

## **SEC NIGERIA ECONOMIC LECTURE**

# **Can the Capital Market be an Engine for Economic Growth in Nigeria?**

**By**

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## I. Context

*Is there some action a government of India could take that would lead the Indian economy to grow like Indonesia's or Egypt's? If so, what, exactly? If not, what is it about the "nature of India" that makes it so? The consequences for human welfare involved in questions like these are simply staggering. Once one begins to think about them, it is hard to think about anything else.*

*Robert E. Lucas, Jr.*

The Fundamental questions which has intrigued and preoccupied economists for a long time are mainly two-fold, namely; why do countries grow over time, and what accounts for the differences in the growth rates of countries. A number of explanations have been advanced in the literature to account for these spatio-temporal differences in growth. These include resource endowments, international trade, factor accumulation, institutional and educational development, well-defined and enforceable legal and property rights, macroeconomic and political stability, and the degree of openness of the economy.

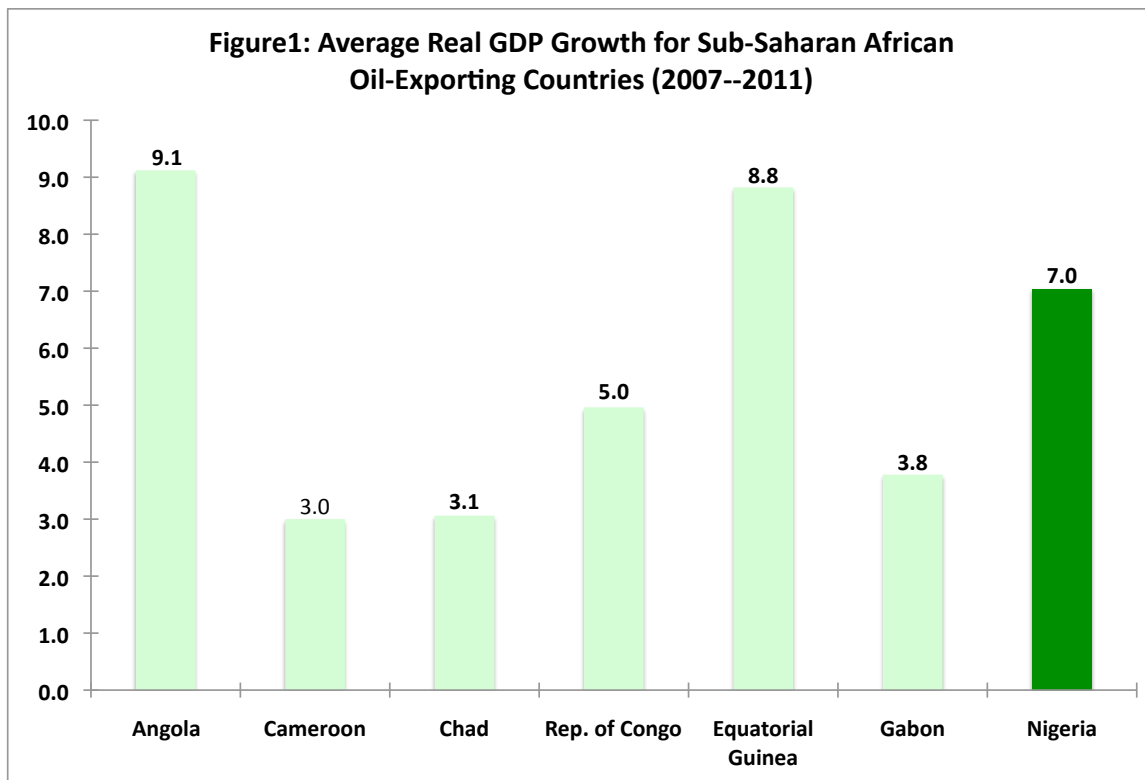
However, since the seminal works of Patrick (1966) and Goldsmith (1969), a large and interesting literature has evolved on the role and importance of the financial system in fostering economic growth (see Levine, 1997 for details). In many African countries, a considerable part of the last few decades was spent reforming financial sectors with a view to facilitating the growth of savings and increasing the rate of return of productive investment. The need to achieve substantial growth in savings arose because African saving rates of 17.2 percent of GDP in the 1990s were not only far below the East Asian average of 37.5 percent during the same time, but far less than was desirable to achieve the growth fillip needed to lift millions of out poverty in Africa.

Despite the aforementioned debate, a consensus has emerged in recent times, which asserts that economic growth in a modern capitalist economy almost certainly revolves around an efficient capital market that is able to pool domestic savings, mobilize foreign capital, and allocate the sum to the most productive sectors of the economy. In this presentation, I will attempt a brief review of recent economic

developments in the Nigerian economy and evaluate the role of the capital market as an alternative and non-traditional means of spurring capital accumulation, accelerating economic growth and engendering development in the country.

## II. Nigeria—Review of Recent Economic Developments

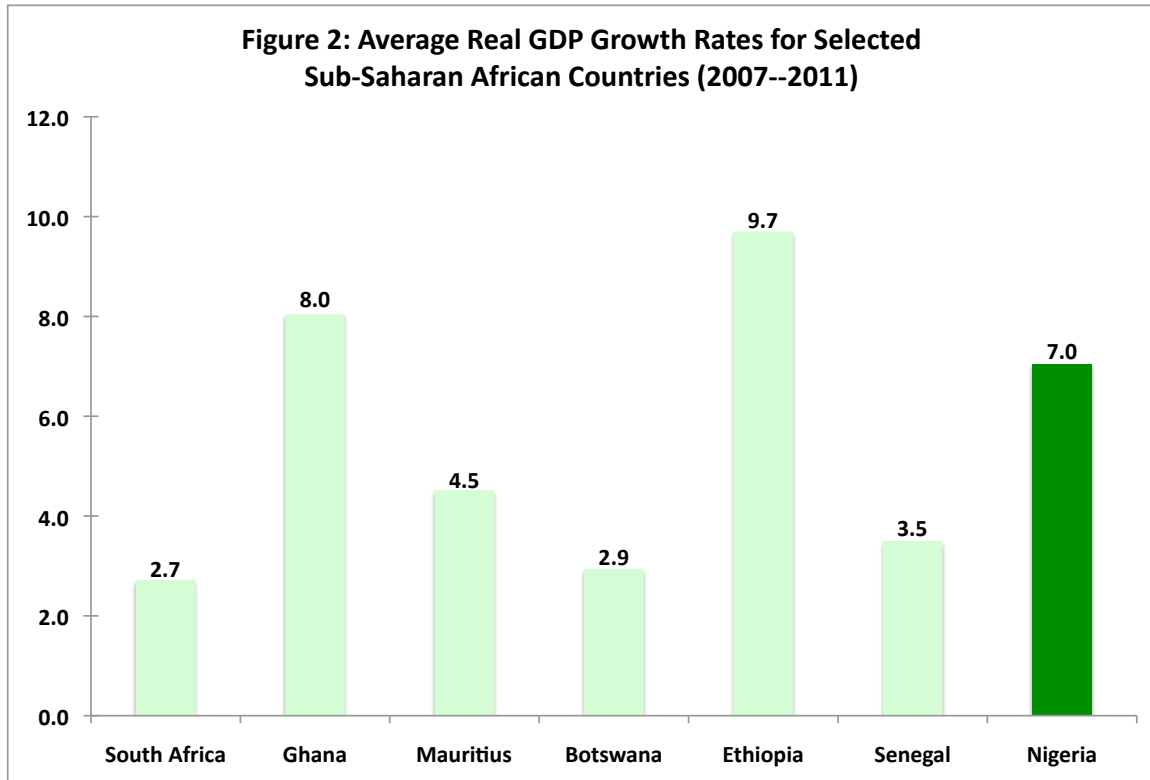
**A. Real Sector Developments**—Although the global financial and economic crisis of 2008—2009 had a significant impact on the economy, real gross domestic product (GDP) in Nigeria has shown resilient and impressive growth rates, averaging about 7 percent over the past 5 years (See Figures 1 and 2). This outcome was mainly due to Nigeria’s enabling policy space including a large buffer of international reserves and low external debt. These buffers allowed the government to carry out counter-cyclical measures to minimize the impact of the crisis.



In 2011, real GDP increased by about 7.4 percent as compared to 2010. This growth rate, which is slightly higher than the 5-year averages in Figures 1 and 2, reflects

a significant contribution by the agricultural sector as well as a rebound in other key sectors of the economy including wholesale and retail trade, and telecommunications.

During the first quarter of 2012, the economy expanded by about 6.2 percent, a growth rate that still outpaced many forecasts including that of the Nigerian Bureau of Statistics.



Interestingly, the growth rate of the GDP over the past several years, including 2012Q1, has been largely driven by the non-oil sector. Indeed, during the first quarter of 2012, the non-oil sector grew by nearly 8 percent while the oil sector declined by about 2.3 percent. The main drivers of growth in 2012Q1 include telecommunications, building and construction, solid minerals, hotels and restaurants, and manufacturing.

The composite consumer price index (CPI), which measures inflation, rose by about 12.9 percent in April 2012 when compared to April 2011. Food inflation moderated somewhat during the first quarter and helped to lower inflationary

pressures in headline inflation, in addition to the CBN's continued tightening of monetary policy.

**B. Fiscal Sector**—In line with President Goodluck Jonathan's promise of job creation, private sector led inclusive growth, and fiscal consolidation, as encapsulated in the Transformation Agenda, the 2012 budget is actually one of fiscal consolidation based on a benchmark oil price of US\$72 per barrel, which implies that the government is able to save the excess, and create the same kind of buffers that were critically helpful during the global crisis. The 2012 budget reprioritized our expenditure mix and reduced recurrent expenditure from 74.4 percent to 71.6 percent in order to increase our capital expenditure, thereby creating room for building more roads and other critically needed infrastructure. The reprioritization also led to a 13 percent decline in the borrowing requirement of government, and a fiscal deficit of about 2.85 percent for 2012. The federal government's share of savings from the partial removal of subsidies (about ₦180 billion) is being invested in building critically needed infrastructure and social safety nets through the Subsidy Reinvestment and Empowerment Programme (SURE-P).

**C. External Sector**—Given the somewhat favourable price of crude oil so far in 2012 (about US\$110 per barrel from January—May 2012), and the government's focus on attracting more foreign capital inflows, our foreign exchange reserves have steadily increased from US\$32.64 billion in December 2011 to about US\$37.69 billion as of June 4 2012. The official Dollar-Naira exchange rate appreciated from about ₦161.6 in January 2012 to ₦157.7 as of mid-March 2012. This appreciation seems to have continued as a dollar traded for about ₦155.8 as of June 5 2012.

**D. Financial Sector**—The Central Bank has continued its drive to instil more transparent and effective corporate governance in our banks. All our banks are now fully capitalized, with sector-wide ratio of non-performing to total gross loans decreasing from around 36.1 percent at the peak of the banking crisis in 2009 to about 11.6 as of June 2011. In line with the government's objective of private sector led inclusive growth, credit to the private sector increased by 43.4 percent as of April 2012 while

credit to the public sector only rose by 0.9 percent. Perhaps reflecting the Central Bank's evolving "new cash policy", currency in circulation decreased by about 4.7 percent in April 2012 as compared to April 2011.

**E. Structural Reforms**—The ongoing reforms in the downstream petroleum sector, the power sector and the ports are proceeding accordingly. The Power Sector Roadmap, which is meant to fully privatize power generation and distribution, is at advanced stage. The reforms in this sector are targeted at providing adequate electricity to everyone while reducing its cost to both rural households and the urban poor. The administration is also focusing its efforts on Ports and Customs reforms to ensure efficiency in the handling of ports and port-related businesses. The reforms are to ensure that all types of cargoes are cleared within a 48-hour period. Bureaucratic activities have been streamlined at the Ports by reducing the number of agencies from 14 to only 7.

With regards to the downstream petroleum sector, the Nigerian Content Development Act has significantly increased the local production of pipes and other engineering support services. This has resulted in a increase from about US\$1 billion in 2010 to about US\$4 billion in 2012 in retained in-country spending for such activities.

Overall, the Nigerian economy seems poised for sustained economic growth that will lift millions out of poverty through well-paying jobs and inclusive growth.

### **III. Can the Capital Market Help?**

*If capital is at the heart of capitalism, then well-functioning capital markets are at the heart of a well-functioning capitalist economy. Unfortunately, of the markets in the economy, the capital markets are perhaps the most complicated and least understood.*

*Joseph E. Stiglitz.*

For quite some time, empirical research on the determinants of growth had focused almost exclusively on technological progress, and sometimes growth in population, as the main drivers of growth. However, more recent research suggests that growth be self-sustaining without significant population growth or technological progress (See Lucas 1988). These new models distinctly show that the financial system

can engender growth through various channels. I will attempt to organize my discussions around four (4) broad roles that the capital market can play in spurring economic growth in Nigeria. These role include:

1. Producing information and allocating capital;
2. Monitoring investments and exerting corporate governance; and
3. Mobilizing and pooling savings.

1. **Producing Information and Allocating Capital**—There are large costs associated with evaluating firms, managers, and market conditions before making investment decisions. Individual savers may not have the ability or wherewithal to do so, and may be reluctant to invest in activities about which there is little reliable information. Such “high information costs” may keep capital from flowing to its most profitable use. Thus, the Nigerian capital market can spur growth by scaling up its efforts at providing potential investors with reliable information about firms and their management, as well as current market conditions, thereby increasing efficiency in resource allocation in the economy. Without such intermediation, each investor would face potentially large and certainly prohibitive fixed costs associated with evaluating firms, managers, and economic conditions.

2. **Monitoring Investment and Exerting Corporate Governance**—The degree to which the providers of capital to a firm can effectively monitor and influence how firms use that capital has ramifications on both savings and allocation decisions. Although individual shareholders can effectively exert corporate governance through voting on crucial issues, such as mergers, and fundamental changes in business strategies, different kinds of market frictions may make this impossible. More also, large information asymmetries usually exist between management and shareholders given that management may have significant discretion over the flow of information. Such scenarios may allow managers to pursue projects for their personal, rather than societal, benefits. These situations may decrease participation in capital markets,

especially for middle-class prospective shareholders. The capital market can play a vital role in monitoring management and exerting transparency in corporate governance so as to provide comfort to prospective shareholders and increase participation in the market.

3. **Mobilizing and Pooling Savings**—If individuals are left on their own to mobilize all the savings needed for investment, it should typically involve the following:

- Overcoming the transaction costs associated with collecting savings from different individuals;
- Overcoming the informational asymmetries associated with making savers feel comfortable to relinquish control of their savings.

Indeed, much of Carosso's (1970) history of Investment Banking in America is a description of the diverse costs associated with raising capital in the United States during the 19th and 20th centuries. Financial systems that are more effective at pooling the savings of individuals can profoundly affect economic growth by increasing savings, exploiting economies of scale, and overcoming the indivisibilities of certain investments. According to Bagehot (1873, p. 3-4), the major difference between England and poorer countries during that period was that in England, the financial system could mobilize resources for "immense works." Bagehot noted explicitly that England's significant growth during that period was not due to the national savings rate per se, but the ability to pool society's resources and allocate those savings toward the most productive ends.

In sum, I believe that capital markets can and should play a significant role in spurring growth in Nigeria through efficient saving mobilization, capital allocation, information gathering, as well as exerting good corporate governance.