Financial Development for Economic Growth in Nigeria

Uyiosa Omorogie

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Abstract

A country's financial system facilitates economic growth by ensuring that funds are available when and where they are required. The provision of alternative financing windows available to operators in the real sector is dependent on the structure of the financial system in place. The Government can ensure (through polices put forward) that transparency and fairness is the norm in the financial sector, this will go a long way towards sustainable economic growth in Nigeria. The financial sector that creates sustainable economic growth must be resilient and strong, with institutional development as a priority, this sector must facilitate fund mobilization for the low-income people to increase and stabilize their income and assets. An investment-friendly interest rate regime (single digit) is a pre-requisite for economic growth in Nigeria, because it would encourage lower costs of borrowing and credit expansion. Tax incentives policies must be maintained to encourage large-scale investment in the economy.

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*Corporate Planning Department, Brass LNG, Lagos,
Email: uyiosaomoregie@yahoo.co.uk
1. Introduction: the financial sector and the ‘real’ sector

Joseph Schumpeter in his magisterial work *The History of Economic Analysis* (1954), suggested that goods and services express all the essentials of economic life – decisions about goods and services and the relations between them constitute the original meaning of the concept of ‘real analysis’ Schumpeter also suggested that “money enters the picture only in the modest role of a technical device that has been adopted in order to facilitate transactions.” According to Schumpeter, the ‘real’ is in the sense of non-monetary processes. Economists use the word ‘real’ for monetary quantities that have been ‘corrected’ for changes in some price level. When money income is divided by a cost of living index, we get real income. But, corrected or not, monetary quantities remain monetary quantities used in monetary analysis.

Following Schumpeter, the particular distinction of ‘real’ in this paper, must not be identified with the distinction between analysis in terms of (for example) dollars of constant purchasing power and analysis in terms of ‘current’ dollars:

Thus, money has been called a ‘garb’ or ‘veil’ of the things that really matter, both to households or firms in their everyday practice and to the analyst who observes them. Not only *can* it be discarded whenever we are analyzing the fundamental features of the economic process but it must be discarded just as a veil *must* be drawn aside if we are to see the face behind it. Accordingly, money prices must give way to the exchange ratios between the commodities that are the really important things ‘behind’ money prices. Income formation must be looked upon as an exchange of, say, labor and physical means of subsistence; saving and investment must be interpreted to mean saving of some real factors of production and their conversion into real capital goods, such as buildings, machines, raw materials; and, though ‘in the form of money,’ it is these physical capital goods that are ‘really’ lent when an industrial borrower arranges for a loan. The specifically monetary problems can then be treated separately, much as we treat many other things separately, for example, insurance (Schumpeter, 1954).

Mordi (2010) defines the ‘real’ economy as consisting of firms, households and other agencies engaged in the production of goods and services which can either be consumed now or put to use with a view to producing more in the future.

According to Mordi (2010), economic activity is conceptualized as ‘real’ because real resources are applied to produce something which people can buy and use. The financial system is mainly concerned either with moving funds around so that those who wish to buy can do so, or helping people to exchange ownership of the productive resources. The activities of the real economy are essential to life. The real economy produces food, heating, lighting, consumer goods and entertainment, among other activities. The job of the financial system is to facilitate that, by making sure that funds are available when and where they are wanted. In that regard, the issue of the structure of the financial system is brought to the fore, as it would provide alternative financing windows which the operators in the real sector can avail themselves. These institutions, therefore, become the conduit through which small or large manufacturing concerns can access finance and, ultimately, increase output.
Directly related to the structure of the financial system, is the role the financial system undertakes to coordinate economic activities including the cost of finance, availability of investment funds and profitable investment outlets. Caprio et al. (1994) state that control through the financial system permits decentralization in decision making - the hallmark of a market economy - provided that some entrepreneur or group of investors is prepared to assume the risks of undertaking a project with borrowed funds, and that some lender believes that the loan will be repaid, the project can go ahead. This view obviously asserts the unquestionable need to ensure the solvency of financial institutions and instil confidence in the payments system which are intended to overcome systemic risk.

Following from above, technology and skills of the operators as well as institutions with oversight roles must be adequately in tandem with the level of development of the financial system to provide the needed support to the real sector. There is yet to be a consensus on whether the link between the financial sector and the real sector is 'real', is unidirectional flowing from the financial sector to the real sector or vice versa and bi-directional. Whichever way, there seems to be an emerging agreement among economists that a link exists. One of the objective of this paper is to discuss the connections between the real economies (the tangible world of jobs, goods and services) and the more intangible world of finance (money/credit flow, interest rates and the stock market).

The financial system comprises financial institutions and financial markets. The financial institutions include the banking system: central bank, banking institutions (commercial banks, merchant/investment banks, other deposit-taking institutions) and non-bank financial institutions ( provident/pension funds, insurance, development finance institutions (DFIs) and others). Financial markets comprise money and foreign exchange markets; capital markets – (equity markets, bond markets, public debt securities, private debt securities) and derivatives markets.

Financial development can be measured by the level of credit available in a country and size of the stock market. Economic growth could be predicted from the level of financial development, because financial markets usually anticipate future growth opportunities, and, according to Rajan and Zingales (1998), the stock market effectively “capitalizes the present value of growth opportunities in an economy.” Hence, financial development, rather than being a causal factor in economic growth, may more accurately be described as a leading indicator of economic growth.

The link between the financial sector and real economy can be explored from two perspectives, namely, the intermediation role of financial institutions and monetary policy perspective, the transmission mechanism of monetary policy impulses. Economists have long believed that financial markets and institutions are important factors in supporting economic development. Some economists state a strong positive empirical relation between the degree of financial market development and the rate of economic growth, and a negative relation between financial repression and growth.
However, early literature failed to give theoretical linkage between financial development and growth.

Recently, many economists have developed a model that drives a formal link between financial intermediation and growth. It is believed that financial intermediaries enhance economic efficiency and, eventually, growth by helping to allocate capital to its best uses. It has been shown that financial development has a positive impact on economic growth, that in the short run, there exists strong linkages between financial development and economic growth in high-income OECD countries, but not in South Asian and Sub-Saharan African regions. It can be interpreted that high financial development increases growth or high growth leads to more developed financial systems. Many economists point out that not only financial development allows for economic growth but economic growth increases the incentive for financial development. Efficient financial systems help countries to grow by mobilizing additional financial resources and by allocating those resources to the best uses. Obviously, the financial sector is growth-supportive only if financial institutions are subject to proper governance structures resulting, in particular, in behaviour of banks that is incentive-compatible with that of depositors or borrowers. This is because the prevailing asymmetric information, subject banks to moral hazard and adverse selection problems.

As economies develop, so must the financial systems that serve them. As the financial system grows, efficient channeling of funds lowers both the transfer costs and risk-taking from savers to borrowers. The financial intermediary allows a better allocation of resources in the economy and, therefore, stimulates capital accumulation and growth. On the other hand, as a consequence of economic growth, investors increase their participation in the financial market. The financial intermediaries lead to a better allocation of savings to investment, increases the rate of capital accumulation and the growth rate of the economy.

Financial sector development and economic development are inter-related. No economy can grow and improve the living standards of its population in the absence of a well-functioning and efficient financial sector. A sound and healthy banking system is directly related to economic growth and development. Modern growth theory identifies two main channels through which the financial sector might affect long-run growth in a country: through catalyzing the capital accumulation (including both human and physical capital) and by increasing the rate of technological progress. An efficiently functioning financial system mobilizes savings for investment, facilitates and encourages capital inflows, and allocates the capital efficiently among competing uses.

2. The Nigerian economy

With about 170 million inhabitants, Nigeria has long been the largest nation in Africa, but it is only now also acknowledged as the continent’s largest economy. In April 2014,
the Federal Government of Nigeria government began to release “rebased” data that show GDP of $454 billion in 2012 and $510 billion in 2013 (Kale, 2014). These figures were compared with the $259 billion and $270 billion that were reported previously, confirming Nigeria’s lead over South Africa as the continent’s largest economy. This rebased data, using updated prices and improved methodology, also reveals an economy that is far more diverse than was previously understood.

At current growth rates, Nigeria is poised to become a major economic force in the coming decades. The government’s rebasing exercise has shown that the country has clearly emerged as the largest economy in Africa. Nigeria has a huge endowment of resources, a growing consuming class, and rapidly growing trade and consumer sectors to propel growth.

Nigeria also faces enormous challenges. As in other parts of Africa, conflict holds back development in a number of regions. Corruption and weak governance are also drags on the economy. Despite a decade of stable economic growth, the number of Nigerians living in poverty has not declined significantly. And while productivity is growing and driving GDP growth, it is still relatively low and is not translating into rising incomes and improved living standards for most Nigerians.

In rural areas, 53 percent of the population lives below the poverty line due to low farm output, poor access to markets, and a rising population that is leading to cultivation of smaller plots. Leke et al. (2014) claim that 81 percent of rural Nigerians live below the “empowerment line”, which they define as $758 per year per person in rural areas. Recent reforms in agriculture are promising, but the scale of challenges is vast, and it may take many years for farm incomes to rise substantially.

In Nigeria’s cities, where the majority of the population now lives, very high rates of informal employment and underemployment contribute to a 34 percent poverty rate. Leke et al. (2014) estimate that 68 percent of urban Nigerians live below the empowerment line, which they define as $1,016 per year per person in urban areas. In both rural and urban Nigeria, high costs of living, particularly for food and housing, exacerbate poverty; it costs more than twice as much to achieve an economically empowered standard of living in Nigeria as in India.

Since 2010, Nigeria’s GDP growth has been driven primarily by improving productivity, which has contributed 55 percent of total growth, more than labour-force expansion. Most GDP growth is coming from beyond the resources sector, which is now just 14 percent of GDP. However, historical weaknesses in the agricultural sector and a poorly functioning urbanization process have prevented most Nigerians from benefiting from this growth. Poverty has barely declined, and approximately 130 million Nigerians, or about 74 percent of the country’s population, live below the empowerment line.

Nigeria has the potential to expand its economy by roughly 7.1 percent per year through 2030, raising GDP to more than $1.6 trillion in 2030. This could move Nigeria from
being the 26th-largest economy today to a top-20 economy by 2030 and would potentially make it bigger than the Netherlands, Thailand, or Malaysia.

Trade and infrastructure represent the majority of the growth potential, likely contributing about a third of GDP expansion through 2030. In addition, Leke et al. (2014) estimate that nearly 120 million Nigerians could move above the empowerment line and 70 million could be lifted out of poverty if growth can be made more inclusive than it has been. Strengthening government capabilities will be essential to capturing the growth opportunity and making growth more inclusive. On health and literacy metrics, Nigeria lags behind other developing economies that spend a similar proportion of GDP in these areas. By employing well-established global practices to improve delivery of programmes and projects, Nigeria can achieve better results.

Nigeria is developing a large consuming class. By 2030, some 160 million Nigerians (out of a projected population of 273 million) could live in households with sufficient incomes for discretionary spending. That would be more Nigerian consumers than the current populations of France and Germany combined.

An economic policy framework with an orientation towards integration into the global economy is perceived as a prerequisite for sustained growth. Policymakers would normally encourage foreign direct investment (FDI) for the enhancement of productivity in-country and the promotion of economic development. According to Alfaro et al. (2006) the belief in FDI among policymakers is that it creates positive externalities as well as direct capital financing.

FDI has been defined as a lasting management interest made by investing to acquire equity (normally 10% of voting stock) in a business enterprise operating in a country other than that of the investor (World Bank, 1996). The effect and importance of FDI varies across different sectors in the recipient countries, but positive growth impact has been reported in many recipient economies, notably in developing countries where FDI is also perceived as a conduit for knowledge and technology transfer. However, it is generally agreed among researchers that the stock of human capital available in-country will determine the magnitude of the effect of FDI on economic growth. Alfaro et al. (2006) have shown that an increase in FDI leads to higher growth in countries with developed financial markets compared with countries with poorly-developed ones. It was also observed by Alfaro et al. (2007) that local conditions (absorptive capacities) are important factors contributing to the effect of FDI on economic growth. Host-country absorptive capacities describe the domestic firms’ ability to respond successfully to new entrants, new technology and new competition. It therefore follows that the benefit of an FDI project will depend on the interaction of the characteristics of the project and the characteristics of the host country. FDI can emerge in many different forms: an acquisition, a greenfield project/investment in a new facility or a merger with an existing local firm.

The ‘multiplier effect’ is the result of the marginal effect on an economic variable from a change in another economic variable, of which the first variable is a component (Lange,
1943). The expenditure multiplier is the ratio of the change in total output (or GDP) induced by an autonomous expenditure change.

Nigeria needs an adequate in flow of foreign investment resources in order to meet its external obligations and sustain economic growth (Omoniyi and Omobitan, 2011). Poor economic growth prospects in developed nations has made sub-Saharan Africa a destination of FDI. According to The Economist, there was an increase of about 50% in FDI to Sub-Saharan Africa between 2005-2012. In 2012, the American bank J.P Morgan added Nigeria to its government-bond index for emerging markets; up until then, South Africa had been the only African country on the list.

FDI has been confirmed as a contributor to economic growth in Nigeria, in research carried out by Adegbite and Ayadi (2010). It was discovered that FDI has contributed significantly to output growth in Nigeria. However, the efficacy of FDI in generating the desired growth may be limited by the level of infrastructural and human capital development in Nigeria.

Umoh et al. provided evidence that suggests a bi-directional relationship between economic growth and FDI inflows to Nigeria. They explain that FDI encourages growth, more growth also encourages more FDI: a positive feed-back relationship between FDI and economic growth in Nigeria. These results have far-reaching implications for policy making in Nigeria.

Ayanwale (2007) revealed that Nigeria’s macro economy encourages FDI inflows, various policy initiatives aimed at encouraging investors is yielding the expected results. Among such pivotal policies are the abrogation of the indigenization policy and the promulgation of the NIPC decree (the Nigerian Investment Promotion Commission Decree 16 of 1995).

3. Impact of financial development on Nigeria’s economic growth

An efficient financial system is essential for building sustained economic growth and an open vibrant economic system. Countries with well-developed financial institutions tend to grow faster; especially, the size of the banking system and the liquidity of the stock markets tend to have strong positive impact on economic growth. The financial sector of any economy in the world plays a vital role in the development and growth of the economy.

The development of the financial sector in Nigeria determines how it will be able to effectively and efficiently discharge its major role: mobilizing fund from the surplus sector of the Nigerian economy to the deficit sector of the economy. This sector has helped in facilitating the business transactions and economic development in Nigeria (Aderibigbe, 2004). A well-developed financial system performs several critical functions to enhance the efficiency of intermediation by reducing information asymmetry,
transaction and monitoring costs. If a financial system is well-developed, it will enhance investment by identifying and funding good business opportunities, mobilize savings, enable the trading, hedging and diversification of risk and facilitate the exchange of goods and services. All these result in a more efficient allocation of resources, rapid accumulation of physical and human capital, and faster technological progress, which in turn results in economic growth (Adekunle et al., 2013).

The major development in Nigeria’s financial sector in recent years is banking consolidation. The banking industry has specific features that make it of particular importance to an economy and indeed possesses certain properties that distinguish it from other industries. Banks contribute greatly to economic growth by playing an intermediating role between borrowers and lenders and providing financial resources to other industries, thus facilitating production. The banking system is also important since any instability therein could lead to financial instability and economic crisis. Hence, a well-functioning banking system is regarded as a cornerstone of a market economy. Consequently, policymakers try to ensure that the banking system is stable, besides ensuring that it is competitive and efficient.

Financial institutions play a crucial role in the effective functioning of Nigeria’s economy, a higher degree of competition in the sector is crucial for financial intermediation and economic growth. A competitive banking sector will be more efficient in terms of allocating funds, especially by operating as an intermediary between depositors and borrowers (Nnaji, 2011).

Competition in the banking sector has been at the crux of policy debates on financial stability. As in other sectors, competition is usually seen as necessary for an effective banking system as it affects the efficiency and the quality of services offered in the industry. Furthermore, competition in banking has implications for other sectors of the economy. Thus, higher competition in the banking sector is found to be associated with a faster growth of other sectors of the economy that rely on external financing. This is because banks advance credit or loans to both firms and consumers and an uncompetitive banking sector will lead to under-provision of such credit. Competition in the banking sector will promote the efficiency required to create a fully-functional credit system, and according to the competition-stability theory, will help improve the stability of the system. High concentration in banking is negatively related to industrial growth in low-income countries but not in high-income ones, suggesting that emerging economies need a relatively more competitive banking sector in order to promote growth.

Banks are service industries. They contribute to economic growth not by producing ‘real’ goods, but by providing the financial services to facilitate production in other industries. An efficient banking sector will make the largest contribution to economic growth. Banks, like other firms, sell products to consumers, thus the need to worry about the efficiency implication of a non-competitive banking sector.

Banks also act as conduits for monetary policy transmission mechanism; a low level of competition in the banking sector may hinder the effectiveness of the conduct of
monetary policy as banks may not respond appropriately to monetary tightening and/or easing.

It has been shown, theoretically and empirically, that the degree of competition in the financial sector has implications (negatively or positively) for access of firms and individual households to financial services, and in turn overall economic growth. Therefore, competition has to be considered as part of a broad set of objectives, including financial sector efficiency, access to financial services for various segments of users, and systemic financial sector stability, the possible trade-offs among these objectives.

Since competition depends on several factors, one has to consider a broad set of policy tools when trying to increase competition in the financial sector. Thus, the role of policy in striking a balance between competition and stability especially in an emerging market like Nigeria becomes very important. While the goal of stability should be the foremost objective of policy makers, competitive policies should not be ignored.

The Nigerian banking system has undergone remarkable changes over the years, in terms of the number of institutions, ownership structure, as well as depth and breadth of operations. These changes have been induced largely by challenges posed by deregulation of the financial sector, globalization of operations, technological innovations and adoption of supervisory and prudential requirements that conform to international standards. As at June 2004, there were 89 deposit money banks operating in the country, comprised of institutions of various sizes and degrees of soundness. Structurally, the sector was highly concentrated, as the ten largest banks accounted for about 50 percent of the industry's total assets/liabilities.

Most banks had capitalization of less than $10 million, with the largest bank having a capital base of about $240. The small size of most of the banks, each with expensive headquarters, separate investment in software and hardware, heavy fixed costs and operating expenses, and with bunching of branches in few commercial centers, led to a very high average cost for the industry. This in turn had implications for the cost of financial intermediation, the spread between deposit and lending rates, and exerted undue pressures on banks to engage in unethical practices as means of survival. Industry analysts were of the opinion that most of the banks were not engaged in strict banking business of financial intermediation; rather, they resorted to quick-business kind of deals and ignored the main function of financial intermediation.

The sector was marred by a lot of challenges, including, weak corporate governance, evidenced by high turnover in the Board and management staff, inaccurate reporting and non-compliance of regulatory requirements. The Central Bank of Nigeria (CBN) forensic investigation done on in 2009 resulted in the sack of management staff from nine banks.

The CBN then embarked on the consolidation of the banking system that reduced the number of banks from 89 to 25 and raised the capital requirement from N5 to N25
billion. Nineteen of the banks emerged through mergers and acquisition among 69 banks, while 6 of the banks raised additional capital to meet the new capital requirement. The majority of the banks were under private domestic ownership with the exception of three foreign-owned banks operating in the country (Citibank, Stanbic and Standard Chartered). Following the consolidation, banks' balance sheets expanded, most of them venturing into universal banking and expanded cross-border transaction into other African countries, United States and Europe. Credit to the private sector equally increased and all other developmental indicators of the banking sector increased as a result of the consolidation exercise. Credit extension boomed and private sector activities boosted economic growth, underpinned by buoyant oil and non-oil commodity prices. There was a reduction in net interest rate margins driven mainly by reduction in large corporate business and a reduction in Treasury Bill rates. Banking sector profitability also declined. Return on assets (ROA) and return on equity (ROE) declined suggesting a more competitive and efficient system.

The banks expanded their balance sheet by more than 60 percent as public confidence in the sector bolstered, evidenced by the increase in deposits. As a result of this growth in the balance sheet and larger capital base, banks were under intense pressure to utilize the funds to provide adequate return to shareholders. The banks established subsidiaries and extended credits in new areas that were previously off limit because of the level of funds required. The banks funded large-ticket items that they were not able to fund under the previous capital base. They moved into new untapped areas, banking the unbanked and expanded branch networks. The number of bank branches increased from about 3,000 to about 5,134 by mid-2009. The ratio of non-performing loans to total loans declined from 18.1 percent post-consolidation to 6.2 at the peak in 2008 and 8.36 in mid-2009.

The question of the role and structure of the financial system that should facilitate and sustain growth has largely remained inconclusive in the recent finance growth literature. The general consensus viewpoints include: (i) countries with better functioning banks and financial markets are more likely to accelerate their growth pace; and (ii) better-functioning financial systems ease the external financing constraints that impede firm and industrial expansion.

Developing the structure of the financial system must incorporate a framework that will ensure macroeconomic stability, effective regulation and supervision, and the elimination of other structural bottlenecks in the financial sector. Many views abound on the sequencing of the structure of the financial sector and raise the question of whether the evolvement of banks should precede capital market development. A microcosm of this question would be on the relative importance of large and small banks. It is argued that low-income countries should make small, local banks the bedrock of their financial systems.

Local community banks and not the stock markets provide capital for the small companies. To create an enabling environment for the private sector, government of developing countries should focus on creating a legal and financial framework to
promote access to credit across the spectrum of demand. Stock markets also promote wider participation in the formal economy—public listings as an avenue for allowing small local investors to participate in privatizations and as a way for large multinationals to list their local subsidiaries.

Others agree that a competitive banking sector is necessary in facilitating firm growth and competition, and that equity markets constitute only a small portion of overall financing in developing countries. The banking sector should be established and tailored to improve the real economy and, as a tool to create jobs and opportunities. A two-tier banking system has been proposed where one tier consist of small banks that serve basic financial needs and the other tier should consist of larger banks that serve medium firms that can create jobs for many others and will grow to large scales.

The form and function of financial institutions are also believed to be country-specific and would rely on the legal and political system as well as the evolving economic activities. A suitable policy objective would be to craft laws, regulations, and institutions that would create an enabling environment to engender competition among financial institutions in the provision of essential credit, risk, and liquidity services to the real economy.

Financial intermediaries perform five basic functions that affect the real economy. Levine (2004) and Zhuang, et al. (2009) identified and summarized key functions that a financial system provides in facilitating growth:

**Mobilizing and pooling savings.**
When it is done efficiently, savings mobilization enhances technological innovation and resource allocation. The process of doing so from diverse savers is expensive. Thus, to mobilize savings, transaction costs and informational asymmetry must be contained. Financial systems that are more effective at agglomerating capital promote economic development by increasing savings, exploiting economies of scale, and overcoming investment indivisibilities. With large, indivisible projects, financial arrangements that mobilize savings from many diverse individuals and invest in a diversified portfolio of risky projects facilitate a reallocation of investment toward higher return activities with positive implications for economic growth.

**Producing information ex-ante about possible investments and allocating capital.**
Individual savers face high costs of acquiring and processing information on firms, managers and market conditions, which could prevent capital from flowing to its best uses. Financial intermediaries reduce information costs through specialization and economies of scale and thereby improving resource allocation and the pace of growth. Only better information can engender the identification of appropriate production technologies and effective and efficient entrepreneurs. Stock markets may also stimulate the generation of information about firms. Expansion in markets and their growing liquidity, incentivize agents to expend resources in researching firms because it is easier to profit from this information by trading in big and liquid markets.
Monitoring investments and exerting corporate governance.
The degree to which the owners of capital (shareholders and creditors) can effectively resolve the principal-agent problem has important implications for savings, decisions for allocating the savings, and their utilization. Good corporate governance helps improve the efficiency with which firms allocate and utilize resources and makes savers more willing to finance production and innovation. Zhuang et al. (2000) state that monitoring and disciplining by creditors (banks or bondholders), shareholder activism exercised by institutional investors (such as banks, pension funds, etc.), threat of takeovers, threat of insolvency, and capital market competition, among others, help the industry.

Facilitating the trading, diversification and management of risks.
Financial systems help mitigate the risks associated with individual projects, firms, industries, regions, and countries, etc. A financial system's ability to provide risk diversification services affects long-run economic growth by improving resource allocation and encouraging savings. Financial systems also enhance liquidity, reduce liquidity risks, increase investment in longer-term, higher-return, but illiquid assets, and promote economic growth. Facilitating the exchange of goods and services. A financial system facilitates transactions in the economy, both providing and improving the payment systems and by reducing transaction and information costs associated with financial transactions. In this way specialization of production is encouraged, technological innovation is enhanced, and growth is ultimately achieved. Backward linkage effects occur from these productivity gains to financial market development and, thus, economic development can spur the development of the financial sector.

Monetary policy can be defined as the measures taken by the monetary authorities to influence the quantity of money or the rate of interest with a view to achieving stable prices, full employment and economic growth. Because monetary policy action works through financial markets, the transmission mechanism provides another link between the financial sector and real economy.

Central banks try to influence the quantity of money and/or interest rates with a view to achieving price stability, full employment and economic growth. This implies that there must be some link (or links) between monetary/financial variables (such as the quantity of money, interest and exchange rates) and macroeconomic variables (such as the price level, the level of employment and the gross domestic product (GDP)). These links are called the monetary transmission mechanism, that is, the way in which monetary/financial changes affect the real economy.

There are various views about the monetary transmission mechanism. Some economists, for example, see a direct link between changes in the quantity of money (M) and changes in the price level (P) but no link between changes in M and changes in real GDP. Other economists emphasize the link between interest rates (i) and investment spending (I) in the economy. They regard interest rates as the outcome of the interaction between the demand for and the supply of money. For example, if the money supply increases, interest rates will tend to fall. At the lower interest rates more investment projects will become profitable, therefore, investment (I) will increase. This,
in turn, will result in an increase in GDP. That is why observers often call on the central banks to lower interest rates in an attempt to stimulate economic growth and employment.

Mishkin (1996) has identified five channels of monetary policy transmission: 1. Interest rate channel (interest rate pass-through); 2. Credit channel; 3. Exchange rate channel (exchange rate pass-through); 4. Other asset price channel; 5. Expectations channel.

4. Conclusion

In order to ensure accelerated economic growth in Nigeria, Adekunle et al. (2013) insist that there is the need for consistent, transparent and fair policy to all the players all financial sector, the need to develop viable and responsive financial services for the poor in Nigeria. There is the need for resilient and strong institutional development of the sector, a strong emphasis on fund mobilization in order to bring help to the low income people to increase and stabilize their income and assets. An investment friendly interest rate regime supportive of the growth objective of the government. The lower costs of borrowing would induce the desire for credit expansion thereby encouraging investment activities in the country. The implementation of tax incentives policies should be maintained. Also the security of lives and properties should be seriously attended to, government should continue to intensify its efforts at promoting confidence of the public on the financial sector through adequate and effective regulation and supervision. The reforms in the financial sector should be sustained so as to be able to channel more resources for investment and productive purposes.

References


