion in rates of return to investment in financially repressed economies, postulating that in the face of great discrepancies in rates of return, it is serious mistake to consider development as simply the accumulation of homogeneous capital of uniform productivity. Thus defining economic development as the reduction of the great dispersion in social rates of return to existing and new investments under domestic entrepreneurial control.

For Mckinnon, control over Public Finance is an essential prerequisite for successful financial liberalisation. This is more so given that government deficits are invariably financed by taxing the domestic monetary system. Foreign exchange controls necessitate a fixed exchange rate system. Therefore, large public sector deficits tend to be incompatible with financial liberalisation and development. The analytical

explanation of how the real deposit rate of interest affects saving, investment and growth is based implicitly on an outside money model, which again is based on two assumptions. The first assumption is that all economic units are confined to self finance, while the second is on the indivisibilities in investments.

THE FINANCIAL DEEPENING

FINANCIAL DEEPENING IN ECONOMIC DEVELOPMENT.

This chapter deals with the theory or hypothesis presented by Shaw (1973). The financial development hypotheses by Shaw (1973) is closely related to that of Mckinnon reviewed in chapter 2. It is worth bearing this point in mind, especially as their postulations sometimes tend to overlap each other. However, there are some obvious distinctions between the two theories which is mainly in the style of description and presentation rather than on the principles of the hypothesis.

The hypothesis presented by Shaw was that:

> "the financial sector of an economy is important in its economic development and in a situation where this is repressed and or distorted, it can intercept and destroy impulses to development".

Like Mckinnon, Shaw postulated that in the market, money is the only good that trades against all other goods, while interest rates are the relative prices that have the most influence relevant to economic decisions. The distortion of the financial prices, interest rates and foreign exchange rates included, led to reductions in the real rate of growth and the real size of the financial system relative to non financial magnitudes.

Again, like Mckinnon, Shaw advocated that a new strategy that has the effect of 'Deepening' finance, that is a strategy of financial liberalization is necessary for economic development. Financial liberalization is also linked with complementarity measures that extends beyond the financial sector.

3.1 NOMINAL AND REAL FINANCE

To clear the analysis of money illusion, a distinction between the real values and real rates of return for financial assets from the nominal is essential. While the nominal finance takes the high growth path, the real finance follow the low path, partly because it is being taxed by inflation (ie deflated by the rate of inflation). The shallow finance in relation to national income or non financial wealth, can be taken to be low or negative real rates of return. In which case, the holders of financial assets including money are penalised or not rewarded for real growth in their portfolios (Shaw 1973 p.5, Mckinnon 1973 p.96 - 98).

The distinction between nominal and real wage rates and wage incomes are of high importance to both trade unions and employers. Both the employers and the unions uses it in determining productivity and wage bargaining. It also assists in realising the four prices of money which can be classified as:

[1] Unity

[2] I/P an index for the purchasing power of money over a basket of goods and services. The real stock M/P, is the money stock valued at its relative worth in goods and services.

[3] Explicit price, that is, real deposit rate of interest d,

the sum of any nominal rate of interest $\underline{d}$ on money balances and the rate of change $\dot{p}$ in money second price : $d = \underline{d} - \dot{p}$.

[4] The foreign exchange rate, the ratio of exchange between one currency to another such as pound sterling to U.S dollar or the Nigerian naira.

Financial analysis would have been simpler had there been one exchange rate between currencies instead of a real or purchasing power parity rate as well as nominal rate and forward or future rates in addition to present or spot rates. In which case, the dominance of multiple pricing in all financial assets and non-monetary assets and money itself. The other distinction is between instruments of financial policy with some bearing on nominal amounts of finance and some on real amounts. Shaw adopted the position that financial deepening results from appropriate real finance policy. That is, real rate of return to real stocks of finance and shallow finance due

to distortions in price.

3.1.1 MEASURES AND INDICATORS OF FINANCIAL DEEPENING

THE FINANCIAL STOCKS:

> "Financial liberalisation policy and elimination or reduction of financial prices distortions lead to increased liquidity reserves. For example, it tends to enhance central bank's stock of international liquidity and a reduction in frequent intervention through rations or licenses on the foreign exchange markets[1]".

Equally fascinating is the capability of diversifying the range of financial assets so as to enable borrowers to adjust their debt structures and the lenders their portfolios by the appropriate margin. Deepening eases the strain on taxation and moderates demand for foreign savings. Capital flight is an evidence of an aversion to finance. Financial deepening prevents or halts it, or at least minimises the scale of capital flight.

In relation to shallow finance, organised finance has been dominated by the banking system and in the process gave them oligopolistic power in the financial sector. Finance through the foreign exchange is dominated by external grants of aid, high cost supplier's credits and direct investment from abroad. The curb market on the other hand is limited to short term transactions at some high risk from borrower's default and government repression.

Financial deepening therefore, increases the real size of the monetary system and generates opportunities for the profitable operation of other institutions. Interest rates is one of the essential measures and indicator of financial deepening, especially for revealing existence of substitution of investment for current consumption. This implies that real rates of interest will be high where finance is deepening. The financial markets tend to prefer to trade at interest rates that overvalue the future in terms of the present (refer to section 5.6.1 of Chapter 5).

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[1] See Ronald I. Mckinnon , Money and Capital in Economic Development , 1973 pp.22 - 29 . The intervention syndrome.

A common feature of shallow finance is the over-valuation of domestic currency on the official markets for spot foreign exchange. For instance, the regulatory policy demands of premium on domestic balances in terms of foreign balances as well as premium in present balances on future balances. Shallow finance has the effect of discouraging exports and saving, but encourages imports and consumption, which is not what LDCs actually need.

3.2 THE AIMS OF FINANCIAL DEEPENING (FD)

Financial liberalisation tends to raise the ratio of private domestic savings to income, as well as savings from foreign sector (Shaw 1973 p.9 - 12, Mckinnon 1973 pp.77 - 79). An increased real growth of financial institutions supplies more investors with access to borrowing as well as incentive to save and to accumulate equity which in turn makes borrowing cheaper.

Liberalisation allows for a smoother financial process of mobilising and allocating savings to replace to some extent the fiscal process, inflation and foreign aid. Fiscal policy is backward in lagging economies and its potential to generate sufficient revenues is constrained by demands for government consumption and investment financing, thereby affecting the economic efficiency and social equity which in turn wipes out the benefits of capital accumulation.

For a good number of LDCs, foreign aid has to some extent been a perfect substitute for domestic savings and the aid gap analysis can therefore be termed as a partial indication of excess demand for savings in these economies that uses relative price to repress domestic savings. Liberalisation offers the tool to broaden the allocation of savings and diversification of the financial market, thereby allowing for greater investment opportunities and competition for the savings flow[2].

Financial repression in LDCs is partly the cause of unemployment because of the combination of low interest which inhibits savings and the relatively high minimum - wage rates to guarantee the supply of labour. For instance, in Nigeria a minimum

[2] In repressed economies, savings flow mainly to the saver's own investments , thus self finance prevails , but offers no portfolio choice or possibility of a common market .

wage of N100.00 per month called the Udorji Award[3] was introduced in 1975. Although the economy was in a boom at the period 1972 - 1977, with a relatively stable oil price, the economic constraint of this minimum wage upon the middle sized firms was high, as most of them can not afford to increase their workforce. This marked the beginning of a long haul in Nigeria's unemployment experience, even though the award brought enormous benefit and higher standard for those already with job.

Minimum wage may be beneficial in liberalised economy but certainly not in a repressed economy because investment flows to capital-intensive production despite the scarcity of capital and the excess supply of labour. Financial liberalisation and similar structural reform policies aims to equalise the distribution of income or at least narrow the gap between them. It also attempts to reduce the monopoly rents that flow from import and other licenses to the few importers and bank borrowers.

To summarise the objectives of FD, financial liberalisation and deepening assists in creating a stable output and employment growth as well as ensuring for a more flexible foreign exchange rates which can absorb some of the shocks of international trading[4]. As for the origin and context of financial repression, its dominance springs from strategy, inflation, interest rate, exchange rate and domestic prices. That is, inflation reduces real rates of interest, making saving to appear cheap while exchange rate policy pushes down the domestic price of foreign exchange. The strategy also reduces relative prices for domestically produced primary products, hence making industrial raw materials cheap for the urban industrial enclave, as well as the benefits of low rates of interest and cheap imports.

Shaw sees the low food prices in the urban areas as being subsidised in order to cushion the effects of wage demands. His postulation is that the strategy created a

[3] A commission chaired by Chief Jerome Udorji to review the wage structure of the public services in Nigeria .

[4] See Mckinnon's flexible exchange discussion in chapter 2.

Dual Labour Market; one for capital intensive industries and the other for industrial labour unionized, making it easier to predict the trend of fiscal policy. It causes excess demand for savings spill-over to capital account balance of payments. Therefore, borrowing at high cost or short term credits pending availability of funding. This may be satisfied by foreign direct private investment or through grants of official aid.

The general purpose of reform or structural change is to move away from relative low levels of income and consumption through changes in the national matrix of products and their inputs. Never-the-less, some choices of strategy such as interventionism with fixed nominal prices and rationing on some critical markets are done deliberately, perhaps due to mistrust of the market forces on the grounds of elasticities of response to relative prices - high or low for desired outcomes, market uncertainties and vulnerability to exploitation and greed or that the country is different. It could also be due to reflex experience with colonialism in one format or the other, such as a strong governmental apparatus or a weak stratum of endogenous entrepreneurship.

The cost of learning the development process by doing it in a context of effective markets and flexible prices may seem unacceptable and the quick way to post colonial economic independence may be through intervention (see Mckinnon 1973, the public intervention syndrome). The choice of strategy also include class interest, such as those that benefits from the monopoly rents or subsidies, will oppose to market forces. Microeconomic decisions which are favourable to one segment of the economy are often taken without the necessary care and consideration of their implication elsewhere.

3.3 THE DEMAND FOR MONEY

Definition :

> "Shaw defined demand on the market for money as demand for real money because there is an absence of money illusion due to rational behavioural choices made by households and firms on the basis of real variables".

Demand for real money is a portfolio demand for one form of wealth constrained by total wealth and consumption as alternative form of wealth and by anticipated real rates of return (r). This can be expressed in the regime of steady growth as Y' (refer to Feige and Parkin, AER June 1971, pp.335 - 349, the optimal quantity of money, bonds, commodity inventory and capital). Therefore real money is demanded on the basis of its own rate of return r_m. The optimal allocation of wealth by the wealth holder will then be:

$$r_m = r = r_c \qquad [1]$$

With perfect common markets in the economy, optimisation by wealth holders is at the same relative price. Thus, equation [1] is a condition for collective optimisation resulting to:

$$r_m = u + \underline{d} - p^* \qquad [2]$$

Assuming $\underline{d} = 0$, real money wealth is in the private optimal amount when:

$$u = r + p^* = r_c + p^* \qquad [3]$$

where p* is the prospective rates of change

$\underline{d}$ is the nominal deposit rate

u is the real marginal product and

r_c is the consumer's rate of time preference .

Equation [3] indicates that the marginal productivity of money can be deduced from the opportunity cost of holding money, the nominal or money rate of interest $i = r + p^*$. In which case the money demand function can be derived from the production

function[5] as follows :

$$Dm = l(Y' , r_c , r , r_m) \qquad [4]$$

Full liquidity or satiation level of demand for money or of demand for money in proportion to income can be derived from equation [3] as:

$$u + \underline{d} = r + p^* = r_c \quad p^* \qquad [5]$$

Also, equivalent stock of money is desired if:

$$u - (- p^*) = r = r_c \qquad [6]$$

The effect is that, the expected and realised deflation at rate p* will be equal to the rates r and rc which induces demand for money to the limit at which the marginal product of money is zero. At this point the monetary system cannot retain its revenues from seigniorage and inflation tax.

The basis for money is the service it performs in clearing the area's matrix[6]. Shaw's postulation was that in lagging and underdeveloped economies, more than one currency area may exist and imperfect foreign exchange markets between the areas may reduce the scale of common markets in output, wealth, labour and securities. Mismanagement of money supply and inefficiency in provisions of services in the payments and intermediation processes causes reversion to segmented markets and barter.

The chance of default by a spending unit on markets where it incurs deficits increases as real money balances are held in lower average volume. This risk diminishes if the

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[5] Productivity function of money's diminishing marginal u,
the wealth constraint and the optimization condition .

[6] The boundaries of the market for money are a currency area where spending units uses money to clear surpluses of net selling and deficits of net buying in other markets (Shaw 1973 ,p.60).

spending unit has access to borrowing facilities (although borrowing can be expensive). It also diminishes if the spending unit holds other disposable assets than money. The problem with inventories is storage cost which of course can be relieved by adjusting payment intervals. One form of saving is through the accumulation of money. This represents a substitute for saving through self - finance of physical investment, purchase of primary securities or acquisition of non-monetary indirect financial assets.

The demand for money depends upon own - yield and opportunity yields and on wealth or permanent income, the expected stream of returns to wealth. This stream is not perfectly foreseen and is subject to revaluation by income recipients, which may be downward in recurring periods of crisis and economic constraints thereby forcing demand for money to fall. It may be upwards when there are public policies that implies renewal or acceleration of economic growth, therefore pushing demand for money upwards. Thus, the determinants of instantaneous demand for real money can be expressed as:

$$D_m = l\ (Y_p, r_c, r, d_n, r_m, t) \qquad [6b]$$

Where Y_p, r_m, t relates to positive effects on money demanded.
The variable t is included as a stimulating effect on demand for money of technological improvement in the monetary sector

3.4 THE SUPPLY OF MONEY AND INSTRUMENTS OF MONETARY POLICY

The monetary system function is to supply the appropriate stock and rate of growth of real money balances and providing services of payments mechanism in which the balances are used. There is a monetary and fiscal (or intermediation) functions. The former brings the monetary system to the market for money, while the latter is for the market for capital. With the growth in real money and maintenance of the money stock being costless, real money supply function can be written as:

$$\underline{M} = M / P = q(i, \underline{d}, p^*, w, e, g, t) \qquad [1.1]^7$$

Given the absence of money illusion in equation [1.1] the quantity theory[8] interpretation of the price level can be expressed as:

$$\dot{P} = \dot{M} - \dot{D}_m \qquad [1.2]$$

Where $\dot{\underline{M}}$ represents the rate of growth in the stock of real money, $\dot{D}m$ is the rate of growth in the stock demanded. p* is the expected rate of inflation, i the rate of interest, t technology, w the real wage cost, e is the real user cost of physical capital, g is the supply price of risk in banking (by the private or state enterprises) and $\underline{d}$ the deposit rate.

The stock of real money can be supplied by an indefinite large number of appropriate combinations of M and P. The same applies to $\dot{\underline{M}}$ and $\dot{P}$ i.e, growth of real stock of money to that of nominal money and price level.

$$\dot{\underline{M}} = \dot{M} - \dot{P} \qquad [1.2]$$

The long run, continuous equilibrium in the market can be expressed as:

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[7] No money demand illusion .

[8] Refer to James Tobin,'Money and Economic Growth' (Econometrica Oct; No.33, 1965, pp.671 - 84; & 'The Neutrality of Money' (Comment, Econometrica, Feb; 1967, pp.69 - 72).

$$\underline{\dot{M}} = \dot{D}_m \qquad [1.3]$$

while the difference is expressed as:

$$\dot{P} = \dot{M} - \dot{D}_m \quad [1.4]$$

That is, the rate of change in prices $\dot{P}$ as determined on the market for money. The rate of inflation or deflation preserves the equilibrium in that market, given the rate of increase in real money demanded by wealth holders and in nominal money supplied by the monetary system. Hence, the manipulation of $\dot{M}$ by the supplier of money constitutes instrument of monetary policy because it is a means of regulating $\dot{P}$. Conversely, the expected rate of change in the price level is for regulating real deposit rate $\underline{d} - p^*$ or d, and the nominal deposit rate as well.

The monetary policy optimality can be achieved when the price level is flexible, with a constant stock of nominal money. Given a condition of steady state - growth, including income - elasticity of demand for money, the rates of price deflation and income growth would be equal. As a result, the nominal deposit rate will be influenced by the difference between income growth and the rate of return to physical capital.

To obtain full liquidity in money holders portfolios, the rate of increase in nominal money must be at $\dot{Y} + \dot{W} + \dot{w}$ and the nominal deposit rate at $r + \dot{W} + \dot{w}$. This can also be called the Wage-Push Inflation; with $\dot{W}$ equal to the money-wage rate and $\dot{w}$ = growth in labour's marginal product.

Shaw explained this by using the analysis of the US economy by Milton Friedman (The Optimum Quantity of Money), because of their experience with inflation and the nature of labour. Shaw's postulation centred on the interdependence between the market for capital and the market for money.
Using a barter economy, applying the situation of the equilibrium in the capital market;

$$I = sF(K, L) \qquad [1.5]$$

By reducing equation [1.5] to a per capita basis and dividing I/L by the capital stock K and assuming a balanced growth equation [1.5] becomes:

$$[s - (1 - s)\pi n]\, f(k) = nk$$

$$nk = sF(k) \qquad [1.6]$$

where n = growth of output, capital and labour
k = capital - labour ratio
s = propensity to save which is constant
nk = growth in demand for capital
sF(k) = savings available to finance it

David Levhari and Don Patinkin in their article, 'The role of money in a simple growth model', (AER 1968 pp.713 - 753) provided an extensive coverage of this analysis. James Tobin, 'The interest elasticity of transactions demand for cash' (Rev.Econ Stat. 1956, 38 pp.241 - 47), Money and Economic growth (Econometrica Oct 1965 33, pp.671 - 84) and The neutrality of money (Comment, Econometrica Feb,1967 pp.69 - 72) also provided analysis of the subject.

The next consideration is the saving - investment and deadweight money[9].

$$I = sF(K, L) - \delta(M/P) \qquad [1.7]$$

Assuming real money demanded to be a constant proportion [o] of income with the market for money in equilibrium, equation [1.7] can be rewritten as:

$$I = sF(K, L) - o\,\delta F(K,L) \qquad [1.8]$$

[9] ie introducing money as wealth , given the rejection that an economy is better off with barter and without money.

dividing by income, equation 1.8 becomes:

$$s_p = s - on \qquad [1.9]$$

where sp = physical propensity to accumulate physical wealth.

s = constant propensity to accumulate wealth in both physical and money form. Adjusting equation [1.6] for a barter economy by excluding monetized savings, the following equation is derived:

$$nk = (s - on)f(k) \qquad [2]$$

That is the substitution effect of growth in real money against real capital. It also implies that if the money - income ratio [o] is a positive function of real deposit rate, the real rate of interest and real deposit rate, are directly related and also, the real rate of interest can be reduced by expected inflation.

Shaw concluded that the consumer welfare in capital market only is improved by a low or even negative deposit rate. It also suggests that welfare is highest when there is no money at all.

Another important consideration is the saving - investment with money as income and as a factor of production. To reconcile the money satiation required for optimality in the market for money with that of optimality on the market for capital meaning no money at all. The first step is to regard growth in real money as income, thereby, replacing equation [1.8] by:

$$Y' = F(K, L) + o\ \delta F(K/L) \qquad [2.1]$$

$$I = s[\ F(K, L) + o\ \delta F(K, L)] - o\ \delta F(K, L) \qquad [2.2]$$

Substituting equations [1.9] and [2] we have:

$$s_p = s - (1 - s)on \qquad [2.3]$$

and

$$nk = [\, s - (\, 1 - s\,)\, on\,]\, F(k) \qquad [2.4]$$

Refer to Tobin's Monetary growth theory, Econometrica 1965.

This implies increasing the physical savings ratio. Another solution is to include the income effect of growth in real money, that is, including real money as a factor of production, which can be represented as:

$$Y = G(K, L, M/P) \qquad [2.5]$$

where ; Y = output, K = Stock of capital and L = Homogeneous labour time. The only inputs are labour and capital, but refined versions includes real money as a productive factor (M/P), all assumed to be mutually substitutable and positive. Therefore, reversing equation [2.4] the equilibrium condition on the capital market can then be represented as:

$$nk = [s - (1 - s)\, on]\, g(k, m) \qquad [2.6]$$

$g'(m) > 0.$

Thus, real money per capita increases the flow of physical savings per capita to the capital market. Each steady growth rate n in output and labour force permits a higher capital - labour ratio k. This indicates that money raises capital - labour and consumption labour ratio.

The final consideration is the Public - Policy and the Dilemma of Optimality. The assumption is that public policy has the perfect costless solution for the dilemma that money satiation occurs at the expense of optimality on the capital market. The central issue to optimal money is the real deposit rate that reduces the marginal product u of money to zero, and for the best k and r, the physical - savings propensity sp. That is, the authorities can use fiscal policy such as spending on public consumption or reduction of tax rates, where k is too high. In which case, monetary technique

affecting d and fiscal technique affecting sp are socially costless and can be combined to eliminate the optimality dilemma.

The problem in this case is that, money is not neutral and changes in real deposit rate do affect the production, savings and consumption functions. An adjustment in the tax rate, government consumption and investment will be therefore required.

Shaw concluded that the stock of real money, its rate of change and its yield are not neutral and public intervention is required, if the optimal deepening of both money wealth and physical wealth are to be achieved.

MONETARY INSTRUMENTS:

Real deposit rate is the main instrument of real monetary policy, which can be manipulated through P and either nominal deposit rate or charter policy. The LDCs are likely to encounter difficulties with charter policy with regards to enforcing competition within the banking industry. The authorities may therefore introduce factor inputs and enforce competitive levels of loan and deposit rates and urge for acceleration of technical change in monetary and banking services. According to Branson, the Federal Reserve Bank controls the level of the money supply first by setting reverse requirements against demand deposits and then by changing the amount of reserves it supplies, both on its own initiative and on the initiative of the banks[10].

Optimality of monetary policy is crucial to the market for money and the market for capital. With heterogeneous output and inflexible prices as well as labour and the money wage rates in the W index, variations in w resulted to relative changes of real wage rates. Deviations of 'p and 'w have consequences in the price structure that affect stability of income, distribution of income and its rates of growth.
The consequences of the erratic changes in 'p is that those averse to risk could be influenced to divert their demand from money and wealth, which means that 'p must be stable.

[10] William H. Branson, Macroeconomic Theory and Policy, 1979, Harper International Edition, New York. Second Edition, 1979, p.268.

The conclusion drawn by the model that the optimal nominal deposit rate is equal to the money rate of interest cannot be upheld in the developing countries because of the lack of uniform rate of interest, as well as procurement of real cost to the monetary system.

3.5 WHAT IS A MONETARY SYSTEM

The monetary system is a financial intermediary attracting savings from spending units that forego consumption to acquire increments of real money. The savings were then allocated to other spending units, some for private or government consumption and investment. Other functions include:

Exchange of its own money debt for the primary debt of spending unit for augmenting real money balances. It intermediates between savers repaying their primary debt to the monetary system and new borrowers.

Money may be a state as well as private issue. It may involve exchange of the state's money debt for the primary debt of the private sector or exchange of increments in real money balances for private savings that the state can redirect to the private investing sector or utilise for its own purposes including capital accumulation, consumption or transfer payments. As for the production conditions; production in LDCs tends to be for subsistence and trade with a heterogeneous inputs, technologies and segmented markets for inputs. The conditions of aggregate production can be written as :

$$Y = H(K_1 \ldots K_n, L_1 \ldots L_n, T) \qquad [1.0]$$

where : Y is the real income;
K = production goods;
L = Heterogeneous labour services; and
T = Collection of production Processes;

The subscripts (K_n, L_n ie, non-monetary finance) employed, where T defines the technology in the financial production function. Equation [1.0] implies a dual income effect of growth in real money growth in the stock of real money extending production possibilities within any constellation of related markets and making feasible the extension of market boundaries. Under the flows of income and product account;

the net national income by factor shares can be defined as:

$$Y = rK + wL \qquad [1.1]$$

where r is the rate of return on the heterogeneous physical wealth and w is the rate of return to human wealth. The interpersonal income distribution are affected by productivity of owned factors and by market power and also by fiscal distributions and transfers. In which case, competitive factor markets cannot be assumed. Equation [1.1] included earnings of factors employed in financial industry but excludes growth in real money.

$$Y = C + I = C + S \qquad [1.2]$$

representing the aggregate allocation of income to consumption, savings and investment. This means that, income is either consumed or it is invested, while investment is financed by savings. According to the analysis, money and non-monetary financial assets do appear in sectoral measurements of the allocation and disposition of income[11].

Savings demand are in a way additions to real money balances and other financial assets, whereas investment is supply, in part of additions to the real stock of primary securities. The monetary system and other financial institutions intermediate by incurring real money and non-monetary indirect debt that savers wishes to hold and by buying real primary debt that investors wishes to owe. Intermediation to increase the stock of real money can be achieved either by increasing nominal money or by decreasing the price level, with the same level of adjustments in the number of bonds B or in the real value of each bond in the monetary systems portfolio.
The other objective of financial policy is to maintain the spread of non-monetary financial institution's realised rate between r and their own deposit rate d.

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[11] Shaw 1973, p.57; J.G. Gurley and Shaw, 'Money in a Theory of Finance', Ch.1 - 3; also Gurley and Shaw, 'Financial Structure and Economic Development', Economic Development and Cultural Change, April 1967, pp.257 - 268.

3.6 MARKETS FOR NON-MONETARY FINANCIAL ASSETS

The postulation is that economic opportunities may exist for deepening not only in money but also in other financial assets. Financial differentiation induced by one variety or another of market imperfection is sometimes wasteful of factor inputs to the financial industry. It is also ineffective in raising rates of saving and neither does it improve the savings allocation[12].

Constraints in the demand and supply functions for financial assets in LDCs limited the efficient differentiation and justifies the primary emphasis on real growth in the monetary system. The wealth constraint plus saver's inexperience in estimating yields and savers traditional commitments to some forms of self financed investment contributed to the small selection of financial assets on the demand side. This implies that a large selection of assets would probably subdivide the total market into inefficient smaller groups whereas, on the supply side are the scarcity of resources for the financial industry, indicating the need for specialisation in a few markets.

On the side of regulation, the government is constrained enough in fulfilling the basic functions without distraction for supervising a complex financial system. Although, Shaw objected to import substitution on market for financial assets as on markets for goods and labour, he argued that importation of financial service may be necessary for LDCs in other to alleviate the burden on the domestic financial industry on the capital market.

He noted in a report by the OECD (General Report: committee for invisible transactions)[13], that the experience of the developed economies suggests that comparative advantage or disadvantage among economies in provision of financial services may have a long term staying power. Hence free finance is better than subsidy in some circumstances for wealth accumulation.

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[12] Therefore , it is not financial deepening (Shaw 1973 p.68).

[13] Organisation for Economic Cooperation and Development .

3.7 FINANCIAL GROWTH AND THE RATE OF SAVING

Development process involves changes in private and social rates of capital accumulation and when accelerated development ends, both private and public budgets deviates from capital accumulation to consumption. These discontinuities can be associated with financial constraint and liberalisation.

Financial deepening and associated measures tend to change the distribution of income within the private sector as well as between private and public sectors, with a tendency of a shift in favour of labour against property. Financial deepening eliminates the uncompensated inflation tax on monetary and other financial assets for example, hyper-inflation indicates that taxation raises the rates of return to physical wealth and so stimulates savings (Kessel and Alchian; Effects of Inflation, JPE 1962 pp.521 - 537). In contrast, savings are reduced by the tax because it drives savers from real money and other financial assets and shrinks the flow of intermediation. The reason for this outcome being that total tax revenues are adversely affected and because of its adverse income effects from demonetisation.

On the investment effects of financial growth, given the homogeneity of capital and the best technique, there seem to be several opportunities for financial growth to improve the investment mix in LDCs. Financial growth allows for the unification of the capital market, reduction of inter-regional and inter-industry differences.
The temporal widening of the capital market and the liberalisation of interest rates from low ceilings can moderate the investment dualism that so often occurs in developing economies. Hence liberalisation policies minimises the part played in investment decisions by windfall gains and losses. Similar to Mckinnon, Shaw postulated that larger lumps of investment are feasible in the private sector when savings are pooled in financial markets as well as diffusion of superior technologies as a result of information accumulated in financial institution.

Financial deepening offers an opportunity for development of new facilities for disposing of partial equities in wealth or for shifting ownership completely. The savings effects of financial deepening tend to increase wealth income ratios for a

given mix of wealth and also reduces its rate of return, while the income and investment effects raises rates of return. On capital and employment; the essence of financial liberalisation and deepening as postulated by Shaw are:

> "to release real rates of interest to disclose the scarcity of savings and to stimulate saving. The other point is to raise accessible rates of return on investment and to discriminate more effectively between investments".

Given the elasticity of substitution between factors in the production function, the elasticity can be defined as:

$$e = - \frac{\delta(L/K)}{L/K} \Big/ \frac{\delta(w/r)}{w/r} \qquad [1]$$

where r = rental rate of capital rather than interest rate. e is higher than unity, therefore any decline in w relative to r increases the labour employed for every unit of capital utilised .The same scenario applies to wL relative to capital's share of income and output.

One of the main arguments the IMF and the World bank used to present against Nigeria is the size of its population[14]. With high population and labour force, the prospect for rapid and socially placid development looks bleak. However, the Nigerian census figure of 1991 which stood at 88 million seems to suggest that the institutions has over-estimated the population and uses it as a negative instrument to escalate the size of the problem. This is not to say that there is no problem with regards to employment but with a realistic figure, the authorities could be able to identify the sources of the problem and address it accordingly[15]. In the context of this analysis, if interest rate elasticities are low for the substitute of labour against capital and savings and consumption,the aggregate investment will therefore be sensitive to the price of savings. This causes unemployment in the long run unless if there is a

[14] See the world report 1989 and the world bank's accelerated development and sustainable growth .

[15] See world bank's Sub-Saharan Africa, from crisis to sustainable growth , 1989,pp.37 - 62.

substantial foreign assistance. It also indicates a possibility of a higher rate of urban-migration and intensified capital-intensive production, with labour depending on extra market processes to protect its share of income. Roe,(1989) provided a look at the new orthodoxy which claims great potential for high nominal interest rates as an element in policy instrument for LDCs[16].

The structure of money and finance can be large in LDCs with the choice based on the principles of maximising income, savings, investment and employment effects. Therefore, the portfolio performance of financial enterprise depends upon its absorption and unbiased use of information about capital productivity.

Two critical issues of organisation emerges, which are:

[1] The degree to which the state shares in financial enterprise; and

[2] The context with which the state regulates private financial enterprise.

Both of these issues are discussed in chapter 5.

3.8 TECHNIQUES OF REPRESSION

The shortage of physical and human wealth in most LDCs has created a huge investment opportunities at high real rates of return. Evidence of this can be found in aggregate data. That is if changes in national income are divided by concurrent or lagged investment and the result multiplied by capital's share in income. It can also be found in project data to report marginal rates of return to physical wealth that dwarf average returns in developed economies. The postulation is that there is no shortage of investment opportunities but there is shortage of savings for their finance. As highlighted in the beginning of the chapter, there are complex price manipulations in almost all markets in the LDCs, especially in markets for financial assets. Intervention tends to comprise a positive and variable inflation rate along with stipulations of loan and deposit rates at banks and other institutions of the organised financial market[17]. The technique presented by Shaw is very similar to the Mckinnon

[16] A.R. Roe, 'Interest rate policy, employment and income distribution,1989, pp.71 - 101.

[17] The inflation rate indicates the pubic policy in fixing a rate of growth in nominal money that exceeds growth in real money balances demanded (Shaw 1973 p.81).

analysis of South Korea 1962 - 67. There are indications of excess supply of primary securities in lagging economies that results from the combination of investment opportunity and controls over interest rates in intermediation. There are various ways of tackling this problem of excess supply including credit rationing among borrowers which according to Shaw (1973,p.85) the inflation inelasticity of demand for money represented an evidence of financial repression.

Two important elements to the limitations of rationing is that it is expensive to administer and vulnerable to corruption. In the case of Nigeria, financial corruption is not something new. Implementing such policy will only serve to exacerbate the level of corruption especially among the civil servants and bank officials. The other problem with such policy not being feasible for Nigeria is the inherit bureaucracy that associates with it. The nature of public service and other institutions alike are entrenched with bottlenecks and will only lead to stagnation of operations which is already crippling business operations in the country. Effective low ceilings on real loan rates intensifies risk aversion and liquidity preference on the part of intermediaries.

Low or negative and uncertain real deposit rates repress voluntary and total demand for real stocks of claims, including money, against financial intermediaries. The presumption is that repression of indirect finance reduces total desired stocks of financial assets plus the constraints on self finance of investment and the private domestic ratio of savings to income. Thus negative real loan rates are left to rationing to clear excess bids for loans at intermediaries.

DIRECT FINANCE

The effect of repression in organised finance is to increase amounts of funds demanded on the curb market at each rate of interest, while the effect of repressive measures on the curb is to reduce funds supplied there at each rate of interest. Some LDCs do have a stock market. For example the Lagos Stock Exchange which is now

the Nigerian Stock Exchange. The establishment and history of the stock exchange in Nigeria is discussed in detail in chapter 5. The stock exchange only trades in few issues including the issues of stock exchange itself.

The domestic stock of physical wealth is too small in the usual case and its growth rate is too low for diversified trading in equities . Hence long term direct finance without compulsion upon savers becomes rare. The other problem with the Nigerian Stock market is that the number of public quoted companies are small. The market still has a long way to go before it can be looked upon as a source of direct finance and international competition with the London stock Exchange, Wall Street, or Tokyo Stock Exchange. However, its activities so far are encouraging as more and more companies are being quoted on the Nigerian Stock Exchange. The government privatisation program is another source of inspiration for the Stock Exchange to widen its scope of operation and for greater number of participating companies.

Finally, the complexity of law, accounting and other elements of sophisticated trading in long securities are too expensive for operations on the small scale that a repressed financial system achieves.

INDIRECT MEASURES OF REPRESSION

Savers and investors are given incentives in tax law and administration to use financial process sparingly. Apart from tax inflation other taxes discriminate against income from financial assets. Taxation in Nigeria tends to be fairly moderate or it can be said to be a very weak policy instrument as far as the economy is concerned at present. There is no sales tax or VAT or taxation of real properties, only the basic income tax and corporation tax.

Inflation and crowding or urbanisation tends to increase the value of properties plus various other factors which makes it an attractive means for savers as they reach toward their desired wealth-income ratios, that is, appreciation in value, design etc. Taxation is also moderate with self-finance than with intermediation or direct finance, example retained business earnings are often exempted from tax.

Indirectly, savings of public firms are taxed through allowance of subsidy prices on electric power, transport etc. While public policy discriminates against financial technique, economic surplus is being diverted from saving to the investing sector by non financial means. There is also the issue of international economic policy bias-ness against the domestic financial process.This is worsened by the overvaluation of domestic currency which depreciates the foreign financial assets. As a result of the fragility of capital towards regulation, there is a strong tendency for multiply restrictions.

Shaw identified four major reasons for the existence of financial repression and why financial liberalisation is not very common in his analysis of the logic and illogic of financial repression. The reasons includes:

(a) Historical antipathy to usury;

(b) Lack of effective control over rates of growth in nominal money and rates of change in the price level;

(c) The misinterpretation of the role of finance in the various models of aggregate economic behaviour; and

(d) Empirical decisions that the potential beneficial results of real financial growth are not worth the costs involved and that alternative solutions of capital scarcity are superior.

For reason (a), high rate of interest are considered to be exploitative and the solution for them appears to be prohibited. It is also considered to be inflationary. If owners of physical capital pay high rates of interest, it is argued that, they must pass on the charges with a cost - push effect upon prices of final outputs. This implies that, the burden of anti - usury laws is a heavy one to prevent stagnation and underdevelopment, to protect the defenceless against exploitation and to contain inflation. Shaw's analysis here is parallel to that of Mckinnon, especially in their utilisation of Keyne's 'natural man' and his opposition to the 'Classical Theory' in relation to anti-usury laws. Rudolph Blitz and Millard Long, 'The Economics of Usury Regulation' JPE 1965 pp.608 - 619, provide a further critique to anti-usury laws.

For reason (b), real financial growth and deepening do not occur unless nominal money is under effective constraint or the inflationary effects of monetary indiscipline are compensated by changes in relative prices including interest rates and foreign exchange rates[18]. The management of nominal money can be and often is the victim of fiscal policy as shown by Mario H. Simonsen, 'Brazilian Inflation: post war experience and outcome of the 1964 reforms'.(also see .....)[19]

As an illustration, consider a government committed to real expenditures Gt in the current fiscal period, to nominal expenditure G_tP_t. The nominal revenues depend upon a tax rate q, local real income Y (assumed to be constant) and on the price level P_{t-1} (ie previous period price). Bearing in mind that fiscal policy requires a balanced budget, with $G_t = qY_t$, but expenditures must be maintained even if it results to deficit which can only be financed through the expansion of nominal money.

The assumption here is that, with real income given, real money demanded and the real money stock are constant at $\underline{M}$. Shaw then interjected a current private expenditure of nominal X that is financed by monetary expansion with growth in nominal money as:

$$\delta M_t = G_tP_t - q(Y_tP_{t-1}) + X_t \qquad [2.0]$$

Given G_t and qY_t to be equal:

$$\delta M_t = G_t (P_t - P_{t-1}) + X_t \qquad [2.1]$$

Therefore, $[(\delta M)_t]/P = (GP)_t + \underline{X_t}$ [2.3]

[18] Uncompensated expansion of nominal money is a tax on real balances and rational holders of financial assets evade the tax by shifting to forms of wealth that are less vulnerable.(see Shaw 1973 p.95).

[19] The World Bank Sustainable Growth and the World Bank Report 1991, pp.31-49, Paths to Development.

ie dividing by the current price.

$$(M.\underline{M})_t = (GP)_t + \underline{X}_t \qquad [2.4]$$

The substitution for $\underline{M}$ and removal of the subscript t yields the expression for real money demanded as a positive function of real income and negative function of expected inflation. This can be written as:

$$M = [GP + \underline{X}\ ]/I(P^*)Y$$

An increase in X of excess money supply can therefore result to government deficit, which must be financed by the inflation tax M.$\underline{M}$. According the study of a 'model of self-generating inflation' by Dean S. Dutton (Journal of Money, Credit and Banking May 1971 pp.245 - 262), this could lead to a cumulative force imposing and reimposing by successive periods with q, the tax collection rate tending to fall in accelerating inflation. With evidence from the Brazilian inflation and the 1964 reforms the nominal money management can become a causality of fiscal policy.

In explaining the reason (c) and (d), Shaw adopted the Keynesian General Theory . This is represented by the equations :

$$M = 1\ (Y, r)\ P- \qquad [2.5]$$

ie the equilibrium on the market for money; and the equilibrium on the market for savings.

$$x(r) = sY \qquad [2.6]$$

In this case, the expansion of the nominal money seems to be the appropriate instrument as it appears to eliminate capital scarcity. The authorities can increase M to reduce the marginal liquidity yield of real money and the bond rate of interest r. The expected outcome is to achieve a higher level of output, which will increase the flow of savings and the stock of capital with falling marginal product of capital, a rise in the wage rate and per capita consumption level.

If the assumption of nominal money expansion is the best instrument to eliminate capital scarcity, the idle resources would be required to generate savings for the capital expansion that would lift income from poverty levels. The problem with this scenario is that, the monetary system issues nominal money not real money and acceleration of issue would result in realization of inflation and expectation of inflation and also lower nominal and real rates of interest.

Shaw's postulation was that in the long run, the fix-price (equations 2.5 & 2.6) model would be a disastrous guide to policy. He argued that this is close to structural inflation model that rationalises repressive financial policy in the LDCs[20]. Shaw rejected the view that relative price of money I/P in this analysis would be determined on markets other than the market for money in the long run. He argued that some expositions of structuralism do not take into account the role of demand for money in the inflation process and in finding a stable relationship between nominal money and the price level.

Structuralism supports the view that excess money supply, positive or negative, has initial effects on output and employment. It failed to emphasize on the after effects and that inflation foreseen and compensated is neutral (Bronfenbrenner and Holzman, 'Survey of Inflation Theory' AER 1963, pp.593 - 661, Shaw 1973 p.103). Full employment depends not on a on stable rate of increase in the price level but on a rising rate of increase in P and hence M. To contain the effects of real employment, P must stay ahead of P* (see Friedman AER 1968 pp.1 - 17 , Lucas and Rapping 1969 pp.342 - 350, Tobin AER 1972 pp.1 - 18). Shaw used the General Theory to rationalise distaste of monetary authorities and for low-velocity deposit balances and powerless coin and currency balances and calling upon it to justify financial repression, especially the trade-off structuralism commitment to rising inflation, with

[20] Note, $i' = r + p^*$ and $x(i - p^*) = sY$ is about the substitution effect of growth in money . Their usefulness upon the reduction caused by the substitution effects on growth in physical capital is to expand the nominal money . In this case inflation imposed exogenously on the market for money creates an excess demand for money in private portfolios . To satisfy excess demand condition would require expansion of nominal money or in the wrong way, by reduce demand for investment , reduced employment and output and reduced savings to finance investment.

the rate depending on the target of full employment.

The analysis presented are not the kind from which financial liberalisation evolves, nor of development that simply ignores finance. The implication is that requisite domestic savings must come through by some of the usual channels such as inflation tax. It also indicates that savings can be achieved upon the implementation of specific controls.

3.9 FINANCIAL REFORM

The following discussion examines the monetary system and the curb market mainly on the exchanges for long-term securities.

The Growth Trajectory of Demand for Money:

The method the monetary authorities usually follow during liberalisation is clearly shown in the real money demand function of private spending units. Shaw gave as an example, the Korean step in money deepening in early 1963, to minimise finance of the central government's fiscal budget by money issue. Monetary growth begins with an awareness by the monetary authority that there is a money demand function and then an estimation of the function. Indications of the possibility to underestimate and of the excess demand for money may precipitate a deflationary crisis or that growth may be over estimated and that excess supply of money through new issues may rekindle inflation can be identified before hand.

As soon as the critical transition is past, growth in real money demanded can be expected to take a comparatively stable trajectory. On the inflation target, real deposit rate acts as the essential policy mechanism on the market for money. There are two possible ways for obtaining the yield of money r_m. First is the payments services supplied by the monetary system. The second is the $\dot{P}$ and P^*, the actual and expected rates of inflation. These are available in a free or open market economy.

In the case of exogeneity of nominal money, the nominal deposit rate and the rate of inflation acts as the conduit for regulation of the real deposit rate. Nominal money is the instrument for regulation of the price level given the long-run growth rate of real money demanded $\underline{M}$ noting that the rate of inflation is determined by $\dot{M}$.

Long-run financial deepening is at best improbable unless $\dot{M}$ is at the discretion of

the monetary authority and is adapted by it to the economy's choice among inflation rate[21]. Therefore, deepening requires exogeneity of the money supply to the economy's real sectors. Looking at the goals and instruments on the market for capital, Shaw adopted the view that money is debt of the monetary system which can be issued to purchase the present or existing wealth to finance governmental and private dis-saving or to draw savings from money holders to capital accumulation.

In this case the monetary system is taken to be a financial intermediary, both borrower and lender of savings. The path commonly followed by LDCs in pursuit of economic growth includes low or negative rates of interest, cheap imports of capital goods, tax concessions for investment and tariff protection for capital intensive production. Liberalisation in finance is for scarce prices for savings to increase the rates of saving, enhance savings allocation, induce some substitution of labour for capital equipment and assist in income equalisation.

3.9.1 THE CURB MARKET

Curb markets causes a dual financial system in Official and Unofficial financial system in an economy that accommodates its operation. No where in the world is this dualism more apparent than in the developing countries, including Nigeria. Since the commencement of the structural adjustment program in Nigeria curb market has become a very buoyant business sector in the country. The government recognising its scale of operations both in the urban and rural areas has decided to grant them licences to operate.

The curb market operation in Nigeria is of particular interest, in that its origin and existence cannot be accurately determined without any subjectivity or bias-ness. It is essentially part of the culture of the society. The only difference now is that it has been acknowledged by the monetary authorities as part of the financial intermediaries in the country. Shaw identified two major implications for the curb market in financial

[21] note also that nominal money can take the form of loan expansion by the central bank or government , e.g , Ghana 1963 - 65; hence , control of nominal money .(see Shaw 1973 pp.119 -120).

liberalisation program:

1. The curb market will have to encounter competition from deepening in the organised sector; and
2. The curb market should be offered opportunities to become part of an integrated capital market, incurring risk and lower costs of other kinds as an open rather than covert activity.

Shaw concluded that dealers and brokers on the curb market may be assisted in moving into organised finance, including banking. However, the problem lies with the scarcity of data and their totally unreliability.

3.9.2 ASSESSING THE OBJECTIVES OF INNOVATION IN LONG-TERM FINANCE.

This implies the organisation of bond markets for risk-averse investors in corporate wealth and of mortgage markets to finance diffusion of control over property. The intention of these markets is to divert savings to newer and smaller ventures not only for democratisation but also for innovation of processes and products and for employment of resources previously idle. As discussed in chapter 2 and in the public intervention policy in this chapter, Credit rations, import licenses and tax favours leads to concentration of economic power. Shifts imposed on terms of trade against agriculture, exports and labour transfers wealth into narrow ownership, hence the need to remove negative real rates of interest and allied devices.

New measures are required because the old techniques of finance have failed to account adequately for growth. Foreign aid is becoming increasingly difficult to acquire by the developing countries, more especially African states. Their own predicament has been systematically worsened by the constant plague of one natural or human assisted disaster to another. The African countries dependency on foreign assistance is or can be said to be at its lowest ebb, judging from the position in the 1960s and 1970s.

Tax reform commissions have generated no apparent optimism that tax income ratios

can be raised or that the income and inflation elasticities of tax revenues can be increased. Most developing economies monetary systems seems to be stagnant and the yield to inflation taxes has fallen as expected inflation has caught up with realised inflation. Perhaps, the LDCs can adopt the new instruments of 'Long Term finance to reduce chronic excess demand for savings'. The legal system, supply of skills and communications facilities have reached the capacity of using new financial techniques cheaply in some countries. The stock of capital is large enough to bring within reach the scale of economies of sophisticated long term markets.

3.9.3 LIBERALISATION AND LONG-TERM FINANCE

As reported by Robert P.Collier in a review paper of the Bank of London and South America (1969 pp.347 - 360), "equities are not a defence against relatively high and unstable inflation nor is the indexation of bonds and mortgages". For Shaw, monetary reform with deepening of money is an indispensable first thing to do. This means that until it occurs, the path of returns to any item of capital stock is a perilous random walk. Recurrent overvaluation of the foreign exchange rate depresses export enterprises, vulnerability of enterprises to unpredictable changes in credit rations, tax concessions and allowance of foreign exchange import licenses. The other problem is that specific price controls have arbitrary effects on earning which also undermines the horizons of savers in a repressive economy. Given all these circumstances, it is quite easy to induce the authorities into implementation of an apparatus of long term finance, more especially when the economy has become disillusioned with repressive policies. The devaluation of the Nigerian naira in March 1992 is believed to have removed the biggest constraint in negotiations with the IMF team. It was hoped that a new standby agreement could be reached which will lead to further rescheduling of Nigeria's $30bn external debt. The government of Babangida intended to float the naira as far back as 1986 after delivering the government budget that seemed capable of producing a realistic exchange rate but never executed the plan until 1992.

The central Bank on the other hand are proposing a fiscal restraint, prudent monetary policies, public sector rationalisation and curbs on state spending. In 1990 inflation was running at 50 per cent and the naira overvalued by about 50 per cent. Now the

government are attempting to recover lost ground. Doubt about the government's renewed commitment to reform is based on more than its struggle with the foreign exchange rate. There are clear evidence of gross mismanagement and wasted resources on a scale that has done great harm to Nigeria than good.

Table 1.

THE NIGERIAN EXCHANGE RATE 1991 - FIRST QUARTER 1992

Average exchange rate	naira / $
1991	9.96
Jan / Feb 1992	9.75
March 1992	18.00

Source: FT March 1992.

Table 1.2. THE NIGERIAN GROSS DOMESTIC PRODUCT

At Constant 1984 Prices	
Year	**Nbn**
1981	70.4
1982	70.2
1983	66.4
1984	63.0
1985	68.9
1986	71.1
1987	70.7
1988	77.8
1989	83.5
1990	90.4
1991(1)	94.3
1992(2)	95.5

Source : Federal Office Of Statistics and National Planning Nigeria.

(1) Provisional; (2) Forecast.

In Nigeria's situation, the recently elected governors have inherited debt-stressed state treasuries and empty bank balances at a time of crumbling infrastructures which indicates the lack of room for manoeuvre on the part of the federal government. To meet the IMF criteria, the government has got to merge the official and competitive market exchange rates and substantially reduce the budget deficit which has been

estimated at 11.4 per cent of GDP in 1991. An effective move to slow down the rate of inflation and a reduction in the domestic petroleum subsidy is inevitable. Nigeria in the past three years has continued to attract substantial inflows of foreign direct investment quoted to be $1bn a year, which is more than the whole of sub-Saharan Africa. The offsetting effect of this is the huge amortisation burden of $3.8bn per annum, including a net repayment of $300m to the world bank. However, Nigeria's scale of liberalisation is subject of a separate chapter.

Finally, as suggested by Kent Sims (the development of private financial markets in Pakistan, 1970,p.16), there are early steps to be taken in arranging 'transactional linkages' between intermediaries with respect both to new security issues and to secondary transactions. These linkages permits intermediaries to optimize their own mixture of assets. This implies that the early stages of development in long term finance should facilitate and exploit economies of intermediation while at the same time exercising caution not to concentrate power among financial institutions. In financial reform money deepening is the first step, while diversification of intermediation becomes the second objective.

3.10 FISCAL POLICY AND FINANCIAL DEEPENING

> The term financial deepening in economic development is one of the methods of escaping from underdevelopment. This is achieved through income, savings, investment, employment and distribution effects.

This section examines the fiscal techniques with particular attention to the various ways in which it complements, displaces or frustrates the technique of financial deepening. A faster economic development can only occur when compatible fiscal and financial reforms are undertaken. Deposit and loan rates are commonly used by governments as instruments of tax and subsidy. They use these financial prices as fiscal instruments to create or accumulate revenue and as a regulatory device. The relative prices of financial assets are taken to be the real deposit and loan rates. Assuming finance to be costless and financial markets perfectly competitive and government not intervening, deposit and loan rates would be equal and accordingly would approximate marginal rates of return to capital. In reality of course, governments do intervene in the structure of real interest rates, distorting the structure as a way of imposing taxes and granting subsidies.

In terms of budgetary considerations, governments undertaking reforms tend to pledge to do without inflation tax. Nigeria's own reform is perhaps slightly more difficult to assess, given that the government are in the process of handing over government to the civilian politicians. This problem of government transition re- echo's Friedman's comment:

> "Governments tends to look little farther than the next election. If that election is close, an increase in the rate of monetary expansion is bound to provide the government with more revenues. The effects on revenue, let alone on more fundamental economic and social matters will come later (Government revenue from inflation, JPE 1971, pp.853 - 854)".

However, inflation tax is a reduction in real deposit rate, which of course can be reduced for the governments benefit without inflation. The government can force its debt upon commercial banks at rates of interest below free-market rates. The savings in interest cost borne by money holders if deposit rate is reduced correspondingly, by bank stockholders if bank profits are affected. Another view is by bank borrowers if banks raise private loan rates, are the equivalent of revenues from the inflation tax.

Alternatively, the central bank can supply reserves to commercial banks by purchase of government securities and pay reserve deposit rate less than free market rates. To prevent bank evasion of the tax, a reserve requirement can be imposed (Harry Johnson, Problems of efficiency in monetary management, JPE, 1968 p.977).
However, not all revenues from the deposit rate tax flows into the government budget. The other reason is that banks are collecting the inflation tax for themselves. Borrowers and stockholders of other financial institutions can realise similar advantages from any rise in $\dot{P}$ relative to nominal $\underline{d}$ and these advantages can be capitalised for sale as private wealth[22].

Most revenues accruing to the government are extracted from private financial accumulation by explicit taxation as well as the inflation tax. The compulsion by savers to hold directly or indirectly, government securities bearing nominal rates of interest below free market levels is another source of revenue to the government.
Shaw illustrated the budgetary stringency among LDCs by using Ghana as an example where it was estimated that during the 1960s, the country's GDP was rising at a rate of 2.5 percent per annum. The current costs of government increased at a rate of 10.5 percent per annum and the government's income by way of taxation rose by an average of 10 percent per annum, hence leading gradually to increasing difficulties in finding the resources to finance the development program (see The Republic of Ghana, Budget Statement for 1971-72).

It has become evidently clear that governments attempts to find resources for current and development budgets will involve growth in public debt at a rate faster than growth in the national wealth as measured by the GDP, in principal bases of taxation and in fiscal revenues. As a result, the service on the public debt has become an impediment to development policy.

[22] See Shaw 1973 p.153 .

Table 1.3. **DOMESTIC PUBLIC DEBT**

Year	(Nbn)
1980	26
1985	40
1987	50
1988	66
1989	81
1990	107
1991	120

Source: Central Bank of Nigeria

Table 1.4. GROSS DOMESTIC PRODUCT :At a Constant 1984 Prices

Year	Nbn	Growth/Decline (%)
1981	70.4	
1982	70.2	0.2 -
1983	66.4	3.8 -
1984	63.0	3.4 -
1985	68.9	5.9
1986	71.1	2.2
1987	70.7	0.4 -
1988	77.8	7.1
1989	83.5	5.7
1990	90.4	6.9
1991(1)	94.3	3.9
1992(2)	95.5	1.2

Source : Growth / decline rate computated from the Nigerian FOS & NP figures of GDP.

Take for instance Nigeria's domestic public debt T1.4, which has consistently rose from $26bn in 1980 to $120bn in 1991. Referring to T1.4, the Nigerian economy experienced a negative growth rate in GDP between 1981 and 1982 of 0.2 percent. The worst decline in growth was in 1983 of 3.8 percent, recovering slightly in 1984 to 3.4 percent. 1985 marked a turn-around with GDP showing a positive rise from the figures of 1984 of 5.9 percent and recovering from a negative slump of 0.4 percent in 1987 to reach the highest peak of 7.1 percent in 1988. It could be said that while 1987 took the full impact of the SAP introduction in 1986, the government reaped it biggest reward of the reform in 1988.

Discussion on the deposit rate tax regulation is in chapter 5; which explores the interdependence of financial and fiscal techniques in the saving - investment process.

3.10.1 SUBSIDISED LOAN RATE AND CREDIT RATIONING

In LDCs loan rate is prevented from reporting capital's marginal product in alternative uses and of equating demand for investment with the savings flow, while in organised markets, it is an administered price set at differential levels that requires complex rationing techniques to resolve excess demand for funds.
It represents a flexible price at a very high rate in traditional or curb markets, hence conferring subsidy on rationed investment from revenues supplied partly by the deposit rate tax on savers.

The flexible rate in turn imposes a tax on demand for funds, excluded from the organised market by rationing for the benefit of savers with access to curb market facilities. By extending the subsidies and imposing taxes, the loan rate is transformed from a financial to a fiscal instrument in the saving-investment process (Shaw pp.81 - 88, 125 - 128 & 158 - 163).

Shaw provided an example with the Korean interest rate reforms and loan rate structure. Mckinnon (1973) provided the original argument that high nominal interest rates can help provide a more favourable short-run time path of real output than stabilisation which emphasises a reduced rate of monetary expansion. Kapur (1976a, 1976b) explored this viewed at a greater length. The fundamental implication of this is that in developing economies, commercial bank credit is the most important external source of financing for productive enterprises. A sudden reduction in the rate of monetary expansion, normally a common phenomenon in LDCs attempts to eliminate excessive inflation and external disequilibrium, will exert a direct effect on the ability of productive enterprises to hold working capital and so enforce an immediate and perhaps large reduction in real output and employment.

An alternative approach which eliminates the excess supply of money which is the root cause of inflationary pressures by using the interest rate to stimulate the demand

for money balances, can potentially avoid the squeeze on credit and working capital and so avoid the loss of real output[23].

The sharpest criticisms labelled against subsidy is that it impoverishes an economy and deepens the imperfection of the capital market. Subsidy induces excess demand for the factor, capital that is scarce and increases excess supply of complementary factors especially labour that is plentiful and distracts the economy from the best production possibilities.

Van Wijnbergen[24] was very critical of the restricted and unrealistic portfolio choices. He argued that the favourable consequences of higher deposit interest rate in the Kapur model (portfolio choices) derived from the assumption that higher deposit holdings and bank loans arise entirely as a result of substitution away from an asset such as cash which is wholly unproductive in terms of financing business activities. His own postulation is that the specification of portfolio choices in LDCs should allow for the possible use of funds directly or indirectly to provide loans in the curb market. Hence, a three way model portfolio substitution involving cash (assumed unproductive), time deposits and curb market loans. His assumption was that the administrative fixing of the time deposit interest rate and the bank's requirements to hold part of it as reserves will be impossible for the commercial banks to meet all the demand for working capital loans which the economy generates. The remaining unsatisfied demand is met by the curb market and the interest rate on curb market loans adjusts to equilibrate this residual demand with the supply of loans which are made available to it (Roe, 1989).

Shaw regarded the loan-rate subsidy as a dubious efficiency for stimulating entrepreneurship and forced feeding of infant industries. Subsidy accrues to promoters of new firms, but high returns to promotion should not be confused with high returns to entrepreneurship or with compensation to infant industries for its learning costs.

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[23] A. R. Roe, Interest rate policy, employment and income distribution, in the book, Market Liberalisation, equity and development, 1989 p.87.

[24] Van wijnbergen 1983a, 1983b.

Hard pressed for revenue, the treasury or the finance minister can switch to the savings market by lowering rates for treasury bills, possibly by decree. The banking system and longer term securities can be thrust into social security funds, pension funds and portfolios of insurance companies. Savers are captive tax payers and sadly enough, the government very often do not give adequate consideration as to the opportunity cost of savings in planning its expenditure budget. Savers in the lower-income category are discriminated against and the long maturity segment of the capital market is closed to private securities. There is rarely public accounting for subsidy and the deposit rate taxes that finance it and also it is not reported in fiscal budgets, as well as obscured by accounting convention.

As for fiscal aid to finance, subsidy of deposit rates of interest in the organised financial sector is used to divert funds from the curb and by the authority as allocation technique. The theory of monopolistic price discrimination appears to fit many of the features of fiscal financial tax - cum subsidy. The government representing the monopolist as seeking to divide the market into fragments, by differentiating the product may be able to limit a price reduction when desired to expand output. To some of the customers, maintaining this charges to others has a negative effect to total revenue, while to increase price in order to expand output, to some of the suppliers it will have a positive effect on total costs.

With regards to coordination of fiscal and financial strategies, financial deepening and fiscal strength are mutually dependent for example, Chile 1960 - 61 and 1965 - 66 (Arnold Harberger, JPE, 1970, p.1012). Public policy lets tax base slip away and government substitute import quotas and licences for tariffs etc. To avert slippage in LDCs, training seems to offer the solution. Slippage begins with the phrasing of tax law and regulation which creates a thriving industry of tax avoidance and evasion, including losses of revenue from shortcomings (Kaldor, Essays on Economic Policy Vol.1 p.216), in valuation of income or property or turnover as well as the administrative costs of inefficient bureaucracy.

Considering fiscal perversity and the loan rate, the technique of finance in the saving -

investment process allows relative price in the form of loan rates to act as the factor for deciding between investment alternatives for scarce savings. Thus, bring savings into the capital market and depends on the market measures and competitiveness for employing them where marginal social productivity is highest .

The un-reliability of this technique is based on two main factors:
[1] The participants in a capital market cannot obtain an appropriate ranking of social productivity or disregards it and attend to a ranking in terms of private advantage.
[2] Demands for savings in a capital market are interest - inelastic, so that loan rate has no power to discriminate.

The conclusion drawn on this was that little is to be gained by development of the capital market intervention to correct private perceptive, rationing and transfers of the investment function to government. The danger is, participants in the capital market are likely to abuse them by monopoly power.

To overcome the problem would be to deepen finance so that more buyers and sellers of loan fund have access to the market and also to lower the differentiation of financial institutions that fragments the market into detached groups. A direct action against monopoly power that derives from fiscal perversity is another way of tackling it. Turnover taxation provides a bonus for vertical integration. Tax exemptions discriminate for established investors at the top of the scale in terms of profits. Failure to tax real property, capital gains and higher incomes allows market strength to accumulate. Subsidised loan rate with rationing in shallow capital markets is not the answer.

In concluding the discussion on fiscal policy and financial deepening Shaw presented reforms in two perceptive. He noted that where capital accumulation lags and is misdirected, financial and fiscal structure and policy are jointly to blame.
Deposit rate tax and loan rate subsidy are fiscal penalties or punishment to the financial system. Fiscal system is not deep or elastic enough as savings and it distorts savers demand for financial assets and choices by financial institutions between loan

options. Inflation reduces the fiscal base and elasticity and the administered pricing while aversion to risk and inflexibility creates opportunities for fiscal perversity. Therefore, reforms that can assist to liberate finance should include:

1. Elimination of taxes that yields small returns net of exemptions and administered costs;
2. Reduction of delays in tax assessments and collection;
3. Tightening of tax administration;
4. Schedular taxation of income can be rationalised, with fewer distinctions between sources and less discrimination against income from financial assets;
5. Rationalisation of government pricing;
6. Revaluation and title to property; and
7. Tariffs can be efficient substitute for import licensing, therefore a strong need for value added tax as a centre piece of the fiscal scheme. However, it does not provide opportunities for avoidance, evasion and slippage that are so offensive to equity.

3.11 FINANCIAL DEEPENING IN THE OPEN ECONOMY

Lagging economies imposes disequilibrium on this market as it does on domestic markets for money and other finance and attempts to clear excess demand with a variety of interventions. The other postulation is with reciprocal effects of distortion in domestic finance and international trade on current account. In general the analysis focused on the long, to issues of growth and stagnation rather than stability or instability.

In an open economy, money becomes tradable and markets appears to determine the price for the foreign exchange rate against external money. There may be a multiple market on which domestic and external money trade against each other, each with a rate of exchange example, official and black or spot and forward markets. Disequilibrium, arbitrary intervention and risks are the common features of the LDCs foreign exchange markets. As Gunnar Myrdal in Asian Drama Vol.3, 1968, p.2082 puts it; "foreign exchange difficulties are not a temporary exigency but a normal and permanent condition in very poor countries".

Shaw adopted Jagdish Bhagwati's theory and practice of commercial policy, to illustrate the scenario for disequilibrium money identity:

$$B = Y - E \qquad [3.0]$$

B		Y		E
Trade Bal		National Income		Usage or National Expenditure

Where B is the current account of the LDC economy's balance of payment with disequilibrium (negative), representing unsustainable excess of aggregate demand for goods and services relative to national output or excess to the desired investment relative to savings[25].

In view of the monetary authority's little stocks of international reserves and limited

[25] Excess demand precipitates a crisis that can only be resolved temporarily by substantial devaluation below borrowing point and by other measures of emergency ... Shaw pp.196 - 197.

borrowing capacity in external capital markets, a regime of quantitative restrictions on imports became introduced, that is, a regime of multiple exchange rates for imports followed by export subsidies, substitution of tariffs for other restraints on imports and devaluation. This is exactly the kind of exchange rate regime in operation in Nigeria. The government official rate pegged at N18.00 to $1.00, and in the curb market at N25 to N30.00 to $1.00. Following the high band in exchange rate, imports of foreign goods becomes restrained, causing to some extent severe shortages especially of machineries and other finished products from abroad. Evidence, of this can be seen in none renewal of contracts or maintenance of existing infrastructures and falling manufacturing outputs and investments (see table 1.5 below).

Table 1.5 **THE NIGERIAN ECONOMY UNDER THE REFORM PROGRAM**

Period	**1981-86**	**1987 - 91**
GDP Growth (% p.a)	0.2	5.7
Investment (% of GDP)	12.0	6.0
Inflation (% p.a)	17.0	24.0
Exports / GDP (%)	14.3	18.0
Imports / GDP (%)	11.3	3.8
Budget Deficit (% of GDP)	5.3	3.7

Source : Central Bank of Nigeria

From table 1.5, it can be seen that investment under performed, averaging 6 percent of GDP[26], as against 12 percent before the start of the reform. Equally, imports collapsed as a share in GDP, itself a partial explanation of the poor investment level in the country. The situation is not helped either by the constant rise in the rate of inflation, which in the period 1987 / 91, stood at 24 percent, compared against 17 percent in the period 1981 / 86.

Shaw admitted that the scenario is incomplete because it neglects the role of markets for money and capital. However, this can be updated by the current and capital accounts in the international balance of payment, with only transactions between

[26] The Gross Domestic Product (GDP) is taken to represent the national wealth .

monetary authorities omitted (Harry G. Johnson, International trade and economic growth, pp.135 - 168). This can be represented as:

$$B = Rf + Rr - Pf - Pr = R - P \qquad [3.1]$$

Where Rf = receipts by residents of payments from foreigners;

Pf = payments by residents to foreigners;

Rr and Pr are identically equal, representing payments and receipts between residents.Before the government decided to float the naira, what it always does is to fix a parity against centre money[27] on the foreign exchange market, with a narrow band between lending and borrowing points. This then generates excess demand for foreign exchange by driving B to negative levels. The other consequence is that it induces excess offers of payments P from domestic money balances relative to bids in all markets for receipts R that restore balances. That is, it imposes excess supply on the market for domestic money.

Shaw argued that, policy in LDCs makes a gesture of integration with the centre economy, but its bias is autarchic and the fixed parity with a narrow band is illusory. This point could be true, because the developing economies currency through fixed parity are grossly overvalued. Maintaining such parity will not only be illusory but will be undermining the exports sector of the economy.

In relation to the instruments of exchange control, all markets in the LDCs are pressed with excess money supply and with a common pattern of devices to suppress its effects. Excess money supply drives nominal rates of interest higher once inflation has come to be expected. In both cases the authorities intervenes with price ceilings. Their intention for intervening is to support money's relative price I/P and to hold down money's opportunity cost and keep real interest rates low.

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[27] Centre money implies currencies such as the U.S dollar or the British pound and the German mark. They are so because the economies of these western industrialised countries are very strong . Also they are used, especially the dollar in international trade pricing standard .

There is also differentiated rationing at each of the various stipulated prices. Therefore, excess demand for any input including foreign exchange is increased by disequilibrium pricing for other inputs.

In the case of disequilibrium money and market structure, there tend to be a dual effects of controls which are:
[1] The centralising effect, which implies privileged access to rationed supplies;
[2] Fragmentation of market structure by multi-monetising the economy. That is, money in the usual form ceases to be the only means of payment and in some markets cannot be accepted as a medium of exchange unless it is combined with a ration ticket or coupon. In which case, money's utility in search and bargain becomes reduced. In Therefore, money's income effect is lost and the disequilibrium system is not money deepening.

3.11.[1] TRADE POLICY AND FINANCIAL GROWTH

The implication of trade policy and financial growth is that financial repression, exchange rate disequilibrium and policy bias against comparative advantage in international trade are interlocking restraints on development. Interventions in flows of trade on current account provides new incentives for financial repression, as well as imposing an implicit multiple pricing on the foreign exchange market. Also distortion of prices of savings and foreign exchange mis-allocation demand and supply among tradable and domestic goods.

The important points with the effects of financial repression upon trade is shown by reduction of domestic savings. Shallow finance as a result led to distortions in trade, hence savers responds to low and unstable real rates of return on financial assets by shifting demand of imports of consumable, to consumable's with high import content, and to domestic goods with export potentials.

The subsidised loan rates effect is the imposition of bias-ness on trade and the diversion of savings into capital-intensive products and processes. Subsidised growth in plant and equipment imposes a growing burden on the balance of payments of

imports in the form of spare and replacement parts. On the effects of trade distortion upon finance, financial policy distorts international trading by the lagging economy and trading policy reciprocates with distortion of finance.

As for international capital flows, financial repression and fiscal inadequacies helps to create a savings gap at rates of growth in national product that approach the aspirations of developing economies. Financial repression upon capital flows imposes a consistent bias for export of domestic savings and also induces cycles of savings flows, tides in and out that cannot be absorbed by efficient adjustments on current accounts for trade. As excess demand accumulates on foreign exchange before a reluctant adjustment of the exchange rate, savers foresee and respond to prospective devaluation.

The inflow of aid has inflationary potentials. The grant from abroad is a tax on foreign savers to finance some miscellany of imports to the lagging economy, and as a conduit for new levy of the inflation tax on domestic savers. According to Shaw, this demonstrates the seamless web that binds all elements of finance: international, fiscal and monetary in restraint of growth.

3.11 [2] THE CHOICE OF POLICY AND FLEXIBLE EXCHANGE RATE

Shaw's hypotheses was that real money policy for deepening the financial system includes specification of target growth rate, preferably low, for inflation of the domestic price level. One instrument in guiding price level, given growth in real money demanded is the growth rate of nominal money. Flexible exchange rate provides an alternative instrument for small developing economies that imports a rate of inflation from the industrialised countries and adapts growth in nominal money to it through balance of payment adjustments.

Disequilibrium emerges when taste diverge and the use of both control instruments; domestic nominal money management and the inflexible exchange rate, provokes a confrontation of monetary authorities with the authorities of the small economy inevitably the loser. Flexible pricing helps with freedom of trade in goods and capital

in the presence of chronic differentials rates of inflation or of chronic differences in the variability of inflation rates.

Real money policy for deepening indicates free convertibility on the foreign exchange. Money's maximum income effect and other benefits from financial markets depends on freedom of payment and transfer through the widest efficient matrix of transactions. It is not achieved when payments are forced to run a gauntlet of rationing and are subjected to the costs and risk of black markets. The optimal foreign exchange market arrives at a single or unified spot rate of foreign exchange rather than a multiple rates in conjunction with interventions to clear excess demands.

3.12 SUMMARY AND CONCLUSIONS

Shaw in his analysis is very critical of low controlled interest rates and financial repression. In his financial development model, financial institutions intermediate between savers and investors. There are loan rate ceilings as well as deposit rate ceilings in most financially repressed economies and there are few competitive banking system in the LDCs.

Shaw's view is that the real rate of interest as the return to savers is the key to a higher level of investment and as a rationing device to greater investment efficiency. The increased quantity and quality of investment interact in their positive effects on the rate of economic growth. Growth in the financially repressed economy is constrained by saving and investment opportunities.

The theory postulated by Shaw, has as its policy prescription for the financially repressed economies, two options;

[1] To raise the institutional interest rates; or

[2] To reduce the rate of inflation.

Abolishing interest rate ceilings produces the optimal result of maximising investment and raising investment's average efficiency.

Shaw argued that the expanded financial intermediation between savers and investors resulting from financial liberalisation and financial development, increases the incentives to save and invest and raises the average efficiency of investment.

The reason for this is that, it raises real returns to savers and at the same time lower real costs to savers by accommodating liquidity preferences, reducing risk through diversification, reaping economies of scale in lending, increasing operational efficiency and lowering information costs to both savers and investors through specialisation and division of labour.

Chapter 4

THE NEO-STRUCTURALIST MODEL

The chapter is to examines the Neo-structuralist models, the empirical evidence on transmission mechanisms and income distribution and the effects of financial liberalisation on inflation and short-run growth.

The main importance of the Neo-structuralist model from that of Mckinnon and Shaw school is that, it provided analysis which are fundamentally different, based on the following five assumptions:

[1] Wages are determined institutionally or exogenously through class conflict;

[2] Inflation is determined by the relative strengths of capitalist and workers;

[3] Savings occur through profits only and not wages;

[4] Price level is determined through fixed mark-up over costs of labour, imports, and working capital finance, that is,interest rate (Taylor 1979); and

[5] Developing Countries depends on imports of raw materials, capital equipment and intermediate goods.

Assumptions 4 and 5 indicates that a restrictive monetary policy that raises interest rates and a devaluation that raises the price of imports can produce stagflation. That is, an acceleration in the inflation rate and a reduction in the rate of economic growth at the same time.

At the centre of the Structuralist model of Developing Countries is the Curb Market, in which money lenders and domestic banks intermediate between savers and investors. The Neo-structuralist claim that banks cannot intermediate as efficiently as the Curb Markets between savers and investors because the Reserve Requirement constitute's a leakage in the process of financial intermediation through commercial banks. The public is assumed to hold a congeries of assets such as currency, precious objects, land and real estate, termed Gold. The other two assets held are bank deposits and curb market loans. This is the first major difference between the Neo-structuralist and the Mckinnon - Shaw models.

Mckinnon and Shaw models emphasises on two assets; Gold or other inflation hedges and money in household portfolios, which means that, the substitution into money must come from substitution out of inflation hedges.

Taylor (1983, p.100) noted that financial liberalisation can not yield the desired result under the conditions of standard assumption that financial assets are gross substitutes. Van Wijnbergen indicated that, whether higher deposit rates do increase the total real supply of credit would depend on the required reserve ratio and on whether the increased holdings of real money balances come mainly at the expense of inflation hedges or mainly from direct lending in the curb market[1].

The conclusion drawn by Edward Buffie, Akira Kohosaka (1984), Taylor and Van Wijnbergen was that in practice, financial liberalisation is likely to reduce the rate of economic growth by reducing the total real supply of credit available to firms.

Given the assumption of a free movement of funds between the Banking System and the Curb Market by the Neo-Structuralist, savers and investors can use either or both markets. This implies that, the relevant interest rate in the Structuralist model is the curb market rate because it represents the marginal cost of borrowing and entering into the money demand function since curb market loans constitute an alternative to holding money balances.

One notable significance is that any rise in the curb market rate also raises the price level since a rise in the curb market rate increases the cost of working capital. Prices are determined by fixed mark-up's over costs in all the Neo-Structuralist models. Secondly, an increase in the curb market rate also reduces output by deterring investment. Commercial Banks are required to maintain a compulsory fixed reserve ratio 1 - q, with the Central Bank. The Central Bank do not extend a credit facility to the private sector as its function is to act as the Government Bank, Bank for other Banks, Bank for International Monetary Agencies and Foreign Governments. Hence,

[1] See Fry 1982c,p.1051.

the reserve money or high powered money which forms the cash base is wholly Outside Money. Three forms of assets are held by the household sector: currency or gold, bank deposits and curb market loans. When the deposit rate of interest increases, it also raises the demand for deposits and reduces demand for currency and curb market loans.

Van Wijnbergen noted the need to incorporate the curb markets into the Monetary Models of the Developing Countries. The model postulated by Van Wijnbergen was partly based on the Wicksellian Credit Availability Effect, which was also used by Domingo Cavallo (1977), Fry (1980b) and Keller (1980). The reason for the inclusion is that, LDCs are dependent on credits to finance their working capital. The other reason is that, their debt/equity ratios tend to be high.

Like Shaw, Van Wijnbergen adopted the Tobin - Type portfolio behaviour on the part of the household sector to analysis the effects of financial liberalisation[2]. Hence, the allocation of the households real wealth W between currency CC, time deposit TD and direct loans to the business sector through the curb market[3] Lh. From this, Van Wijnbergen obtained the following financial development model in the steady state:

$$CC = f^{c}(\pi, i, r_{td}, y)W \qquad [1.0]$$

$$TD = f^{td}(\pi, i, r_{td}, y)W \qquad [1.1]$$

$$L^{s}_{h} = f^{L}(\pi, i, r_{td}, y)W \qquad [1.2]$$

where the left hand variables including i and y (on the right hand) are the endogenous variables while the right hand variables represented the exogenous variables. π is the inflation rate, i is the nominal curb market rate of interest, r_{td} represented the real time deposit rate of interest and y is real income.

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[2] Van Wijnbergen 1983a, pp.435 - 436.

[3] The curb market can also be referred to as the unorganised money market .

CC is currency at constant prices, TD is time deposits at constant prices while Lsh denotes household sector loans to business firms through the curb market at constant prices and W represents real wealth.

It follows that since demand for currency and time deposits are positively related to income, the household sector's supply of funds to the curb market is negatively related to income, given the level of wealth. According to Van Wijnbergen (1983a,p.436) the cash base, which consists of currency in circulation and bank reserves is not supported by any private assets because it originates from transfer payments. The bank loan supply in real terms Lsb to the business sector will depend on their demand for excess reserves, the level of deposits and the required reserve ratio.

This can be expressed algebraically as:

$$L^s_b = b(\pi, r_L)q.TD \qquad [1.3]$$

where r_L denotes the bank lending rate in real terms. The nominal bank lending rate is fixed by the government below its equilibrium level as opposed to the curb market interest rate which is free to find its market clearing equilibrium level.The equation for firms demand for loans which is determined by the real product wage w and output y can be written as:

$$L^d = L(w, y) \qquad [1.4]$$

In this formulation, loan demand is completely inelastic with respect to the curb market rate of interest.Therefore, the equilibrium in the curb market can be expressed as:

$$f^L(\pi, i, r_{td}, y)W = L(w, y) - b(\pi, r_L)q.f^d(\pi,i,r_{td},y)W. \qquad [1.5]$$

From equation [1.5] through differentiation, the upward-sloping LM curve is obtained while by differentiating the simple Keynesian output equation:

$$y = A(i - \pi, y) \qquad [1.6]$$

where $Ai < 0$, and $0 < Ay < 1$ ([4]).

From equation [1.6] the IS curve is obtained. See figure 4.0 below.

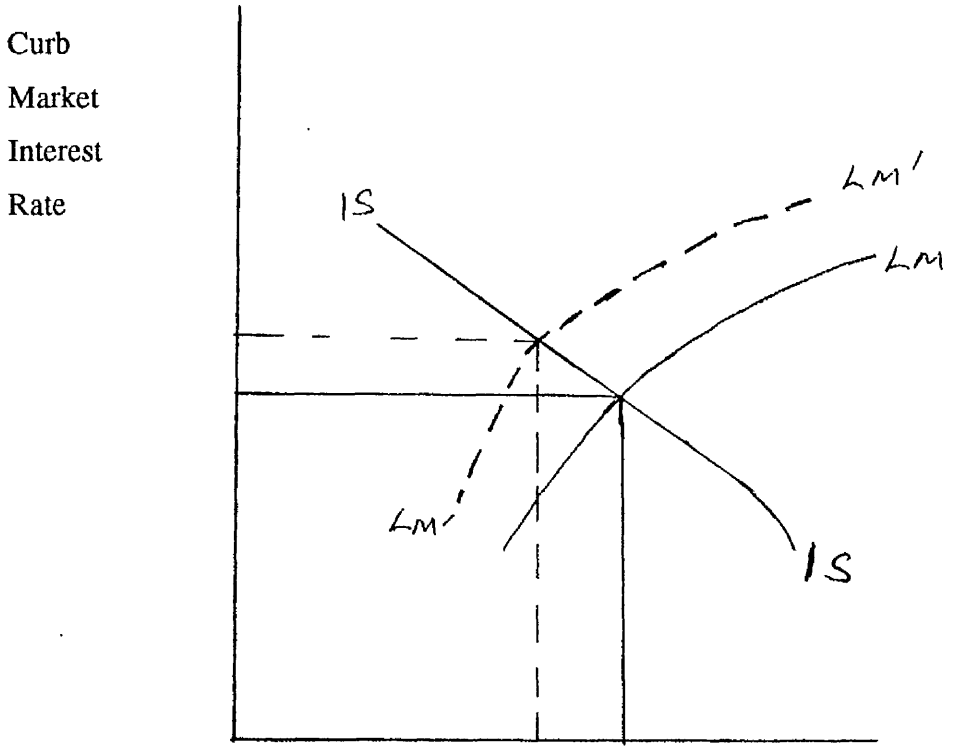

Figure 4.0 The IS-LM Curves in Van Wijbergen's Model

The IS curve does not shift because a change in the time deposit has no effect on the goods market therefore, the money market is only subject to two effects which are:

[1] A higher time deposit rate increases money demand and as a result shifts the LM curve upwards; and

[2] The substitution out of currency and into time deposits increases the money supply and shifts the LM curve downwards.

[4] See Branson 1987,pp....

The required reserve ratio and the relative elasticities of demand for currency and curb market assets with respect to time deposits will determine the net shift in the LM curve. The Policy Implication is that, a rise in time deposit will influence people to substitute from curb market loans to time deposit resulting to the total supply of funds to the business sector declining. The assumption here is that the curb market provides one-for-one intermediation whereas banks provide only partial intermediation due to the reserve requirement. In which case the LM curve shifts to the left, the curb market rate rises and output falls.

However, when people starts to substitute mainly from currency to time deposits after a rise in the time deposit rate, the total supply of funds to the business sector increases, the LM curve shifts to the right and the curb market rate falls forcing output upwards. This scenario gave rise to the Neo-Structuralist expectation. Van Wijnbergen argued that in the long run the initial decrease in financial deepening as a result of the higher market rate will persist over time[5].

The other policy implication is that a tight monetary policy reduces growth by squeezing total credit availability. That is, if the supply reducing effect of such policy is greater than the demand reducing effect, the balance of payment on the current account will deteriorate after the introduction of such policy.

4.0 THE EFFECT OF PERFECT CAPITAL MOBILITY

Given a perfect international capital mobility, domestic credit policy has no effect on investment since the real borrowing rate remains at the world level. On the other hand, a restrictive domestic credit policy does affect disposable income in this situation by increasing the country's debt service burden. An increase in the cash base will raise the output through the credit availability effect and slows inflation. The accelerated monetary growth need not be inflationary as long as it is all spent on productive investment.

[5] Van wijnbergen 1983a,pp.448 - 449, Maxwell.J. Fry 1988,p.93.

4.1 TAYLOR'S MODEL

Taylor provided an accounting identity and empirical relations that characterises the LDCs. He reformulated the analytical models applicable in developed economies to fit the developing economies. Taylor's analysis emphasises on the importance of structural features like surplus labour, the distinction between tradable and non-tradable goods (terms of trade between the rural and urban sectors) and the changing distribution of income among different socio-economic groups. He also analyses the effects of an increase in the time deposit rate when households hold gold, bank deposits and curb market loans.

His results are closely similar to those of Van Wijnbergen depending on the extent of the financial intermediation that the commercial banks can legally provide. The informal or unorganised market has no reserve requirement which enables them to direct resources toward firms with greater efficiency. Therefore, unless the banks are able to draw hoarded assets such as gold into deposits when the nominal deposit rate of interest id rises, the overall effect of reform can be stagflation.

The subscript id denotes a partial derivatives with respect to the interest rate on loans to firms and the deposit rate.

His analysis of the effect of monetary contraction used a model in which the output Y is determined by the available fixed capital K which can be expressed as:

$$Y = \sigma K \qquad [1.7]$$

Dividing output into labour, capital and interest costs:

$$PY = (1 + i)wN + rPK \qquad [1.8]$$

where P = the price level

i = the nominal curb market interest rate

w = the nominal wage rate

N = the quantity of labour and

r = the profit rate.

As the labour and all other current inputs are paid for in advance, the interest cost of working capital can be denoted as iwN. Substitutability factor was not allowed in the model, thus, labour use is proportional to output.

$$N = \beta Y = \beta\sigma K \qquad [1.9]$$

Substituting equation 1.9 into 1.8, gives the expression for the profit rate as:

$$r = \sigma\left[\frac{1 - (1 + i)w\beta}{P}\right] \qquad [2.0]$$

By inverting equation 2.0 we obtain the expression for the price level:

$$P = \frac{\sigma w(1 + i)\beta}{(\sigma - r)} \qquad [2.1]$$

Therefore, the equilibrium condition for the goods market in real terms will be:

$$C + I + G = Y \qquad [2.2]$$

Given s is a fixed fraction of saving out of the total profits rPK, consumption in nominal terms will be:

$$PC = (1 + i)wN + (1 - s)rPK \qquad [2.3]$$

Hence, the saving - investment balance can be expressed as:

$$g + \tau\sigma - sr = 0 \qquad [2.4]$$

Equations 2.0 and 2.4 determine the equilibrium price level. The growth rate of the capital stock (investment) depends on the difference between the profit rate and the curb market interest rate, both expressed in real terms as:

$$g = g_0 + h[r - (i - \pi)] \qquad [2.5]$$

The final price level can be expressed as:

$$P = \frac{(s - h)\sigma w(1 + i)\beta}{[s - (h + \tau)]\sigma - g_0 + h(1 - \pi)} \qquad [2.6]$$

The above equation implies that an increase in the curb market rate will raise the price level through working capital cost push but will lower the price level by reducing investment demand. Whatever circumstances that prevail, an increase in the interest rate will lead to a reduction in the rate of economic growth, as long as the increase in the profit rate affects savings by more than it affects investment. This condition is also represented by equation 2.4; the standard stability condition.

The equation for IS curve or the equilibrium in the goods market can be written as:

$$\frac{(s - h)\sigma(1 + i)w\beta}{P} - h(i - \pi) + g_0 - [s - (\tau + h)]\sigma = 0 \qquad [2.7]$$

An increase in the price level raises the nominal value of firms fixed capital. The implication of this is that such windfall gains stimulate investment, leading firms to demand more loans. As more and more resources are drawn into the curb market from deposits through a higher rate, the loan market equilibrium curve will become upward sloping.

Taylor provided the same argument as Van Wijnbergen on the policy effects using the IS - LM curve. Under a tight monetary policy, the commodity market equilibrium curve will shift to the right. It could also occur when the money demand function shifts upwards. This is illustrated by the Taylor's two asset model (see figure 4.1).

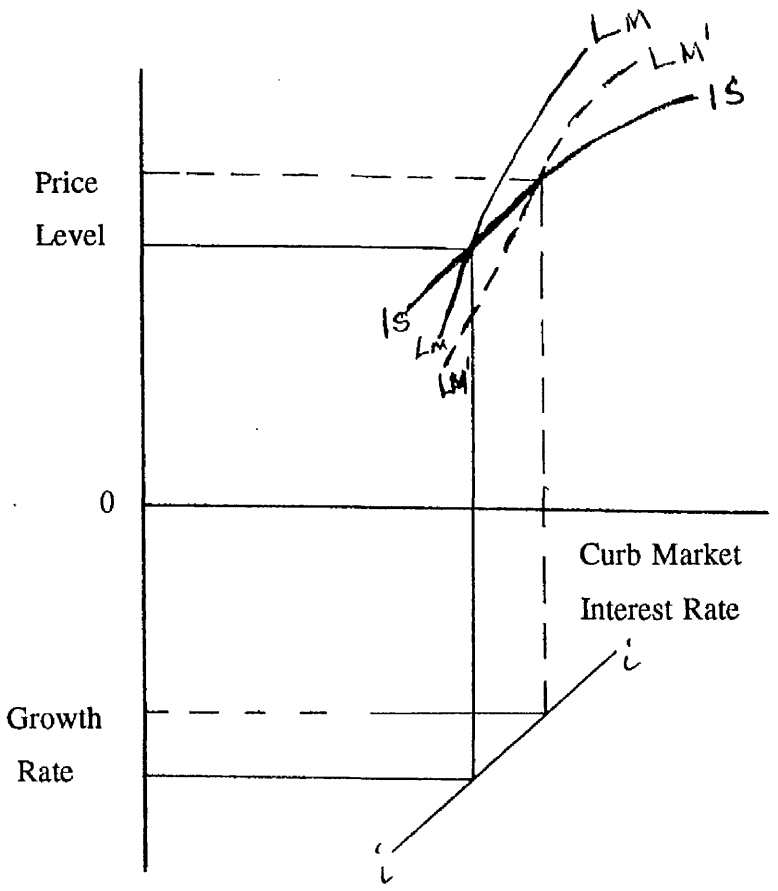

Figure 4.1 :

Short-run Equilibrium in Taylor's Two Asset Model

The long run effect is that it could result to an increase in the curb market rate of interest, a decline in investment and a fall in the rate of economic growth. This led to the postulation of an aggregate supply function of the form:

$$X = x[P/(1 + i)w] \qquad [2.8]$$

At the price level P an increase in interest rate i would lead to cost pressure that would induce producers to reduce their output X. Alternatively, if supply falls more than demand, the resulting aggregate excess demand would lead to a rise in the price level as shown in figure 1.1. Therefore, monetary contraction in the short-run would slow growth, drive up prices, reduce output and increase unemployment[6].

[6] Taylor, 'Structuralist Macroeconomics ' 1981,p.97. The result produced by Taylor is the same as that obtained by Van Wijnbergen, as well as Kohsaka (1984,p.428).

Using a Tobin - Type portfolio framework, Taylor produced his full model with households holding bank deposits, curb market loans and gold that yields an equilibrium in the curb market. The equilibrium condition can be written as:

$$w\beta\sigma K - \frac{H}{1-q} + Ç(i, id, \pi, \pi z)(H + PK + PzZ) = 0 \quad [2.9]$$

where; H = cash base

1 - q = required reserve ratio

π = inflation rate

πz = rate of change in the price of gold

Z = quantity of gold held by the public sector.

Under the condition of equation 2.9, the general price level and the price of gold falls, the level of investment and growth declines. Diagrammatically, this shows a downward sloping curve of the commodity market equilibrium (see figure 4.2).

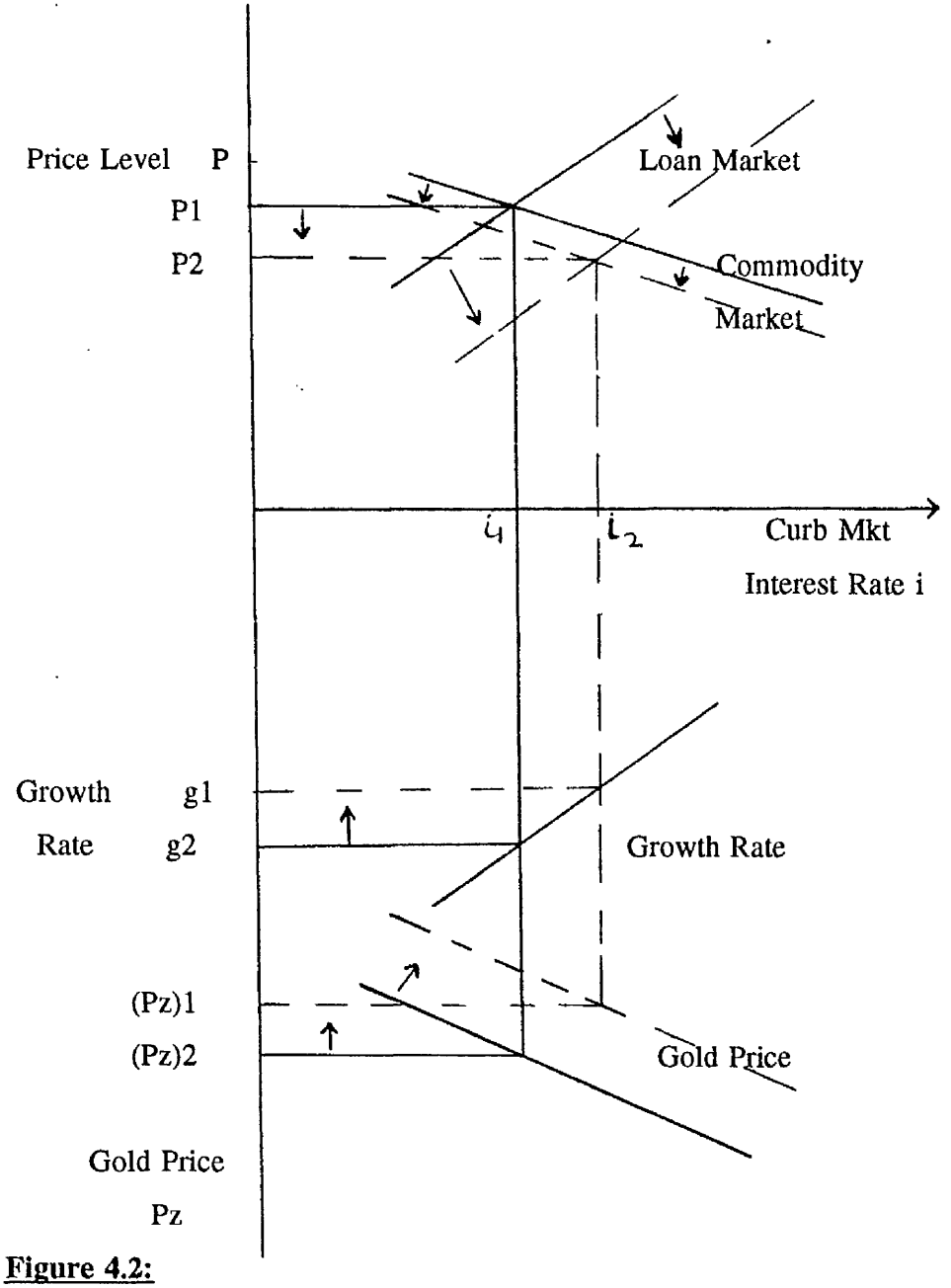

Figure 4.2:

Taylor's Three-Asset Model: The Short-Run Equilibrium

Figure 4.2 shows the effect of an increase in the deposit rate of interest id which increases the money demand Md due to the increase in the substitution out of curb market loans.

> "Therefore, unless there is another combination with expansionary monetary policy such as a reduction in the reserve requirement, it is unlikely that financial liberalisation will yield a beneficial economic performance in the medium term (Taylor, 1983,p.122, Fry 1988, p.100)".

This means that, if the aggregate demand effects dominates the supply effects after an increase in the deposit rate, the inflation rate would decline and the real wage rises because of the lagged indexing system. Thus, the rise in real wage reduces the profit rate, investment and growth. According to Giovannini (1983b) a strong saving response to higher deposit rates could salvage the growth rate, however, empirical results on this evidence is weak.

In another empirical work, Buffie (1984) argued that, if the above statement by Giovannini is the case, the long-run multipliers can be opposite in sign to the short-run multipliers. That is, the curb market rate may rise in the short run because the total supply of credit falls with the substitution from curb loans to bank deposits. As for the long-run effect, the curb market rate could fall if higher deposit rates stimulate a sufficient increase in savings to counteract the leakage through reserve requirement.

4.2 THE CURB MARKET UNDER THE NEO-STRUCTURALIST

In an attempt to extend the model by Van Wijnbergen, Jung and Chang 1984, introduce two alternative curb markets models:

[1] A competitive curb market with close links to the banking system on both the demand and supply side;

[2] An uncompetitive, primitive and fragmented curb market operating independently from the banking system.

Their analysis suggests that substitutability between time deposits and curb market loans may not be high for large savers because the assets have different risk attributes. Small savers responds to an increase in the time deposit rate than the larger savers. Therefore, the effect of financial liberalisation would be an increase in the total supply of credit to the business sector.

In both the competitive and uncompetitive curb markets, interest rates adjust to clear the market. Both markets can be taken to be unofficial private bank, as the government will not bail them out in the event of insolvency. The implication of this, is that, they are likely to hold reserves to meet defaults which will probably be greater than the official banking sector and as such their financial intermediation will be limited. Imperfect information and the small scale of operation may prevent the unofficial private banks from allocating credit as efficiently as the official banks.

Finally, the argument about the inefficiency of the curb market in allocation of resources disproves the Neo-Structuralist claim and their conclusion about the effects of financial liberalisation.

4.3 THE NEO-STRUCTURALIST DYNAMISM

Both Taylor and Van Wijnbergen specify rational formation of expectations in their models, which in a non-stochastic model implies an assumption of perfect foresight. Since the expected inflation is actual inflation, it follows then that, expectation can not provide a source of dynamic adjustment.

Taylor's dynamic adjustment analysis involves a profit squeeze where the mark-up rate τ varies over time as a function of capacity utilisation u or the level of unemployment. Assuming the labour capital ratio N/K = ßu and the Capital / full employment labour supply Nf to be K. The labour employed to the total labour force N/N_f to be μ. Thus, a simple substitution would yield the expression:

$$\mu = (N/K)(K/N_f) = ßuk.$$

In the case of the mark-up rate, it would vary over time as follows; given the conditions stated above:

$$\delta\tau / dt = \alpha(1 - ßuk) \qquad [3.0]$$

or

$$\delta\tau / dt = \alpha(1 - \mu) = \alpha(1 - ßuk)$$

Hence, τ falls when μ rises and full employment is approached, that is, if the level of capacity utilisation respond positively to the mark-up rate, the profit squeeze that occurs as capacity utilisation rises and unemployment falls would produce convergence to a stable growth path. The convergence may be monotonic or cyclical[7].

If the fully employed labour grows at the rate of g*, then the growth rate of k will be:

$$\delta k / \delta t = (g - g^*)k \qquad [3.1]$$

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[7] Taylor,1983,p.35, Fry,1988, pp.102 - 103.

Now let ^ (hat) over a variable denote its growth rate.

Therefore, the new expression will be:

$$K^{\wedge} = (\delta k / \delta t)/K = K^{\wedge} - L^{\wedge} \qquad [3.2]$$

and

$$K^{\wedge} = (\delta k / \delta t)/K = g \qquad [3.3]$$

Given this ideal growth trajectory, the variables will adjust according to the JACOBIAN equations 3.0 and 3.1 (a two dimensional system).

$$\begin{bmatrix} -\alpha\beta k(\delta u / \delta \tau) & -\alpha\beta u \\ K(\delta g / \delta \tau) & 0 \end{bmatrix} \qquad [3.4]$$

..... because $g = g^*$ at equilibrium.

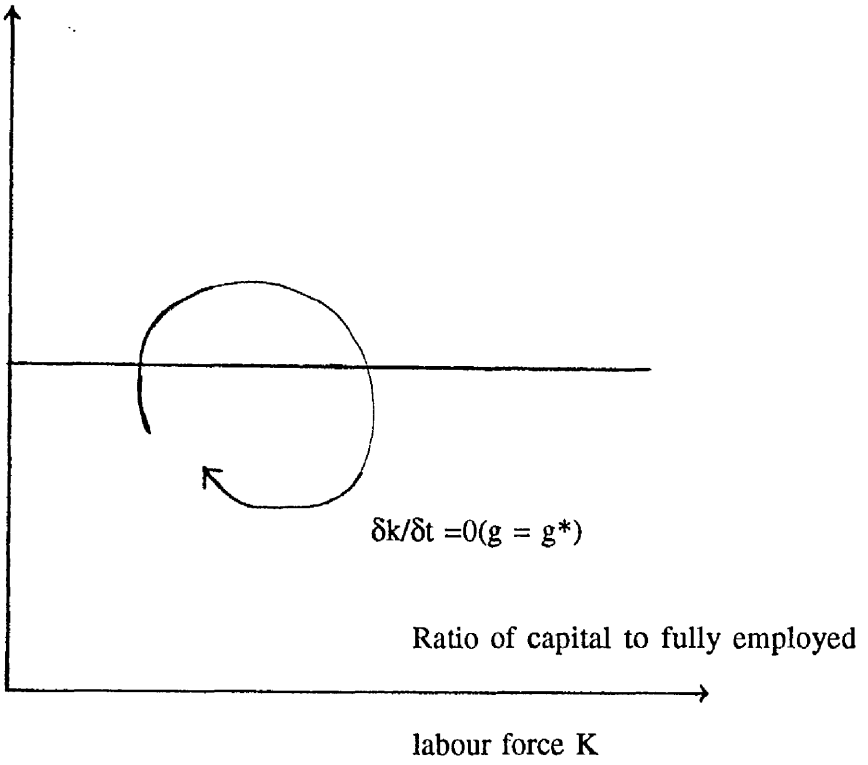

Figure 4.3: DYNAMICS OF ADJUSTMENT TO STEADY - STATE GROWTH IN A PROFIT - SQUEEZE MODEL.

Note : Dynamics within a steady - state solution as defined by $\mu = 1$ and $g = g^*$ implies that a full employment of labour and the capital stock is growing at the same rate as the labour force at the steady state.

For a two dimensional system like equations 3.0 and 3.1, the stability conditions are that the trace of the Jacobian matrix must be negative and the determinants positive. The determinant of the matrix in 3.2 is positive, while the trace will be negative when $\delta u/\delta \tau > 0$.

Taylors conclusion from the above deductions was that when the level of capacity utilisation responds positively to the mark-up rate, then distributional changes induced by a profit squeeze will lead the economy toward steady growth. In effect, the profit squeeze that occurs as capacity utilisation rises and unemployment falls would produces convergence to a stable growth path. The convergence may be monotonic or cyclical as mentioned earlier. This is illustrated by the spiral path sketched in figure 2[8]. Taylor suggested a wage adjustment process as an additional source of dynamic adjustment for an inflationary economy.

Looking at the structural adjustments in Nigeria, one crucial element the authorities have turned a blind eye to is the problem of wages. Nigeria exhibits a situation of high devaluation of the currency, high inflation and high unemployment and yet the government is preoccupied with a solution to stabilising the exchange rate and the external debt problem. Given the hypothesis by Taylor and the Nigerian case, wages catch up with higher prices only at discrete intervals, this is because in equilibrium, wages are fully indexed to the price level. The lagged adjustment means that the average real wage is related inversely to the inflation rate. The consequence is that dynamic mechanism has actual money wages growing faster than inflation when real wages are high.

Rapid money growth produces lower inflation, a higher growth rate and higher real wages when the interest rate effect that raises working capital costs dominates. Faster money growth produces higher inflation and higher growth but lower real wages, when the interest rate effect that reduces investment dominates. Therefore, the dynamic adjustment mechanism simply traces out the path from one steady-state situation to another. Once again, convergence can be monotonic or cyclical (M. Fry,1988,p.103).

Van Wijnbergen model discussed earlier in this chapter, treated inflation as exogenous, but his dynamic model of the Korean economy (1982), treated it as endogenous. His

[8] Taylor,1983, p.35. ' Cyclical convergence towards the equilibrium could be expected'.

dynamic adjustment comprises of two categories:

First is the partial adjustment in the consumption and investment demand, firms price setting behaviour, the unemployment rate and financial asset and liability demands. Second is the expected-augmented Phillips curve used to determine the nominal wage rate w. The workers target real wage is set at w* and at the end of each period, their nominal wage demands are based on their current nominal wage and the price level anticipated in the future time period P^e.

4.3.1 THE WAGE SETTING SCENARIO

Assuming an inflationary shock previously erode the real wage below w*, workers will raise their wage demand; hence we have the expression:

$$w^{\wedge} = C_0 + C_1P^e + C_2(1/U_{t-1}) + C_3(w^* - w_{t-1}/P_{t-1}) \quad [3.5]$$

where; U_{t-1} denotes unemployment rate at the end of previous time period and ^ (hat) representing the percentage rate (%) of change. Thus, if w^* becomes a declining function of U_{t-1}, equation 3.5, can then be rewritten in terms of observable variables as:

$$w^{\wedge} = a_0 + a_1P^e + a_2(1/U_{t-1}) + a_3(w_{t-1}/P_{t-1}). \quad [3.6]$$

The equation for the expectations-augmented Phillips curve included in the Van Wijnbergen model can be expressed as:

$$p^{\wedge} = \pi^e + \Sigma(A_d - y) \quad [3.7]$$

where $p^{\wedge}$ = rate of change in domestic prices.

π^e = expected inflation

A_d = aggregate demand and

y = aggregate supply.

Disequilibrium between demand and supply is eliminated through gradual price adjustment because of the stickiness of the domestic price in the goods market. The other essential factor is the rational expectations. This means that πe will always be equal to π, the actual inflation rate. This can be decomposed into domestic and imported components of the form:

$$\delta \hat{p} + (1 + \delta)\pi^* .$$

where π^* is the foreign inflation rate .

As noted by Mckinnon, monetary contraction has the initial effect of reducing credit in real terms because prices do not rise immediately to their new equilibrium level. Therefore, the net effect on inflation will depend on whether the credit squeeze reduces supply through the working capital channel by more than it reduces investment demand. Empirically, it will be interesting to test the inflation rate for the effects of monetary contraction as well as the demand and supply effect in Nigeria. Especially as some observers of the Nigerian economy are attributing the fall in imports as a reason for the falling rate of investment caused by the credit squeeze (Financial Times survey of Nigeria 1992).

Stabilisation through deposit rate can also produce adverse results as stressed by Van Wijnbergen because with substitution mainly out of curb market loans, the real credit supply is reduced by the interest rate reform. This means that, the cost push inflation would occur in the short-run as higher interest rates are passed on in prices and output falls due to the credit availability effect. This implies that the Mckinnon and Shaw policy instrument model is as destructive as the monetary contraction in the Neo-Structuralist Economy (Fry, 1988,pp.104 - 105).

As for solutions, Van Wijnbergen postulated a growth reducing effect of monetary deceleration as a first step toward increased money stock level. This will then be followed by a gradual reduction in its growth rate[9].

[9] The optimal control solution of Kapur (1982) is also similar to this postulation by Wijnbergen.

However, an initial monetary acceleration in conjunction with interest rate liberalisation will also be required to stabilise growth (Fry, 1988).

For the credibility problem of such a strategy, Van Wijnbergen (1982, p.66), indicated that an initial reduction in the deposit rate of interest would serve just as well as an increase in the money stock level.

Taylor believed the curb market to be agile or competitive, while Chang and Jung do not share his view and I am inclined to share the view of Chang and Jung.
This largely because it will be extremely difficult if not impossible, for the curb market to finance a large scale financial investment or to see the curb market loan system become as competitive as the official financial intermediaries.

In the Taylor, Chang and Jung models, all has the velocity of circulation between currency and time deposits as indeterminate, hence it would appear as if the monetary expansion can stimulate aggregate supply by more than the aggregate demand which will lead to a reduction in the price level.

In Mckinnon, Shaw and Neo-structuralist models, the government uses revenue raised from the reserve requirement tax for transfer payments. For example, assuming the government has a fixed PSBR[10], any increase in real money demand would be met by a reduction in the required reserve ratio. This means that, the marginal financial intermediation of the banking system will be the same as the curb market, especially if the cash base is not entirely outside money.
According to Fry;

> "if one assumes that the official banking system is more efficient at allocating investible funds than the curb market and the households substitute mainly out of unproductive tangible assets, that is inflation hedges, when the real deposit rate of interest increases, financial liberalisation raises the total real supply of credit, the quantity and quality of investment and the rate of economic growth".

[10] PSBR - stands for public sector borrowing requirement.

The Neo-Structuralist models produced exactly the opposite of the Mckinnon - Shaw model, indicating that an increase in the real deposit rate of interest toward its competitive free-market equilibrium level will be accompanied by a reduction in the inflation rate and an increase in the rate of economic growth. Both the Mckinnon-Shaw school and the Neo-Structuralist expect higher reserve requirements to reduce funds available for investment by reducing the demand for deposits or reducing the fraction of a given volume of deposits that are available for investment.

Anthony Courakis (1984, 1986) provided some evidence under which higher reserve requirements would generate a larger volume of deposits. For this condition to happen, the demand for loans would have to be interest inelastic relative to the demand for deposits that equilibrium deposit rate rises with an increase in the required reserve ratio.

Fry's (1981b) partial equilibrium on tapping consumer surplus through differential pricing of non-homogeneous components of the money stock, showed that the monopolistic profit maximising or cost-minimising deposit rate can be secured from a competitive banking system through the imposition of differential reserve requirements against different types of deposits.

4.4 THE TRANSMISSION MECHANISMS AND INCOME DISTRIBUTION

The focus here is on the household allocation behaviour and the issue of substitutability between curb loans, time deposits and currency or inflation hedges. Wijnbergen provided a model which included the time deposits, curb loans and inflation hedge. Although his estimates seem to indicate greater substitutability from curb loans than from inflation hedges into time deposits after an increase in the time deposit rate of interest, evidence of movements in the curb market interest rate following time deposit rate changes do not support the Neo-Structuralist hypothesis that higher time deposit rates reduce the overall supply of credit.

4.4.1 FINANCIAL SAVING AND PORTFOLIO ALLOCATION

The financial aggregate generally consists of currency in circulation, all types of bank deposits excluding government and inter-bank deposits and deposits held in non-bank depository institutions. Financial saving however, is the process of accumulating financial assets, which is directed toward claims offered by depository institutions.

M3 is the growth in the inflation adjusted or real magnitude of the monetary aggregate. Is employed to measure financial saving, and the changes in the liabilities of the financial system represented by the increase in its resources. Therefore, it is taken that inflation - adjusted growth in M3 is an indication of the extent to which financial intermediaries can increase the supply of credit in real terms or in relation to the level of economic activities. The demand side determines the rate of change in the real stock of financial assets whereas, the nominal stock of financial assets is determined on the supply side, and the imbalances between the demand and supply are reconciled through inflation.

Fry estimated a time series for 14 Asian developing countries covering the period 1961 - 1983. His pooled time series result showed that the rate of change in the real stock of financial assets is influenced by the rate of change in per capita permanent or expected real income $\delta\log(y/n)^e$, the change in real deposit rate of interest $\delta(d - \pi)$ and the lagged dependent variable, that is;

$$\delta\log(m) = 0.928\ \delta\log(y/n)^e + 0.847\ \delta(d - \pi^e) + 0.414\ \delta\log(m)_{t-1} \qquad [4.0]$$
$$\qquad\qquad (8.578) \qquad\quad (17.141) \qquad\quad (10.568)$$

R - Squared Bar = 0.573

where m = per capita real money balances (M3)

The above result showed that the interest rate effect on financial saving is substantially greater than the interest rate on national saving. In this case, an increase in the real deposit rate of interest increased the proportion of saving directed toward investment through the financial intermediation channel.

Lanyi and Saracoglu (refer back to chapter 1) provided evidence on the effect of interest rate policies on financial deepening, as measured by the rate of growth in real M2 money balances δlog(M2/P). Where P the price level and the interest rate policy index r yields the following:

$$\delta\log(M2/P) = 4.460 + 6.140(r) \qquad [4.1]$$
$$(5.776)\ (5.873)$$

R-Squared Bar = 0.61

From this result Lanyi and Saracoglu concluded that positive interest rate policies stimulates output growth, and that this stimulus is transmitted mainly through the intermediation of financial assets accumulation.

On the question of causality, Jung's 1986 Formal Granger - Causality tests indicated the predominant direction of causality is from financial conditions to the rate of economic growth.

Fry in his analysis was more concerned about the allocation efficiency of portfolios. He argued that holding institutional interest rates below their free - market equilibrium levels, the proportion of saving directed through financial intermediaries will be sub-optimal. He postulated that an increase in the institutional interest rates towards their competitive free - market equilibrium level would improve allocation efficiency due to the ensuing substitution effect and also enhance the efficiency with which financial intermediaries allocate the larger real volume of investment funds at their disposal.

4.4.2 TIME DEPOSITS, CURB MARKET ASSETS AND CREDIT AVAILABILITY

The empirical question of whether increased demand for time deposits caused by an increase in the real deposit rate of interest reduces the demand for currency (inflation hedges) or the demand for curb market loans, has been a major part of contention between the Mckinnon - Shaw school and the Neo-structuralist.

Van Wijnbergen used a portfolio model in which households allocate wealth among curb loans, time deposits and currency. He estimated the demand for time deposits in real terms, TD/P. His function included the nominal curb market rate ic, the time deposit rate it, and the inflation rate π, all compounded ie;

$$\text{Log}(TD/P) = \hat{i_c} + i_t - \hat{\pi} + \log(\hat{y}) + \log(TD/P)_{t-1} \qquad [4.2]$$

Equation 4.2 is derived from a model of household portfolio allocation among curb loans, time deposits and currency, with real returns on these three assets $r_c - \pi$, $r_t - \pi$, and $-\pi$. The demand for time deposits depends on $i_t - \pi$ and the returns on the two substitute assets can be expressed as :

$$\text{Log}(TD/P) = b_1(i_c + \pi) + b_2(i_t - \pi) + b_3(-\pi) \qquad [4.3]$$

Assuming all assets to be gross substitutes; $b_1 < 0$, $b_2 > 0$, and $b_3 < 0$.
Therefore, rearranging equation 4.3, equation 4.4 is derived,

$$\text{Log}(TD/P) = b_1 i_c + b_2 i_t + ß\pi \qquad [4.4]$$

where $ß = -b_1 - b_2 - b_3$.
Thus $b_3 = - ß - b_1 - b_2$
This represents a restricted coefficient of the interest rates and inflation. In the model, the curb rate coefficient was greater than the inflation coefficient leading Van Wijnbergen to conclude that in the Korean case, the elasticity of substitution is higher for curb market loans than for currency. He however, failed to explain whether or not

the coefficients of the curb market rate and the inflation rate are significantly different. Maxwell J. Fry argued that using actual inflation rate as a proxy for π^e under 2SLS procedure would bias its coefficient downwards (Fry 1988,p.161).

Equation 4.2 represented an estimation of the demand for time deposits using nominal instead of real returns for all the three assets.

(Note; the nominal returns are i_c, i_t, and π which are portfolio allocation among curb loans, time deposits and inflation hedges).

Both Taylor and Van Wijnbergen treated currency and inflation hedges as synonymous, despite the fact that currency yielded a zero nominal return, as opposed to the nominal return on inflation hedges which is the inflation rate.

Fry argued that combining the two models could produce a different results. Fry's assertion was that an increase in the time deposit rate of interest would lead to an increase rather than a decrease in the total supply of credit in real terms. An examination of the behaviour of the curb market rate is another alternative for ascertaining whether or not total credit supply increases or decreases after a rise in the real time deposit rate of interest.

Kohsaka study of Korea (1984), showed Korea's interest rate reform of 1965 to have effect on the curb market rate only from 1967, after which the curb market rate declined. His result showed no change in the real credit supply in the short run but did show an increase in the medium run. However, the interest rate reform in Taiwan did increase total credit immediately.

The possible explanation for the different short-run outcomes in Taiwan and Korea is that reserve requirements were raised four times between 1965 and 1967 in Korea to absorb capital inflows from abroad. The segmented financial market produced cheap foreign credit for large firms but tightens domestic credit conditions for firms unable to resort to the foreign markets. The implication of this is that, it demonstrates the potential opportunities for large firms to utilise their economies of scale to attract

foreign credit, as well as for foreign direct investment. It also highlights the benefits and drawbacks of financial liberalisation.

In the case of Nigeria, the authorities pursued policies which exhibit the features of financial repression from the period 1970 to 1985. These policies include; tight interest rate controls; bank deposit and credit controls; and direct investments. The official interest rates were averaging around 3 percent to 6 percent in the period 1970 to 1981, while at the same period inflation was averaging about 16 percent. Only in 1972 were real interest rates positive for savings deposits. From 1982 to 1983 interest rates were raised to 7.25 percent and 9.5 percent in 1984 to 1985, hence enabling positive real rates in 1985 (see table 4.1).

Table 4.1

Year	GDP at factor cost in constant (Naira) prices.	Nominal Savings Interest Rate (%)	Annual Inflation Rate (%)	Real Savings Interest Rate (%)	Nominal min. Lending Rate (%)	Real Lending Rate (%)
1970	5500.4	3	-	-	7	-
1971	6951.9	3	16.1	-11.2	7	-7.9
1972	7646.2	3	2.7	0.30	7	4.2
1973	11223.6	3	5.7	-2.54	7	1.25
1974	18652.0	3	12.5	-8.5	7	-4.9
1975	21475.1	4	33.5	-22.07	6	-20.6
1976	27317.8	4	22.1	-14.8	6	-13.2
1977	32051.8	4	21.3	-14.3	6	-12.6
1978	33660.4	5	60.5	-34.56	7	-33.3
1979	39938.6	5	11.6	-5.9	7.5	-3.6
1980	43280.2	6	10.0	-3.6	7.5	-2.3
1981	56602.2	6	20.9	-12.3	7.75	-10.8
1982	60483.1	7.5	7.9	-0.35	10.25	2.2
1983	63293.4	7.5	22.9	-12.5	9.5	-10.9
1984	69950.3	9.5	39.8	-21.7	10.5	-20.94
1985	78775.8	9.5	5.6	3.7	9.75	3.95
1986	79740.4	9.5	5.4	3.9	10.5	4.7
1987	n/a	14	10.12	3.5	17.5	6.7
1988	n/a	12.07	39.3	-18.9	16.3	-15.9
1989	n/a	12	40.9	-20.5	25.5	-10.9

Sources: Computed from various issues of The Central Bank of Nigeria (CBN) Financial and Economic Review; The CBN Annual Report and Statement of Accounts; The Nigerian Digest of Statistics.

Between the period 1962 and 1970, the Nigerian government adopted a fixed credit ceilings and interest rate ranges , allocating about 35 percent of each banks loans to domestic firms. However, the international oil price rise in 1973 created a huge domestic liquidity and the government became a net lender to the banks and rejected interest rate rises to restrict credit, hence reinforcing the adoption of credit allocation and control.

During the mid 1970's, the central bank was setting the share of loans and advances which each bank should make to each 16 different sectors of the economy. Agriculture and other priority projects get the lowest interest rate ceilings. It also sets targets for banks to increase branches in rural areas. The banking development in Nigeria is analyzed in the next chapter.

The government indigenisation programme ultimately insisted that 60 percent of the equity in foreign owned banks should be owned by Nigerians and Nigerians should manage the banks. The side effect of this policy was to concentrate Corporate or Economic Power with the commercial banks which hold 80 percent of all bank deposits. The financial repression pushed savers to look for alternative assets which would provide a greater and safer returns.

Despite the low interest rate, financial savings increased because many Nigerians benefited from oil funds. However, this created a problem of capital flights, which grew much more rapidly during the period of relative economic growth, that is, early to mid 1970s.

The cost of capital for investment was higher than necessary because oligopolistic banks were able to insist on high intermediation costs with a wide margin of 3 to 4 percent between deposits and loan rates. When the oil price eventually fell after 1981, the effects of repression became abundantly clear. Big banks profits increased reflecting their ability to attract viable projects, while small and newer state owned banks, with weaker portfolios due to politically directed lending, faced growing bad debts and several of them ultimately collapsed.

4.4.3 INDUSTRIAL CONCENTRATION AND THE INCOME DISTRIBUTION

The evidence from Gilbert Brown (1973), Cho (1984) and Tybout (1983), showed that financial liberalisation do improve income distribution; while Vogel (1984) provided evidence that subsidised credit increases income accruing to the wealthiest 10 per cent of the population from a study of Costa Rica.

Contrary to these studies, the one from Ness (1974) indicated that Brazil's attempt to stimulate capital market development in the Mid 1960's through strong tax incentives to buyers of new equity issues worsened their income distribution.

In the case of Korea, their financial system was not liberalised to the extent of Taiwan, with its selective credit policy confined to exports. For example, between 1966 and 1977, institutional finance in Korea operated a zero real interest rates and also a selective credit policies that directed subsidized funds to priority sectors. The studies from Asian and Latin American countries indicate a support for the theory that low interest rate and selective credit policies do lead to industrial concentration and to a less equal income distribution.

Cho conclusion was that, the low interest rate policy in Korea transferred wealth from small depositors to large borrowers, resulting in highly capital - intensive production techniques being chosen and a lower demand for labour.

Tybout noted that selective credit policy in Colombia favoured large firms, as small firms were liquidity constrained and as such could not expand. The situation was worsened by the artificial low market prices, which induced large firms with access to cheap credit to take over smaller firms, with the consequence of high concentration in the economy.

The lesson from these studies is that financial repression and the ensuing credit rationing worsen's income distribution and increases industrial concentration. Therefore, subsidised credit policies discriminate against rather than favour small borrowers.

The effects of financial liberalisation on inflation and the short run growth is examined by Van Wijnbergen and Fry. Fry's real money demand is determined by one or more price variables and a budget constraint in his model for Turkey. This implies that tangible assets used as inflation hedges rather than bonds are the dominant substitute assets for broad money. He estimated expected income growth first and then adjusts previous years actual income level for expected income growth in current year. His justification for this approach was that the rate of growth in GNP follows a random walk (Fry, 1988,p.167).

The findings by Fry on the relationship between the short and medium term rate of economic growth and the real deposit rate of interest are consistent with the Mckinnon - Shaw model. The assumption based on the Fisherian Phillips curve, is that, if higher real deposit rates increases credit availability in real terms, the rate of economic growth would rise in the short run following an increase in the real deposit rate. However, if real deposit rates reduces total credit availability in real terms due to substitution from curb market loans into time deposits subject to the reserve requirement leakage as the Neo-Structuralist argued, then the rate of economic growth would decline.

It can be implied that disequilibrium interest rate and exchange control systems in Nigeria prior to the economic reforms, indicate that real money demand determines to a large extent the real supply of domestic credit because domestic credit is the primary asset backing the monetary liabilities of the banking system.
For example, using Fry's Turkey model, the supply link between credit availability and real economic growth would come from the ratio of credit to output. The normal or noncyclical growth Yn would then be determined by among other factors, namely the volume and productivity of investment.
This can be expressed by the following equation :

$$\pi = (\mu - v) - \tau^e - \delta(d - \pi)^e \qquad [4.5]$$

Where μ is the rate of growth in M2, v is the population growth and π represents the

continuously compounded rate of change in the GNP deflator. $\delta(d - \pi)^e$ is the expected change in the real deposit rate of interest and τe is the expected growth in per capita real GNP.

Equation 4.5 shows that an acceleration in the nominal money growth would raise the inflation rate and the general price level. Conversely, an increase in the P/P^e (price level / expected price level), would raise growth in real GNP. This can be shown by the following equation:

$$\tau = (\tau^{na}) + (P\hat{}/P^{e}\hat{}) + (d - \pi)^e \qquad [4.6]$$

Where τna is the trend growth in the adjusted real GNP against fluctuations in agricultural output about its long run trend. P is the actual price level, while P^e is the expected price level.

Equation 4.6 represents the standard short run Phillips curve trade-off. It also implies that when expected inflation rises, leading to a reduction in both P/P^e and $d - \pi^e$, the growth rate declines. In the long run equilibrium, P will be equal to P^e because inflation is fully expected or anticipated and only the negative impact of the lower real deposit rate $d - \pi^e$ would be felt. With d held constant and below its market equilibrium level, the long run Phillips curve would produce a negative relationship between inflation and growth in a financially repressed economy such as Nigeria through the real credit supply mechanism, even before the effect of inflation on the savings rate and on the average efficiency of new investment is taken into consideration.

Equations 4.5 and 4.6 also shows that a higher deposit rate of interest reduces inflation and raises the growth rate at the same time. In which case, the optimal monetary policy must set the nominal deposit rate at its upper bound, for example, abolish all institutional interest rate ceilings. According to Fry one method for solving this problem would be to fix a minimum deposit rate and to require banks to satisfy all deposit demand at that rate, thus producing competitive results. This would be subject

to the condition that loan demands are elastic at rates above the competitive loan rate of interest.

Van Wijnbergen proposition in relation to inflation and the short-run growth started off by dividing the economy into export and non-export sectors, with the export sector facing a perfectly elastic supply of credit at a special export loan rate of interest, whilst the non-export sector faces credit rationing. Real consumption, investment and intermediate imports are all affected negatively and significantly by the real curb market rate of interest. His wage equation is a standard expectations - augmented Phillips curve, with unemployment negatively affected by the wage rate. By using Okun's law, unemployment alone is determined by the gap between potential and actual output; unemployment and actual output are both seasonally adjusted .The financial sector of the model determines the banking system's balance sheet .

In his model for the Korean economy, he specified a function that determines the nominal amount of inter-office borrowing by Japanese branches in Korea from their parent banks. Inter-office borrowing is influenced by the ratio of the korean bank lending rate to the Japanese call money and the level of foreign borrowing which is affected by the difference between the Korean bank lending rate and the three - month Euro-dollar rate. The nominal supply of bank loans to the non-export sector was influenced by the difference between the Korean bank lending rate and the bank of Korea's discount rate. He found that direct foreign borrowing by the non-bank private sector was affected negatively by the Euro-dollar rate and positively by the curb market rate.

Like Fry, Van Wijnbergen also used the Tobin's portfolio allocation model in his money demand model. His result for the time deposit demand in real terms was affected negatively and significantly by both the curb market rate and the inflation rate, while positively and significantly by the time deposit rate of interest[11].

[11] See Maxwell J.Fry, money,interest and banking in economic development, 1988. pp181 - 183, and Van Wijnbergen, 1982,pp.140 - 166.

He completed the analysis with an accounting identity for M2 money supply which equals net domestic credit to the government plus bank loans to the export and non-export sectors plus net foreign assets minus other liabilities. The changes in other liabilities are derived from the revaluation of net foreign assets due to exchange rate changes.

The curb market interest rate is determined by the equilibrium of M2 supply and M2 demand. The demand for M2 is the sum of the demands for time deposits and M1. Wijnbergen found that a rise in the time deposit rate produces greater substitution from curb market loans than from M1 component of the money stock into time deposits.

Given that there is no intermediation leakages from reserve requirements in the curb market loans, this pattern of substitution reduces the aggregate supply of domestic credit and raises the curb market interest rate. He then analyzed three dynamic simulations of the model. The first is the base run, followed by a one - short reduction in the money stock by 5% and the third traces the effects of continuous reduction in the monetary growth by 10% each over a three year period.

4.4.4 SUMMARY

The Neo-Structuralist model demonstrates a restrictive monetary policy that raises interest rates and a devaluation that raises the price of imports. That is, an acceleration in the inflation rate and a reduction in the rate of economic growth simultaneously.

The core of the Structuralist model is the incorporation of the Curb Market, in which money lenders and domestic banks intermediate between savers and investors.
The structuralists do not wholly believe that financial liberalisation can yield the desired result under the conditions of standard assumption that financial assets are gross substitutes. Their conclusion was that in practice, financial liberalisation is likely to reduce the rate of economic growth by reducing the total real supply of credit available.
Taylor's model provided an accounting identity and empirical relations that characterises the developing countries economies, by reformulating the analytical models applicable in developed economies to fit the developing economies.
Taylor's result and that of Van Wijnbergen are similar depending on the extent of the financial intermediation that the commercial banks can legally provide. This is more so given that, the Curb or Unorganised Market has no reserve requirement which enables them to direct resources toward firms with greater efficiency.

Taylor, by using a Tobin - type portfolio framework, produces a full model with households holding bank deposits, curb market loans and gold that yields an equilibrium in the curb market.
The analysis by Van Wijnbergen, Chang and Jung 1984, suggests that substitutability between time deposits and curb market loans may not be high for large savers because the assets have different risk attributes. Small savers responds to an increase in the time deposit rate than the larger savers. Hence the effect of financial liberalisation would be an increase in the total supply of credit to the business sector. However, the inefficiency of the curb market in allocation of resources disproves the Neo-Structuralist claim and their conclusion about the effects of financial liberalisation.

Fry, in his analysis of the allocation efficiency of portfolios argued that holding institutional interest rates below their free - market equilibrium levels, the proportion of saving directed through financial intermediaries will be sub-optimal.

A major departure of the Neo-Structuralist from the Mckinnon - Shaw school is on whether increased demand for time deposits caused by an increase in the real deposit rate of interest reduces the demand for currency or the demand for curb market loans.

Chapter 5

STRUCTURAL ADJUSTMENT AND THE NIGERIAN FINANCIAL SYSTEM

PRODUCTION

On the review and appraisal of the structural adjustment programme, the Nigerian minister for finance, Chu Okongwu stated:

> "A useful departure point is a review of the developments and the proximate causes of the economic crisis which led to the structural adjustment programme (SAP). Although the causes of our predicaments are by now well-known, human memory is rather short and it is easy to forget or play down past problems especially where the pains have worn thin. A review of the antecedents is therefore essential as a backdrop to the introduction of the SAP[1]".

Growth could be taken to imply positive changes in the economic variables but such changes might not necessarily guarantee national development which should be reflected in quantitative and qualitative improvements in the living conditions of the people. As stated in the aborted Fourth National Development Plan 1981 - 85 Guidelines: "The over-riding aim of development is an improvement in the living conditions of the people using the resources, human and material, with which the country is endowed".

The Second and Third National Development Plans are comprised of laudable objectives and programmes which were thwarted by incongruous policies.

The Fourth plan was aborted by the manifestations of policies pursued in the two previous plans. The Second and Third Development Plans attributed a higher priority to agro-allied[2] and export industries but in the end they received low policy incentives. For example, the Operation Feed the Nation, the National Accelerated Production Programme and the Green Revolution, all were introduced in order to mobilise resources for agricultural development.

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[1] Dennis Odife, Structural Adjustment and Economic Revolution in Nigeria 1989,pp.3 - 7.

[2] That is the agricultural and related products.

The Economic Stabilisation Act, which involved some stringent exchange and trade control measures provided no significant improvement in the country's foreign exchange position, or the domestic economy. This culminated to the introduction of more stringent measures in 1983 and 1984 and which were retained in the 1985 budget, but yielded little result. Three key factors that are important to production in the Nigerian economy include: Agriculture, Industry and Finance.

5.0 AGRICULTURE

The Nigerian economy was significantly transformed from one dependent on agriculture to one heavily dependent on oil. This is shown by the contribution made by agriculture to Gross Domestic Product (GDP) declining from 40 per cent in the early 1970's to about 20 per cent in 1980, whilst by 1980, oil accounted for about 22 per cent of GDP, 81 per cent of government revenue and 96 per cent of export earnings.

At the time of independence in 1960, the main source of revenue to the then regional governments was agriculture. Agriculture contributed to about 70 per cent of the total GDP and above 80 per cent of exports. Nigeria's total land area is about 231 million hectares of which about one third is arable land and land under permanent crops; and more than half of the potential agricultural land in the country is not utilised. Hence, Nigeria has the potential for agricultural growth although this sector has been systematically neglected[3]. Confirming this view is the fact that annual growth in agricultural production was averaging about 1.5 per cent in the 1960s and 1970s, while the economy as a whole was growing at 6 per cent in the 1960's and more than 8 per cent after 1973 when the price of crude oil escalated.

With reference to the reasons for the decline in agriculture, the third national development plan identified the following factors:

1. Shortage of qualified manpower in key areas;

[3] Essien, E. Nigeria under SAP, 1990,p.20.

2. Inadequate supply of agricultural inputs;

3. Inadequate extension services;

4. The poor condition of feeder roads and other transport facilities;

5. Lack of effective supporting services such as farm credit etc;

6. The problem of land ownership imposed by the land tenure system;

7. Problems of diseases and pests;

8. The problem of labour shortage in the rural areas as a result of rural-urban migration;

9. Inadequate technology;

10. Drudgery in farm work and low returns from agriculture which forces the workforce to migrate to urban areas instead of pursuing a career in farming; and finally

11. Labour shortages especially at peak periods of demand during the farming season.

The guidelines to the third plan included one more; " failure to offer price incentives to food crop producers and the payment of low producer prices for export crops" .

Moyart, M.G in 'Approach to the problems of Nigerian agriculture', in the development of Nigerian agriculture, pp.12 - 14, included;

"Psychological resistance and the million naira mythology".

This implies that it is easier to make large and quick profits on trade than on agriculture. This becomes the first mental barrier termed the 'Trade Spirit' and has become worse since the 1973 oil boom, when quick profits could be made. The million naira mythology implies lack of recognition for the farmer, when during the boom period, no investment was respectable if it was not at least one million naira.

The over involvement of the government in agriculture is also part of the problem. No effort was made to solve the problem of rural transportation and infrastructure inspite of its mention in the second plan. The same applies to the problem of diverging rate of returns in the different sectors of the economy .The current reforms have led the way in addressing all these problems.

5.1 INDUSTRY

The evaluation in this section is mainly of policies adopted to encourage manufacturing production, even though the policies turned out to be repressive in the long run. In the last two decades Nigeria has undergone a very substantial growth in the manufacturing sector, such as the production of soft drinks, brewing, cement, paints, flour, electronics (radios, television sets), detergents & soap, motor vehicles (mainly assembly plants for Peugeot cars, Toyota, Leyland Rovers etc) and refined petroleum products.

In 1974, the total value of gross output of the manufacturing industry was 1.5 million naira, and in 1978 the value had risen to 5 million naira.

In 1958, according to the second development plan:

> "the contribution of manufacturing activity to GDP at current factor cost amounted to N81.0 million or 4 per cent of the GDP and in 1963, the value added had risen to N157.8 million and the percentage contribution had gone up to 5.6 per cent. The annual rate of growth during the five year period (1958 - 63) was 17 per cent".

Despite these early encouraging signs industrial growth significantly slowed down throughout the 1980s. Between the period 1965 and 1980, the average annual growth rate of the manufacturing sector was 14.6 per cent but this fell drastically to 3 per cent between the period 1980 and 1985. While the 1965 - 80 period recorded a positive 13.4 per cent average growth, the 1980 - 85 period recorded a negative growth of 5.8 per cent (World Bank Development Report, 1987, Statistical section).

According to the Central Bank of Nigeria Annual Report, production in the manufacturing sub-sector was seriously hampered by the shortage of industrial inputs as a result of the continued acute scarcity of the foreign exchange needed to import them. Most manufacturing industries suffered considerable capacity under-utilisation and persistent postponement of production plans as raw materials orders became unfilled due to the inability of those industries to secure sufficient import licences backed up by foreign exchange.

On an annual basis, the index of manufacturing production which stood at 454.7 (1972 = 100) in 1983 declined to 371.8 in 1984, representing a decline of 18.2 per cent in 1984 compared to the decline of 5 per cent in 1983 (CBN Annual report 1984, p.24). In effect this indicates the consequences of the repressive policies the country had followed during those periods; thus confirming the urgent need for economic liberalisation.

The industrial policy of the immediate post independence era was that of import substitution, supported by a number of fiscal and other incentives such as income tax relief granted under the pioneer status, the Approved User Scheme which allowed for the importation of raw materials either free of import duty or at very concessionary duty rates and the accelerated depreciation of capital.

The Second Development Plan included the following industrial policy objectives:

1. To promote an even development and fair distribution of industries in all parts of the country;
2. To ensure a rapid expansion and diversification of industries in all parts of the country;
3. To increase the incomes realised from manufacturing activity;
4. To create more employment opportunities;
5. To promote the establishment of industries which will cater for external trade for revenue purposes;
6. The continuation of the import substitution policy;
7. To initiate schemes designed to promote internal manpower resource development in the industrial sector and;
8. To raise the proportion of domestic ownership of industrial investment.

Since the introduction of Structural Adjustment in 1986, the growth in manufacturing production began to rise, but at a much reduced rate, which according to the Central Bank Report (CBN), 1989, at 516.4 (1972 = 100) the index of manufacturing production rose only by 2.2 per cent in 1989, compared with the increases of 16.9 and 33.7 per cent in 1988 and 1987, respectively.

The marginal increase in the level of manufacturing production was confirmed by the CBN's nation wide survey of six hundred and forty two businesses in which 56.8 per cent responded. Respondents attributed low manufacturing activities to the shortage of raw materials, the high cost of replacing obsolete machinery and materials and the sharp increases in interest rates. The high resulting costs led to high prices of finished goods, reduced demand and high levels of inventories. In addition, the average level of capacity utilisation rise only marginally by 0.9 to 42.4 per cent[4].

In the mid 1970s, the Nigerian Enterprises promotion Decrees were promulgated[5]. The decrees reserved certain activities for Nigerians and enabled the government to enter into the business of managing the financial institutions. The indigenisation decree arguably had the effect of driving foreign private capital out of the country, while at the same time encouraging Nigerian entrepreneurship. Nigeria's share of manufactured exports was less than 0.2 per cent in 1987 and 1 per cent in 1991[6].

5.2 FINANCING

The finance for development in the country has come mainly from the petroleum industry. The incorporation of the oil industry into the structure of the Nigerian economy has both merits and demerits. The merits were more significant after the Nigerian Civil war when there was a great demand for funds both internally and externally for reconstructing the damage and reviving the economy for growth and development.

The demerit of the oil industry arose from the view that oil revenue flowed into the treasury as if providence was compensating the nation for damages suffered in the war years and in the process the unexpected revenues were misappropriated.
In 1970 oil revenue was N509.6 million. It trebled to N1,893.5 million in 1973 and

[4] Central Bank of Nigeria (CBN), Annual Report and Statement of Accounts 1989,pp.28 - 30.

[5] The Nigerian Enterprises Promotion Decrees 1974 and 1977.

[6] World Bank Development Report 1987, p.47 and 1991, p.234.

following the oil price rise in 1973 revenue quadrupled to N5,365.7 million in 1974, reached a peak of N13,523.0 million in 1980 and then started a downward slide[7].

The huge petro - naira led to a massive influx of contractors and suppliers into the country. It was during this boom period that Nigeria entered into the net of the International Capital Market (ICM) and with it came the Nigerian external debts. With the exceptions of direct revenue and foreign exchange benefits, the oil industry had no direct developmental impact, mainly for the reasons stated above. The oil industry is highly capital intensive and as such, in terms of employment its contribution was minimal (25% of the GDP and 6% of the labour force). The extent of technological transfer is negligible hence the only gain was its fiscal redistribution effect.

While the oil industry was directly financing government expenditure, the financial system was taking care of the needs of the private sector under repressive terms. For example, banks operated strictly in accordance with government policies. Banks like any other businesses would seek to maximise their profits in areas where the demand for loans is high such as in traditional short term businesses such as financing exports and imports. As at December 1979, commercial banks were still having 80 per cent of their loans maturing in 180 days and only 2 per cent exceeded 5 years.
The consequence of this was that commercial banks hardly ever financed industrial activities. Therefore, the government was obliged to establish the specialised banks.

During the period 1969 to March 1972, the method used was that of setting the rates of changes for aggregate and components of commercial banks loans and advances. This was reintroduced in 1976 and continued until the 1990s; but the aggregate and credit ceiling was dropped between the period 1972 and 1976; while the authorities concentrated on sectoral distribution of credits. The Minimum Lending Rate (MLR) in 1980 was 7.5 per cent with other rates ranging up to 11.5 per cent (refer back to table 4.1 chapter 4 for the MLR).

[7] See Essien, E . Nigeria Under SAP, 1990, pp.27 - 33.

Savings were low because with the existence of higher returns from other investments, according to Essien (1990, p.32), total savings since 1972 had consistently been on the increase but not because of the attractions of yields but on the fact that the boom period made the society generally excess liquid. The capital market can not be said to have provided sufficient autonomous development funds. In the indigenisation era, the stock exchange was boosted but that was because the companies that patronised it were forced to do so. None went to the exchange voluntarily for the purpose of raising funds for expansion or new projects. The reason being that low interest rates at the banks meant that companies would go for such loans instead of going through the ordeal of raising funds in the capital market.

5.3 THE NIGERIAN POLITICAL ECONOMY: THE NEED FOR REFORM

The best way to begin a study of the Nigerian economic instability is to note the country's historical experience and the consequent distortion, disarticulation and underdevelopment of institutions and structures and forces of production and exchange.

Ihonvbere 1990, indicated that Nigeria's historical experience meant that the institutions, forces and factors of politics, production and exchange were severely deformed and disarticulated to a point where they lacked the internal and relatively autonomous stimulus for growth, development and accumulation. He argued that:

> "Since Nigeria's independence in 1960, the country has gone through novel developments which have consolidated and or influenced some shift in the country's relations with capital and its historical determined location and role in the international division of labour; a civil war, an oil boom, several coups, attempted coups and counter coups, partial nationalisation and indigenization programmes. Experiments with the Westminster parliamentary and American executive presidential systems of government. Currency changes, a new anthem, new states, a new federal capital, new educational, agricultural, urban and industrial policies and currently a structural adjustment programme through the inspiration of the World Bank, IMF and the European Clubs[8]".

[8] Julius O. Ihonvbere, Structural adjustment, the coup and democratization in Nigeria ; African Quarterly, vol.29, nos 3 - 4 1990 pp.17 - 39.

These changes and developments consequently influenced the nature of social classes, the power, and structures of the state, the content and direction of class contradictions and class struggles as well as class relations. Inspite of all these 'influences' the country remains debt-ridden, foreign dominated, unstable, dependent and underdeveloped. The frustration arising from the government inability and weaknesses to increase legitimacy and ensure stability has compelled it to become defensively radical and repressive. Export concentration leading to excessive dependence on a foreign dominated oil sector culminated in the neglect of agriculture and the rural areas, rising food imports, migration to the urban centres, waste and corruption (See section 5.0 to 5.2).

Ihonvbere's postulation was that the inefficiency, corruption, decadence and confusion among the Nigerian bourgeoisie's and the institutions of the state have militated against the development of a clear and sustainable ideological position, the promotion of industrialisation and rational accumulation. He argued that the crisis of dependent capitalist development, arising in the first instance from the historical disarticulation of the Nigerian economy and secondly from the colonial corruption, waste, mis-management, indiscipline, decline in oil revenues and finally pressures from credit clubs and international finance institutions that forced the government to embrace the structural reform.

5.3.1 THE REFORM: BACKGROUND, AND CONSEQUENCES

Although the Babangida regime is the first Nigerian government to seriously consider and implement the Structural adjustment Programme, the policy responses to the economic crisis predated his administration. The General Olusegun Obasanjo regime in 1977 introduced some 'belt-tightening' measures at the start of the decline in foreign exchange receipts from oil exports. These measures included; restrictions on imports of certain goods,elimination of some benefits to public servants and some tax measures. The measures unfortunately failed to achieve the intended objective due to lack of adequate co-ordination. The civilian government that took over in 1979, once again, in the face of declining oil rents, massive corruption, misplaced priorities and gross mismanagement was expelled in April 1982 to introduce 'Austerity Measures'

through the Economic Stabilisation (Temporary Provisions) Act, as its response to the structural crisis. In January 1983, the Shehu Shagari government appointed an 'Expert Committee' on the Nigerian economy under the chairmanship of Dr J.S. Odama. The committee recommended:

> "a fundamental structural adjustment as the best hope for a virile and responsive economy[9]".

The broad outline of Shagari's austerity measures included, negotiations for an adjustment loan from the International Monetary Fund (IMF), the payment of re-scheduled short term debts, imposition of new user fees, taxes, levies and tolls, the general retrenchment of workers in the public services, funding for only core capital projects, reduction of public expenditures, incentives to foreign investors and the privatisation of public assets among other monetarist measures.

The Buhari regime which overthrew the Shagari administration, inherited a crisis ridden economy and desperate political environment with inflation averaging above 45 per cent. The regime's response to the repression were first; political repression through the promulgation of draconian decrees and proscription of unions. The second; economic; counter trade involving the battering of Nigeria's oil for goods and services and the acceptance of structural adjustment as the only option to putting the economy on the path to early recovery and self-sustained growth[10].

The life of the Fourth National Development Plan was extended in addition to rapid repayment of external debts, mass retrenchment of workers, reduction of budgetary allocation to ministries and public institutions, privatisation and commercialisation of public corporations and increased incentives to transnational corporations. The authorities at the same time refused to accept the IMF prescriptions on devaluation, trade liberalisation and the removal of subsidies from petroleum.

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[9] J.S. Odama, SFEM in the context of a developing economy; in J. Attah et al (eds) , The Nigerian Economy under (S)FEM (Zaria: Dept of Economics Ahmadu Bello University, Nigeria, 1985 p.11).

[10] Major General Buhari, M ; Address at the Nigerian Institute For Social and Economic Research (NISER), Ibadan, 26 Nov. 1984.

When Babangida overthrew the Buhari administration in the coup of August 1985, his government accepted the structural adjustment and dispensed with all sentiments on the possible consequences of adjustment. The government immediately began to implement the conditionalities of the IMF. First, a 15 month economic emergency period was declared during which a stabilisation programme was introduced. This consisted of measures such as a 30 per cent levy on imports, 2 - 20 per cent economic recovery levy on workers, the removal of 80 per cent subsidy on petroleum and the extension of wage freeze. These policies enforced the alienation of the people from the state and increased the extent of poverty and other social vices.

The President in July 1986 admitted that the stabilisation programme had little impact on the economy and that the performance of the economy was mixed given the adverse effect of reduced oil receipts and slow non-oil exports. Nigerian creditors could not take the rejection of IMF loan and as a result the nations credit rating dropped from about 55 per cent in 1980 to 24 per cent by March 1986. All this resulted in Nigeria's inability to reschedule its huge external debt, thus the stage for tougher economic measures (Newswatch (Lagos) SAP: what alternatives, vol.10(4) July 24 1989,pp.14 - 15). Consequently, most importers who had import licences could not effectively use them for opening letters of credit and the flow of essential imports was seriously impeded [Odife 1989,p.5].

In July 1986, the government in pursuit of its reform policy had to introduced a new economic measure under the supervision of IMF and World Bank officials.
The programme had four objectives:

1. To find the real value of the naira;
2. Overcoming inefficiency in the public sector through rationalisation and improved public expenditure;
3. Relieving the debt burden through a comprehensive rescheduling of Nigeria's medium and long-term debts;
4. Encouraging the net-inflow of foreign capital while keeping the lid on foreign loans.

5.3.2 REFORM AND THE ECONOMY

The emergence of Structural Adjustment Programme (SAP) in the 1980's was to enable developing countries primarily in Latin America and Africa to reduce their balance of payments[11] deficits. It is a device for shifting from state to market led policies with emphasis on pricing as the major instrument for organising the economy. SAP's other objective includes measures to revive agricultural production ie food and cash crops, through a combination of policies involving devaluation and reductions in state expenditure and subsidies.

Sumit Roy postulated that the root cause of the Nigerian and other LDC's repression was due to the recession (1979 - 81) which emerged from a combination of factors. The factors are referred to here as" THE CRISIS CYCLE".

At the start was the sharp and steep rise in oil price which had a direct and indirect effects on the world economy. The price increase then accelerated inflation in the developed economies leading to their adoption of deflationary policies which led to unemployment and lower growth rate.

The LDCs facing problems of not only having to finance deficits in their balance of payments because of the increase in oil import prices but also a fall in their exports to the developed countries; hence a decline in their terms of trade and outflows of capital. (The Nigerian trade policy and tariff is discussed in detail later in this Chapter and Chapter 6). The LDCs problem was worsened by the increase in interest rates. The Latin American economies in particular were able to borrow from Western Commercial Banks which had recycled surplus oil revenues built up by OPEC countries. As Roy (1990) put it:

> "indeed, this was a major factor behind the accumulation of debts by the developing countries".

The other factors which motivated the Structural Adjustment Programme or Economic Reform and the role of the major international institutions mainly, the IMF and the World Bank are:

[a] Economic reform was needed in response to the debt crisis centred on measures

[11] Sumit Roy, SAP, Economy and Rural Sector, African Quarterly, vol.30,1990,pp.1 - 12.

which could bring about economic recovery, repayment of external debts and restoration of balance of payments equilibrium[12].

[b] Economic reform has been underpinned by a shift from state to market led ideology, centred on allowing the price mechanism to shape economic activities (see also Ihonvbere 1990). The objective of the strategy is to reduce domestic output and demand for imported materials and investment goods. This will in turn reduce incomes and slow down demand for consumer goods. In addition state expenditure has to be drastically curtailed.

To realise these measures, the currency has to be devalued; at least to boost exports and encourage domestic production of goods to replace imports which are made more expensive. Hood (1987), Roy (1990), "a mixture of devaluation and expenditure cuts form the basis for correcting the imbalance of international payments while maintaining full employment of resources".

5.3.3 THE INTERNATIONAL MONETARY FUND AND STRUCTURAL ADJUSTMENT

The grants from the IMF and World Bank, are conditional loans, which stipulated the adoption of specific policies by borrowing countries. The IMF stipulated the 'Structural Adjustment Facilities (SAF)' in March 1986, which became effective from December 1987.

The purpose of the IMF (SAF) was to provide credit facilities to low income countries (of which Nigeria is now classified as, after been grouped as a medium oil exporting country in the 1970's and part of 1980's); with a protracted balance of payments problem. Moyo and Amin, 1989, noted that:

> "the impetus was on assisting eligible member countries to undertake strong three year macro-economic and structural adjustment programmes to improve their balance of payments position and foster growth".

[12] Sumit Roy, SAP and Rural Sector, 1990, pp.2 - 3.

5.3.4 THE WORLD BANK'S ROLE

The World Bank in 1980 initiated a 'Structural Adjustment Loans (SAL)' to Sub-Saharan Africa which is usually expected to last for 3 to 5 years.
Following in the footpath of the IMF loans, the recipients must submit a letter of intent in which they undertake to comply with the conditions.

Unlike the IMF however, the World Bank do not insist on quantification of macroeconomic variables but do demand a restructuring of tariffs, abolition of price controls, increasing prices of public goods and services, promotion of exports and devaluation of currency. Institutional and government measures are expected to support specific economic sectors such as industry and agriculture. The World Bank's SAL are often linked with the IMF stabilisation loans.

5.3.5 CRITIQUES OF THE IMF/WORLD BANK LOAN POLICIES.

Given the impact of the structural adjustment programme on Nigeria, there are now considerable debate among academics, politicians and ordinary citizens about the virtues of such policies. The critical argument against the fund and the bank is their over-emphasis on growth and reduction of balance of payments deficit and the neglect of social protection for the poor.

The IMF especially has been too concerned about repayment of external debts which brings into question the whole issue of adjustment and whether it is simply for repayment of debt or if a wider concept of development is needed to be incorporated into the analysis. The debt based definition of adjustment unfortunately failed to take into consideration the real concern of growth and equity which the proponents of international trade cited as the major cause of domestic instability.
The overall criticism of the IMF/World Bank SAP policy is that it produces adverse socio-economic effects with multinationals, banks, technocrats, importers and exporters and the ruling groups being the main beneficiaries[13].

[13] See: Roy, 1990;p.5, Ihonvbere, 1990;p.23, This Week(Lagos) - The New Rich: The Rising Cocaine Profile, The Booming Corruption, 1990, 2 April, No.167.

5.4 A BRIEF OVERVIEW OF SAP IN AFRICA

There are two dimensions of SAP in Africa; first the macro and second the sectoral. This view originates from the World Bank classification of the region into four groups.

1. Countries with strong structural adjustment program;
2. Countries with weak structural adjustment program;
3. Non-adjusting countries; and
4. North Africa.

Group 1 GDP was found to have negative average annual growth rate of about 1.5 per cent during the period 1980 - 87. Their performance also varies from year to year (refer back to chapter 3 table 1.3. for the Nigerian GDP).

The groups 2 and 3 achieved an overall average annual GDP growth rate of 1.2 and 3.1 percents respectively during the same period as group 1. Groups 2 and 3 achieved annual positive growth rates throughout the period except in 1983 -1984 for weak adjusting countries and 1986 - 87 for the non-adjusting countries.

Group 4 had an average annual GDP growth rate of 1.5 percent positive for the period 1980/87 with a negative growth rate only in 1980/81. The overall annual growth rate for Africa as a whole was a relatively low 0.4 percent between 1980 and 1987 as a result of the poor performance of the group 1.

Table 5.0

Groupings	**Type of Program Strong SAP**	**GDP Growth Rate 1980 - 87**
1	Weak	-1.5
2	Non-Adjusting	1.2
3	N. Africa	3.2
4		1.5
Overall Average	(All)	0.4

Table 5.1 Sub-Saharan Africa

Ratios	Pre - Adjustment (%)	Post Adjustment (%)
GDP Growth	2.7	1.8
Investment/GDP	20.6	17.1
Budget Deficit/GDP	-6.5	-7.5
Debt/Service/ Export Earning	17.5	23.4
Current A/c /GDP	-9.4	-6.5

Source : Ibid: 23, World Bank, 1988.45

According to the World Bank study in 1988 of Sub-Saharan African countries that adopted the SAP (see table 5.1 above), comparing the key economic indicators in the pre-adjustment with the post adjustment period, the GDP growth declined from 2.7 percent to 1.8 percent while the investment/GDP ratio reduced from 20.6 percent to 17.1 percent. The budget deficit rose from -6.5 percent to -7.5 percent of GDP. The Debt Service/Export earning ratio rose from 17.5 percent to 23.4 percent while the Current account/GDP ratio improved slightly from -9.4 percent to -6.5 percent.

The second view takes into account the contribution to GDP by the rural sector. Ghai and Smith 1987, on the role of agricultural production in Africa showed that SAP has a significant effect for growth and poverty.

The Structural Adjustment Programme (SAP) assumed that peasants can respond to changes in prices especially with the determination to produce sufficient food for the household. As farms expand the surplus is marketed, thus leading to export crops been produced by the household farm. The pricing mechanism has been affected by the use of devaluation and reductions in state expenditure which has a significant effect on the agricultural sector and the economy as a whole.

The hypothesis is that, reliance on the market mechanism and the dismantling of marketing boards have been a major instrument for stimulating agricultural exports.

Mosley and Smith 1989[14], found that the impact of SAP in some African countries that had adopted it, for example, Ghana, Cameroon and Tanzania, created a big doubt as to its effectiveness. This is more so given the severe devaluation by inflation and reduction in overall development expenditure, including agriculture and related social welfare sectors.

Nigeria has the benefit to learn from these countries in that some of their reforms started first. Never-the-less, only far reaching structural adjustment, well thought out and effectively implemented can be anticipated to secure economic recovery, growth and development in Nigeria. The other crucial factor when considering Nigeria in relation to other Sub-Saharan African countries is that, as Laurence Harris[15] commented;

> "Nigeria is very unique and different in nature and circumstances from the other economies that has implemented the structural adjustment programme".

This does not necessarily mean that the country should be treated fundamentally different from the rest of the region or any other country in the world undergoing similar process however, certain criteria have to be applied in evaluating the Nigerian system.

On the question of aid, it is one method of assisting to compensate for cuts in expenditure (Roy, 1990,p.7; Ibid,332 - 333) but aid flows to Africa were at best constant rather than increased in real terms during the early 1980s with aid been reversed from capital projects to conditional project loans mainly to finance consumption. As a result, the weight of such attempts at fiscal stabilisation has fallen on governments capital spending. It has added to the diminished virtues of adopting the IMF/World Bank guiding principles of adjustment with growth. Nigeria's total debt stock at the end of 1990 was estimated at US$36 billion. Out of this amount, about 52 per cent is owed to the Paris Club of Official creditors, 18 per cent to the

[14] Mosley, Paul and Smith, Lawrence, Structural Adjustment and Agricultural Performance in Sub - Saharan Africa 1980 - 87, Journal of International Development, vol.1; No.3 July,1989.

[15] Prof. Laurence Harris comment during a discussion on my essay about the Nigerian economic reform.

London Club of Commercial Bank Creditors, 11 per cent to Multilateral Institutions (ie World Bank), 5 per cent to East Europe governments and 14 per cent in Promissory note obligations. Between 1980 and 1990, the total debt stock of Nigeria quadrupled from US$9 billion to US$36 billion.

Nigeria however, has two very important factors working to its advantage.
First is a large domestic market and second is the potential to become along with South Africa, one of the continent's two major growth poles. Assuming a growth rate of 3 percent, Nigeria will need to achieve a GDP growth of at least 55 per cent per annum for the rest of the decade to recoup some of the decline in living standards experienced since 1981. Gilbert da Costa (1992) indicated that such a growth rate can only be achieved if the country doubles its investment ratio from an average of 11 percent of GDP in the 1980's to 25 percent while simultaneously improve investment efficiency to a level more superior than that of the 1980's[16].

The government floated the national currency Naira on the 5th of March 1992. The short term objective of the floatation was to deregulate the amorphous foreign exchange market, thereby bridging the gap between the official and unofficial rates of the naira. The other aim was to use the prescription of SAP to calm the nervous economy[17].

[16] Gilbert da Costa, Looking for Clues , West Africa, 1992, pp.916 - 917.

[17] Nigeria at the crossroads, West Africa 1-7/6/1992,p.909.

5.5 THE STRATEGIC POLICIES OF THE STRUCTURAL ADJUSTMENT PROGRAMME (SAP)

The strategic policies of the structural adjustment can be categorised as[18]:

1. The strengthening of demand management policies and adoption of measures to stimulate domestic production and the supply base of the economy;
2. The implementation of realistic exchange rate policy through the establishment of the second-tier foreign exchange market (SFEM)[19];
3. Rationalisation and restructuring of the tariff regime to assist the promotion of industrial diversification, trade and payments liberalisation[20];
4. The determination to reduce complex administrative controls and to promote reliance on the market forces[21];
5. The adoption of appropriate pricing policies for public utilities and privatisation of the public sector enterprises.

Structural adjustment was regarded by the authorities as a means for establishing the appropriate financial environment for economic growth and promotion of policies that can mobilise resources for development and ensuring its productive utilisation.

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[18] see also Robertson - Policy Adjustment in Africa 1992,pp.183 - 85.

[19] A device targeted at eliminating the over-valuation of the Naira through the setting up of a viable Second Tier Foreign Exchange Market (SFEM) assisted by adjustments to the official rate. This is with the hope that it will bring a convergence of the two rates.

[20] As a means for relieving the debt burden and at the same time attract a net inflow of foreign capital, while keeping a lid on foreign loans .

[21] As a measure to overcome the observed public sector inefficiencies through improved public expenditure control programmes and the rationalisation of national assets .

5.5.1 ACTS, DECREES AND DIRECTIVES.

HOW THE FINANCIAL REPRESSION ORIGINATED.

The recession of 1982/83 forced the Government to introduce austerity measures in Nigeria. For the first noticeable time, the curb market rate exceeded the official exchange market (from N1.50 to £1, to N5 to £1, and now N30 to £1). A gross excess demand existed for all consumer goods in the country. Nigeria's exports fell sharply with oil being the only principal export commodity and production quota by OPEC for Nigeria pegged at 1.3 million barrels per day. The recession in the industrialised economies forced the oil price to fall which led to the fall in Nigeria's foreign exchange earnings (see the Crisis Cycle section 5.3.2).

THE ECONOMIC STABILISATION (TEMPORARY PROVISIONS) ACT 1982

As a result of the fall in Nigeria's foreign exchange earnings the Economic Stabilisation Act was passed to assist the authorities in rationalising the limited foreign exchange resource[22]. The fiscal, exchange control, monetary and credit policies of the 1983 Federal Budget contained provisions for:

[1] Reduction of imports; and

[2] Conservation of foreign exchange.

From then onwards, several commodities were gradually placed under import licensing restrictions, while the imported ones were subjected to high custom tariffs.

In an attempt to conserve foreign exchange, compulsory advance deposits against imports was required on a scale ranging from 250 per cent for cars to 10 per cent for raw materials. In the area of credit, interest rates which had been increased in 1982 were reduced by one percent across the board. In terms of the results of the 1983 measures the critical question is why are the measures so different from their objectives. According to Odife (1989), the answer is that the government deceived or misled itself into seeking temporary provisions to solve what it perhaps termed a temporary problem which turned out to be a protracted one by emphasising on the oil glut as the main problem. The other explanation is that the analysis of the economic

[22] Economic Stabilisation (Temporary Provisions) ACT 1982, Federal government printer Lagos.

problem was incorrectly diagnosed. One identified problem was the excess demand which built up pressures in the economy and consequently overflowed into the foreign exchange market. In an attempt to reduce demand the government only succeeded in reducing supply. The 1984 budget proposed some major structural adjustments which included a reduction in government expenditure, privatisation, increase in interest rates and procurement of external loans. The major policy objectives of the budget include reduction in imports, foreign exchange and stimulation of domestic production. Despite the potential merits the repression continued. The government expenditure only fell 3 per cent from 1983, agriculture only got a proposal to set up a special fund for aid. The establishment of a National Loan Fund negates the proposal to make state owned enterprises more commercial[23].

On the demand side, the economic and fiscal policies has been repressive.
The repressive policies include: low interest rates, underpricing of securities, price controls, subsidised petroleum products and foreign exchange rates control. With these measures, the producers had to deal with high cost of imported raw materials, high tax and tariffs, low rates of capital allowance, dividend restrictions and the Compulsory Advance Deposit Scheme introduced in 1982.
The effects of these repressive policies are:
[a] a reduction in production output;
[b] a wider gap between demand and supply; and
[c] a spiralling prices.

The demand side measures has over the years led to excess demand by the government and the private sector for housing, labour, consumer durable and non-durable like foreign travel and medical facilities. Therefore, to determine whether the supply-side measures can be successful or not, the repressive policies (ie the demand side measures) has to be eliminated first (that is low interest rates, price controls, free housing, free education, high taxation, and foreign exchange controls).

[23] Odife, D; Structural Adjustment and Economic Revolution in Nigeria, 1989,pp.14 - 15.

5.5.2 REMEDIES TO THE REPRESSIVE POLICIES

The remedies will include measures that will stimulate domestic investment, production and increase the supply of goods and services. Among the instruments that can be used are: Lower corporation tax to encourage investments in industries etc, Tax on dividends and elimination of restriction on the amount of profits payable as dividends. To introduce measures such as increased capital allowance to encourage investments in assets and a stop to state governments practice of deficit financing (given its effect of creating a rise in expectations which leads to higher demands) as well as the federal government budget deficit. And finally a stop to the building of white elephant projects (ie uneconomic capital intensive projects) such as the Ajaokuta Steel Complex, the Kaduna Refinery and the Steel Rolling Mills.

5.5.3 THE ISSUE OF TAXATION

The Nigerian taxation system is complex. If that is to simplistic, look at it as a spaghetti junction of motor free ways. On the income tax level a Pay As You Earn (PAYEE) system operates while on the corporation tax side confusion operates. Companies has to pay some tax to the government in the form of customs duties and when goods are produced, even as they are taken out of the factory gates, excise duties are paid to the federal government. When profits are realised a 45 percent corporation tax is paid to the federal government and 15 percent to the state government. This means that in reality more than 60 percent is being paid by companies in the form of corporation tax alone.

Foreign investors in turn have to apply to the Federal Ministry of Finance for permission to remit their own share of the dividends. Usually before this is processed by the Ministry it is time for the next financial year's dividend to be declared. The system itself is an evidence as to why foreign investment was so negative in the country prior to the SAP. The system does not encourage voluntary compliance, nor does it distinguish between manufacturers and traders. It does not indicate the direction to which resources should be channelled. Corporation tax ought to be split into two different rates between public limited companies (plc's) and non-public limited companies as in the United Kingdom Corporation Tax System.

5.6 THE EXCHANGE RATE POLICY : OPTIONS AND CONSEQUENCES

> "The importance of exchange rate policy as an instrument of macro-economic management is derived from the fact that exchange rates have significant implications for a country's balance of payments position, its terms of trade, reserve use, rate of domestic price inflation and even its income distribution and growth[24]".

The sustained maintenance of disequilibrium exchange rates can cause serious damage to the country's economic performance and welfare. The influence of exchange rate is very visible in Nigeria, especially as the country embarked on a course of rapid economic growth throughout the 1970s to early part of 1980's. Export expansion has not .been able to match up with the import requirements which are vital for the economy's development. On the other hand, export activities are taxed whenever a fixed exchange rate is combined with domestic inflation generated by deficit financed development programmes.

The implication of this is that, foreign exchange reserves will be depleted and the country may resort to borrowing unless the necessary adjustments are made. The usual short term policy response by LDC's is to restrict imports through exchange controls, higher tariffs, and pre-imports deposit. Failure to identify the role of exchange rate changes in the economic adjustment process will lead to a substantial resource mis-allocation. Thus, rationality in choosing an appropriate exchange rate policy becomes essential to macroeconomic management (H.Branson, IMF staff paper vol.30, no.7, March 1983, pp.33 - 66).

Nigeria has experimented with various forms of exchange rate policy. The need to adopt an appropriate mechanism not just Nigeria alone but by all LDC's became necessary since the breakdown of the Bretton Woods Fixed Exchange Rate System in the early 1970's. Before the industrialised economies adopted floating exchange rate in 1973, most of these economies had maintained a par value against an intervention

[24] T. Ademola Oyejide; Exchange rate policy for Nigeria. Some options and their consequences, in the book - Management of Nigeria's Foreign exchange resources. A proceedings of the 1985 One - Day Workshop. Published by the Nigerian Economic Society.p.17.

currency such as the dollar, franc or the pound sterling[25]

The studies by D. Brodsky, G. Helleiner and G. Sampson, on the impact of the current exchange rate system (1981,pp.31 - 53) showed that, the generalised floating of the industrialised nations currency renders this practice inappropriate given the level of uncertainty which is introduced by fluctuations in effective exchange rates which are the product of instability of the foreign currencies.

The variations on the exchange rate induces greater unpredictability of import prices and export receipts. One can now begin to understand why exchange rate policies have been a topical issue in Nigeria. The country's attempt to find the right or suitable path way have been dogged by consistently repressive policies. The next five sub sections examine some of the guiding general principles of the exchange rate policy and examines the Nigerian exchange rate policy.

[25] See R. M. Bantista, Exchange rate flexibility and the less developed countries: A survey of empirical research and policy issues,Philippine Economic Journal, Vol.xx, No.1, 1981, pp. 1 - 30.

5.6.1 THE GENERAL PRINCIPLES OF EXCHANGE RATE

A Simple Definition:

> Exchange rate can be defined as the price of one currency in terms of another. That is, the unit rate at which the domestic currency is measured in relation to a basket of foreign currencies or a single foreign currency or simply, the price of one currency in terms of another.

The Nigerian naira's foreign value may be measured in terms of the US dollar or the British pound sterling. There is a distinction between the 'spot' rate of exchange and the 'forward' rate.

The spot rate is the rate at which one currency can currently exchange for another while the forward rate is an agreed rate at which one currency can be exchanged for another at some pre-determined date in the future (usually 90 days). Forward exchange market enables traders to hedge against the foreign exchange risk and it gives rise to certain types of speculative activity and Interest Arbitrage[26].

HEDGING:

An importer may incur a debt which has to be paid for at a future date. The foreign exchange risk is the risk that the exchange rate will change in the meantime involving the importer in a possible loss. The trader can hedge against this risk by buying "Forward" foreign exchange. This means that the trader can enter into a contract with a bank to purchase an amount of foreign exchange at the appropriate future date at a rate of exchange agreed upon at present (the'forward' rate). Banks levy a small charge for this service.

SPECULATION:

Some speculators attempts to take advantage of the difference between the 'forward' rate for some given time period and the 'spot' rate which they expect to prevail at the end of that time period.

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[26] Philip Hardwick et al, An introduction to Modern Economics, 1984, pp.436 - 7.

INTEREST ARBITRAGE:

The objective of interest arbitrage is to allocate funds between financial centres in response to interest rate differentials in order to realise the highest possible rate of return. If for example, 90-day interest rates are higher in London than in Lagos it may be worthwhile for investors to transfer their short term funds from Lagos to London. To do so, they will need to convert naira into pound at the spot rate and at the same time they can avoid the foreign exchange risk by arranging to convert the proceeds of the arbitrage back into naira at the forward rate. Therefore, whether or not this transaction is worthwhile depends on the interest rate differential between the two financial centres and the difference between the 90-day forward rate and the spot rate.

The concept of an 'effective exchange rate' indicates that, given the emergence of many bilateral rates under the framework of floating rates, there is a potential need to design a different measure which would reflect the average movement in a country's exchange rate. The effective exchange rate (EER) is calculated as the trade - weighted average of bilateral exchange rates. There are three different methods which can be used:

[1] Weighted imports;

[2] Exports; and

[3] Total trade.

The real effective rates are derived by adjusting the component bilateral nominal exchange rates for changes in the relative price levels in the trading partner and home countries (Brodsky et al, 1981).

The real effective rates however, do fluctuate between currencies and between intervals on a regular basis. This is usually influenced by the activities within the financial markets, industry, and the economic and political outlook. The primary focus of the policy is the real exchange rate because it provides the signal for inter and intra-sectoral resource movements (D. Cavallo and Y. Mundlak, 1982, Oyejide,1985). This refers to the measure of the terms of trade between the traded and non-traded

sectors[27] of the economy. A fall in the real exchange rate would divert resources away from the traded sectors. The real rate however, is not controlled directly by the authorities instead, they utilise the policy instrument of nominal rate. Its variations can be used to maintain a specified real exchange rate target.

5.6.2 THE OBJECTIVES FOR A STABLE EXCHANGE RATE

The first aim is to improve the balance of payments position which is expected to be realised by enhancing the external competitiveness of a country's traded goods sector. The second objective is to use the changes in exchange rates to regulate domestic costs and prices. That is towards achieving domestic price stabilisation policy.
The third is exchange rate protection. The aim here is to prevent the tradable and non tradable price ratios from continuing to fall for example, the oil export proceeds.
These three objectives highlight the reasons why a country may choose as a policy strategy to maintain a constant or target equilibrium real effective exchange rate (REER) or to minimise short term fluctuations.

The main advantage of a system of exchange control is that, it exerts a prompt, direct and predictable effect on imports and it may be used selectively to discriminate between imports. The disadvantages are; it suppresses rather than solves the basic underlying problems. It involves a complex and costly administrative structure and encourages corruption.

5.6.3 THE MAIN DISTINCTION BETWEEN EXCHANGE RATE POLICY AND CONTROL

Exchange rate policy works through the intermediation of price changes and price elasticities response. Exchange control works through the mechanisms of an administrative system which bureaucrats prefer. This preference is mainly because of the powers and privileges that goes with the exercise of discretion than the actual problem of market imperfections.

[27] Traded products - agriculture and import - substituting manufacturing goods.

5.6.4 THE DOMINANT FORMS OF EXCHANGE RATE REGIMES

After the collapse of the Bretton Woods system of fixed exchange rate in the early 1970's, the International Monetary Fund (IMF) adopted the Second Amendment to the Fund's Articles of Agreement which allows each member country to freely determine the degree of exchange rate flexibility that is consistent with its economic structure and domestic policy objectives (Oyejide 1985).

FIXED EXCHANGE RATE REGIME

Under the fixed exchange rate mechanism, the government can determine the par value of the country's currency. The country's Central Bank takes an active role in the foreign exchange market, selling or buying the domestic currency when its rate starts to deviate from the fixed value. The demand and supply are reconciled through fluctuations in the central bank's holdings of foreign exchange reserves rather than through changes in the exchange rate.

There are two variants of the fixed exchange rates:

[1] The Rigidly Fixed Exchange Rates System;

[2] The Crawling Peg System.

Under a rigidly fixed exchange rates, the exchange values of currencies are fixed in terms of some common unit such as Gold or other currencies. A fixed exchange rate arises when the exchange rate of a currency is fixed in terms of some units of gold or any other foreign currency. The maintenance of a fixed rate requires each government to keep a foreign exchange reserve, typically maintained in gold or in a major currency such as US dollar or the British pound sterling.

This reserve is drawn upon whenever the country's total imports exceeds its total exports in value. An import surplus means that the demand for foreign currencies (to pay for imports) exceeds the supply of foreign currencies (earned through exports).

PEGGING.

The value of a country's currency is maintained within a well defined range relative to some other currency or group of currencies. The aim of pegging to a basket of currencies is to moderate changes in the prices of imports and exports. Those countries unable to construct their own currency baskets use the Special Drawing Right (SDR)[28].

CRAWLING PEG (THE ADJUSTABLE PEG SYSTEM)

At the Bretton Wood conference in 1944, the allies came together in an attempt to design an International Monetary System that could operate in the post-war period. The Bretton Wood Conference resulted in the formation of the International Monetary Fund (IMF).

Members of the IMF have the right to adjust their rates of exchange from time to time in the event of a fundamental disequilibrium. With the Crawling Peg, there should be a parity of exchange, but the parity itself would be allowed to move from day to day, that is, not allowing it to move by a large amount.

The problem with the crawling peg is that if reliance is placed on small exchange rate movements to get adjustment from a system of fundamental disequilibrium, the remedy would take a considerable length of time to solve the cause of the disequilibrium. Therefore, to succeed with this method, the monetary authorities would require reserves larger than that under a system with quicker adjustments mechanism. Without a large reserve base, events might be abandoned and devaluation resorted to; which will in turn lead to a greater need for adjustments.

The view taken by most IMF members was that the system of fixed parities and intervention points made a major contribution to the peaceful development of international trade and a greater flexibility ought to be achieved.

[28] The IMF has defined the Special Drawing Right (SDR) as a basket of Sixteen currencies to which such countries can peg their currencies .

The suggested solution was that when a currency is under pressure (in either direction) the intervention point could be moved either way in the appropriate direction at the end of a quarter or shorter period. This process of slow devaluation or revaluation became known as the Crawling Peg System.

FREE FLOATING SYSTEM

This is a system of market determined rates. That is, the evaluation of a currency in a free market like any other commodity. Its worth is determined by the interaction of supply and demand. Hence, the rate of exchange of a currency is determined by the supply of and the demand for it in foreign exchange markets.

The rates at which currencies exchange for one another are free to move up or down without limit in response to the dictates of supply and demand. There is neither an upper limit or a lower limit (except zero) to the fluctuations. In a free market, the naira-price of say dollar or pound sterling is free to move up or down without limit as is the dollar or pound sterling price of naira.

The only qualification is that the naira price of dollar in Lagos, whatever is the level, must be the reciprocal of the dollar-price of naira in New York. For example, when N1.00 = $0.8000 in New York, $1.00 must be equal to N1.2500 in Lagos. Where the compatibility does not hold, (ie; different rates), then arbitrage tends to occur. The consequence of the incompatibility is that dealers sell naira for dollars in Lagos, resell the dollar so obtained for naira in New York realising a profit in the process, purchase more dollar in Lagos with the proceeds and so on. This movement continues until no further profit can be made by arbitrageurs. The 1978 amendment to the statute of the IMF accepted and permitted the floating exchange rates.

FLEXIBLE EXCHANGE RATE REGIME

Under this regime the central bank does not participate in the foreign exchange market. The forces of demand and supply are allowed to determine the exchange rate of the currency in relation to all foreign currencies. In reality, governments do not leave the determination of their exchange rate entirely to the market forces instead,

they follow a Managed Floating System. Under the Managed Floating System, the central bank intervenes to reduce day to day variability of market rates while the market forces are allowed to determine exchange rate trends over the long run.

Before the full deregulation of the financial system in Nigeria, the floating system was considered unsuitable for the economy. Oyejide (1985), argued that Nigeria is a highly open developing economy and does not have an internationally integrated capital market to benefit from such a system.

One of the main concerns of the governments and their monetary authorities is a fluctuating exchange rates inherent in flexible exchange rates system. Seasonal fluctuations are predictable, but fluctuations due to sudden shifts in international demand or to erratic shifts of capital especially of short term capital are not predictable. The ensuing exchange instability is viewed as a risk which calls for the intervention of the government.

The idea of free-floating rates implies that the government will not intervene in the market. However, the fact is that no government will abrogate its freedom to intervene when its judgement intervention is expedient. Governments are expected to confine interventions to off-setting temporary items and not to interfere with long-term trends as determined by underlying forces.

Attempts to off-set temporary items often produce rub-off effects on long term trends. The possibility of rub-off effects is not sufficient to prevent the need for official intervention. The essence of official intervention is that, should there be a downward movement that the government knows to have been caused by some random event beyond the knowledge of the participants in the market, the government will not want to let the exchange rate fall when it knows quite well that the cause of weakness is temporary.

The alternative is to buy the domestic currency with foreign currency in order to prevent a depreciation of domestic currency. By offering foreign currency in exchange

for a given amount of domestic currency, the price of the foreign currency is prevented from rising relative to the domestic currency. A stabilisation fund consists of a pool of various currencies to which the central authority adds or from which it subtracts as conditions warrant; thus the stabilisation fund can act to stabilise the international value of a currency.

The success of a stabilisation fund is dependent largely upon the magnitude of its resources, if large-scale or prolonged operations prove necessary. Relying on exchange rate adjustment may complicate the task of using domestic instruments of adjustment to achieve a viable balance of payments position. Therefore, monetary and fiscal measures might be undertaken to ensure consistence with long-term trend.

5.6.5 THE HISTORY OF NIGERIAN MONETARY SYSTEM AND EXCHANGE RATE EXPERIENCE BEFORE THE SAP

Over half a century ago, Nigeria use to import the British currency, pound sterling. When the West African Currency Board was created in 1912, it started to issue the West African Pound for the then Four British colonies, namely, Nigeria, Ghana (formerly Gold Coast), Sierra Leone and the Gambia[29]. Prior to 1912 period various medium of exchange were used as money for example, Cowries and Manilla.
The essence of the currency reform of 1912 was to create a unified currency in the four British colonies especially in Nigeria where different regions uses different medium of exchange.

The next stage of the Nigerian monetary history came with the establishment of the Central Bank of Nigeria and the issue of the first Nigerian pound in July 1959, which effectively replaced the West African Currency Board notes and coins[30].
The Nigerian pound external value was then fixed at par with the British pound sterling which resulted in the Nigerian pound been valued in US dollar at $2.80. After gaining independence in 1960 Nigeria became a member of the International Monetary Fund (IMF).

In June 1962 the Nigerian pound had its parity defined in terms of gold, at One Nigerian pound equal to 2.48828 grams of fine gold. Since the US dollar had a fixed value under Bretton Woods system at that period, the Nigerian pound also had a fixed value in relation to the US dollar, as well as the British pound gold value.

The Nigerian authorities felt content with the fixed exchange rate regime and no attempt was made to change it even though the British pound was later devalued by 14.3 percent against its gold parity in November 1967. Despite the worsening balance of payments position during the 1960 - 70 period, other measures such as exchange control and import restrictions were preferred to nominal exchange rate changes in

[29] CBN Economic and Financial Review, June 1972.

[30] CBN - Economic and Financial Review, Vol.2, No.1, June, 1973.p.5.

dealing with the emerging problems. However, in August 1971 when the US unilaterally suspended the convertibility[31] of its currency to gold, the Nigerian position of "no action required" immediately changed. Since the US dollar was used as a reserve currency by most countries, it also meant a change to floating exchange rate system. This change posed a big problem for the unsuspecting LDC's who were ill-equipped for this new phenomenon.

After experimenting with a version of the Dual Exchange rate system for a couple of months Nigeria abandoned it by the end of 1971 but still maintained the parity of the Nigerian pound at 2.80 US dollar. The parity with the dollar meant that Nigeria's pound is automatically floated along with the US dollar against other currencies. When the US dollar was devalued against gold after the New Smithsonian Agreement in December 1971 Nigeria still ties its currency to the dollar and refused to devalue. Following the devaluation of the US dollar, the new par value of the Nigerian pound rose from US$2.80 to US$3.04, meaning appreciation for the Nigerian pound.

In January 2, 1973, the naira went into circulation, thus replacing the Nigerian pound. It's par value was set at half the pound. Therefore, the exchange rate with the dollar became US$1.52 to the naira. Shortly after the introduction of the naira the US dollar was devalued again by 10 percent. The devaluation was due to worsening US balance of payments position which triggered off a massive speculative pressure on the dollar. The Nigerian monetary authorities immediately devalued the naira by 10 percent[32]. According to the then Governor of the Central Bank of Nigeria, the devaluation was necessary in order to maintain first, an efficient allocation of resources in the economy and Second, to improve performance of the deteriorating non-oil export sector and thirdly, the need to rationalise the demand for imports from Nigeria's major trading partners.

The implication of the change in policy stance signifies that perhaps a fixed

[31] World Bank Report, 1991,p.17. on US foreign exchange.

[32] CBN, Economic and Financial Review, June, 1973,p.10.

relationship between the naira and any other currency could not be sustained especially if Nigeria wanted to be able to respond independently to economic changes in the light of it's own objectives and peculiar circumstances.

The effect of this was the termination in April 1974 of the rigid relationship between the US dollar and the naira. The naira and pound sterling fixed rate had earlier been broken in June 1972 when the pound sterling started to float officially. As from April 1974, the monetary authorities adopted the policy of progressively appreciating the external value of the naira, especially against the dollar and sterling with the aim of producing naira exchange rates that would adequately reflect the country's balance of payments position. The inflow of oil revenue undoubtedly allowed the naira to be overvalued, which helped to improve Nigeria's balance of payments position (CBN 1974, pp.13 - 14).

To justify this policy measure, the authorities maintained that depreciating the naira would be helping to intensify inflationary pressures in the domestic economy thus counteracting the effects of the government's anti-inflationary policy. The appreciation of naira during the last three quarters of 1974 was aimed at moderating the extent of imported inflation. Between the period 1974 and 1978 the Nigerian exchange rate was managed independently of any single foreign currency.

In February 1978, Nigeria adopted a system of determining the naira exchange rate against a basket of currencies of Nigeria's main trading partners. The policy assisted the process of promoting a fairly independent exchange rate policy and the minimisation of exchange rate induced fluctuations in the prices of imports and exports.

At this stage there seems to be a realisation that the naira is overvalued and that this has some undesirable effects especially on the non-oil tradable goods sector. However, instead of adjusting frequently the nominal exchange rate appreciations the main priority of the authorities was to sustain the existing nominal exchange rates while at the same time attempting to protect the non-oil sectors and the balance of payments

position by imposing a higher import duties and establishing a regime of direct exchange control and import licensing.

Robertson (1992, pp.179 - 181) noted that the overvalued exchange rate also affected the authorities trade policy. The exchange rate was overvalued because the demand for foreign exchange exceeded the supply (at the official rate) hence, requiring tight controls on foreign exchange flows including restrictions on imports.

Keesing (1989), stated that Nigeria maintained what has been characterised as 'a low growth, high cost, disequilibrium exchange rate'. Oyejide (1975) and Robertson estimated the exchange rates distortion in the 1970's and early 1980's to be between 30 and 80 percent. The extent of the exchange rate overvaluation increased during the 1970s because of the increased nominal rate and the high rates of domestic inflation relative to increases in international prices. For example, the Consumer Price Index (CPI) increased by 320 per cent between 1970 and 1980 while in the USA the Wholesale Price Index (WPI) increased by 143.3 percent. This means a decline in the real exchange rate.

The missed opportunity of what the government should have done, was to establish an equilibrium real effective exchange rate which once established should be systematically adjusted so that the selected equilibrium real exchange rate can be maintained. This does not necessarily mean that a point estimate of the equilibrium real rate must be found. A real rate around which there is a narrow band will be sufficient. Edwards (1989) using data from the IMF and World Bank (various years) estimated the real exchange rates by using the Nigerian CPI and the US GDP Deflator. For the period 1970 to 1980 the real exchange rate appreciated by 63.0 percent of which about 23.3 per cent was due to appreciation of the nominal exchange rate. For the period 1975 to 1980 the real exchange rate appreciated by 53.5 percent as the nominal rate increased by 11.1 percent. The nominal exchange rate began to depreciate after 1980 mainly because of the authorities realisation of the need to confront the deteriorating balance of payments as oil revenues began to fall.

Table 5.2

Nominal Exchange Rates [Against Naira] Before The Liberalisation.

(Quarterly 1974 - 1984)

PERIOD	US DOLLAR ($)	BRITISH POUND (£)
1974 II	1.5855	0.6616
IV	1.6228	0.6836
1975 II	1.6263	0.6847
IV	1.5980	0.7448
1976 II	1.6011	0.7977
IV	1.5914	0.8746
1977 II	1.5789	0.8504
IV	1.5352	0.8612
1978 II	1.5826	0.8390
IV	1.5548	0.7877
1979 II	1.5679	0.7851
IV	1.7442	0.8043
1980 II	1.7776	0.7912
IV	1.8628	0.7850
1981 II	1.6566	0.7850
IV	1.5404	0.8220
1982 II	1.4847	8.8331
IV	1.4530	0.8725
May 1984	1.5560	0.7470

Source: CBN various years

Table 5.3

Balance of Payment (Balance on Current and Capital Accounts)

[In Millions of Naira] Before The Liberalisation Program

Year	Oil	Non - Oil	Total
1974	5192.9	-2136.3	+3056.5
1975	4190.4	-4006.7	+183.7
1976	5224.2	-5431.6	-206.5
1977	6611.1 (2)	-7033.2 (2)	-422.1 (2)
1978	5561.7	-6926.5	-1364.8
1979	8983.5	-7160.8	+1822.7
1980	11657.7	-9290.1	+2367.6
1981	10216.2	-13285.1	-3068.9
1982 (1)	8243.6	-9690.9	-1447.3
1983 (1)	6876.3	-7070.0	-193.7
1984 (1)	7761.4	-7605.8	+155.6
1985 (3)	9495.7	-8589.1	+906.6

Source : CBN: Annual Report and Statement of Account (Various years)
Bracket index: (1) Revised
(2) Provisional
(3) Estimated

Between the period 1980 and 1985 the nominal exchange rate dropped from US$1.83 to US$1.11; a 38.9 percent decline. The depreciation of the real exchange rate during this period was limited by the increasing inflation rate. There was a depreciation of 10.5 percent in 1980 - 82, as inflation fell to an average of 12.8 percent. In 1983 - 84, inflation increased sharply to an average of 31.4 percent thus reversing the previous period. The real exchange rate appreciated by 28.7 percent. In 1985 when the rate of inflation dropped to 5.5 per cent the real exchange rate depreciated by 13.8 percent as the nominal rate depreciated by 14.2 percent.

5.7 THE NIGERIAN FINANCIAL SYSTEM: BEFORE THE LIBERALISATION

Financial resources is one of the key elements in any economic development. In the case of the Developing Countries, mobilisation of resources has been identified as the most essential factor in attaining a rapid economic take off. In which case there is a fundamental need for capital formation. This requires the release of domestic goods and services for real investment and or the importation of resources from abroad plus an encouragement for domestic savings.

> "This requires an institutional arrangement which encourages and mobilises savings (Agu, 1988)".

Developments on the Nigerian financial system concentrated on changes in structure, growth and the emerging challenges. This is reflected in the number of institutions participating in the system and their various impacts on employment, income and prices in the economy (Orji, 1989). Therefore, there is a need for adequate financial intermediation in the country. The financial mobilisation problem is very closely linked with the savings problem and developing countries are generally characterised by a low rate of domestic savings.

Khatkhate and Riechel (1980) found that, what is really lacking in LDC's is the efficiency in the process by which savings being accumulated in the economy are translated into savings usable for productive investment. This is of course given the fact that Gross Domestic Savings rate has been found to be fairly high in a large number of developing countries including Nigeria.

Many LDC's relied on the inflow of financial resources from outside in various forms such as: 'official and private' capital inflows and 'direct foreign investments' as a means of speeding up their economic development. Dependence on internal sources of finance facilitates the successful implementation of any planned economic development. This requires a wide range of independent and well organised financial institutions, which has to mobilise internal resources for the purpose of capital formation and allow the capital to be invested conveniently and freely in desired development projects (Agu,1988).

Some empirical studies have been carried out to support some of the differences of opinions regarding how the exogenous and endogenous factors affecting the banking system actually impact on the savings - investment process. This has resulted to the emergence of two main schools of thought. The first is the Financial Repression Hypothesis while the second is the Structuralist Hypothesis.

The proponents of financial repression hypothesis postulates that financial intermediation through the banking system induces economic growth by assuming that there are no government policies and legislation working towards distorting its growth - oriented effects. This means that government intervention in the organised domestic financial market through interest rate regulations among others factors hinders banks in their savings mobilisation role in the economy.

The Structuralist postulation was that, the 'relative backwardness' of the economic state of a country determines both the impact of banks on the economy and the subsequent trend in industrial expansion and growth.

Some of the advocates of the first school include Mckinnon and Shaw. Their work has been extensively reviewed in chapters 2 and 3. Others are Schumpeter 1934, Gurley 1969, Shaw and Gurley 1955, Patrick 1966, Goldsmith 1969 and Cameron 1972. The Structuralist include: Taylor, Van Wejinbergen, Fry and Saracoglu whose work has been reviewed in chapter 4.

The next stage attempts to evaluate the growth and structure of banking in Nigeria. The first section deals with the banking history in Nigeria up to 1960. The second section examines the trend from 1960 to 1986 and the third from 1986 onwards.

5.7.1 THE ECONOMIC HISTORY OF THE FINANCIAL SYSTEM IN NIGERIA

The banking system started in Nigeria in the 1890s. Commodity currencies had been in use in Nigeria for a long time in the form of cotton, gin and rum and supplemented by various metal currencies such as the Spanish doubloon, the American half eagle and double eagle, Austrian Maria Theresa dollar, French Napoleon, Mexican dollar and the British Sovereign[33].

The most commonly used medium of exchange in the Sixteenth century Nigeria was the cowry shell because the metal currencies had their own intrinsic value and were often melted down for ornaments. Given the various currencies in circulation, the British colonial government decided to introduce the shilling at about the end of the nineteenth century with the purpose of harmonising the currencies in circulation in the country. In 1825 the British Treasury directed that the silver coins were to be used throughout the whole of British Empire but there was a considerable resistance to its introduction and acceptance in Nigeria. The British Governor General for Nigeria; Governor Usher, issued the Ordinance No.2 of 11 May 1880 demonetising all these currencies with only ten days notice. From the 21 of May 1880 the British silver coins were introduced as the only legal tender in Nigeria. The colonial government having succeeded in replacing the foreign monies with British coins in Lagos Island, their next target was to replace the metal currencies used in the Delta and Creek areas. The rates of exchange of these currencies against the British coins were fixed[34].

The Native Currency Proclamation No.14 of 1902 formally fixed the exchange rate of different grades of manillas[35] (still in use in the country, in addition to the official currency) in terms of shillings. In 1908, new British coins were introduced (the pennies and tenths) following the ban of copper wires and rods. In 1911, manilla and

[33] P.N.C. Okigbo, The Nigerian Financial System, 1982, p.75.

[34] The fixed rates were manipulated by the native courts working within the framework of the Native Courts Proclamation of 1901 or by the Native Market Proclamation in areas where the courts did not exist.

[35] The metal currencies are in the form of manilla rods etc Okigbo 1982,p.76.

metal currencies were demonetised by the Native Currency Repeal Ordinance and by legislation in 1948. The importation of the cowries used in the Ibo hinterland was banned by the Cowries Prohibition Proclamation No.6 of 1904, with a fine of £50.00 or three months imprisonment against its violation. Alternative metal currencies were minted in aluminium. Nickel was later used in place of aluminium under the Nigeria Coinage Ordinance 1906[36].

The British coins were by 1912 the official medium of exchange. This was strengthened by the annexation of the northern provinces which led to a greater demand for coins for the payment of troops, public officials and local labour. The effect of this was a rise in the quantity of silver coins imported into the country from £24,426 in 1886 to £874,850 in 1911, that is, a 35 percent rise. In view of this trend, the establishment of a bank became highly necessary in the country.

5.7.2 THE EVOLUTION OF THE BANKING SYSTEM

Through the influence of Elder Dempster and Company in Nigeria (a British trading and shipping company), the African Banking Corporation opened a branch in Nigeria in August 1891 (the bank at that time was already operating in South Africa). The bank was later taken over in March 1893 by Elder Dempster and Co. at a cost of £1000.00. The purpose at this stage for acquiring the bank by the Elder Dempster & Co was to support their trading activities along the Nigerian coast in the late nineteenth century[37]. The takeover of the bank enabled the company to acquire the monopoly of importing silver coins from Britain for use in Nigeria and their shipping business.

By December of 1893 at the request of the Colonial Government in Lagos through the Crown Agents, a joint stock bank was incorporated as the Bank of British West Africa (BBWA). The bank had an authorised capital of £100,000 of which £30,000 was called up and £12,000 paid up. The BBWA later became the First Bank of Nigeria

[36] Okigbo 1982, p.77, J. Mars 1946, p.183.

[37] CBN: Bullion April/June, 1991,p.8.

Limited in 1979. Between the period 1894 and 1910 the bank had opened three branches and by 1919 despite the World War 1, it had opened five more branches in Nigeria and one in Cameroons.

The next bank to follow BBWA was the Anglo - African Bank 1899 -1912 which later became The Bank of Nigeria in 1905. The two banks merged in 1912 and as a result ending banking competition in Nigeria for three years.

The Colonial Bank was established in 1916 through Act of Parliament to operate anywhere in the British empire. This was later taken over in 1925 by Barclays Bank DCO (Dominion, Colonial and Overseas) as an integrated overseas bank, to become Barclays Bank Nigeria Limited and is now known as The Union Bank of Nigeria Limited. The bank became a major competitor of the BBWA.

In 1948 the British and French Bank for Commerce and Industry based in London opened a branch in Nigeria. The Bank is now called The United Bank for Africa Limited (UBA). The establishment of the UBA Limited in Nigeria was as a result of a mission to Nigeria in 1947 which reported favourably on the possibilities for establishing a bank in the country. It had a catchment area from the French speaking population[38] and by 1961 it had ten branches in Nigeria.

In 1948, the first commission of enquiry was appointed known as the Paton Commission[39]. At the time the commission reported, there were two foreign banks and three domestic banks with a total of forty branches. The second commission reported in 1976 and by then there were eighteen commercial banks with a total of four hundred and fifty six branches in the country. In 1952 the first Banking legislation was enacted. Prior to 1952 there were no banking laws and banks could be set up freely under the Companies Ordinance. It was this absence of banking legislation which earned that period the name "The Free Banking Era" (Nwankwo, 1980,p.45).

[38] That is, the French enterprises and nationals, Indian traders who came to Nigeria via Hong Kong (Okigbo, 1982,p.82).

[39] Nwankwo, G.O, The Nigerian Financial System, 1980, p.45.

5.7.3 THE DOMESTIC BANKS ERA (1929 - 52)

A large number of domestic banks were established between 1929 and 1952 obviously taking the advantage of the free banking boom. Unfortunately, all of the banks that opened in this period failed except the National Bank of Nigeria Limited[40], which was founded in 1933. The Industrial and Commercial Bank Limited was established in 1929 and liquidated in 1930. In addition the Nigerian Mercantile Bank 1931 - 36 and the Nigerian Penny Bank 1945 - 46 both also went into liquidation, prompting the introduction to the economy of Banking regulation.

In 1948 regulatory provisions were recommended known as "the Paton Report[41]". The acceptance of the report by the government induced a great rush to open new more banks as the report provided a 3 year period of grace to allow the banks to comply with the required guidelines. In between the period February 1951 and May 1952, eighteen domestic banks were registered and without exception, all of them collapsed.

The failure of these banks could be attributed to lack of banking expertise, non prudent lending policies and the great depression which according to Okigbo, saw the Nigerian import and trade fell by more than 59 and 50 per cent respectively.
Newlyn and Rowan[42], postulated that the cause of the large number of banks can be attributed to the timing of the rush of the registrations to the uncertainty of the government's intentions based on the Paton Report of 1948. Thus, the spate of beat-the-law registrations of domestic commercial banks led to the abortive domestic banking boom of 1951 - 52.

The Second World War provided Nigeria with an opportunity to expand its banking system given that, the country provided Britain with soldiers, the take-off bases and

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[40] CBN: Bullion,April/June,1991,p.9; Okigbo, 1982, p.86; Nwankwo,1980,p.46.

[41] The commission was set on the 7th of September, 1948 and submitted its findings on the 25th of October, 1948.

[42] W.T. Newlyn and D.C. Rowan, Money and Banking in British Colonial Africa, (Oxford), 1954, pp.230 - 2.

the vitally scarce products such as vegetable oils, cocoa and timbers. These endowed the indigenous population with funds which were invested in banking during this period[43].

5.7.4 THE WEST AFRICAN CURRENCY BOARD (WACB) AND THE FORMATION OF THE CENTRAL BANK OF NIGERIA (CBN)

Prior to the establishment of the Central Bank of Nigeria, the West African Currency Board (WACB) which was formed in 1912, had the responsibility for issuing legal tenders (see sections 5.7.1 & 5.7.2). The role of WACB was to promote the financing of export trade, issue of a West African Currency, the exchange of existing currencies, the repatriation of existing currencies and investment of reserves among the Four British West African colonies. There was a fixed parity of the local currency with the British pound. Reserves were invested in Britain thus, facilitating Nigeria's international payments. The WACB being linked with the British system could not engage in monetary management and there was a lack of a trained indigenous population to engage in monetary management.

To promote the growth of the domestic money and capital markets, the Central Bank of Nigeria (CBN) was formed in 1958 and it commenced operation on the 1st of July, 1959. The Ordinance of 1958 firmly established the Central Bank of Nigeria. It was not possible to establish the central bank earlier since the Federal government was still under the colonial control. The financial and economic structure began to change tremendously after the country gained internal autonomy in 1957.

The formation of CBN constituted a basis for other financial developments in the country. Apart from the eight banks established between 1959 and 1962, no new bank was established in the country between 1962 and 1970. The main reason was that a period of consolidation was needed to allow the new banks to establish themselves. The other major reason was the dislocations, disruptions and political uncertainties and insecurity brought about by the civil war of 1967 -1970.

[43] Nwankwo, G.O; Indigenisation of Nigerian banking, Bankers Magazine July 1972,p.16, 1980,p.47.

The banks minimum paid up capital for foreign incorporated banks were increased from N200,000 under the 1952 Ordinance to N400,000 in 1978 and subsequently increased to N1.5 million. The other fundamental aspect to development was trade. The bulk of external trade was with the United Kingdom (U.K) prior to independence. In 1950, 60 percent of total imports came from the U.K, while in 1960 it was still as high as 44 per cent.

The Nigerian Mineral Ordinance restricted trade with countries outside the Non-Sterling area countries. Nwankwo (1980) argued that this restriction was responsible for the paucity of non British investment in general and the absence of foreign banks other than British up to 1959 in Nigeria. Independence in 1960 transformed the entire Nigerian economic structure. The exclusion of non - UK investors in mineral oil prospecting and the general restrictions on transactions with non - sterling area countries lapsed with independence in 1960. Nigeria was from then able to negotiate business with any country in the world it so wishes to.

The discovery of oil in commercial quantities in the late 1950s added to an apparent political stability and the general freedom then to repatriate profit and capital to improve the investment climate in the country. This led to a lot of countries trying to gain a foothold in Nigeria's expanding market and with it came the foreign banks to service these enterprises and to share in the subsequent boom.

5.7.5 THE COMPOSITION AND GROWTH OF THE FINANCIAL SYSTEM

The financial industry in Nigeria comprises of:

[1] The Central Bank of Nigeria :

This is wholly owned by the Federal Government of Nigeria and has among its numerous duties, the following functions;

(a) the issue of legal tender;

(b) the maintenance of external reserve for safeguarding the international value of naira;

(c) the promotion of monetary stability and regulation of the financial system;

(d) to serve as the banker to other Central banks;

(e) to serve as the banker and adviser to the government and its agencies.

[2] Commercial and Merchant Banks:

The awareness for making institutionalised saving was primarily induced by the commercial banks and as such forms the nucleus of the banking system.

Two main functions are performed by the commercial banks:

(1) the creation, distribution and transfer of deposits and the provision of commercial credits;

(2) the saving function which include the mobilisation of savings from the surplus units of the economy and the channelling of such funds towards the funding of consumer items and capital projects.

The Merchant banks bridges the gap in terms of structure of credit provided by the commercial banks which tends to be short term. The first merchant bank Philip Hill Nigeria Limited was founded in 1960. This was later merged with the Nigerian Acceptances Limited (NAL) to become NAL Merchant Bank Limited. The forty eight merchant banks as at the end of 1990 were mainly wholesale bankers. They engaged in "made to measure" banking while the commercial banks dealt in "off-the-peg" or "retail" banking.

The merchant banks accept large deposits usually not less than N50,000. Only a small proportion of their loans and advances are of the overdraft form. The merchant banks apart from their own paid - up capital rely on other banks and institutional investors for their source of fund and then apply the funds mainly for loans and advances.

The area of specialisation of the merchant banks includes:

(a) the provision of term loans;

(b) Equipment leasing and debt factoring;

(c) Investment management;

(d) Loan syndication for capital intensive projects;

(e) Advisory and other services on mergers and acquisition;

(f) Privatisation of state owned enterprises; and

(g) Capital reconstruction.

The merchant banks assets and liabilities as at the end of 1990 totalled N28.59 billion while the commercial banks was N82.3 billion.

[3] The development banks comprises of the following:

The Nigerian Industrial Bank (NIDB);

The Nigerian Bank for Commerce and Industry (NBCI); and

The Nigerian Agricultural and Cooperative Bank (NACB).

They provide medium to long term funds to the agricultural, industrial, commercial and other sectors of the economy. They also provide financial and advisory services to enterprises and act as an agent of the government in disbursing funds to industrial enterprises.

[4] The Federal Mortgage Bank of Nigeria (FMBN) was established by Decree No.7 of 1977 to take over the assets and liabilities of the Nigerian Building Society (NBS). The NBS carried out the function of mortgage administration in Nigeria since inception in 1956 until its abolition.

The FMBN provided banking and advisory services, supervision and control of mortgage institutions in Nigeria and provision of guarantees for loans from private investment sources for building purposes. The bank performs the function of research and development relating to architecture, mortgage finance and housing in rural and urban centres. The FMBN is financed by the Federal Government, the Central Bank, the banks and private sources. The assets and liabilities of the bank as at December 1990 stood at N837.1 million.

[5] The FSB International Bank Limited formerly known as the Federal Savings Bank (FSB) replaced in 1974, the Post Office Savings Bank established in 1889.

The FSB was formed by Decree 33 of 1972 with the aim of encouraging savings especially among the low income groups in the country.

Its function include: the provision of easy to facilities for the deposit of savings and

the promotion of "thrift" and mobilisation of savings. As a result of the advancement in commercial and merchant banking in the country, the FSB lost a large number of its customers hence, the government privatisation of it in 1990. The FSB is now a limited liability company.

[6] The People's Bank of Nigeria (PBN) is a special bank.

It first started as a pilot scheme on the 3rd of October 1989 but later received a legal status by Decree No.22 of 1990. The reason for the formation of the bank was due to the realisation that low income earners normally lacked access to institutional credit because of their inability to provide suitable collateral demanded by banks before credit worthiness is ascertained. Thus, the bank was to provide easy credit, curb mass unemployment and encourage economic self-reliance.

The bank started by granting credit facilities of N50 to N5,000 with Zero interest. An administrative fee of 15 per cent (formerly 5%) is charged but no collateral is required. An interest of 17 per cent is paid on deposits placed with the bank.

To induce loan repayments, loans are usually granted on the basis of group membership of cooperatives and trade associations. A borrower is expected to be a member of a group of at least fifteen people with a repayment period of fifty weeks. The People's Bank is financed through loans and grants from the Federal Government, the Central Bank, low interest bearing loans from international financial organisations and from charitable organisations. The bank received N150 million capital allocation in the budget of 1991, as its equity base.

[7] The Community Banks.

These are established to provide financial and banking services to all sectors.The first licensed community bank commenced operation in December 1990. The bank is a self sustaining institution, owned and managed by a community or group of communities and financial services at local level. Community banks may be owned by Community Development Associations (CDAs) or by Cooperative Societies. A minimum equity share capital of N250,000 is required and applications are received and processed by the Community Bank Implementation Committee.

[8] The Stock Exchange.

One of the most important developments in the Nigerian financial system was the establishment of the Lagos Stock Exchange on the 5th of June 1961. This was established as a result of the "Barback Committee[44]" which was appointed in 1958 and reported its findings in 1959. The Lagos Stock Exchange is now known as the Nigerian Stock Exchange.

The Lagos Stock Exchange was incorporated as a limited liability company under section 21 of the Companies Ordinance of September 15, 1960. The aim was to promote commerce in Nigeria as a non profit making organisation limited by guarantee[45]. The Stock Exchange itself is a continuous auction market, but is not yet developed to the extent that exchange of ownership can be effected with the same speed as in the developed capital markets of the industrialised countries[46].

[9] The Rural Banking Scheme.

In June 1977, the Central Bank and the Government launched the Rural Banking Scheme. The objective was to encourage:

(a) banking in the rural areas;

(b) mobilisation of savings for development in the rural areas;

(c) Transformation of the agro-economy of the rural areas through provisions of investment finance; and

(d) creation of employment in the rural areas, hence preventing the rural - urban migration. The ratio of the person-to-bank branch in Nigeria prior to the Rural Banking Scheme was 1:170,000. A report issued by the central bank noted that, two hundred branches were selected for opening among the eighteen various commercial banks in the country during the first phase of 1977 - 88[47].

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[44] Barback was the Minister for Industry and was appointed Chairman of the committee.

[45] Areago, R.B. (1990), 'Genesis of the Stock Exchange in Nigeria', Nigerian Stock Exchange: Genesis, Organisation, and Operations, Heinemann Educational Books, 1990, p.3 -6.

[46]Odife, D.O. (1984), 'The Nigerian Financial System', Understanding The Nigerian Stock Market. Vantage Press, New York, 1984, pp.41 - 44.

[47] The CBN: Annual Report, 1987, p...

The Central Bank of Nigeria granted the commercial banks numerous concessions such as:

Monopoly provisions for a rural branch for three years in its area of operation. Thus, a 100 per cent compliance level was attained for the first phase. The second phase was 1980 - 85 and out of two hundred and sixty six allocations to twenty banks only two hundred and sixty branches was opened, indicating a 98 percent compliance.

The third phase of the Rural Banking Scheme was from the 1st of August 1985 and officially ended on the 31st July 1989. Only seventy two of the three hundred allocated branches to twenty eight banks were opened (See table.5.3(b)).

The estimated population per bank branch office showed a declining trend as a result of the Rural Banking Scheme. From one bank to 115,281 person's (I:115,281) in 1980 to one bank is to 72,177 person's (1:72,177) in 1987. Total number of commercial banks rose from twenty nine with seven hundred and forty branches in 1980 to thirty three with one thousand four hundred and eighty three branches in 1987. The total number of Merchant Banks rose from six with twelve branches in 1980 to sixteen with thirty three branches in 1987.

As postulated by Orji, the downward trend do not seem to have had any positive impact on banking efficiency in the country, which dropped from 68 percent in 1982 to 58.5 percent in 1985 while population per bank branch improved from 91,219 to 77,087 for the same period.

Table :5.3(b)

BANK EXPANSION IN NIGERIA (1980 - 87)

COMMERCIAL			MERCHANT		TOTAL C + M		Nat* Pop/Bank	
Yr	Banks	Bran	Banks	Branches	Banks	Branches	Popul	Branch
							(Mill.)	(Pers)
1980	29	740	6	12	35	752	86	115,281
1981	20	869	6	15	26	884	89.01	100,690
1982	22	991	8	19	30	1010	92.13	91,219
1983	25	n/a	n/a	n/a	n/a	n/a	95.35	-
1984	27	1242	11	25	38	1267	98.69	77,893
1985	28	1297	12	26	40	1323	102.14	77,087
1986	29	1367	12	27	41	1394	105.72	75,839
1987	33	1483	16	33	49	1516	109.42	72,177

Source: CBN Economic and Financial Review, Annual Report(Various Issues)
Nat. Popul represents National Population (A 3.5% compound growth rate was assumed for population). n/a represents Not Available.
Nat* Estimated National Population

The third phase failed partly because of the high cost of establishing an infrastructural base in the Structural Adjustment Programme era plus the lack of basic amenities in these rural areas. This is more apparent given the fact that banks are profit oriented and would be better off operating with fewer branches in profitable areas.

It can be postulated that the stage of national economic development does not encourage savings mobilisation in the rural areas (which is one of the objectives of the scheme). The income levels are too low in these areas and the banking habit is far from being developed. The risk aversion in granting credit to rural based economic activities such as agriculture is too high for the banks to handle without any meaningful insurance against non repayment.

[10] THE INSURANCE AND PROVIDENT FUND

(a) Insurance Companies:

The insurance business in Nigeria is still in its preliminary stages of development. This is mainly because it is only recently that significant importance has been attached to this side of financial services in the country. The total income of all insurance businesses in the country in 1960 amounted to N7 million and their aggregate premium from all forms of insurance business in 1974 was 54.8 million naira.

Most of the business is concentrated in the motor vehicle and other properties, with life insurance accounting for only a small percentage. For example, in 1977 out of 195 million naira income of these companies, only 46 million naira was from life insurance business.

(b) National Provident Fund:

The National Provident Fund is a social security scheme meant to provide protection to contributors in their old age, invalidity or temporary loss of earning. Where a member dies prematurely, the scheme provides for payment of benefits to the benefactors, within the limits of the contributions made.

The aim of the fund was to make saving compulsory but in principle, it is insurance. It differs from the insurance scheme to the extent that insurance is a voluntary contractual arrangement whereas the National Provident is compulsory.

The fund's share of institutional savings started to rise from the period 1962 - 67. It's share in 1962 was 2.4 percent, reaching 24 percent in 1967. It's investments are mainly in gilt - edged securities and government development stocks which in 1970 amounted to 82.7 million naira and by 1975 it has risen to 200 million naira and reached 340 million naira in 1978.

5.7.6 THE INDIGENISATION PROGRAMME

Definition:

This is a process by which the citizens of the country are able to acquire ownership, control and management of key economic activities in the country, formerly occupied by expatriates.

This implies that it is foreign ownership, control and management that is the target of indigenisation especially commerce and industry. As a result of the Nigerian Enterprises Promotion Decree 1977, popularly known as the Indigenisation Decree (Phase II) or NEPD 1977, the Nigerian capital market was expected to change very significantly. The first indigenisation Decree was in 1972. The NEPD 1977 was promulgated in 1977 to implement the decisions of the government as contained in the white paper on the report of the Nigerian Enterprises Promotion Panel.

The report described the NEPD 1972 as a failure, due to the weakness of the implementation mechanism than the actual provisions of the decree. The NEPD 1977 therefore, recommended that all enterprises operating in Nigeria should have Nigerian equity participation, ranging from 40 per cent in those enterprises considered to be difficult to run, to 100 per cent in those enterprises which Nigerians are considered capable of managing by themselves.

The decree provided for an implementation authority known as the Nigerian Enterprises Promotion Board (NEPB). The board was empowered to decide in what schedule or category of Nigerian equity participation any enterprise belonged and what constitutes compliance with the decree when compliance has been effected. Pricing of the shares and determination of the terms and conditions of the offer remains with the Capital Issues Commission (C.I.C), as contained in the CIC Decree 1973 (Capital Issues Decree 1973: Decree No.14 ' Federal Ministry of Information, Printing Division Lagos). The 1977 Federal Budget contained some provisions geared to facilitate this transformation in the capital market as well as attaining the objectives of the NEPD 1977.

5.7.6[1] THE INDIGENISATION OF THE BANKING INDUSTRY

The indigenisation programme enabled the monetary authorities to ensure that the ownership, control and management of the Nigerian Financial System are controlled by Nigerians. The Federal Government owns 60 percent equity interest in the foreign banks while the state governments predominantly own the domestic banks.

In 1977, many new industrial shares were sold to the Nigerian public following the implementation of the second phase of the indigenisation scheme and thus increasing the number of companies and securities listed on the Lagos Stock Exchange[48]. Until the end of 1979, activities in the capital market continued to be buoyant which reflects the effect of the extended second phase of the Indigenisation Decree, as firms which could not meet the December 1978 deadline actually came into the market with issues in 1979([49]).

5.7.7 THE AGRICULTURAL FINANCE

In an attempt by the government to induce banks to participate in agricultural development in the country, the Central Bank of Nigeria introduced 'The Agricultural Credit Guarantee Scheme' (ACGS) in 1977. A total of 34,518 loans valued at 129.3 million naira were guaranteed under the ACGS in 1989. Small scale farmers borrowing up to N5,000 and below comprised the largest proportion (96% in number and 68% in value) of the beneficiaries of the ACGS.

[48] CBN, Annual Report 1977, p.31.

[49] The Central Bank of Nigeria Annual Report and Statement of Account, 1979, December, p.31.

Table 5.4

COMMERCIAL AND MERCHANT BANKS IN NIGERIA FROM 1893-90

Year	Number of Commercial Banks (1)	Number of Merchant Banks (2)	Total Number of (1) + (2)
1893	1		1
1917	2		2
1933	3		3
1937	4		4
1945	5		5
1953	6		6
1959	8		8
1960	9	1	10
1961	13	1	14
1962	17	1	18
1971	17	1	18
1972	17	1	18
1973	17	2	19
1974	17	3	20
1975	17	5	22
1976	18	5	23
1977	19	5	24
1979	20	6	26
1982	22	8	30
1983	25	10	35
1984	27	11	38
1985	28	12	40
1986	29	12	41
1987	33	16	49
1988	41	24	65
1989	47	34	81
1990	56	48	104

Source : The Central Bank of Nigeria

5.8 THE NIGERIAN FINANCIAL SYSTEM FROM THE 1980s

AN OUTLINE OF ECONOMIC DEVELOPMENT AND POLICY

The financial and economic structure of Nigeria has undergone a substantial transformation since the country's attainment of independence in 1960. This is reflected in the changing sectoral contribution to the Gross Domestic Product (GDP) between 1960 and 1985 (see table 5.5 below).

Table 5.5

THE STRUCTURE OF THE NIGERIAN ECONOMY: Shares of Non - Oil GDP By Sector 1960 - 1985 (%)

Per-iod	Agricult ure	Manufa cture	constru ction	Utili-ties	Serv-ices	Govt	Min-ing**
1960	58.1	2.2	3.0	0.1	34.3	2.2	(4.0)
1965	57.1	2.4	4.4	0.2	33.5	2.4	(18.3)
1970	49.5	5.1	5.0	0.2	33.5	6.8	(28.8)
1975	36.6	5.7	9.3	0.4	40.5	7.6	(30.0)
1980	29.2	9.2	12.5	0.6	42.2	6.4	(31.2)
1985*	47.2	11.1	1.9	0.6	39.2	n/a	(17.8)

Source: The Federal Office of Statistics and The World Bank

* The 1985 Figures are provisional estimates

** Estimates after 1965 includes all petroleum, as a percentage of non-oil GDP.

The economy was dominated by agriculture in 1960. With the rapid increase in government revenues from oil exports, the relative size of the public sector almost tripled between the period 1960 and 1980 as construction and utilities spurred by increasing public expenditures increased from 3 per cent to 12 percent and from 1 percent to 6 per cent respectively. The manufacturing sector although still very small, increased its share of non-oil GDP by more than 400 percent.

The extent of the swings in oil market conditions are shown in table 5.6. Prior to the 1973 price increases, oil revenue accounted for 79.6 percent of total exports.

Table 5.6

NIGERIAN OIL EXPORTS AND REVENUES : 1971 - 1985

Period	Average Value Exports		Average Growth Rates			(%) of
	Naira (m)	Dollar (m)	Naira (m)	Dollar	Price	Total Exports (m)
1971 - 73	1341	1887	57.1	60.7	29.3	79.6
1974 - 78	5787	9169	39.6	41.7	41.3	92.1
1979 - 81	11340	19482	30.0	35.0	42.5	95.4
1982 - 85	8734	11404	2.7	-6.6	-8.2	96.4
1971 - 85	6794	10371	31.3	31.3	26.5	91.6

Source : IMF [1986, 1987].
Growth Rate of Oil Prices are based on an index of prices in dollar (1980 = 100).

The government's share in total revenue increased from 26.3 percent to 81.4 percent (data from the FOS), with an average annual oil export rate of 55.6 percent (ie, from 166.4 million to 8880.9 million naira). According to the World Bank report (1987d) government consumption rose by 13.5 per cent on average per annum, while that of the private sector was 7.0 per cent.

5.8.1 PRE - STRUCTURAL ADJUSTMENT TRADE POLICY

Trade policy in Nigeria prior to the structural adjustment programme consisted largely of measures aimed at influencing the level and composition of imports, and the maintenance of an overvalued exchange rate. The authorities therefore had a problem of maintaining the prices of imported consumer goods and provision of protection to domestic industries. The policy adopted meant that the country was pursuing an inward-looking strategy toward its economic development. The economic policies pursued by the authorities significantly influenced the structure of the economy and contributed to the unsustainable position when oil revenues declined substantially in the early 1980s.

5.8.2 THE IMPLEMENTATION OF STRUCTURAL ADJUSTMENT PROGRAMME AND POLICIES FROM 1986

Table 5.7

THE PERFORMANCE OF THE ECONOMY DURING THE PERIOD 1965 - 85

(Average Real Growth Rates, Percentages)

	1965 - 80	1980 - 85
REAL GROSS DOMESTIC PRODUCT	7.9	-3.4
1. Agriculture	1.7	1.0
2. Industry	13.4	-5.8
3. Manufacturing	14.6	3.0
4. Services	8.8	-3.5
CONSUMPTION & INVESTMENT		
Private	7.0	-1.5
Government	13.5	1.3
Gross Investment	14.7	-18.0
MERCHANDISE TRADE		
Exports	11.5	-9.9
Imports	15.1	-11.5

Source: World Bank (1987c).

Table 5.7 showed the disappointing performance of the Nigerian economy between the period 1980 and 1985. The General Buhari administration which overthrew the civilian administration of President Shagari in December 1983 responded by introducing a series of stringent austerity measures. The measures failed in its objectives because economic policies were changed accordingly, instead, the economic repression continued. The government intervention in resource allocations increased substantially.

The Structural Adjustment Programme was formally launched with the official document 'Structural Adjustment for Nigeria: July 1986 - 1988'. The focus of the structural adjustment was on the nature of policy reforms that would transform the economy and achieve the following objectives:

[1] Further rationalization of import tariffs and excise duties;

[2] Replacement of direct administrative controls with greater reliance on market forces;

[3] Adoption of appropriate pricing policy, especially for assets like petroleum products and rationalization of state owned enterprises (Phillips and Ndekwe 1987, Robertson 1992, p.184).

Other objectives are:

a. The institution of market determined exchange rate;

b. The simplification and rationalization of the tariff structure (aimed at reducing variations in effective protection of local industries);

c. Elimination of import licence requirements (only agricultural products and luxury goods still remain);

d. Closure of agricultural commodity marketing boards (now fully implemented);

e. Privatisation of state owned industries (also implemented and still going on).

5.8.3 THE INTERNATIONAL MONETARY FUND CONDITIONALITIES FOR NIGERIA

Following Nigeria request for a US$2 - 3 billion extended facility repayable over three years after a three year moratorium. The International Monetary Fund (IMF) insisted that, the granting of the request will be subject to an adoption by Nigeria of the following conditions:

1. A reduction in the aggregate public expenditure, particularly in the size of the budget deficit;
2. Introduction of greater budgetary discipline;
3. Review of an on - going projects with a view to determining their priorities;

4. Reduction in grants, subventions and loans to state owned enterprises;
5. Classification of state owned industries into 'social' and 'economic' activities for the purpose of restructuring them to achieve cost - effectiveness, accountability and profitability;
6. Stoppage of non-statutory transfers to state governments;
7. Simplification and rationalisation of custom tariffs;
8. Upward review of interest rates and reduction in the sectoral allocation of credit;
9. Phase removal of subsidies on fertilizer;
10. A vigorous export drive to broaden the export base;
11. A review of industrial incentives and policy including the abolition of the Approved User Scheme;
12. Adjustment of producer prices of agricultural commodities;
13. Strict external debt control and management;***
14. Improvement in the operational efficiency of revenue collection agencies such as the department of customs and excise and the inland revenue;
15. Trade liberalisation;**
16. Removal of petroleum subsidy; ** and
17. Adjustment of the rate of exchange of the naira (devaluation of the currency).**[50]

[50] ** the government considered these 3 factors to be very critical and consequently, rejected the IMF conditions. *** were pursued vigorous by the Nigerian authorities.

5.8.4 THE NEW SYSTEM OF EXCHANGE PRIOR TO THE FLOATATION OF NAIRA

There are two main issues regarding exchange rates; first, the real exchange rate fluctuations and secondly, the effectiveness of nominal devaluations as policy tools (see also Williamson 1983b, Marston 1988 and Edwards 1989). The real exchange rates (RERS) became increasingly volatile, especially as Nigeria maintained a fixed nominal exchange rate regime after the collapse of the Bretton Woods System (refer to page section 5.6.4 on page 176 and section 6.1.2 to 6.1.5 pages 230 to 239).

A fundamental principle in the macroeconomics of an open economy is that, in order to have a sustainable macroeconomic equilibrium, monetary and fiscal policies must be consistent with the chosen nominal exchange rate regime. Therefore, the selection of an exchange rate system imposes certain limitations on macroeconomic policies. If these limitations are violated, the result will be severe economic disequilibrium which is usually reflected in the misalignment of the real exchange rate[51].

Until 1978, the naira continued to be administratively managed while maintaining the broad policy stance of a strong naira. This was achieved by fixing the naira rate in terms of the major currencies, to reflect the relative strength of these currencies.

From February 1978 to the commencement of SFEM in 1986, the naira exchange rate was based on external factors such as:

[1] The perceived relative strengths of various currencies of Nigeria's major trading partners;

[2] The economic indicators such as the level of reserves;

[3] The trend of the balance of payments position;

[4] The movement of the two intervention currencies;

[5] Arbitrage as well as the rates derived from Nigerian imports.

[51]Edwards, S. 'Exchange Rate Misalignment in Developing Countries'. The World Bank Occasional paper no.2 / new series, 1988, The Johns Hopkins University Press, Baltimore and London, p.10, 1988.

Between January and December 1980, the naira appreciated by about 2.9 percent against the dollar from $1.7841 to $1.8367 but depreciated by about 3 percent against the pound sterling from £0.8089 to £0.7850. Between January and June 1981, the naira was fixed at N1.00 = £0.7850 or £1.00 = N1.2739.

REASON FOR FLOATING

Given the severe balance of payments difficulties reflected in sizable external payments arrears, a move from the fixed exchange rate system became necessary. The IMF encourage the government to float with a view of providing technical assistance. The fund's stance for this view was because of the protracted balance of payments problems that included arrears. However, after a series of discussions with the IMF, as well as the continued existence of arrears to the Fund which precluded discussions on the use of Fund resources, the floating system was not implemented[52].

Nigeria then adopted a unified floating arrangements. This is because of the desire to bring into the open sector a large illegal or unofficial market in which the local currency was substantially depreciated, coupled with smuggled goods and capital flight associated with that market. The initial depreciation when floating began and subsequent movements to maintain continuously a realistic exchange rate were seen as major factors in encouraging market participants to repatriate earnings.

In Nigeria, just as in Sierra Leone, and Zambia, the primary factors leading to adoption of the foreign exchange market arrangements were a perception that the previous administrative system for allocating foreign exchange had broken down and that the system would lead to a more efficient allocation, including more effective provision of foreign exchange for critical spare parts.

The other essential reason was the desire on the part of the authorities to shed political responsibility for the adjustment of the exchange rate. Discrete adjustments to a managed or fixed exchange rate usually involved unpopular political connotations.

[52]P.J. Quirk, et al; 1987, 'Floating Exchange Rates in lDeveloping Countries experience with Auction and Inter-bank Markets', IMF, Washington D.C, Occasional Paper no.53, pp.3 - 18 May 1987.

With the rate determined in the open market, the authorities were better able to deflect political criticism and focus their attention on other areas of economic management.

FLOATING MARKET ARRANGEMENT

Under Floating Exchange Rates the authorities are faced with essentially two forms of market arrangements. The first is to opt for a market that is operated within the private sector by commercial banks and licensed foreign exchange dealers. The second is to use an auction system to ensure a sufficiently competitive market.

In an auction market, the central bank conducts the market and serves as the channel for auction process. Nigeria instituted a composite of both options, as an auction is used by the authorities to price and distribute foreign exchange receipts from oil to an inter-bank market.

INTER-BANK SYSTEM

Under this system in Nigeria, the exchange rate is determined in negotiations between banks and their clients and in transactions between the banks. The exchange rate is free to vary from hour to hour and day to day. To ensure the competitive operation of the market, in all instances there are maximum or minimum limits imposed on commercial bank holdings of foreign exchange.

The purpose of such regulations is twofold:

[1] To prevent major dealers from cornering the market or from using inside information to speculate on their foreign exchange operations;

[2] To prevent imprudently large exposure of banks to exchange risk.

Such limits on stocks was important particularly in the initial stages of the market when a minimum volume of trading is necessary to establish confidence. The size of the limits are established initially by reference to the previous behaviour of the commercial bank's working balances and then adjusted in the light of experience with the market. Such limits are also seen as assisting the responsibility of the central bank for managing accumulation of international reserves from the low initial levels

generally prevailing.

A second type of regulation on the market involved an upper limit on the volume of foreign exchange surrendered to each commercial bank, to prevent any bank from cornering the market in a flow sense. There are official requirements for surrender of exchange to the official market. In Nigeria, the Philippines, and Sierra Leone, all receipts from exports of goods and services are required to be surrendered to commercial banks. All oil receipts in Nigeria are surrendered to the Central Bank of Nigeria.

Demand for foreign exchange by the public sector, including public enterprises, is met at the prevailing exchange rates either through the commercial banks or through the central bank. In Nigeria, the Central Bank acts as an agent when it is requested by the government to purchase on its behalf foreign exchange from commercial banks or at the auction market. An important question in setting up a competitive market is the degree of freedom of access to the market. Nigeria has a large number of commercial banks and other licensed dealers. Thus, the easier are entry requirements into the market, the more competitive and stable it will be.

THE AUCTION MARKETS

The role of the authorities in an auction system is a more central one than in an inter-bank market. The central bank decides the amount of exchange to be auctioned and the minimum reserve price below which it will not accept bids for example, US$50,000. The minimum amount of the sales may be predetermined as part of a macroeconomic program. Where licensing requirements are retained, all bidders with a valid with a valid imports license are required to lodge an advance deposit, either partial or equivalent to 100 percent of the foreign exchange they intend to purchase, before the submission of bids.

The bids submitted to the auction are then examined and all bids in excess of the highest bid which fully exhausts the available supply of foreign exchange, that is the market clearing price, are accepted provided they exceed any reserve price established

by the central bank.

Table 5.7.1

Independently Floating Unitary Exchange Rate Arrangements in Nigeria: Summary Characteristics 1988

number of commercial banks	41
Form of Arrangement	Inter-bank (Auction for Oil Receipts)
Regulation of Commercial Bank's Position	Net Foreign Position, both Spot and Forward
Rate Determination	Negotiable between dealers and their clients; marginal price for successful bidders at auction
Role of Central Bank of Nigeria Intervention	None in Inter-bank System; Possible by adjusting amount of foreign exchange supplied to the auction
Foreign Exchange Surrender Requirements	100 percent of all receipts to commercial banks
Forward Exchange Market: Development and Plans	Organised Market exists but very few transactions

Source: The International Monetary Fund (IMF).

The market-clearing marginal rate becomes the market exchange rate. After the auction, the market exchange rate, the total number of bids received and the number of successful bidders are announced. The auction-determined exchange rate applies until the next auction date to all exchange transactions, including surrenders for the next auction and any transactions that may not be required to be channelled through the auction market, except in Nigeria's composite auction / inter-bank arrangements, under which the inter-bank market exchange rate immediately supersedes the auction rate for all purposes other than customs valuation.

Advance deposits lodged by unsuccessful or partly successful bidders are returned in whole or in part, respectively, but bids are not normally allowed to be withdrawn.

The main difference between inter-bank and auction system arrangements are the treatment of the supply of foreign exchange to the market and the frequency or continuity of adjustment of the rate. The auction market arrangement requires the surrender of foreign exchange to a central unit ie; central bank. In contrast, in an inter-bank arrangement the ownership of foreign exchange may remain diffused in the private sector. The Nigerian auctions took place weekly.

On the demand side of the market, authorised Nigerian foreign exchange dealers are free to participate in the auction for a portion of foreign exchange receipts. Without provision of documentation regarding end-use of exchange; for the purpose of capital controls they act as agents of the government in their sales in the inter-bank market.

Another aspect of auctions is the choice of arrangements for determination of the exchange rate between a "Dutch Auction" and a "Marginal Pricing" approach. Under the Dutch auction system, each bidder whose bid is accepted must pay his bid price for foreign exchange. The adverse effect of this system is that participants may pay a price higher than the market clearing price if they assess demand conditions in the market incorrectly but their bid is successful.

Nigeria operated marginal price auctions. Under the marginal price system, a single rate, the most appreciated bid price at which the available foreign exchange is exhausted, which is the market clearing price, is applied to all successful bidders. Bidders who have offered rates more depreciated than the market - clearing rate will receive all the foreign exchange they bid for at the clearing rate. Those who have offered a rate more appreciated than the clearing rate will not receive foreign exchange. Those who have offered the marginal rate will receive only part of what they have bid for, on the basis of an allocation rule.

AN OVERVIEW OF THE CHOICE AND IMPLEMENTATION OF FLOATING ARRANGEMENTS

The main objective of auction and inter-bank market systems is to establish an exchange rate that will move flexibly to equilibrate the supply of and demand for foreign and thus to reduce dependence on exchange and trade restrictions. The choice between the two forms of arrangement must take into account the institutional and economic structure of the country.

With sufficient number of capable commercial banks or pre-existence of network of operators dealing in the parallel market, the inter-bank arrangement is likely to be the more efficient, and will require less resources at an official level to ensure its success. As for the role of the International Monetary Fund (IMF) in floating arrangements, the need for exchange rate flexibility has been an important element in the design of member's financial programs supported by the use of fund resources, see table below.

Table 5.7.2 Independently Floating Exchange Rate Arrangements in Nigeria, Including Elements of in Fund-Supported Economic Programs, January 1983 - December 1986.

Date of Program	**Date of Adoption of Independent Float**	**Floating Arrangements Linked To Program**	
		Performance Criteria	**Other**
December 1986	September 1986	Yes[1]	Yes[1]
Prior Use of Official Multiple Exchange Rate System (Introduced as Part of Program)[2]		Yes (Yes)	
Length of Time Multiple Rates Maintained		Unified 1987	

Source: IMF. [1] Program was tentative at time of introduction; [2] The reference here is to a dual exchange market other than illegal parallel market which was present in most cases at the time of institution of the floating rates.

Between the period January 1983 to December 1986, most programs included elements to ensure greater flexibility in exchange rate policy, either by managing the rate or by permitting it to adjust in response to market forces.

The dual exchange rate system, Known as the Second-Tier Foreign Exchange Market (SFEM) was introduced with the first weekly bidding commencing on September 29, 1986; that is two months after the adoption of SAP by the authorities. The First-Tier Rate is the Government determined exchange rate of the naira against other foreign currencies, whereas the Second-Tier Rate is the market determined rate.

THE SECOND-TIER FOREIGN EXCHANGE MARKET (SFEM)

The Second-Tier Foreign Exchange Market (SFEM) is a strategy designed by the Federal Military Government to prepare the economy in readiness for structural reform (S.O. Ogundipe, SFEM in Nigeria, 1986.p.1). It is a nation-wide market established for buying and selling foreign exchange through Authorised Dealers at Market Determined Rates (MDRs).

The rationale for setting up the SFEM is based on the need to adjust the naira to a realistic market determined rate rather than the fixed adjustable Peg System of exchange rates. The Peg System was seen as encouraging indiscriminate importation of goods which the country's foreign exchange earnings could not afford.

The highest powers are reserved for the Finance Minister; who then delegates the function of supervising the market to the Central Bank of Nigeria. Before the Commercial and Merchant banks can operate in the market, they are required to obtain 'Authorised Dealership Licence' either from the Minister of Finance or from the Central Bank of Nigeria.

The Nigerian Exchange Control Act of 1962 as amended by the SFEM Decree of 1986, Section 5(1) stipulates that 'The Minister of Finance appoints Commercial and Merchant Banks to Act as Authorised Dealers'.

The authorised dealers are required to carry out their appointed duties in accordance with instructions and directions as are issued by the Central Bank.

Given the seriousness of Nigeria's disequilibrium in the balance of payments position, radical solution was necessary. Central to the IMF/World Bank initiated SAP was the policy to allow the market forces of demand and supply to determine the rate at which the naira is exchanged against other foreign currencies therefore leading to the determination of a 'realistic value' of the naira and ensuring a more optimal use and allocation of foreign exchange to the various sectors of the economy than could be achieved through the import licensing policy[53].

A major policy recommendation by the National Economic Council (NEC), 'Expert Report on the State of the Economy', February 1983, was the need to restructure the economic base and systems for the correction of external imbalance, domestic inflation and unemployment.

> "In view of the proponents of the free-market in Nigeria, the root of the Nigerian economic crisis and the increasing decline witnessed since it started can be attributed to the state controls and interventionism. The best option would be to roll back the frontiers of the state[54]".

Thus, the state entered into negotiations with the IMF for a supporting loan to finance current imports, capital and interest payments on short and medium term loans. At the same time a belt - tightening policy (through fiscal and monetary measures) was adopted to check the external imbalance, internal and external indebtedness, and the problems of depression/staginflation (Attah et al 1987,p.2).

In July 1987, the two tiers were merged to form the Foreign Exchange Market (FEM). In effect, it was the First-Tier that was abolished leaving the Second-Tier Market as the foreign exchange market for the country. Under the new system, foreign exchange was auctioned weekly and later bi - weekly through the banking system. The market based second tier foreign exchange market led to the devaluation of the naira by 179 per cent against the dollar during the second half of 1986.

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[53] J. Attah; M. Kwanashie, O. Ojowu; The Nigerian economy under (S)FEM: The economics of foreign exchange market in a developing economy, 1987,p.3.

[54] Adebayo Olukoshi, The performance of Nigerian industry under the SAP: a critical assessment, in the book Crisis and Adjustment in the Nigerian Economy, 1991,p.94.

The two changes had an immediate effect on the economy. The effects included raising significantly the prices of and reducing the rents on imported goods. The removal of import license restriction allowed industries to import raw materials and spare parts more freely than in previous years. It also led to an increase in incentive to export.

At the first stage of the reform, the tariff and excise tax rate schedules were revised and the resulting interim tariff introduced in October 1986. The tariff rates were set according to government guidelines. The resulting interim tariff rates ranged between 0 and 100 percent, with 91 percent of the rates falling between 10 and 30 percent threshold. This implies a reduction in the trade weighted average tariff from 34.7 percent to 25.9 percent and a further reduction in the variation of rates. The average tax rates for goods subject to excise fell by 60 percent from 9.8 to 5.9 percent.

James Robertson (1992) analysis of the structure of incentives argued that the depreciation of the exchange rate and reductions in excise tax rates served to increase protection levels, while the reductions in the variation and levels of tariff rates worked in the opposite direction.

Estimation of the effects of tariffs, excise rates and exchange rate changes on the structure of effective protection was not possible given the considerable changes the economy was under going, plus non - existence of any meaningful data before the reforms.

Robertson and Cleron (1987), developed a model to stimulate the impact that policy changes had on the price distortions and the resulting structures of incentives.
The results are shown on table 5.8 below:

Table 5.8

PRE AND POST REFORM (INDICATIVE) RATES OF EFFECTIVE PROTECTION IN NIGERIA (PERCENTAGES)

Industrial Sectors	1986 (NET)	1987
Consumer Goods	24.5 (-37.7)	19.5
Intermediate & Capital Goods	12.4 (-43.8)	7.4
Average	19.2 (-40.4)	14.2

In their estimation for manufacturing activities, they concentrated on the effects on incentives of changes in the exchange rate, import restrictions, tariffs and excise tax rates. Their firm level input coefficients were obtained from the 1984 industrial census returns. The indicative and net effective rates of protection was based on the Pre-SAP (1986) and the interim (ie, February 1987, the post interim tariff) policies covering one hundred firms in forty one industrial activities at firm level were later aggregated.

Table 5.8 indicated the distortions between the production of final goods and inputs which were high and may have possibly increased. The result means that the level of effective protection declined from the level that prevailed during the past fifteen years.

INSTRUMENTS EMPLOYED IN THE FOREIGN EXCHANGE MARKET EXCHANGE CONTROLS.

Before the Exchange Control Act of 1962, Nigeria as a British colony applied the Exchange Control Ordinance of 1950. Under the Ordinance residents of Nigeria were free to earn and invest their foreign exchange in the United Kingdom because the Nigerian pound was convertible to the British pound (ie; the market was practically free).

Nigeria gained independence in 1960. As a sovereign state, a new exchange control act was promulgated in 1962 with the following objectives:

[1] To maximise foreign exchange receipt;

[2] To ensure favourable balance of payments position;

[3] To stabilise the external value of the naira;

[4] To ensure that allocation of foreign exchange resources is in line with the valuation nation's objectives;

[5] Application of exchange controls to enhance confidence in the external payments system[55].

An approved form 'M' serves as an authority for opening a letter of credit. In addition to this, a scheme for Mandatory Pre-shipment Inspection of all imports not so exempted either on the basis of value or type was introduced. At the end of the inspection exercise, inspection agent (SGS) issues a Clean Report of Findings. If the inspection revealed discrepancies in relation to quantity, quality and price, a Non-Negotiable Clean Report of Findings will be issued[56].

5.8.5 THE WELFARE IMPLICATIONS OF S(FEM)

As already mentioned earlier, the Second-tier Foreign Exchange Market S(FEM) constituted to the devaluation of the naira. The inelasticity of Nigeria's demand for imports due to the high import content of the domestic production processes implies a commitment of higher amount of the nation's foreign exchange resources to almost an unchanging quantity of imports. The inflationary impact of S(FEM) policy thus had serious ramifications on the welfare and development of the general public. The general price increase attendant to the implementation of this policy led to a reduction of the real value of wages and salaries, hence causing welfare loss to workers and the

[55]With the application of Exchange Control as a monetary tool, application for purchase of foreign currencies had to be supported with satisfactory documentations. The foreign exchange market became no longer free. For example, the introduction of form 'M' in 1979 in respect of all visible imports, irrespective of their value and type.

[56] G. Ovwielefuoma (1988), 'The Nigerian Foreign Exchange Market and Finance of International Trade', Mike-Win Publishers Nigeria Limited, Lagos, p.15, 1988.

aggregate effective demand to fall resulting in reduced investment, real output and employment.

The combined effects of the Second-tier Foreign Exchange Market S(FEM) on imports and exports appeared to have worsened the problem of external imbalance than assisting to solve it in the short run. In the long run, the policy is likely to have a positive impact on the development of the economy. As a result of the high cost of imported inputs, producers are forced to search for local raw materials and develop new products as well as new methods of production requiring the use of local inputs. Attah et al 1987 expressed the view that, to achieve the long term objectives would require the adoption of the appropriate strategies necessary for attaining local technological know - how.

Therefore, it may be necessary to reduce the degree of openness of the economy in the short run. The effect of this will be, a reduction in the economy's dependence on external raw materials, technology and capital, leading to an improvement in the external balance. Therefore, the objective of the dual exchange rate is to eliminate the repressive system of import licensing approach to the allocation of foreign exchange which was characterised by fraudulent and corrupt practices that the procurement of foreign exchange became dependent on whom one knows, rather than on the forces of demand and supply. The new system allowed the market forces to determine the rate and the sectoral allocation of foreign exchange.

5.8.6 A CRITIQUE OF THE SECOND-TIER FOREIGN EXCHANGE MARKET S(FEM)

Kwanashie (1978)[57] raised a number of questions designed to investigate the capability of the Second-tier Foreign Exchange Market S(FEM) policy to bring about the desirable structural adjustment that will put the economy onto the path of recovery. He concluded from the ensuing analysis that this single policy is incapable of lending to the desired fundamental changes necessary to meet the expectations.

[57] M.Kwanashie , In the paper SFEM: prospects for Nigeria's economic recovery.

The devaluation of the naira implicit in the SFEM policy lies between 200 and 300 percent. The agricultural sector small and medium scale industries which formed the bulk of the economic activities in Nigeria was unable to accommodate the sudden and unregulated increases in the cost of production. Attah (1987) argued that the good intentions of the government as stipulated in the 1987 budget to bail the economy out of disequilibrium may not be realised. The efforts of stimulating the economy is thus seen to be in direct conflict with the operation of the S(FEM) policy.

The authorities in an attempt to achieve the goals, introduced the Second-tier Foreign Exchange Market S(FEM) and later to the Inter Bank Foreign Exchange Market (IFEM) and shortly before the floatation of the currency, the authorities changed to Foreign Exchange Market (FEM) for the weekly auctioning of the naira. The last change was followed by a devaluation of naira by 40 percent. Import licensing, Current Exchange Transactions, and some Capital Transactions were effectively abolished.

Trade was liberalised through the removal of controls on investments, the review of the indigenisation programme and the industrial policy. The government then embarked on the promotion of **'export - all - exportable'** policy in the drive for foreign exchange earnings as well pursuing vigorously policies of commercialisation of state owned enterprises, privatisation and Debt Equity Swap.

A ban on importation of maize, rice, wheat and malt was imposed in an attempt to encourage local production and the use of substitutes. Interest rates were deregulated, monetary and fiscal policies were tightened, allocation to social services were reduced and subsidies removed or drastically curtailed. Most of these implementations were an attempt to satisfy the World Bank and the IMF, the Credit Clubs in Europe and Some Western Governments, of the country's total commitment to economic recovery.

5.8.7 ASSESSMENT OF THE ECONOMIC REFORMS

Some progress has obviously been made by Nigeria since the inception of the structural adjustment programme, especially in addressing a number of the key economic issues and the repressive financial policies pursued by the authorities throughout the 1970s and part of the 1980 which to a large extent appear to have undermined efficient economic growth. The overvalued exchange rate was probably the most significant distortion affecting trade during the late 1970s and 1980s. The reform has began to reduce the anti export bias inherent in Nigeria's trade policies.

Agricultural export has started to respond as well as limited developments in the exports of manufactured goods (see World Bank 1987d). Some types of production for domestic consumption has also increased in response to the changing internal terms of trade despite the fall in aggregate demand.

Critically, the 'official' usually unreliable data showed that little has been achieved. This view is supported by the United Bank for Africa's (UBA) report[58]:

> "As part of the manipulation of data to create the impression that the economy was being diversified, the CBN in April 1990 re-classified the exports of petroleum products as non - oil exports as against the traditional practice. Therefore, the first quarter of 1989 (January - April) only $150 million was realised from non oil exports, while in the first quarter of 1990 when agricultural exports actually declined the reclassification increased the figures to $546.413 million, that is an increase of over 200 percent".

The devaluation of the naira has been blamed for the massive decline of domestic businesses, especially those in small scale businesses who can not obtain or are severely restricted access to bank loans due to high floating interest rates and unable to compete with companies cushioned by huge foreign exchange accounts. The policy of auctioning the naira weekly increase the cost of importing raw materials thus, encouraging the ever-increasing factory rate prices of finished products (Julius Ihonvbere,1990,p.24). The removal of petroleum subsidy led to a rise in transport fares and food prices simultaneously and as such led to riots in Lagos and in some other major cities in 1991 and 1992.

[58] UBA's Monthly Business and Economic Digest Vol.13(6) (June) 1990, p.3.

The other argument against SAP is that it seems to have worsened the Nigerian balance of payments position and the terms of trade. This is given the fact that more is being paid for imported inputs than is received for exports. The much expected inflow of foreign participation has not really materialised. Only multilateral and bilateral assistance has trickled into the country while private investment is yet to materialise.

The deregulation of the banking system in the country has aided to the high interest rates and generally high cost of capital, which in turn stagnates economic growth. According to Pita O. Agbese[59] 1989, factory capacity utilisation in many industries is less than 10 percent. Millions of workers have been retrenched or are unable to find employment. However, Nigeria has only just began full liberalisation. On the country's past partial reforms, the tools for its assessment are limited and therefore, the expressed views must remain to some extent conjectural.

The process of implementing the Structural Adjustment Programme contributed substantially to these problems. Lessons can be learned from the Nigeria experience that would be of use to other countries embarking on similar efforts. As observed by Robertson, (1992):

> "One of the major factors underlying the failure of economically efficient trade policies was the absence of clearly stated objectives and a well defined guidelines for those responsible with the implementation of these policies".

The other major concern relates to the speed and method of liberalising trade restrictions. According to Krueger (1986):

> "Rapid removal of all controls may be the least painful way of proceeding. New signals in place will prevent resource misallocation in response to altered signals before the transition is completed. Instantaneous adjustment may prevent political opposition from diluting it. Therefore, an immediate transformation of the economic environment may reduce the uncertainties".

This seems to be relevant in view of Nigeria's experience with the attempted phase introduction of policy changes and moreover the eminent transition to civilian regime and the inhibiting effects of uncertainty over the sustainibility of the programme.

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[59] Pita O. Agbese, State, Media and the Imperatives of Repression: an analysis of the ban on Newswatch ; International Third World Studies Journal and Review, Vol.2, 1989, p.328.

The fact is, there is little prospect that the domestic producers would be able or more motivated to make the necessary adjustments if removal were delayed. Delays would only lead to additional costs without the corresponding benefits.

Robertson's view also seems to advocate for an immediate implementation of a relatively low and uniform tariff rate structure and the removal of most import prohibitions. The other feature of Structural Adjustment is derived from the belief that the economy has been over-regulated; consequently, the reform aim's at simplifying the complex administrative controls while placing greater reliance on market forces[60].

[60] Kayode, The Role of the Finance Industry, 1987, p.13.

5.9 THE BANKING SYSTEM AND THE MANAGEMENT OF THE ECONOMY

The unexpected growth in oil earnings in the mid 1970s was not fully internalised into the economic system[61]; hence the consumption - production pattern became largely import-oriented. A growing debt burden also surfaced in the early 1980s as a result of loans contracted from the international capital market. External debt outstanding went up from $593.6 million in 1976 to $18.6 billion in 1986 and to $30 billion in 1990.

The repressive policies pursued by the authorities included:
An overvalued exchange rate policy, low interest rate on deposits, heavy public sector spending, relegation of the agricultural sector to the background, plus the debt burden combined to create distortions in the production, consumption and payments patterns. The precipitous decline in oil earnings in the 1980s necessitated a policy re-direction aimed at re-aligning the domestic production pattern with the local resource base.

As outlined in section 5.5 of this chapter, the major features of SAP included the re-alignment of the naira exchange rate to reflect market forces, trade liberalization, privatisation and commercialisation of state owned enterprises, the promotion of locally source raw materials and de - regulation of the economy. The banking system formed an integral part of the on-going structural reforms and has played a leading role in the management of policy making. The Central Bank of Nigeria (CBN) played an active role in the management of the economy through its traditional and development functions.

5.9.1 TRADITIONAL FUNCTIONS OF THE CENTRAL BANK

First is the issue, safe custody of stocks and distribution of currency. Economic transactions in the Nigerian economy is still largely cash - oriented. The value of currency in circulation as at end of December 1990 was 16.3 billion naira, an increase

[61] See also the Structural Adjustment Programme (SAP): features, dimensions and some assessment by Prof. M.O.Kayode, in the book - The role of the finance industry in the successful implementation of the SAP; Papers and Proceedings of the 1987 Bank Directors Seminar, [June 9 - 10, 1987, p.10].

of 29 percent over its level in December 1989.
Second is the role of banker to other banks. This enables it to promote confidence in the system. It's supervisory activities include the monitoring of monthly and quarterly performances of the commercial and merchant banks.

It undertakes ad-hoc and on the spot examination of the statement of accounts of the banks. Thus facilitating effective monitoring to assess quality of loans, fraud, compliance with monetary policy guidelines and the pursuit of prudent banking practices. The CBN also consolidates public sector accounts especially since the directive of May 1989 "that all Government accounts be maintained with the CBN".

Third, the promotion of monetary stability . This function is performed through the regulation of money supply and the control of other monetary aggregates. For example, when inflation in 1988 reached 38.3 percent, the CBN adopted monetary policy measures to moderate the rate of inflation. A slower growth in the stock of narrow money M_1 was induced[62]. M_1 increased by 30.8 percent over the level at the end of 1988. This represented a substantial deceleration from growth rate of 43.6 percent recorded in 1988. Both M_1 and M2 (the broader money) rose by 40.7 and 34.8 percent respectively (N30.6bn and N27.7bn) at the end of 1990.

The Central Bank of Nigeria (CBN) attributed to the substantial increase as a result of the monetisation of governments foreign exchange earnings and the rise in aggregate banking system credit. The other measure taken by the CBN in August 1990 was the introduction of Stabilisation Securities to mop up excess liquidity in the system. To carry out these functions the CBN used the instruments of monetary policy such as direct controls of credit, variable discount rate, special deposit and stabilisation securities, reserve requirements and moral suasion.

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[62] Definition of M_1: Notes and coins in circulation with the public plus naira current accounts held by the private sector less transit items (ie public sector and external sector holdings).

M_2 is a broader definition. This included M_1 but with the addition of private sector naira deposit accounts with the deposit banks and the discount houses.
(Applied Economics in Banking and Finance, H. Carter and I. Partington, 1982,pp.30-31, Oxford University Press UK).

Fourth, direct control of credit. The imposition of credit ceilings had been used by the CBN as a major policy tool to promote economic stability. This ensures that the growth in money supply is restricted to the amount perceived to be needed to support a reasonable growth rate without over extending the economy. As a measure to induce adequate growth rate in the non-oil sector in line with the objectives of the reform, the CBN under the 1991 Guidelines to Banks, directed the Commercial and Merchant Banks to accord priority to agricultural and industrial sectors (see table 5.9 below).

Table 5.9

SECTORIAL ALLOCATIONS OF CREDIT (%)

SECTOR	COMMERCIAL BANKS	MERCHANT BANKS
A. High Priority Sectors	50.0	50.0
i Agricultural Production	15.0	10.0
ii Manufacturing	35.0	40.0
B. Others	50.0	50.0
Total A + B	100.0	100.0

Source: CBN Bullion April/June 1991.

The structure of the Nigerian economy as an influential factor in the process of monetary management can be viewed from three perceptive:

[1] The underlying ideology which is 'Mixed Economy';

[2] Sectoral shares in economic activities; and

[3] Level of economic development.

Nigeria has never explicitly declared its ideological leaning except in the 1979 Federal Constitution in which the Mixed Economy is implicitly stated - Section 16, 1(a), (b), (c)[63]. The prolonged use of direct control and credit ceiling created distortions leading the CBN to state in the 1991 Monetary Guidelines that the Monetary Policy

[63] See Ndekwu , Monetary Development and Management in Nigeria; 1990, pp.174 - 175.

will shift towards Market - Oriented Approach in line with the structural adjustment programme. The three main instruments of the Indirect Monetary Management Approach are :

[1] Cash Reserve Requirements;

[2] Liquidity Ratio;and

[3] Open Market Operations (OMO).

The CBN also used selective credit control to focus bank's attention to the priority sectors of the economy, which includes the agricultural and manufacturing enterprises (See table 5.9) rural borrowers, indigenous businesses and small and medium scale enterprises (SMEs).

5.9.1[1] INTEREST RATE POLICY

Interest rate in Nigeria was severely repressed through intensive control and regulation until 1986 when SAP was introduced. The rates were gradually deregulated from 1986 and decontrolled from August 1987. It is now left almost entirely to market forces. In response to the high inflation rate in 1989 the Minimum Rediscount Rate (MRR) was revised upwards from 13.25 to 18.50 percent. As the inflation rate declined, the rates charged by the banks remained sticky downwards making it very difficult for manufacturers to borrow from the banking sector. In January 1991 the MRR was cut to 15.5 percent to enable the banks lower the interest rates charged to their cost of funds (Banks Lending Rate = Maximum of 21% p/a). The Central Bank of Nigeria objective was to ensure positive returns on savings, promote industrial expansion and encourage competition among the banks.

5.9.2 DEVELOPMENT FUNCTIONS OF THE CBN

Unlike most central banks, the CBN is totally relied upon for the introduction and implementation of fiscal and monetary policies in Nigeria. Success or failure of any financial policy lies solely on the bank. The bank plays a dominant role in other areas of economic development such as; promotion of agricultural activities through agricultural finance, industrial development, development of financial market, rural banking, export finance and management of external reserves.

5.9.3 PROMOTION OF A COHERENT FINANCIAL SYSTEM

With the introduction of the structural adjustment programme and the consequent deregulation of the financial system, the number of banks and other financial institutions grew rapidly. Therefore, to ensure that the expanded financial system is sound and to curtail the incidence of illiquidity and capital erosion in banks, increased enforcement of prudential standards in line with what is practised in developed financial markets became essential. In 1990 the risk-weighted approach to capital adequacy was introduced. Guidelines on provision for loan losses and asset classification was also introduced.

(i) CAPITAL ADEQUACY

It is essential that the commercial and merchant banks have sufficient capital to absorb unusual losses (bad debts). Therefore, the CBN's prudential requirement for banks to maintain adequate capital to assets ratio imposed a discipline on bank's lending activities.

> Note: The guidelines are set in compliance with the recommendations of the Basle Committee of the Bank For International Settlement (BIS), which set out common standard of measurement of capital adequacy by all member countries.

The Central Bank of Nigeria circular BSD/FE/48/Vol.6/303, 30th March 1990; issued a directive that all licensed bank's Chief Executives must comply with the following:

[1] A maintenance of a minimum of 7.25 percent of risk weighted assets as capital.

[2] At least 50 percent of the total components of capital of all banks should be made up of CORE or TIER CAPITAL (that is paid up capital plus reserves and retained earnings less intangible assets and published losses).

[3] The ratio of capital to total risk - weighted assets should be at least 8 percent with effect from 1st January 1992.

(ii) ASSET CLASSIFICATION AND PROVISION

Banks are expected to suspend interest on non-performing loans and to write off uncollectible assets after a specified period of time. This ensures prudence of financial monitoring and compliance with the monetary policy regulations. The most important

role of the commercial and merchant banks is intermediation in the savings and investment process. Table 5.10 below shows the aggregate credit to the economy in the period 1980 to 1990. The aggregate credit to the economy increased steadily over the years from 10.7 billion naira in 1980 to 49.2 billion naira in 1989 and 66.0 billion at the end of 1990. Commercial Banks credit to the Government and the Private sector totalled 3.0 and 22.3 billion naira respectively at the end of 1989. The Merchant Banks credit to the Government and the Private sector amounted to 90.7 and 7.1 billion naira, respectively at the end of 1989.

Table 5.10

AGGREGATE CREDIT TO THE ECONOMY FOR THE PERIOD 1980 TO 1984 (MILLION NAIRA)

TOTAL CREDIT	1980	1981	1982	1983	1984
Economy	10787.5	16268.5	21906.8	28128.1	33879.4
Govt	3596.6	6614.3	10535.3	15828.2	19094.9
CBN	956.8	4580.9	7557.0	10528.2	9409.2
Com Bank	2632.4	2026.3	2971.2	5296.3	8719.3
Merchant	-	-	-	-	895.4
FSB	7.4	7.1	7.1	3.7	-
PRIVATE SECTOR	7190.9	9654.2	11371.5	12353.9	14784.5
CBN	756.4	910.4	918.0	1062.8	1302.2
Com Bank	6434.5	8743.8	10453.5	11291.1	11639.8
Merchant	-	-	-	-	1842.5

TABLE 5.10(1) AGGREGATE CREDIT TO THE ECONOMY FROM 1985 TO 1990 (Naira in Millions)

TOTAL CREDIT	1985	1986	1987	1988	1989	1990
Economy	35301.8	39314.1	46926.4	57326.3	49259.1	66011
Govt	19623.5	18907.3	21450.3	27552.7	18316.3	29380
CBN	8841.8	14293.5	14293.5	21767.2	15189.8	22028
Comm. Banks	9614.4	6866.3	6866.3	5728.9	3035.8	7037
Merch.	1167.3	290.5	290.5	56.6	90.7	315.5
Priv. Sector	15678.3	25476.1	25476.1	29773.6	30942.8	36631
CBN	1423.6	1917.3	1917.3	2418.5	1502.2	1400.1
Comm Banks	12276.6	17899.7	17899.7	20828.9	22325.8	26365
Merch Banks	1978.1	5659.1	5659.1	6526.2	7114.8	8866.4

Source: Central Bank of Nigeria (CBN)
Keys: Comm -indicates Commercial Banks
Merch For Merchant Banks
FSB is Federal Savings Bank
Note: The total credit to the Economy is Net.

Many of the banks participated in some of the special programme schemes such as the National Economic Reconstruction Fund (NERFUND), The African Development Bank Export Stimulation Loan Scheme (ESL) and the Small - Scale Loan Scheme. Additional loanable funds were made available to the banks through the special schemes for the purpose of promoting industrial development.

5.9.4 SUMMARY

The various Nigerian National development plans attempted to provide a structured programmes and objectives toward achieving long term economic growth.
The Nigerian economy was significantly transformed from one dependent on agriculture to one heavily dependent on oil. Hence the systematic decline in the growth of agricultural production.

Industrial growth also slowed down significantly throughout the 1980s. Production in the manufacturing sub-sector was constrained by the shortage of industrial inputs as a result of the foreign exchange problems. The industrial policy of the immediate post independence was that of import substitution. This was supported by a number of limited fiscal policies.

Financing for development was mainly from the oil industry, that is financing directly the government's expenditures. The financial system catered for the private sector under repressive terms. The effect of this was that commercial banks hardly ever finance industrial activities, therefore the government was obliged to establish the specialised banks.

On the political economy front, Nigeria's historical experience as demonstrated by Ihonvbere (1990) meant that, the institutions, forces and factors of politics, production and exchange were severely deformed and disarticulated to a point where they lacked the internal and relatively autonomous stimulus for growth, development and accumulation.

The problem of inefficiency, corruption, decadence and confusion among the Nigerian bourgeoisie and the institutions of the state have militated against the development of a clear and sustainable ideological position, the promotion of industrialisation and rational accumulation. Hence the need for a structural adjustment. In July 1986, the government in pursuit of its reform policy had to introduce a new economic measure under the supervision of IMF and World Bank.

The initiation of the structural adjustment programme (SAP) by the IMF and World Bank during the 1980s was to assist the developing economies to reduce their balance of payments deficits. Therefore forcing a shift from state to market led policies with emphasis on pricing as the major instrument for organising the economy and reviving agricultural production through a combination of policies involving devaluation and reductions in state expenditure and subsidies.

A major criticism of the Fund and the bank is their over-emphasis on growth and reduction of balance of payments deficits and the neglect of social protection for the less well off in society. The Fund's excessive concern about repayment of external debts, which brings into question the whole issue of adjustment, and or if a wider concept of development is needed to be incorporated into the analysis. The debt based definition of adjustment unfortunately failed to take into consideration the real concern of growth and equity which the proponents of international trade argued are the main cause of domestic instability.

As for the remedies to the repressive policies, it will include measures that will stimulate domestic investment, production and increase the supply of goods and services. Among the instruments that can be used are lower corporation tax, tax on dividends and removal of restriction on the amount of profits payable as dividends, capital allowance, removal of state practice of deficit financing and a stop to construction of uneconomic capital projects.

The need to adopt an appropriate exchange rate mechanism is vital. The usual short term policy response of restricting imports through exchange controls, higher tariffs and pre-imports deposits has failed to achieve the desired results. The choice of fixed and managed exchange rate policies resulted to gross macroeconomic mis-management, hence the adoption of SFEM, and later the Floatation of the naira.

Developments on the Nigerian financial system concentrated on changes in structure, growth and the emerging challenges. This is reflected in the number of institutions participating in the system and the various impacts on employment, income and prices

in the economy. Financial mobilisation is very closely linked with the savings problem. Financial intermediation through the banking system induces economic growth. This is by assuming that there are no government policies and legislation working towards distorting its growth - oriented effects. Therefore, government intervention in the organised domestic financial market through interest rate regulations among other factors hinders banks in their savings mobilisation role in the economy.

The economic history of the financial system in Nigeria sketches from the start of banking in Nigeria in the late 1890s to 1992. Providing an insight into the development of the medium of exchange in the country, currency constituents and the financial laws and decrees. The need for bank expansion in the country as well as the development of special and merchant banks, and the role of the banks in the management of the economy.

The chapter provides analysis of the Nigerian indigenisation programme. A process by which Nigerians are able to acquire ownership, control and management of key economic activities in the country formerly occupied by expatriates.
Finally, a thorough analysis of the economic development and policy outline, pre - structural adjustment trade policy and the implementation of the structural adjustment programme are provided.

Analysis of the economic liberalisation was provided in great depth, especially the exchange rate management policy.

LIBERALISATION OF FINANCIAL CONTROL.
MCKINNON'S ORDER OF ECONOMIC LIBERALISATION.

This chapter is a consolidation of the ideas and propositions expressed from chapter one to five of this study; whilst, at the same time reviews Mckinnon's 'Order of Economic Liberalisation: Financial Control in the Transition to a Market Economy'(1992). Mckinnon in the 'Order of Economic Liberalisation', concentrated mainly on developments in the socialist economies of Eastern Europe and Asia, since the introduction of Perestrokia; that is, Economic Restructuring in the former Soviet Union. The analysis focused essentially on securing financial control and macroeconomic stability and less on redefining property rights or on some crash program to rapidly privatise state - owned industrial assets and the banking system. The order of economic liberalisation did not take the place of the analytical framework laid out in Money and Capital (1973) which was reviewed in chapter 2.

The previous chapter looked into detail the various distortions operating in the Nigerian economy and the objectives giving rise to it. By the mid 1980s, short of any ideological underpinning or general economic rationale with regards to interventionism, most LDCs have lost confidence in the efficacy of their policies in terms of state ownership or control of the means of production in industry and agriculture.

Given the problem of external debt in LDCs, especially in Africa and Latin America, the advocacy for financial liberalisation has been called into question[1]. Diaz Alejandro analyzed why financial reforms carried out in several Latin American countries such as Chile, Argentina and Uruguay during the 1970s aimed at ending 'financial repression', as defined by Mckinnon (1973), and free the domestic capital market from usury laws and government induced distortions failed.

[1] See Carlos Diaz-Alejandro; "Good - bye Financial Repression, Hello Financial Crash", Journal of Development Economics, 19, 1985, pp. 1 - 24.

argued that how fiscal, monetary and foreign exchange policies are sequenced are of critical importance and that governments cannot and perhaps should not, undertake all liberalising measures simultaneously.

The 'optimal' order of economic liberalisation may vary for different liberalising economies depending on their initial conditions (Mckinnon,1992,p.4).
Mckinnon postulation is that before price inflation can be feasibly phased out, and before the capital market is opened for free borrowing and lending, governments must balance the central governments finances. Fiscal control should precede financial liberalisation as well as low tax rates for successful liberalising governments.

6.1 FINANCIAL REPRESSION AND THE PRODUCTIVITY OF CAPITAL.

Definition:

> Financial repression is the distortion of domestic capital market of an economy caused by the government.

Government distortions can be in the form of taxation, usury restrictions on interest rates and heavy reserve requirements on bank deposits. It causes uncertainty when inflation is high and unstable.

As hypothesized by Mckinnon and Shaw (1973), repressed monetary system fragments the domestic capital market (see chapters 2 and 3), with regards to the quality and quantity of real capital accumulation which includes:

> "The flow of loanable funds, interest rates cut off of bank lending variations, the process of self - finance within firms and households, illiquidity of firms due to financial deepening outside the repressed banking system and inflows of foreign financial capital which may be unproductive due to distortions in the domestic capital markets and unpredictability of foreign exchange rates[2]".

To overcome these fragmentation, Mckinnon and Shaw advocated for a positive and uniformly high real rates of interest within comparable categories of bank deposits and loans and removal of onerous reserve requirements, interest ceilings and mandated allocations of cheap credit, thus encouraging domestic savers and investors.

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[2] Mckinnon, R. 1992, pp. 11 - 12.

The Mckinnon-Shaw view was that by stabilising the domestic price level while keeping real interest rates "close to" market clearing levels, financial flows through the foreign exchange rates would be less volatile, with fewer fluctuations in the nominal and real exchange rate. There should be also a consideration on the acceptance that, flows of saving and investments should be voluntary and significantly decentralized in an open capital market at close to equilibrium interest rates (refer back to chapter 5, section 5.6, on the discussion of exchange rate in Nigeria).

Mckinnon (1992), now postulates that "the optimal order of liberalisation may require major fiscal reforms such as increases in tax revenues and cuts in government expenditures, before the inflation tax and other repressive financial policies may be safely phased out. He argued that countries that have sustained higher real rates of interest and more stable prices have generally had better financial growth by using ratios on private holdings of "broad" money[3] (M3) to Gross National Product GNP (with the ratio of M3 to GNP averaging about 0.227 for the groups of slowly growing economies).

This implies that they had fairly low levels of domestically held financial assets.
A high or rising M3/GNP ratio indicates a large real flow of domestic loanable funds for new investments (M3/GNP ratio of 0.75 for Japan, Germany, Singapore and Taiwan. Also refer back to chapters 1 and 4, on discussions on interest rates).

The World Bank study analyzed by Alan Gelb (1989), incorporated other monetary and investment-saving variables in the estimations used as well as using point estimates for interest rate effects to undertake further quantitative analysis. From this continuous measure of the Real Deposit Rate of Interest (RR), Gelb found a strong positive correlation with output growth over the time period 1965 - 85 :

$$DYY^4 = C + 0.256RR^5 \qquad [6.0]$$

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[3] Broad money supply (M3) consists of: Coin and Currency, Savings Deposits and shorter term time deposits in banks or other quasi - monetary institutions (such as Postal Savings).

[4] DYY is defined as the real rate of growth in Gross Domestic Product (GDP).

(5.72)

Maxwell J.Fry's (1988,152) estimate of Gelb's single equation point estimate yielded a higher coefficient. The implication of this equation is that, for Gelb, every one percent increase in the real deposit rate, output growth increases by 0.2 - 0.25 percent. For Fry, a one percentage point increase in the real deposit rate of interest toward its competitive free - market equilibrium level is associated with a rise in the rate of economic growth of about one half a percentage point.

On the Productivity of capital and the Saving-Investment Rate, in the Money and Capital, 1973, Mckinnon was concerned about the relative importance of higher social savings (as a share of GDP) as against the improved productivity of capital.

Alan Gelb (1989) estimated the Incremental Output Capital Ratio, IOCR and the ratio of Investment (domestic plus foreign saving) to GDP, denoted as IGDP, for Thirty - Four countries (see table 6.0).

[5] RR is the real deposit rate of interest.

Table 6.0 :

Growth Rates and Other Economic Indicators for Country Groups with Positive, Moderately Negative and Strongly Negative Real Interest Rates.

	1965 - 73			1974 - 85		
	Negative			Negative		
Indicators	Positive	Moderate	Strongly	Posi	Moderate	Strongly
Real Int. Rate[6]	3.7	-1.7	-13.7	3.0	-2.4	-13.0
GDP Growth Rate	7.3	5.5	4.6	5.6	3.8	1.9
M3/GDP	28.9	27.0	29.1	40.3	34.0	30.5
Investment/ GDP	21.4	19.7	21.4	26.9	23.2	23.0
Change in GDP/I	36.7	31.1	21.7	22.7	17.3	6.2
Change in Real M3/real saving[7]	18.7	12.7	6.4	16.6	8.2	-0.9
Inflation Rate	22.2	7.1	40.2	20.8	23.9	50.3
Volatility of Inflation[8]	17.1	5.3	27.2	12.2	9.1	23.5

Source: World Bank, World Development Report, 1989,31.
(Classification covering 34 countries in Africa, Asia and Latin America).

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[6] Calculated from nominal rates according to the formula: [(1 + r)/(1 + p) - 1] * 100. Where r = the deposit rate, p = inflation rate . Inflation is the percentage change in the CPI.

[7] M3 is currency plus the sum of non-bank deposits of the public at all identified deposit taking institutions. Real saving is the Gross Domestic Savings deflated by the average annual consumer price index (CPI) rate.

[8] Volatility of inflation is the absolute deviation of inflation rate from its level of the year before.

From the pooled observations (1965 - 85) Gelb found the varying investment efficiency across countries strongly and positively correlated with the average real deposit rate.

Referring back to chapter 4, Fry[9] also found the analysis to be robust well as Gelb, that is IOCR = C + 0.989RR - 0.139Shift (Rsq Adj = 0.563)

(5.90) (- 5.39)

They also found that the effect of the real interest rate on measured social saving - domestic and foreign, much less of the variance. The rate of growth for a single country is simply the propensity to save times the average (marginal) productivity of capital (Mckinnon 1992,p.21). Mckinnon reproduced Alan Gelb's (1989) partitioning of the sources of output growth from increases in the real deposit rate of interest. By differentiating:

$$Y^*/Y = DYY = \sigma(1/Y) = \sigma(IGDP) = \sigma s \quad [1]$$

Where $s = S/Y = IGDP$

Thus, differentiating [1] with respect to RR, yielded:

$$\frac{\delta(DYY)}{\delta(RR)} = \frac{\delta(IOCR)}{\delta(RR)}\,\underline{IGDP} + \frac{\delta(IGDP)}{\delta(RR)}\,\underline{IOCR} \quad [2]$$

Where the underlined IGDP and IOCR variables are cross - country averages.
Note: equation [1] was obtained by assuming that the second term on the right hand of $y = \sigma K^* + K\sigma^*$ is 0, then dividing through by Y.

By weighting the last two ie $\delta(IOCR)/\delta(RR)$ and $\delta(IGDP)/\delta(RR)$, with IGDP and IOCR, Mckinnon found that the efficiency effect was almost four times as important

[9] Maxwell J. Fry 1988.

as the investment effect in explaining differences in real GDP growth across the sample of 34 countries. Therefore, "higher real deposit rates of interest had their major impact through increased investment efficiency (as measured by IOCRs) rather than through increased investment or aggregate saving as a share of GDP".

In an inflationary economy, real rates of interest on financial assets are usually negative and less attractive to savers. The inflation tax extracted by the government is classified in the GDP accounts as if it was private saving, whereas, real personal financial assets are not accumulating and the flow of loanable funds may be low even though the flow of private savings as measured in the GNP accounts might be high.

Mckinnon argued that, because this forced saving effect offsets the negative substitution effect of inflation on accumulating liquid financial assets, systematic relationships between the flow of social saving and real rates of interest or between aggregate saving and inflation are weak or ambiguous. Therefore, cross country studies as shown by Gelb and Fry, tend to have a positive correlation between real interest rates and real growth seems to be strong and unambiguous.

6.1.1 THE IMPLICATIONS OF FINANCIAL REPRESSION AND PRODUCTIVITY OF CAPITAL ON DOMESTIC FINANCE

In reviewing the empirical analysis by Gelb for the period 1965-85, and his finding that the high-growth half of the countries sampled grew by 3 percent per year faster than the low - growth half; thus concluding that it is due to the greater financialisation of the domestic economy and the stabilisation of the foreign exchanges.

Mckinnon (1992), argued that the results from the empirical studies were so because it relied heavily on the real deposit rate of interest as the main indicator of the success of a monetary stabilisation program. In which case, stabilising the price level apart from raising real interest rates serves to limit the financial risk and lengthen the term structure of borrowing and lending. In addition, the M3/GDP ratio might also be increased by bank branches in the rural areas or taking other steps to increase the convenience and liquidity of holding bank deposits.

Domestic Financialisation can be defined as "marginally, associated with the extent new investment appears to be intermediated by the banking system or intra-marginally, by considering cross country variation in the M3/GDP ratio". In terms of marginally, it will be important when assessing the pay off to new investment, whereas, the latter, could be important for the efficiency of the existing capital stock. In this case, the best method for determining how interest rates operates through the financial system to influence real growth is still inconclusive.

Domestic financialisation operates mainly to increase the quality of the capital stock, both by raising the incremental output/capital ratio and by increasing the productivity with which the existing capital stock is distributed. In terms of incremental output/capital ratio, the effect may be associated with new investment reaching a more stringent market test when firms borrow from banks at a positive real interest rate. Higher deposit rates of interest increase the flow of bank funds available for new investment, even as lower-productivity investments are foreclosed if lending rates of interest are also increased from 'repressed' levels where loans had been tightly rationed.

Loans could actually fall when inflation or bank reserve requirements are reduced, while the flow of loanable funds intermediated by banks still remains high. Required reserve ratios against bank's liabilities feature in both the Mckinnon-Shaw and the Neo-Structuralist models. The Neo-Structuralist view of the reserve requirement constitutes a leakage in the intermediation process. The existence of required reserves may therefore reduce the intended effects of financial liberalisation or even produce adverse results (Fry 1988, pp. 108 - 109).

Both the Mckinnon-Shaw school and the Neo-Structuralist expect higher reserve requirements to reduce funds available for investment by reducing the demand for deposits or reducing the fraction of a given volume of deposits that are available for investment. The reserve requirement implications is discussed in greater detail later on in this study. In most LDCs such as Nigeria, there exists a large fringe of smaller firms, farms and investing households, without access to credit from the organised

banking sector. One major reason for this is the cost of servicing such small scale loans which are normally very high. Lack of adequate collateral or high risk is another reason for denying most firms access to loanable funds.

In chapter 5, I discussed extensively the various methods the Nigerian authorities had attempted to stimulate the domestic financialisation, through various decrees and special programs. In contrast to the views expressed by Mckinnon and Shaw as regards to the Neo-Structuralist views on inflation, interest rate and bank's intermediation, refer back to chapter 4 (pp.1-3). Also in chapter 4 of this thesis, table 4.1 provided the Nigerian GDP (at constant factor cost), the savings rate and the minimum-lending rate from 1970 - 89.

Drawing conclusions from table 4.1, it can be postulated that, by reducing the rate of price inflation, firms in industry and agriculture are deterred from undertaking relatively low yield internal investments or from holding non productive inflation hedges. Instead firms can hold cash balances as measured by the M3/GNP ratio.
The effects of holding various forms of stable valued money, from coin and currency to demand deposits, to saving and time deposits with attractive yields, according to Mckinnon is "complementarity" with investment in more productive physical capital (1992,pp.25 - 26).

6.1.2 FOREIGN EXCHANGE IMPACT ON THE QUALITY OF INVESTMENT

Repressive domestic financial policies can reduce the quality of investment by inducing instability in the foreign exchanges as well as reducing the depth and flow of loanable funds for new investments. Chapter (5), showed how repressive domestic financial policies caused 'in part' economic decline in the Nigerian economy. It also showed the instability of the naira exchange rate promoted by the general breakdown in the commitment to 'Fixed Exchange Rates' after 1973 (see sections 5.6 and 5.6.5 of ch5).

The severe terms of trade shocks, although the rise in the price of oil in the early 1970s cushioned off the effects to a certain extent, higher domestic financial repression led to higher inflation and lower deposit rates of interest (refer to table 4.1 of chapter 4). The difficulties of many economies have been related in one way or another to inappropriate exchange rate policies[10]. The move to floating rates in 1973 has a varying degrees of enthusiasm and many economies had been arguing the desirability of greater flexibility for years, for example, Harry G. Johnson (1973, p.198 - 222):

> 'The Case for Flexible Exchange Rates', 1969, in his book, A further Essay in Monetary Economics (Harvard University Press, 1973).

Consolidating the views so far with the analysis in chapter 5, by assessing the implications of the observed variability in floating exchange rates. Starting with the distinction between short term Volatility and Persistent rate misalignments.

VOLATILITY: The term implies: the amount of short-run variability in the exchange rate from hour to hour, day to day or week to week etc.

MISALIGNMENT: This means a persistent departure of the exchange rate from its long run equilibrium level[11].

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[10] Edwards, Sebastian - The World Bank, Occasional Paper Number 2 /New Series ; "Exchange Rate Misalignment in Developing Countries", 1988,p.vii.

[11] John Williamson; 'The Exchange Rate System', Institute for International Economics .Policy Analysis in International Economics, September 1983 Revised June 1985, pp. 9 - 10.

These two dimensions of variability are distinct. Rates can be volatile around an equilibrium level of competitiveness or stable over long periods while being misaligned.

6.1.3 VOLATILITY OF EXCHANGE RATE

To measure the volatility, two options are available. The first would be to seek the typical change in the rate from one period to the next. According to Williamson (1985) the International Monetary Fund (IMF) prefers this approach, stating the funds findings (1983) that:

> "The increased flexibility of member's exchange arrangements in the 1970s as compared with the Bretton Woods system is evident from a comparison of the average magnitudes of exchange rate changes in the period January 1948 - August 1971, and in the subsequent period through the end of 1981. For the fund membership as a whole, the average monthly change rose four folds, from 0.3 percent in the former period to 1.4 percent in the later. The increase in flexibility was more marked for the group of industrial countries, for which average monthly changes increased almost ten fold, from 0.2 percent to 1.9 percent".

The second approach is to seek the typical deviation of the rate from its short run moving average. Usually the measure of volatility is the coefficient of variations (standard deviation divided by mean) of exchange rates quoted at frequent intervals around a moving average. In terms of policy implications, there are some difficulties with rates quoted at frequent intervals, in that, they can not be corrected for inflation, since price indices are published relatively infrequent. Hence, the calculation is done in terms of nominal exchange rates.

Short term decisions on which volatility impinges are Bilateral rates against a particular currency, especially the US dollar (which is the major vehicle currency), rather than average; that is, Effective Exchange Rates. See table 5.2 in chapter 5 for the naira exchange rates against the dollar and pound for the period 1974 to 1984. Table 6.1 below compares the coefficient of variation of the other major currencies around a six - month moving average in the final years of the Bretton Wood System and the first year of floating.

Table 6.1:

Exchange Rate Volatility under Pegged and Floating Exchange Rates.

	1968	1969	1975	1982
Deutschemark	0.3	1.2a	1.7	1.6
French Franc	0.1	2.3a	1.6	2.2
Japanese Yen	n/a	n/a	0.7	2.5
Pound Sterling	0.7a	0.2	1.0	1.1

Source: IMF International Financial Statistics.
Note: a. Figure was influenced by a par value change.

According to Williamson (1985), the exchange rate volatility in the Bretton Woods period was very sensitive to par value as can be seen from the table above. The volatility led to the devaluation of the French franc and revaluation of the Deutschemark in 1969. As mentioned in chapter 5, the Sterling was devalued in 1967 and its measure of volatility during the period when there was no par value change was 0.2 percent and under floating, it was as high as 2 percent.

Williamson concluded that the increase in volatility is not sensitive to the particular measures chosen and that volatility has increased since the mid - 1970s. He further supported the postulation by stating that it is consistent with the findings by Kenen and Rodrik (1983) and Shafer and Loopesko (1983).

Technological advancements in telecommunications has led to far closer links between the main markets which enabled news to have an instantaneous worldwide effect on financial markets. Most of these advances occurred at the same time as the breakdown of the Bretton Woods system; thus making it more difficult to ascertain the extent to which technological progress rather than floating may have been responsible for the increase in volatility as indicated in table 6.1. The liberalisation of capital controls in the US in 1974, in UK in 1979 and in Japan in 1980, has led in part to increased capital mobility.

6.1.4 MISALIGNMENT OF EXCHANGE RATE

Real disturbances such as the sharp increases in the relative price of oil in 1973 - 74 and 1978 - 79 have been responsible for some of the changes in real exchange rates. Movements in relative prices led to sharp changes in exports and imports, disruption of normal trading relations and causing shifts in employment and output in the export and import competing sectors of the economy.

Many of the largest changes in real exchange rate experienced recently do not represent the equilibrium adjustments of relative prices to real disturbances. Instead, these changes represent the temporary but sustained departure of real rates from their long-run equilibrium levels. It is these departures of real exchange rates from equilibrium that is referred to as "Misalignment".

Misalignment may be associated with shifts in monetary policy or financial disturbances which change real exchange rates only because wages and prices are imperfectly flexible in the short-run. It may be associated with shifts in fiscal policy, which can change real exchange rates even when wages and prices are flexible, if those shifts are unsustainable in the long-run[12].

Exchange rate problems have become a dominant theme in policy discussions in Nigeria and many developing countries. The debt crisis (Cline, 1983), the disappointing outcome of the Southern cone experiments with free market policies (Corbo et al, 1986) and the dismissal performance of Africa's agriculture sector (World Bank, 1984, Essien, 1990 and refer to chapter 5, section 5.0), have been the result of inappropriate exchange rate policies.

Real Exchange Rates (RERs) have become increasing volatile especially for those LDCs that after the collapse of the Bretton Wood System maintained a fixed nominal exchange rate regime.

As noted by Sebastian Edwards (1989,p.2),

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[12] Richard C. Marston, "Misalignment of Exchange Rates: Effects on Trade and Industry"; 1988, pp.1 -2.

"it is now well accepted at the theoretical level that excess volatility in RERs and in particular situations of real exchange rate misalignment, will be translated into important welfare costs".

Maintaining the RERs at the "wrong" level generates incorrect signals and greatly hurts the degree of competitiveness of the tradable sectors[13]. Among the traditional policy measures to face exchange rate misalignment and external sector disequilibrium, devaluation is the most important. As we shall see later in this chapter, domestic capital markets are highly repressed in Nigeria as well as in most developing countries. This results in a reduced capacity for engaging in traditional monetary and fiscal policies.

Why Should a rate be regarded as misaligned even though it may clear the market; that is equate demand and supply? The best way to answer this question is to distinguish the three concepts of equilibrium.

[1] Market Equilibrium:

This is the exchange rate that balances demand and supply in the absence of official intervention. Market equilibrium refers to the nominal rather than the real exchange rate and tends to change rapidly whenever some relevant "news" changes. As noted by J. Williamson (1983), "absence of equilibrium is signified by heavy intervention and perhaps reserve borrowing intended to sustain the rate".

[2] Fundamental Equilibrium:

Is that which is expected to generate a current account surplus or deficit equal to the underlying capital flow over the cycle, given that the country is pursuing internal balance as best as it and not restricting trade for balance of payments reasons. This is what is usually referred to when rates are described as "overvalued " or "undervalued".

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[13] Willet, T; "Exchange Rate Volatility, International Trade and Resource Allocation". Journal of International Money and Finance, Supplement March 1986.

The fact that rates can become overvalued when a country inflates faster than its partners makes it obvious that this concept of an equilibrium rate relates not to the nominal exchange rate but rather to the real rate. That is, exchange rate adjust for inflation at home and in competitor countries. The fundamental equilibrium exchange rate (FEER) may change either because the underlying capital flow changes or because of changes in the pattern of demand for or conditions of supply of traded goods.

[3] Current Equilibrium:

This term is intended to indicate the rate that would be obtained if markets had full knowledge of all relevant facts and reacted rationally to that knowledge.

The current equilibrium rate would depend upon such temporary factors as the path of interest rates, which will depend on the stance of macroeconomic policy and the state of the business cycle given risk aversion, on net asset position vis-a-vis the rest of the world.

The current equilibrium rate will deviate from fundamental equilibrium when policy variables are set at levels which drive the exchange rate away from its FEER.

As noted by Rudiger Dornbusch (1976)[14] for example, a high interest rate relative to other countries will appreciate the currency involved, so as to create expectations of a yield-equalising depreciation over the period that the high interest rate is expected to persist.

Like the market equilibrium rate, the current equilibrium rate adjusts in response to relevant news. It also refers to a nominal rather than a real rate. Unlike the market equilibrium rate, identification of the current equilibrium rate requires subjective judgement.

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[14] Dornbusch, R. (1976). " Expectations and Exchange Rate Dynamics". Journal of Political Economy, Vol.84, No.6, (December).

6.1.5 REAL EXCHANGE RATE MISALIGNMENT

Definition:

Real exchange rate misalignment is a sustained deviation of the actual real exchange rate from its long-run equilibrium level.

When the actual real exchange rate is below the equilibrium RER value, it is said to be real exchange rate overvaluation. If on the contrary, the actual RER exceeds the equilibrium RER, it is then said to be undervaluation. Traditional policy analyses have tended to follow the purchasing power parity (PPP) doctrine of equilibrium real exchange rates in understanding this phenomenon from the definition of misalignment.

As stated by Dornbusch (1982, "Equilibrium and Disequilibrium Exchange Rates"), the theory assumed that the equilibrium real exchange rate is constant, its equilibrium level is found by looking at the value of the RER in some distant period that exhibited external equilibrium. Edwards, S. (1989, p.8), adopted a different approach from the Purchasing Power Parity (PPP) view. The equilibrium real exchange rate (ERER) is defined as:

> "that relative price of tradable to non-tradable that, for a given sustainable (equilibrium) values of other relevant variables, such as taxes, international prices, and technology, results in the simultaneous attainment of internal equilibrium".

Internal equilibrium means that, the non-tradable goods market clears in the current period and is expected to be in equilibrium in future periods. External equilibrium is attained when the inter-temporal budget constraint that states that the discounted sum of a country's current account has to be equal to zero is satisfied. That is, the current account balances (current and Future) are compatible with long-run sustainable capital flows. Unlike Fry and Gelb, Edward's analysis of twenty three Asian, Latin American and African LDCs over the period 1965 - 85, focused on the behaviour of real

exchange rates[15] under alternative definitions.

He defined the bilateral real exchange rate against the dollar as :

$$BRER = \frac{EP^*}{P} \qquad [3]$$

Where E = domestic currency / dollar,

P = domestic CPI (consumer price index)

P* = the American wholesale price index (WPI).

Edwards intention was to define the 'real exchange rate' as the relative price of tradable to non-tradable goods, where the foreign WPI is a proxy for domestic tradable and the domestic CPI is a proxy for the price of non-tradable.

Mckinnon termed the proxies as crude, arguing that if the WPI had been used for each country, fluctuations in BRER would have corresponded to the deviations from Purchasing Power Parity (PPP). Therefore, the BRER as defined in equation [3] are similar whether the domestic WPI or CPI were used.

As observed in chapter 5, the US dollar began to fluctuate sharply against other major currencies after 1973. As a result of these fluctuations, Edwards defined each LDC's real exchange rate on a multilateral trade - weighted basis as the 'real effective exchange rate', expressed as :

$$REER = \frac{\Sigma \alpha i Ei P^*i}{P} \qquad (i = 1, 2 \ldots, K), \qquad [4]$$

Where K is the number of partner countries over which the summation proceeds, αi is trade weight assigned to each and Ei is an index nominal exchange rate between the

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[15] The real exchange rate (RER) is defined as the relative price of tradable with respect to non-tradable goods (or vice versa):

$$RER = \frac{\text{Price of tradable goods}}{\text{Price of non-tradable goods}}$$

RER is a proxy for a country's degree of competitiveness in international markets . It measures the cost of domestically producing the tradable goods. See Edwards, S. 1988, p.3.

country concerned and its ith trading partner. The implication of this, is that, the potential for variation in the real exchange rate increases when inflation in P, the domestic level and denominator of [3] and [4], is high and unstable.

Variability in the LDC's terms of trade did not systematically affect growth in his sample periods, however, a sustained fall in the price of a key primary export can be very damaging in an individual LDC whose export mix is undiversified. While the terms of trade are outside the control of the LDC's authorities, fluctuations in the real exchange rate are very much influenced by its domestic financial policy.
The empirical study by Edwards showed a sharp decline in the productivity of investment (IGDP) after 1973, similar to that found by Gelb, (from 0.310 in 1965 to 1971,to 0.157 in 1978 to 1985). One possible explanation for this is the increased domestic financial repression in the period 1978 - 85; which according to Mckinnon, Edwards did not take into consideration.

In view of the difficulties Nigeria encountered in its exchange rate management in the mid 1970s; it can be postulated that 'stable prices permit greater domestic financial deepening and higher real deposit rates while limiting risk and the liberalizing government's task of stabilising its real exchange rate'. Without any agreement among the advanced industrial countries to maintain a stable exchange parities among themselves, the authorities in other countries will continue to experience more difficulty in stabilising their real exchange rates and their domestic price levels (Mckinnon, 1992,p.30).

Mckinnon analysis of the country studies discussed so far, was to demonstrate that achieving financial liberalisation while retaining monetary control has a real pay off, even when the international monetary system remains in some disarray. For a successful economic development to occur, there must be a stable domestic direct price controls. The deposit and lending rates of interest will have to be kept sustainable positive in real terms while limiting variance in the real exchange rate.

6.2 INSTRUMENTS OF FINANCIAL REPRESSION

Mckinnon used Colombia and Nicaragua to illustrate his discussion on the instruments of financial repression. The authorities in almost all the LDC's are usually constrained in raising revenue and as a consequence tends to rely on tariffs and other restrictions on foreign trade. Government interventionism in Nigeria and other LDCs are well discussed in 2, through to Chapter 5. The commonly used instrument by the authorities included, high reserve requirements, specialise credit agencies and interest ceilings on deposit and loans (Mckinnon 1992,pp.43 - 46).

6.2.1 INTERACTION BETWEEN INFLATION AND THE RESERVE REQUIREMENTS OF COMMERCIAL BANKS: A PARTIAL EQUILIBRIUM ANALYSIS.

The analysis by Mckinnon was to show that the relationship between the real lending rate of interest and the nominal rate of inflation is strong and positive and that the relationship between inflation and the real deposit rate of interest is negative. Assuming π to be the actual and expected rate of price inflation, ie p*/p, where p is the relevant general price index that depositors and borrowers use in determining their real returns.

If id is the average nominal deposit rate of interest offered by the banking system on all deposits and il is the nominal loan rate charged on borrowers, the real deposit rate rd and the real loan rate, rl will therefore be:

$$r_d = i_d - \pi, \text{ and } r_l = r_l - \pi \qquad [5]$$

If an average reserve requirement of k percent, where $0 < k < 1$, is imposed on all deposits, D, such that private loans, L, are only (1 - k) percent of the deposit base:

$$L = (1 - k)^D \qquad [6]$$

Assuming this reserve requirement is non - interest bearing for the commercial banks, and with no official interest ceilings or other usury restrictions, the reserve requirement would force the commercial banks to reduce the deposit rate of interest and raise the loan rates, thus contracting the flow of loanable funds.

Further more, let's assume that banks operate with zero - profits, that is current earnings from loans are fully paid out to depositors:

$$i = \frac{id}{1 - k} \qquad [7]$$

where the nominal interest paid out to depositors is (1 - k) of that received from borrowers per dollar lent. In terms of real interest rates, subtracting π from each side of equation [7] and substituting (rd + π) for id to obtain :

$$r_l = \frac{r_d}{1 - k} + \frac{\pi^k}{1 - k} \qquad [8]$$

Equation [8] implies that the amount by which the real loan rate exceeds the real deposit rate is an increasing function of k, π, and rd. It also means that the real loan rate must increase with the rate of inflation. Therefore, the burden of a given reserve requirement k on the flow of loanable funds depends directly on the rate of price inflation even when no other interest restrictions exists. Other forms of distortions include: direct ceilings or usury restrictions on deposit and loan rates of interest and how they interact with reserve requirements when inflation is present.

6.2.2 DILEMMA'S IN FINANCIAL POLICY IN THE LIBERALISING ECONOMY

The developing countries' governments are constantly faced with the difficult choice between best and second best policies in their determination to eliminate financial repression and promote rapid growth in the flow of loanable funds. Various ad hoc decisions are made by the planning authorities to divert funds from the constipated financial system to support this or that enterprise, which may have some chance of improving resource allocation when considered one at a time. However, savers in the deposit banks would be left with low or negative real yields.

The best policy, as presented by Mckinnon is to stabilise the price level and eliminate reserve 'taxes ' on the commercial banks. It could involve substantial improvement in fiscal policies, including the phasing out of all credit subsidises.
At the institutional level, it is essential that the government withdraw the various subventions, interest regulations and special credit facilities or foreign exchange allotments that already influence the microeconomic allocation of investment resources in the economy.

This involves: dismantling old government bureaucracies, the relinquishing seats on the board of the Central Bank by old government ministers, allow for discount policy and foreign exchange policy; thus, allowing the independent board with a mandate to stabilise the domestic price level to operate effectively.
The implication of this is that, for such a successful reform, the commercial banks and related institutions would have to be aggressively swift to providing high interest loans to well diversified segments of industry and agriculture whose special credit lines and other interest subsidies have been phased out. The other implication in the transition to a more competitive banking system is with regards to increases in interest rates on deposits and loans and the allowance of new commercial banks to operate, hence making the older commercial banks face serious bankruptcy threats.

Caution about licensing a host of new domestic or foreign banks to enter the newly opened domestic capital market in the initial stages of liberalisation is necessary.

The need for caution can be justified looking at the financial deregulation and the effectiveness of bank supervision in Nigeria. In a survey by the Nigerian Deposit Insurance Corporation (NDIC) of Nigerian banks in 1989, it was found that the banking industry had many firms operating below solvency levels with negative shareholder's funds amounting to N763 million. The survey also found that a total of twenty - three banks did not meet the statutory paid-up capital of N20 million for commercial banks and N12 million for Merchant banks. In May 1991, capital for commercial banks was raised to N50 million and N40 million for Merchant banks[16].

The uneasiness arose from the recognition that the ongoing financial deregulation has changed the industry a lot in Nigeria. Banking has diversified considerably, investment options have been broadened and liability management is now prevalent.
Regulations have been relaxed in a number of ways. Banks can now hold stocks in non-financial companies, deal freely in foreign exchange and engage in equipment leasing. Entry barriers into the industry have been softened with the number of banks as at August 1992 standing at 124, compared to only 40 in 1986 when deregulation commenced. (see chapter 5, sections 5.7.1 - 5.8)

[16] A.A. Alawode, "Financial Deregulation and the Effectiveness of Bank Supervision in Nigeria", Savings and Development, No.1 ,1992, pp.101 - 110.

6.3 THE INFLATION TAX, MONETARY CONTROL AND RESERVE REQUIREMENTS ON COMMERCIAL BANKS.

The aim here is to analyze the problem of macroeconomic control when an uncovered fiscal deficit exists that makes some financial repression inevitable, that is, government expenditures including credit subsidies, exceeding revenues.

Since there is no major open market in primary securities, the government can not sell treasury bonds or bills directly to the public, instead the government extracts seigniorage - implicit tax revenue from the financial system through the issue of base money[17].

Referring to the seminal analysis[18] by Friedman (1971), Mckinnon (1992) postulated that by assuming a single homogeneous demand function for non - interest - bearing base money (ie, Coin, Currency or Official Reserves held by the banking system), the flow of loanable funds through the commercial banking system is not explicitly considered in the Friedman's analysis. He then proceeded to distinguish two forms of demand for base money. The first method is the "demand for Currency held by households (and firms)". The second is the "commercial (and savings) bank reserves held with the central bank".

6.3.1 THE MODEL

Given the financing problem facing the government of a repressed economy, expressed as follows:

$$Z = G - T \qquad [1]$$

where Z denotes the consolidated government deficit that must be financed by extracting revenue (seigniorage) from the domestic banking system, G represents the measure of government expenditures and T is the flow of ordinary taxes collected.

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[17] That is, reserve requirements on the banks and inflation interact to tax the holders of money and near monies. It also tax borrowers from the domestic banks through higher real loan rates.

[18] The conventional models of the inflation tax and the extraction of non-inflationary seigniorage.

The deficit term Z is taken to be stated in nominal terms and will vary with the price level. Assuming the government's known need for real finance from the domestic monetary system be given exogenous such that:

$$Z/P = \alpha Y + v \qquad [2]$$

where P is the general price deflator

Y is exogenously given real income (GNP) used here as a scale factor. v is a random stochastic disturbance reflecting some lack of official control over the fiscal system. α could be taken as a policy parameter; of which a reduction in it could lead to an increase in ordinary tax collections or a decrease in official credit subsidies to preferred borrowers. For a steady - state financial repression, Mckinnon assumed the parameter α to be a positive constant and v to have a significant variance with mean zero.

Let's assume the objective is to minimise the rate of expected price inflation (in the steady state) subject to the constraint that the fiscal deficit must be financed by the domestic banking system. Apart from maintaining the interest - rate subsidies on credits to officially designated borrowers that are part of the government deficit in equation [2], the central bank are not constrained to maintain general interest rate controls (usury laws), unless they prove useful in reducing the rate of price inflation. The central bank remains free to manipulate reserve requirements on all classes of deposits without any direct concern for the "Crowding Out" of private borrowers.

The other instrument of financial policy available is for the government to effectively tax the financial system by establishing non - interest bearing reserve requirements. On the central banks Balance Sheet, all narrow money usable for making payments to third parties is aggregated into the variable C. All reserves against term deposits are denoted by R. The accumulated sum of past government deficits $\Sigma(Z_t)$, is the central bank's only asset in this closed economy.

Table 6.2

CENTRAL BANK BALANCE SHEET

Government debt $\Sigma(Z_t)$	Currency + Reserves against demand deposits C Reserves against time deposits R Monetary Base M

The real revenue flow accruing to the government from the issue of base money can be expressed as:

$$Z/P = M^{\cdot}/P = (M^{\cdot}/M)(M/P) = \mu(M/P) \qquad [3]$$

Where $M^{\cdot}$ is the absolute rate of change in base money and μ is its proportional rate of change. The above equation [3], implies that real revenue from the banking system is the percentage in nominal money supply times the real monetary base[19].

An additional important feature here is the demand for un-subsidized loans in the free part of the capital market. Based on resources accumulated through the issue of term deposits. Commercial banks may lend at whatever interest rate denoted by i_l they can get. The demand function for real loan can be expressed as:

$$L/P = h(\pi, i_l) \qquad [4]$$

where L is the nominal quantity of loans.

It is important to note that, the non - interest bearing reserve requirement on term deposits drives a wedge between the open - market interest rate on deposits and that on loans. The inflation tax on reserves is shared between depositors, whose yields are driven down and borrowers whose costs are driven up. If the nominal interest rates on deposits are scaled upwards to reflect π, then the wedge between deposit and loan

[19] In a steady state, this would depend on the level of real income Y.(Mckinnon, The Order of Economic Liberalisation, 1992,p.60).

rates of interest will increase with π. This means that, as inflation increases, banks are forced to pay a higher nominal interest rate on deposits in order to maintain their real deposit base. Because of the non interest bearing reserve requirement, the loan rate must increase for the banks to continue to break even.

Therefore, when these nominal interest rates are free to adjust, inflation increases the wedge between deposit and lending rates of interest.
This can be represented in equation form as:

$$r_l - r_d = \frac{r_d k}{1 - k} + \frac{\pi k}{1 - k} = i_l - i_d \qquad [5]$$

For any given r_d, the wedge between deposit and loan rates increases with k and π. The higher the reserve tax k, the greater the effect of inflation in increasing the wedge between deposit and loan rates. Therefore, how much r_l increases absolutely and rd falls absolutely depends on the elasticity of demand for loans equation [5], compared with the elasticity of supply of deposits that is the demand for term deposits:

$$D/P = q(\pi, i_d)Y \qquad [6].$$

6.3.2 RESERVE REQUIREMENT FOR MINIMISING INFLATION

Now, lets consider the minimization of the inflation rate, π, with respect to k subject to the market clearing conditions below.
Condition [1] Private loanable funds are (1 - k) percentage of deposits, which can be expressed as follows:

$$L/P = (1 - k)D/P = h(\pi, i_l) = (1 - k)q(\pi, i_d) \qquad [7]$$

At this point it is worth noting that the demand function for the base money is defined as:

$$M/P = KD/P + C/P \qquad [8]$$

Condition [2] The government deficit is equal to the rate of change in base money, which can be expressed as :

$$Z/P = (kq + f)(\pi + \tau) \qquad [9]^{20}$$

Condition [3] : Competition drives bank profits to zero:

$$i_l(1 - k) - i_d = 0 \qquad [10]$$

This optimization procedure based on the above three equilibrium conditions determines the endogenous variables i_l, i_d, and π.

Condition [2], that is, the exogenously given government deficit Z/P, must be financed by issuing currency and reserves against term deposits.

[20] This is derived by assuming an exogenously given steady growth in real income, τ, to which there corresponds a steady state inflation that depends on μ such that: $\pi = \mu - \tau$. [a]
Where π is the rate of price inflation, P*/P. That is, given τ, minimising π will correspond to minimising μ, the percentage rate of issue of base money. Therefore, combining eqn[a] with eqn[8] yielded the expression for equation [9].

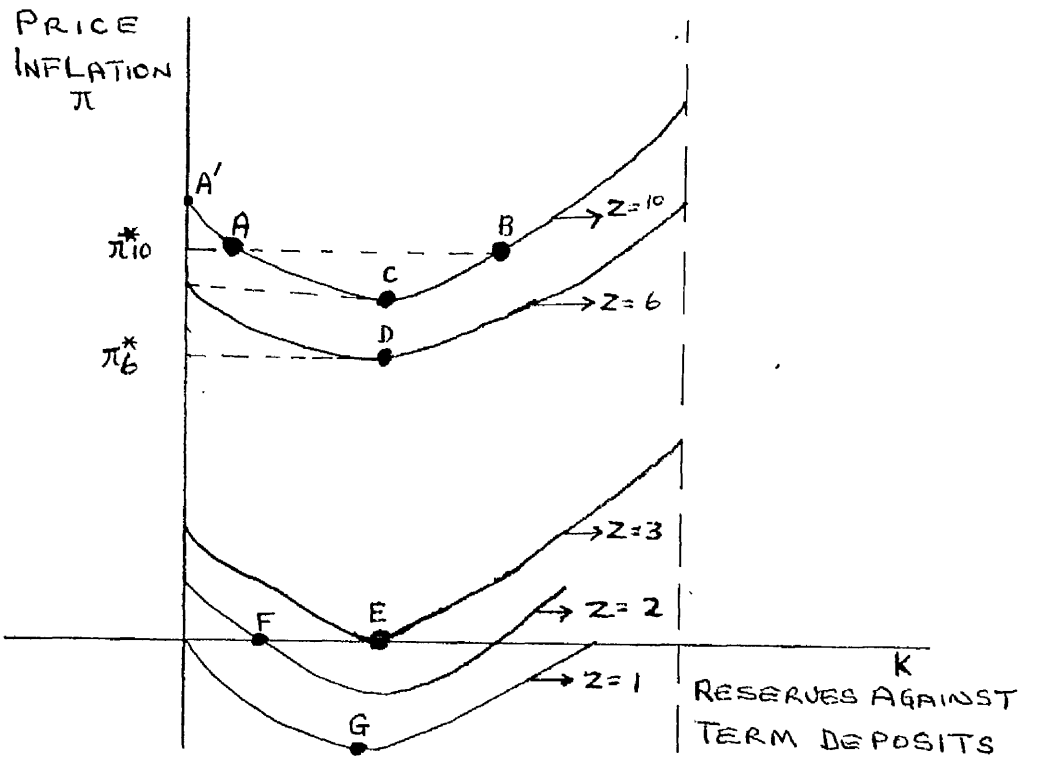

Figure 6.1:

Inflation, Fiscal Deficit and Optimal Required Reserves (the Mckinnon version).

From the diagram, z represents various levels of the fiscal deficit. The decision variable, the reserve requirement, k, ranges between 0 and 1. When set at 0, the government gets no revenue from the term deposit part of the system.

When it is at 1, so that the nominal yield on term deposits falls to zero, everyone abandons term deposits in favour of more liquid demand deposits and currency, thus government revenue falls to zero. For z = 10, the optimal solution is at point C, where the reserve requirement is set at a fairly high level to minimize the relatively high inflation rate and high rate of issue of base money.

As k, increases, the relative tax burden is shifted toward the term - deposit part of the market. The extent of the shift will depend on the elasticity of response of depositors and borrowers. The more inelastic is the demand for term deposits and for real loans with respect to a fall in i_d and a rise in i_l, the greater will be the optimal reserve requirement to minimize the inflation rate π.

Alternatively, the more inelastic is the demand for currency, the lower will be the optimal reserve requirement as more of the inflation tax burden is shifted towards currency holders. Figure 6.1 is used by Mckinnon in his analysis to illustrate the ways in which the optimal reserve requirement, the inflation rate and different levels of the exogenous fiscal deficit are likely to interact.

In conclusion, the higher the natural real rate of growth and the flow of non-inflationary seigniorage in the economy, the lower will be the minimum necessary inflation rate to finance the given fiscal deficit.

6.4 PROTECTIONISM IN FOREIGN TRADE: QUOTAS AND TARIFFS.

> "Bhagwati and Kruger (1965) defined trade liberalisation as a process of moving away from quota restrictions at, possibly, disequilibrium exchange rates to arrive at a system where only tariffs are used at an equilibrium exchange rate".

Nigeria which has had quite a number of exchange controls, licensing and import quotas, by applying the above definition will mean that the country has been absolutely illiberal.

On the conditions for perfect equivalence to hold, Bhagwati (1965, 1978), it is essential to state how the additional import licenses are allocated. If they are auctioned off or simply given to a single person or firm, like a trading house or agency house with a history of importing that product, then a potential monopoly is created. The exclusive license could generate a further rise in price by restricting supply.

Where licenses are apportioned to users by some economic criterion such as 'capacity' for utilising imported industrial materials, this will immediately sets off a scramble by potential demanders to satisfy this criteria. Only in the unlikely event that licenses are distributed widely and by economic criteria extraneous to the industry in question will one avoid some endogenous shift in the domestic supply or demand curve that distorts resource allocation beyond that occasioned by a simple tariff.

6.4.1 THE FIVE PHASES OF QUOTA RESTRICTIONS AND OTHER EXCHANGE CONTROLS.

Phase 1. Is characterised by the imposition or sharp intensification of relatively in-differentiated or across the board import controls, usually undertaken to influence the balance of international payments. This could result from a sharp drop in price of some major export or from unexpected capital flight occasioned by the build-up of external indebtedness, thus, running down foreign exchange reserves (see sections 5.5 and 5.9 of chapter 5, of how phase 1 relates to the Nigerian economy).

The problem with across - the - board tariffs are, it usually require cumbersome legislation or parliamentary approval. It is too slow or too uncertain to offset the macroeconomic impact of the initiating disturbance and achieve balance of payments equilibrium. The authorities having committed itself to generalised exchange controls, the country then succumbs in phase 2 to much stronger protectionist.

Phase 2: Is characterised by increased and more specific restrictiveness of the entire control system. Its significance is the proliferation of detailed regulations, administered by a large bureaucracy, to differentiate among alternative end uses of imports. Import licenses are distinguished according to origin and destination, for example, between wholesalers and final users and according to very detailed type such as capital goods, intermediate goods and consumer goods.

The problem with phase 2 is that, administration of licensing procedures can become more sophisticated in the sense that taxes or special customs duties are often levied to absorb some of the economic rents accruing to particular import licenses although others in the same commodity categories may be exempted. Specific exporters may get special subsidies to offset the overvalued domestic currency. Foreign exchange shortages may become too severe, as in the case of Nigeria, or too many obvious anomalies develop in the pricing and allocation of imports. Thus, pressure develops to devalue the currency and rationalise.

Phase 3 is a major discrete devaluation. The degree of rationalisation accompanying devaluation can vary enormously. The naira devaluation was to bring it down to its real value among other international currencies, as well as simplifying the administration of foreign trade . Exchange controls are relaxed and some subsidies for exporters and surcharges on imports, except on some luxury goods were eliminated. There was a real intent by the Nigerian authorities to push the real devaluation much further, as they did in March 5, 1992, by deregulating (floating) the naira in order to increase the export orientation of the economy and to reduce net incentives for import substitution by actually eliminating import quota restrictions.
Phase 4, quota restrictions are greatly reduced and or replaced by formal tariffs so that

relative prices become more important in determining what is actually imported.

Phase 5 is full currency convertibility on current account with quantitative restrictions on foreign trade not employed as a significant means of regulating the balance of payments.

The pegged exchange rate is at its equilibrium level and monetary and fiscal policies are consciously employed to maintain external balance . According to Mckinnon (1992, p.96), in the process of economic development, free currency convertibility seems to be either very hard to attain or not a highly regarded objectives on the part of the authorities in poor countries.

6.4.2 APPRAISAL OF THE MACROECONOMICS OF DISTORTIONS FROM QUOTA RESTRICTIONS.

Starting with the originality of quota restrictions, the industrialised countries, Japan and USA for example, maintained more-or-less fully convertible currencies and honour the most- favoured - nation (MFN) principle of the General Agreement on Tariffs and Trade (GATT). The problem is that these industrialised nations have not applied this principle consistently in negotiating export outlets in LDCs.

According to the postulation by Mckinnon (1992, p.96), aid tying including the extension of export credits at below market rates of interest, in effect require recipient LDCs to regulate their imports by source or by payments conditions. The United State's attempts to improve its balance of payments position in the 1960s encouraged the proliferation of preferred lists of American goods from which aid recipients had to choose. Exports of American food grains to LDCs in the 1960s under public law 480 encouraged the profileration of LDCs import restrictions on like products that were not similarly subsidised.

Dumping in LDCs of European commodity surpluses sometimes has similar side effects. Major donor countries like Japan often include their development assistance as a subsidy element in ordinary commercial credits. Such assistance can be obtained

by the LDC in question only if it agrees to restrict its purchases from such credits to Japanese goods.

Article XVIII of the GATT is a general escape clause that allows poor countries at their behest to impose any tariff or quota restriction for "developmental" purposes. Unlike the industrial economies, therefore, LDCs are not effectively part of the GATT legal mechanism for securing freer trade. Therefore, to conclude this section, it is essential to note that the outcome in phase 2 is that, the import licensing authorities, whatever their initial intent, begin to influence the whole internal flow of trade and commerce. The distribution or redistribution of income through the assignment of license premiums becomes quantitatively very significant.

6.4.3 THE IMPACT OF GATT, TRADE AND THE DEVELOPING COUNTRIES

> "There has been a progressive dismantling of many trade barriers since the end of the Second World War, which can be attributed in large measure to the role and influence of the General Agreement on Tariffs and Trade (GATT)[21]".

In the view of Paul Krugman, GATT lacks a theoretical underpinning. He argued that GATT can be characterised instead as "enlightened Mercantilism" or as he labels it, "GATT-think".

The guiding principles of GATT-think are: Exports are good and imports are bad; and an equal increase in imports and exports is good. Despite the seeming illogic of GATT-think. He noted that, it has led to a remarkable degree of achievement in trade liberalisation. However, trade policy as currently practised does not reflect clearly the model of free trade.

Bhagwati on the other hand grants there is reason to be concerned about unfair trade and to permit countervailing duties and anti-dumping actions to counteract it.

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[21] R.M. Stern, "Mini Symposium: Issues for the global Economy in the 1990s", in The World Economy (the leading of International Economic Relations), 1992, July, Vol.15, No.4, pp.416 - 417.

He pointed out that there is clearly some danger involved in-so-far as measures aimed against unfair trade can be misused for protectionist purpose[22].

Bhagwati notes that allegations of unfair trade are a manifestation of the increased protectionist pressures dating from the early 1980s and may also reflect the suspicion that non-tariff interventions are inhibiting trade in ways that are not always obvious. Factors giving rise to sentiments of unfair trade include the increased magnitudes and complexities of foreign direct investments, problems arising in coping with exchange rate volatility.

He noted that there is still a further challenge to the GATT system, which is the increasing resort to the formation of regional trading blocs. The inclusion of article XXIV in the GATT agreement was a recognition of the possible benefit that might result from customs unions and free trade areas. The recent revival of interest in regional trading bloc, according to Bhagwati, reflects a shift in US policies. This may be due in part to the perceived need to form a North America bloc and may be a larger Western Hemisphere bloc to countervail the size and influence of an economically and politically integrated bloc in Western Europe.

According to Anne Krueger[23], in the period 1945 to the late 1960s, there was a considerable homogeneity in the economic structures of LDCs and a commonality of inward looking and costly domestic policies. Krueger noted that:

[1] Countries that adopt the right policies can grow very rapidly and succeed in international competition.

[2] With more countries adopting outward looking policies, the supply of exports will increase.

[3] The LDCs are no longer a homogeneous group.

[4] The future of LDCs exports depends crucially on there being open markets in

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[22] Jagdish Bhagwati, "The Threats To The World Trading System", The World Economy, 1992, pp.443 - 456.

[23] Anne O. Krueger, Trade prospects for the developing countries, 1992, pp.457 - 474. The World Economy.

the industrialised countries.

There are two critical issues that will determine how favourable the trade prospects for LDCs will be. The first is whether it is possible to maintain and strengthen an open, multilateral trading system under GATT. The second is the success that individual LDCs may experience in the reorientation of their policies and adaptation of their domestic economies in ways that will be conducive to the realisation of greater economic efficiency and growth. Slow progress at the GATT negotiations has led the World Bank to conclude that a division of the world into trading blocs, Europe, the Americas and East Asia is the fast road to multilateral free trade[24].

The problem with this postulation by the World Bank is that Africa has not been grouped into any bloc. May be perhaps the Bank's neglect of the region could be because of the repressive policies most countries in Africa are still pursuing.
With liberalisation in Nigeria, the ECOWAS[25] zone of which Nigeria is a member could become a viable trading area.

6.4.4 THE RATIONALE FOR QUOTA RESTRICTIONS IN FINANCIALLY REPRESSED ECONOMY.

In discussing the rationale for quota restrictions in financially repressed economy, Mckinnon (1992, p.99) questioned why phase 2 is observed in so many LDCs in Latin America, Africa and Asia, whilst, observe less extreme quota restriction situations such as phase 1 and 4. Some of the answers presented for the above enquiry are:

[1] The macroeconomic instability tends to generate a "demand" for quota restrictions. Relating this to Nigeria, it has been argued in the previous chapters that some of the restrictions imposed by the Federal Government was to curb the excess consumption of foreign goods, which is taking a large portion of the gross domestic product (GDP) see table 5.7 of chapter 5.

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[24] World Bank Policy Research, Bulletin May - July 1992, Vol.3, No.3.

[25] ECOWAS: Economic Community of West African States.

Domestic financial and price level instability which is usually associated with high and variable inflation, generates a second -best argument for quota restrictions because real and nominal exchange rates become highly variable and unpredictable (Edwards 1989).

This increased exchange risk has potentially deleterious effects on the productivity of domestic investment. Thus, the authorities attempts to mitigate this investment risk by protecting some of their producers with absolute quota restrictions because the protective effects of such restrictions are relatively invulnerable to exchange rate changes. In contrast, the protective effect from given import tariffs can easily be upset by a real appreciation of the domestic currency, causing domestic producers of import substitutes to incur unexpectedly large losses.

[2] On the microeconomic arguments, the proliferation of quota restrictions may depend on the realm of politics as much as in economics. Mckinnon's view was that, for countries with weak constitutional limits on the assertion of economic power by the government of the day, favourable allocations of quota restrictions can reward one's political friends. The denial of licenses, including the permission to export freely at an equilibrium exchange rate, can be economically devastating to groups who are politically unfriendly.

Many governments in LDCs are self - styled socialists, who view their legitimate mandate to be one of extending state control over domestic economic activity. Even Military Governments such as in Nigeria, are often uninhibited interventionists, in their attempt to regulate the foreign exchange of the naira, import controls to the domestic banking system.

Governments in LDCs find that foreign trade is more easily controlled than domestic trade because of the need of traders to change from foreign to domestic money and vice versa, plus the usual practice of raising revenue by tariffs and licensing at a limited number of border - crossing stations and ports that conveniently encompass the economy. Therefore, quota restriction regimes are an indirect but Second-Best

method of exercising a socialist or otherwise interventionist mandate.

For Mckinnon, the fiscal inefficiency of using restrictions on foreign trade are essentially to compensate for the domestic economic distortions. Both Bhagwati (1971) and Johnson (1965), advocated that taxes and subsidies should be used to offset distortions directly in the markets where they occur.

This means that, for those new industries where technological spill-over is very high and proportional to the level of production, direct production subsidies should be employed. But in Mckinnon's view, quota restrictions on foreign trade must be a distant fourth - best or worst - possible solution to the problem of overcoming domestic distortions.

This leads to the question, why are quota restrictions so prevalent in practice? In answer to this question, Mckinnon emphasized that, the problem is that this theoretical critique of using trade restrictions to correct domestic distortions implicitly presumes that governments in LDCs have control over their public finances. Frequent fiscal crisis in LDCs often revolve around the problem of covering public sector deficits in a situation where capital markets are too rudimentary to permit government bonds to be sold directly to the non-bank public.

Therefore, the authorities are frequently induced into manipulating the flow of foreign trade and payments, as well as the flow of money and bank credits.
In a financially repressed economy, an open capital market barely exists and is incapable of channelling funds for investment into high priority uses. Entrepreneurs find that they cannot effectively bid for bank credit, despite the highly protected import - competing sector. In which case, the possession of an exclusive license to import some necessary intermediate goods such as industrial materials or capital equipments, performs an important dual role of:

(a) The holder of a license gets a capital grant in the form of a premium that can be applied toward investment.

(b) The exclusivity of the license allows the holder to bid more easily for funds from the repressed financial system.

6.5 SUMMARY AND CONCLUSION:

The Mckinnon hypotheses was that, financial repression provided some microeconomic rationale for the persistent use of quota restrictions in Less Developing Countries to encourage particular kinds of investments.
This implies that, the successful elimination of quota restrictions regimes is more likely and may only be fully desirable economically, if packaged with a more general program to re-establish financial stability by reducing volatility in the real exchange rate and improving the workings of domestic capital.

The optimal order of economic liberalisation may vary for different liberalising economies depending on their initial conditions. Therefore, before price inflation can be feasibly phased out, and before the capital market is opened for free borrowing and lending, it is essential that the government attempt to balance the central government's finances.

The policy prescription for overcoming the monetary system fragmentation should include a positive and uniformly high real rates of interest within comparable categories of bank deposits and loans, as well as removal of onerous reserve requirements, interest ceilings and compulsory allocations of cheap credit, hence encouraging domestic savers and investors.

Domestic financialisation operates mainly to increase the quality of the capital stock, both by raising the incremental output/capital ratio and by increasing the productivity with which the existing capital stock is distributed. Both the Mckinnon-Shaw and the Neo-Structuralist schools expect higher reserve requirements to reduce funds available for investment by reducing the demand for deposits or reducing the fraction of a given volume of deposits that are available for investment.

Exchange rate problems have become a dominant theme in policy discussions in Nigeria as in many LDCs. The debt crisis, the disappointing outcome of the southern cone experiments with free market policies and the dismissal performance of Africa's agricultures sector, are all attributed to the inappropriate exchange rate policies.

For a liberalising Economy, the best policy may be to stabilise the price level and eliminate reserve taxes on the commercial banks; which could involve substantial improvement in fiscal policies including the phasing out of all credit subsidises.
On quota restrictions, Nigeria's reason for doing so was to curb the excess consumption of foreign goods, which is taking a large portion of the gross domestic product. Domestic financial and price level instability which is usually associated with high and variable inflation generates a second best argument for quota restrictions. This is because real and nominal exchange rates become highly variable and unpredictable.

Therefore, the microeconomic arguments, the proliferation of quota restrictions may depend on the realm of politics as much as in economics.

7.0 CONCLUSION

The theses examined the role of interest rates and saving in determining economic growth. It looked at the various hypotheses advanced by Mckinnon, Shaw and the Neo-Structuralist schools.

Mckinnon postulation was that the existing economic assumptions are not adequate in the context of developing countries. He provided an alternative model in which real balances are complements to rather than substitutes for tangible investments.
Control over public finance according to the analysis is an essential prerequisite for successful financial liberalisation.

Shaw in his Financial Deepening hypotheses was very critical of low controlled interest rates and financial repression. His view was that, the real rate of interest as the return savers is the key to a higher level of investment and as a rationing device to greater investment efficiency. The postulation therefore is that, expanded financial intermediation between savers and investors resulting from financial liberalisation and financial development, increases the incentives to save and invest as well as raising the average efficiency of investment.

At the centre of the Neo-Structuralist model was their incorporation of the Curb Market, in which money lenders and domestic banks intermediate between savers and investors. The Structuralist do not fully support the view that financial liberalisation can yield the desired result under the conditions of standard assumption that financial assets are gross substitutes. Their conclusion was that financial liberalisation is likely to reduce the rate of economic growth by reducing the total real supply of credit available.

A major distinction of the Neo-Structuralist from the Mckinnon - Shaw school is on whether increased demand for time deposits caused by an increase in the real deposit rate of interest reduces the demand for currency or the demand for curb market loans.

The Nigerian economy has significantly been transformed from one dependent on

agriculture to one heavily dependent on oil since gaining independence in 1960. The foreign exchange problems facilitated the slow down in industrial growth throughout the 1980s. The industrial policy of the immediate post independence was that of import substitution, which was supported by a number of limited fiscal policies.

The problem of gross inefficiency and corruption among the Nigerian institutions of the state as well as the private sector have militated against the development of a clear and sustainable ideological position, the promotion of industrialisation and rational accumulation. Thus the essential need for a structural and economic adjustment.

On the part of the International Monetary Fund (IMF) and the World Bank, the Nigerian structural adjustment programme (SAP) was essentially to reduce the country's balance of payments deficits. Hence, forcing a shift from state to a full market led policies. The emphasis was on pricing as the major instrument for organising the economy and reviving the agricultural production through a combination of policies involving devaluation, privatisation and reductions in state expenditures and subsidies.

The need for a coherent exchange rate mechanism is essential. Nigeria has learnt the mistakes over the years of keeping to a rigid fixed exchange rate system is viewed as macroeconomic mis-management. Hence, the adoption of SFEM, and later the floatation of the naira. The usual short term policy response of restricting imports through exchange controls, higher tariffs and pre-imports deposits has failed to achieve the desired results.

Developments on the Nigerian financial system concentrated on changes in structure, growth and the emerging challenges. The deregulation of the financial sector meant non - government intervention in the organised domestic financial market through interest rate regulations among other factors. Thus, banks can concentrate on their savings mobilisation role in the economy.

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