CHAPTER ONE

1.1 INTRODUCTION

Financial deepening is defined as the process of development and expansion of financial institutions such as, banks, stock markets, and insurance companies etc relative to the size of a country's economy. It also refers to the increase in the provision of financial products and services with a wider choice to all level of the society. A robust financial system plays a crucial role in the economic development of a country. It facilitates the process of economic growth through mobilization and efficient allocation of financial resources and provision of a well-functioning system of payments/transfer of funds. One of the factors behind rapid, and sustained economic, growth achieved by middle and high-income countries (Mexico and Venezuela, United Kingdom and United States of America respectively) has been their well-established financial sector. On the other hand, one of the common characteristics of low Income countries is the poor performance of their financial system. The strength and performance of a financial sector can be evaluated in terms of some macro-indicators like monetary assets to GOP ratio, currency to money ration, deposits ratio, interest rate spread, money multiplier etc:

Financial deepening or depth is characterized by the following: Less use of cash i.e. increase in the level of non-cash payments and transfer of funds, diminishing velocity of money markets and capital markets, competitiveness and specialization in financial functions and institutions, high and stable ratio of money supply (broad money) to GDP and low premiums savings and lending rates etc. The following are indices that have been used in the measurement of the level of financial deepening.

1.1.1 MONEY/GDP RATIO

This is a major indicator of financial sector deepening. It refers to the ratio of monetary assets in the economy to the GDP. It is a measure of the level of liquidity in the financial system and the ability of such a financial system to finance economic growth. Thus a country with a higher Money / GDP ratio-will have a more developed and efficient financial sector. Economic units will only the form monetary assets/instruments when they feel convenient in terms of liquidity, risk, return and efficiency of payments.

Such money instruments will only be offered by a well developed financial sector. Money /GDP ratio is higher for more developed countries when compared with those of low income countries. A financial sector with a higher Money/GDP ratio is thus able to provide funds needed for investment purposes than a financial system with a low money/GDP ratio.

1.1.2 CURRENCY RATIO

This is the ratio of currency in circulation to monetary assets. A low currency ratio is indicative of a efficient financial sector in which there is a high level of financial intermediation. It also signifies the efficiency of the financial system in mobilizing savings as well as the existence of an -efficient payment system. In middle income and high income countries. this ratio is usually low and reduces over time but the same situation does not exist in developing countries in which a large amount of money in circulation is in the form of liquid cash (currency).

1.1.3 MONEY MULTIPLIER

Money multiplier indicates the responsiveness of money supply to the changes in the monetary base (total amount of currency that is either circulated in the hand of the public or in the commercial bank deposits held in the central bank's reserves}, as an indicator of financial deepening, it shows the ability of the monetary

authority in altering the total amount of money in circulation using the monetary base.

1.1.4 MARKET CAPITALIZATION/GDP RATIO

This gives a picture of the level of development of the capital market in an economy. The capital market is a market for raising long-term funds for investment. The market capitalization of the capital market is the sum total of the product of the price of each quoted stock and the total number of the outstanding (issued) stocks. The ratio thus measure the ability of the capital market to supply the needed funds for investments and economic growth, the larger this ratio the more developed the financial sector would be and the higher the impact of the intermediation activities in the capital market on economic growth.

1.1.5

M_2 is a category within the money supply that includes M_1 in addition to all time related deposits, savings deposits, and non institutional money-market funds.

This is one of the most widely used measures of financial deepening. The higher this ratio is the greater the level of financial sector development. This measure however has a shortcoming when used to measure the level of financial sector development. This measure however has a shortcoming when used to measure the, level of financial deepening for developing economies in which the payment system is cash based, an" increase M_2 /GDP ratio cold have been brought by an increase in currency outside the banks such that the ratio will be measuring level of liquidity preference rather than financial depth.

The increasing importance of the financial sector in the process of economy has come to the limelight in recent times. The financial sector assumes an important role in the process of economic growth because of its primary function as an intermediary between sectors of the economy which have excess funds on one hand and those that are in need of funds on the other hand. In recent times, the effect of financial deepening on economic growth in any economy has been underscored and this derives its strength from the financial liberalization theory championed by Mckimnon, Shaw and curly 1973. Since in development economics, capital is a function of investments on the other hand depends on level of gross national savings. It then follows all things being equal, that any factor or policy that can increase the level of savings in any economy will surely lead to economic growth. It is worthy to note that in most developing country which record low levels of savings to GDP, the governments always practice financial repression in which financial controls such as interest rate ceilings and floors, mandatory credit allocation policies are used to enforce a regime of low interest rates which is expected to boost investments, but contrary to this expectation, the opposite is the case as savings and consequently investments still remain low because of the existence of negative real interest rates usually caused by a high inflation rate which is common in most developing countries.

Since positive real interest rates encourage savings. Financial sector liberalization as opposed to repression has been advocated as a policy for bringing development to the financial sector through financial deepening. Thus with liberalization, the demand for and supply of savings and loanable funds are determined by market forces which will also ensure a more efficient allocation of the financial resources towards the attainment of economic growth.

1.2 STATEMENT OF THE RESEARCH PROBLEM

The Nigerian financial system has moved from a period of direct government controls to an era of increased liberalization, the financial sector however has shown evidence of increased deepening over the years, Little is known in empirical terms about the effect of the financial deepening on the economy growth of the country. to this end, it becomes

imperative to investigate the effect of financial deepening on economic growth of the country.

1.3   RESEARCH QUESTIONS

The research hopes to answer the following questions:

1.   Is there a link between real deposit (money in bank over a period of time) and the level of savings (money that can be used at any time) in the economy? If so, in what direction is this relationship?

2.   Has financial liberation over the years had an effect on the level of deepening in the financial system and if so what direction?

3.   Is there any relationship between financial sector development and economic growth and if so, what is the nature of this relationship?

1.4   BROAD OBJECTIVE OF THE STUDY

This research thus aims at investigating whether financial deepening in the Nigerian financial system as led to any significant growth of the economy.

1.5   SPECIFIC OBJECTIVES OF THE STUDY

Through this study, the researcher intends to:

1.   Determine the relationship between gross national savings and real deposit rate.

2.   Determine the nature of relationship between indices of financial sector development and economic growth.

1.6   STATEMENT OF HYPOTHESIS

To discern if financial deepening has impact on economic growth, the following hypotheses are stated in null form:

1. H_O: That real deposit rates have no significant relationship with the level of savings in the Nigerian Economy.

2. H_O: That real income does not have any significant relationship with the current level of savings.

3. H_O: That level of savings of a previous period has no significant relationship with the current level of savings.

1.7   JUSTIFICATION OF THE STUDY

Most financial sectors in developing economics including Nigeria have at one time or the other operated under institutional controls imposed by their governments or regulatory authority. This however, has not augured well for the mobilization of financial resources for the purpose of investments in the economy. The inability of the financial system to carry out its primary function is seen in the Nigerian economy and the role of the financial sector in the process of economic growth with a view to prescribing necessary remedies to the problems that hamper the growth of the financial sector and its ability to significantly contribute to economic growth in the country.

FINANCIAL DEEPENING AND ECONOMIC GROWTH IN NIGERIA

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