Policy Alternatives for Economic Recovery: Role of the Capital Market Regulator

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ABSTRACT

The Securities and Exchange Commission (SEC) is statutorily mandated to regulate and develop the Nigerian capital market. This paper, after reviewing the relevant literature and evidence, explains a number of policy tools the SEC has pursued in order to develop and further deepen the capital market. Ultimately, this enhances the prospects of fiscal actions of taxation and expenditure to be more useful tools of aiding recovery and growth. While making a case for the re-continuation of privatization in view of the fact that private firms expectedly perform better than state owned enterprises, the paper cautions the need for closer regulation and concludes that the current wave of regulatory innovations is in tandem with capital market development and economic recovery and growth.

Key words: Economic recovery, fiscal policy, capital market regulation, capital market master plan

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1 Introduction

In August 2016, Nigeria was declared to have gone into a period of economic recession, after at least two successive quarters of negative growth. There is no doubt that all countries at one state or another do experience bouts of economic recessions. For Nigeria, this is certainly not the first economic recession neither will it be the last. What makes the current recession more worrisome is that it is coming against the backdrop of high inflation. As the experiences of some countries have shown, economic recession could unleash social upheavals and engender political unrests. It is therefore important for all stakeholders to join hands to bring the economy back to the path of growth. As the apex regulator of the capital market, the SEC has a mandate to develop the capital market thereby contributing to economic growth. This paper sets out to explain what the SEC has been doing to deepen the capital market and how that could support government policy for getting out of recession. In order to undertake this, the rest of the paper is divided into five sections.

Section two is the background, tracing the causes of the recession such as sluggish global growth rates, increased supply of crude oil on the world market and domestic security concerns in parts of the oil producing regions of the country. Section three is an overview of the theory and evidence on whether or not fiscal policy does influence growth. Starting with the Ricardian equivalence upon which Solow (1956) and others have argued that fiscal policy cannot influence growth, the section presents a contrasting view proffered by Barro (1990) and others that a careful selection of tax and expenditure policies could actually spur growth.

Section four draws on theory and evidence that argue in support of fiscal policy as a credible weapon for influencing economic growth. The section goes further to explain a number of policy actions that SEC has pursued in order to deepen the capital market and promote its efficacy. Section five extends the discussion by examining the literature on privatization that argues that in terms of efficiency private firms perform better than state-owned enterprises. State owned enterprises face soft budget constraints through government largesse and therefore often pursue non-profit objectives such as size. In contrast, managers in private firms face hard budget constraint and can be disciplined by the market in the event of poor performance. In view of this the paper recommends the pursuit of privatization and concerted actions by the regulators to ensure that the operators conduct their affairs within the ambit of the law.

Section six offers conclusions, supporting the need for all stakeholders in the capital market to collaborate in the implementation of the capital market master plan, a framework seeking to further develop the capital market as a tool for strengthening the ability of fiscal policies to aid economic growth and recovery.

2 Origin of the recession

Nigeria's economy has suffered from structural weaknesses occasioned by an overdependence on oil. Crude oil exports have remained the single most important factor both as a source of government revenue and foreign exchange earnings. Consequently, events in the global oil market have tended to shape the fortunes of Nigeria's economy, leading to buoyancy in times of favourable prices and recessions in times of declines. For instance, Table 1 shows that crude oil price declined from US$105.87 in 2013 to US$49.49 in 2015 while GDP growth rate decreased from 5.4% to 2.7% during the same period.

Table 1: Crude oil price and Nigeria's GDP Growth Rate

	2013	2014	2015	2016
Crude Oil Price	105.87	96.29	49.49	39.35
GDP Growth rate	5.4	6.3	2.7	-1.7*

Source: OPEC, CBN Statistical Bulletin and * IMF World Economic Outlook

The current economic recession has been caused largely by the events in the global oil market which have combined to cause a steady fall in crude oil prices. On the demand side, sluggish growth in Organization for Economic Cooperation and Development (OECD) countries, Latin America and to a lesser extent, China, has been a factor and the outlook for growth has been rather bleak. Specifically, the IMF World Economic Outlook released in July 2016 lowered the growth forecasts for the world economies. For instance, the U.S. growth has been reviewed downward from 2.4% in 2015 to 2.2% in 2016; U.K 2.2% to 1.7%, China 6.9% to 6.6%.

Most countries in the west have been faced with very low interest rate regimes, offering little scope for further reductions in interest rates as a means for restoring growth. On the supply side, non-traditional sources of supply have increased. Shale oil extraction has been advanced by technological breakthroughs which have turned countries such as the United States from a net importer to a major supplier of oil on the world market. Moreover, Iran, the second largest OPEC producer, has resumed exports following the lifting of international sanctions on it. Figure 1 depicts that Global Oil Supply has been increasing; with a value of 89.6mbpd in 2012, it has increased to 95.2mbpd in 2016.

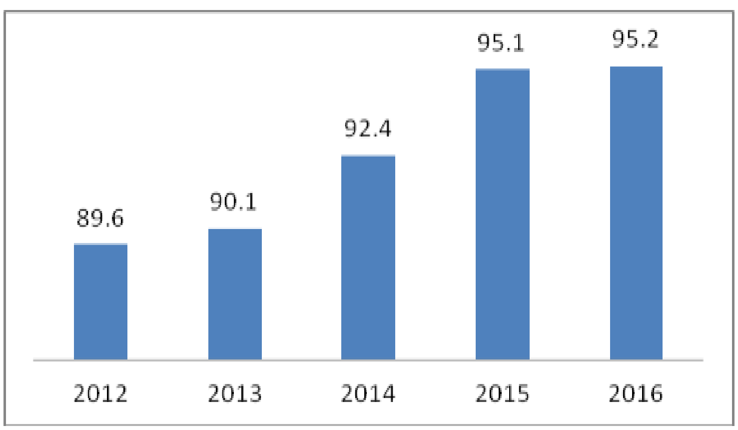

Figure 1: Global Oil Supply (mbpd)

Source: OPEC Monthly Oil Market Report

These supply and demand factors have combined to push crude oil prices to historical lows, falling from well over US$140/barrel in their peak in July of 2008, to well below US$35/barrel in recent past. As a result, oil revenues for Nigeria have declined significantly. Yet, the structure of the economy has not changed. To make matters worse, crude oil export volumes have declined beyond reasons that can be explained by the supply and demand factors mentioned above. Domestic security challenges in the oil producing regions of the Niger Delta have contributed, causing daily crude oil production to ebb.

With both price and production falling, the effects on the country's export earnings have been considerable. The country's trade balance has shifted to negative territory and government revenues have fallen well below target. Consequently, the country's currency has depreciated, falling from about N190 to the dollar to more than N400 on the parallel market. With the naira losing ground against major currencies on a scale of this kind, the concomitant effects on prices have been significant. Inflation, estimated at 17.9% as at September 2016, is set to add significant strains on living standards in a country with massive unemployment problems. Unlike recessions of recent memory, the prevailing one has a unique feature of being associated with crude elements of stagflation (inflation coexisting with unemployment).

The authorities in Nigeria are committed to overcoming the challenge, taking into account that the causes of the steady fall in crude oil prices are largely external. One approach is to lay a solid foundation for infrastructure development, agricultural transformation and combating insurgencies in the north-east as well as in the Niger Delta. Although these efforts have begun to yield fruits, they have to be sustained and improved upon to reach the desired destination. Crude oil prices have begun to recover, but such recovery has yet to return prices to even half of their previous peaks. Overcoming security challenges has produced impressive (though incomplete) results in the north-east; and the Niger-Delta region has become more stable. The outlook for recovery is therefore bright, although crude oil prices are unlikely to attain previous heights due to the above demand and supply factors explaining their downward spiral.

3 Role of Fiscal Policy

As apex regulator, the SEC is committed to developing the capital market. The main thesis of this paper, therefore, is that a more developed capital market is a necessary enabler for government's fiscal and monetary policies needed to lift the country out of recession. The focus here is that financial markets are critical in making fiscal policies of government more effective. Both economic theory and evidence have tended to underscore the role of fiscal and monetary policies in influencing the course of economic activity and therefore in providing the necessary policy tools for recovery.

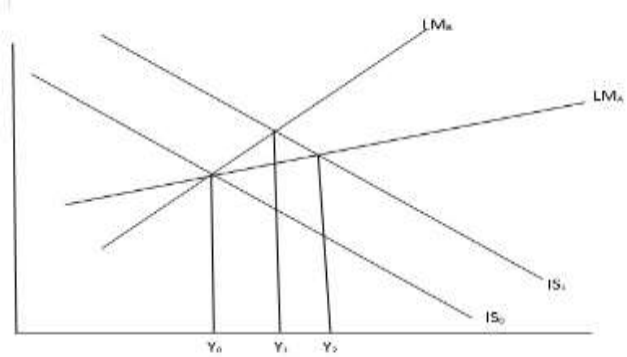

Figure 2: Similar Fiscal Responses Producing Varying Growth Outcomes

Figure 2 can be used to explain an important point about the tendency for similar fiscal actions to result in widely different growth outcomes. Imagine two countries both of which are at initial income levels of Y_0 during a recession. In both countries, fiscal policy is assumed to shift the IS curves from IS_0 to IS_1. Because of a more developed financial market, the LM curve for country A is more elastic, with its LM curve intersecting the common IS curve at higher level of output (Y_2) compared to that of country B, for which the new equilibrium level of output is at Y_1. According to Solow (1956) fiscal policies are ineffective means of promoting growth. Solow's idea is a variant of the Ricardian equivalence, which argues that government fiscal policies cannot promote growth. The Ricardian equivalence postulates that agents are rational and could correctly anticipate the effects of fiscal policy on their future earnings and therefore take actions to counter it. Suppose a country was in recession and the fiscal authorities borrowed in order to meet additional spending obligation, rational agents, according to the Ricardian equivalence, would correctly anticipate the implication as the debt would have to be paid in the future with interest.

Viewed in this light, additional borrowing by government to counter a recession would be just offset by reduced consumer spending since rational agents would save more to meet additional future tax obligations to pay the debt. Solow's position has its supporters, with the neoclassical economists such as Judd (1985) and Chamley (1986) advocating a lack of any significant relationship between fiscal policy and growth.

In contrast, the endogenous growth models popularized in the works of Barro (1990), hold the opposite view that fiscal policy, if employed wisely, could actually provide the necessary stimulus for growth. It should be recalled that with the advent of the housing bubble in the United States and the ensuing global financial crisis, many OECD countries including the United States (arguably the bastion of free markets) had employed a variety of fiscal measures to boost their economies and restore growth. Their actions were based on political realities as well as supported by economic theory and evidence. For example, Kneller, Bleaney and Gemmell (1998) came to a conclusion that supported the role of fiscal policy in rejuvenating growth. Kneler et al. (1998) classify fiscal actions into four categories: taxation can be distortionary or non-distortionary; and expenditure distortionary or non-distortionary. Their study produced interesting findings that offer some important lessons for Nigeria. Among their results, Kneller et al. (1998) find that distortionary taxation is inimical to growth while non-distortionary taxation does not harm growth; and that productive government expenditure is good for growth and non-productive expenditure is not.

For the EU countries, a more recent study by Benos (2009) has lent credence to the prevailing argument that fiscal policy has the potency to support growth. Studying a sample of EU countries, Benos reports that public expenditure on infrastructure contributes to economic growth. Further, the author finds that government expenditure on defense and social protection does not contribute to growth. These findings imply that spending on infrastructure is an important form of non-distortionary expenditure; while social protection expenditure is distortionary. Although raising interesting fiscal policy issues relevant for a country such as Nigeria, Benos offers a number of caveats. One is that there is a clear absence of a generally acceptable theoretical framework for estimating the relationship between fiscal policy and economic growth. He also notes that empirical studies on fiscal policy and growth have tended to vary in the basket of countries used in the sample, a factor contributing to the absence of a clear consensus. Different countries have tended to vary markedly in the quality of data on fiscal policies.

4 Capital market development, fiscal policy and growth

Extending the analysis further, King and Levine (1993) provide a new twist to the debate on the relationship between fiscal policy and economic growth. The authors argue rather persuasively that for fiscal policy to achieve the desired objective of stimulating growth, it must also include tax and expenditure measures to strengthen the financial systems. They provide four reasons for this claim. First, financial systems are useful means of evaluating prospective entrepreneurs and choice of projects. Second, financial systems mobilize resources to finance the evaluated and chosen projects. Third, they help greatly in diversifying risk and reducing uncertainties. Finally, they encourage research and innovation, by rewarding new and better ways of doing things.

To enable the financial markets, perform this role, efforts to strengthen and deepen the capital market are necessary. As the regulatory body concerned with capital market development and by implication the development of the Nigerian economy, the SEC has embarked upon a series of efforts to achieve long term development objectives. As discussed below, the SEC is also well positioned to restore investor confidence and thus to support the efforts of government at mitigating the impact of the recession and launching the economy back onto the path of economic recovery and growth.

Since its establishment in 1978, the SEC has pursued initiatives that will develop the capital market to provide long term finance, thereby promoting economic growth. Amongst the more recent initiatives, the Nigerian Capital Market Master Plan, 2015 – 2025, aims to contribute to the development of the capital market. The master plan was initiated by the SEC, which set up three committees, the membership of which was drawn from all the major stakeholders in the capital market. The Master plan therefore was a product of stakeholder consensus on how to make the Nigerian capital market achieve its dream of becoming one of the deepest, largest, most modern and liquid in the world.

The Nigerian capital market experienced a period of unprecedented growth from 2003 to 2007 during with the capitalization of listed equities on the Nigerian Stock Exchange (NSE) growing by over 66% per annum as shown in Figure 3. The fixed income market was concurrently enjoying a period of growth with a revival of FGN bond issuances as well as state government and corporate bonds. The rapid market development played a crucial role in supporting the recapitalization exercises that both the banking and insurance sectors underwent between 2005 and 2007. After attaining a then peak of N12.6 trillion in March of 2008, the stock market capitalization endured a steep decline, losing about 70% of its value within the year as illustrated by Figure 4.

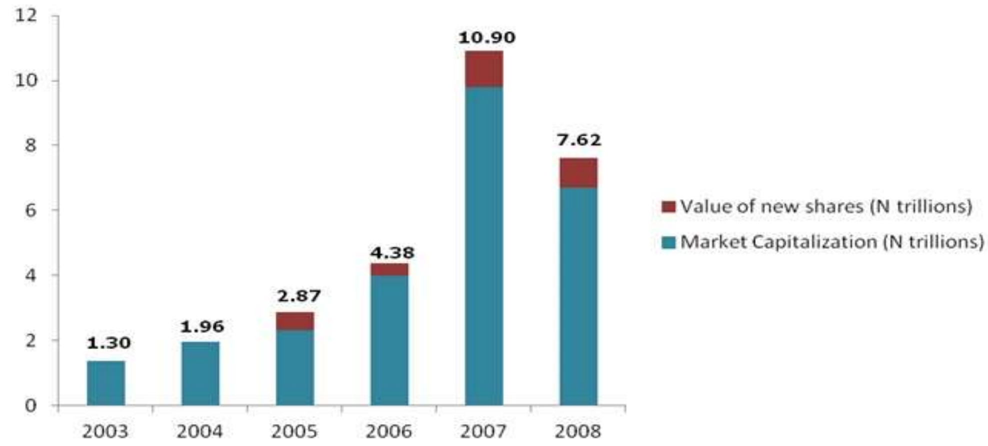

Figure 3: Rapid growth of the Nigerian Stock Market
Source: Author's compilation from SEC and NSE data

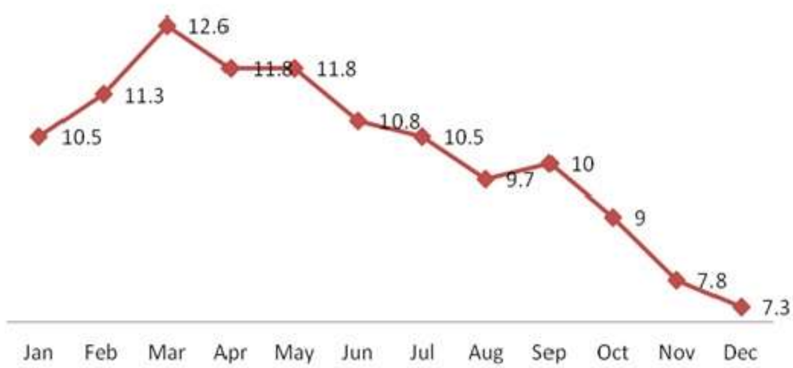

Figure 4: NSE Market Capitalization Crash in 2008
Source: Author's compilation from SEC and NSE data

The stock market crash of 2008 dealt a huge blow to investor confidence in the Nigerian capital market, particularly retail investors. Since then, the SEC's focus had been on implementing initiatives that restore investor confidence in order to attract them back to the market. Restoring investor confidence is expected to contribute to early return of growth. The capital market master plan contains over one hundred initiatives that can improve the competiveness and attractiveness of the market.

While the master plan has a ten-year implementation timeframe, the SEC has chosen to prioritize those initiatives capable of restoring confidence, reducing cost, improving efficiency and reforming the regulatory framework for early implementation. A brief description of some of these initiatives follows.

- *E-Dividend*: A move to make the payment of dividends to shareholders more efficient. Through partnership with the Central Bank of Nigeria (CBN) and the Nigerian Inter-Bank

Settlement System (NIBSS), the SEC developed an electronic platform to enrol all shareholders unto the e-dividend platform which leverages know-your-customer database of the banking system. Once enrolled, dividends are credited directly into investors' bank accounts against the current system that relies on posting dividend warrants. The ease of dividend payment can significantly boost retail investor confidence, curb the unclaimed dividend phenomenon and encourage more Nigerians to save and invest.

- *Direct Cash Settlement*: This scheme was mandated by the regulator to ensure that when investors sell securities in the market, the proceeds are credited directly into their respective accounts. Under the previous system, such proceeds were firstly credited into the broker's account before onward transfer to the investor. Such situation allowed opportunities for abuse by the broker. Indeed, a substantial number of the complaints received by the SEC from investors involved non-remittance of sale proceeds by the broker. Direct cash settlement will therefore improve investor confidence by reducing market infractions.

- *Dematerialization*: Relying again on the bank verification number database, the capital market community has been able to cooperate to convert virtually all existing share certificates into electronic records with the Central Securities Clearing System (CSCS). Records from the CSCS showed that as at June 2015, less than 40% of the share certificates in the Nigerian capital market were fully dematerialized. However, since efforts were made in this regard the level of dematerialization in Nigeria has gone above 97%.

- *National Investor Protection Fund (NIPF)*: The market crash of 2008 brought about deep-seated investor apathy. One of the ways to attract investors back to the market was to develop a scheme that compensates investors for some of the losses suffered during the crash. The SEC has therefore incorporated and operationalized a NIPF to compensate investors who suffer pecuniary losses in the market due to defalcation of capital market operators other than broker/dealers. So far the NIPF has compensated hundreds of investors within only a few months of its existence. The NIPF complements other investor protection funds operated by registered exchanges as required by the Investments and Securities Act (ISA) 2007.

- *Recapitalization of Capital Market Operators*: The need for strong institutions operating in the capital market necessitated the review of minimum capital requirements for all operators in the capital market. This exercise has been completed ushering in stronger operators capable of making the needed investment in market infrastructure and institutional governance.

- *Corporate Governance Scorecard*: The SEC's code of corporate governance is the most far-reaching in Nigeria covering public companies across all economic sectors. Based on the code, the SEC worked with the International Finance Corporation (IFC) to develop the first corporate governance scorecard of its kind in Africa. The scorecard will impact the quality of corporate governance compliance in Nigeria with the attendant benefits on growth and efficiency.

- *Financial Literacy*: Poor financial literacy has been identified as one of the major reasons for the low level of financial inclusion in Nigeria (Kama et al., 2013). To help tackle this challenge, the SEC has focused on several financial literacy initiatives as part of its market development drive. In particular, robust public enlightenment campaigns are continuously conducted across all media including radio, television, print and social media. Similarly, efforts are being made to boost financial literacy among young people with school programmes, literacy week and capital market curriculum.

- *New Rules for Product Innovation*: A major part of the SEC's intervention for developing the financial system involves improvements to the legal and regulatory framework. This is usually done through rulemaking or amendments of the law through legislative advocacy. So far SEC has released rules to encourage innovation of new products like securitization, market making, securities lending, real estate investment trusts (REITs) and infrastructure funds amongst others. These revolutionize the economy when properly applied by market participants. For example, REITs can play a major role in reducing Nigeria's lamented housing deficit. Similarly, the rules on securitization and infrastructure funds can attract financing for major infrastructure projects across the country whenever structured. Some of these new rules have enabled the pension system regulator, National Pensions Commission (PenCom) to develop new guidelines that will attract more investments by pension funds in the market when released.

- *Non-Interest Products*: Nigeria is a very fertile market for non-interest products considering its demographics. The SEC has issued rules on sukuk issuances in Nigeria which enabled the government of Osun state to raise N11 billion from Nigeria's first sukuk. SEC is similarly working with the Debt Management Office for the issuance of sovereign sukuk by the Federal Government. This can attract substantial capital from other more developed Islamic finance markets around the world. Developing a vibrant secondary for non-interest products will go a long way in catalyzing more issuances. As such, SEC has advocated and supported the CBN to issue guidelines that granted liquidity status to sukuk.

- *Advocacy for Fiscal Incentives*: As part of the master plan implementation, SEC set up a high-level advocacy body called the Capital Market Master Plan Implementation Council (CAMMIC). The CAMMIC is expected to lead advocacy and provide strategic guidance in the master plan implementation process. So far, such advocacy efforts have led to important fiscal incentives being introduced by both the Minister of Finance and the Federal Inland Revenue Service (FIRS). These incentives when fully applied will improve the attractiveness of our market to both foreign and domestic investors.

- *Improved Issuance Process*: As a result of reduced revenues, the finances of state governments are significantly constrained. Capital markets provide state governments a number of avenues to raise affordable long term capital for infrastructure investment and social interventions. The SEC has therefore reviewed the bond issuance process to allow for speedier approval of such issuances. A separate framework has also been developed for corporate and other types of bonds. This is in addition to a more streamlined and clearer process for supranational issuers.

- *Development of Commodities Exchanges*: Another aspect of the master plan draws attention to SEC's determination to promote the development of commodities market especially in areas of Nigeria's comparative advantage such as oil and gas as well as cocoa and grains. This will support the drive for economic diversification which is a key national priority.

Implementing all of these initiatives and many more over the next decade will significantly develop the Nigerian capital market, advance the financial system and catalyze economic growth. There are precedents from other climes where dedicated efforts to implement a master plan for the market have had positive multiplier effects on entire economies. An important example is Malaysia, one of the so-called Asian tigers. Following the devastating Asian financial crisis of the late 1990s, Malaysia developed a ten-year master plan for its capital market for implementation between 2000 and 2009.

Consequently, their market doubled in size from US$317 billion in 2001 to US$606 billion by 2010 (Malaysian Capital Market Master Plan II (2010)). Following the success of the first master plan, Malaysia went on to develop a second one which is currently being implemented from 2010 to 2019. The more developed capital market in Malaysia has been credited with enabling its economy to outpace the growth of the ASEAN-5 (Indonesia, Malaysia, Philippines, Singapore, and Thailand – members of the Association of Southeast Asian Nations) since 2003 (Capital Markets Malaysia, 2015).

5 Implications for privatization policies

More developed financial markets are clearly better able to support long-term investment and growth. There are several ways that a more developed capital market might contribute to growth but one area this paper attempts to address is the question of privatization, an issue that has attracted attention. In the face of dwindling revenues associated with recession, government needs to curb certain expenses, what Kneler, et al. (1998) would refer to as distortionary expenditure. This could be facilitated through the removal of controls on economic activities. The wave of privatization in the past in Nigeria has achieved results, but there is scope for further improvements as the capital market becomes more developed and takes a more active role in the process of privatization.

An important question raging in policy circles is whether the fiscal authorities in Nigeria should pursue privatization. Fiscal policy involving tax and expenditure policies must not be directed in ways to create the impression that state ownership is preferred to private one. Both literature and evidence suggest that privately owned firms have better performance than state-owned enterprises (SOEs) (World Bank, 1992; Bishop & Thompson, 1993). Managers face different objective functions in private and state ownership regimes. State owned enterprises tend to pursue objectives such as employment rather than profit and efficiency. In that scenario, there is the tendency for managers to boost the size of the firm and therefore to make the political cost of bankruptcy too high to bear. As Kornai (1986) has argued, managers of SOEs are able to pursue employment rather than profit objectives because they face soft budget constraints. In contrast, where the capital market is more developed and the regulatory authorities very vigilant, managers of privately owned firms would more likely pursue profit and efficiency objectives. Managers are prone to the discipline of the market because of the prospects for job losses in the event of bankruptcy.

This theoretical argument that firms under private ownership tend to do better than those under state ownership has been supported by empirical evidence. The World Bank study mentioned above finds for twelve firms drawn from different countries that performance improved with privatization. By the same token, Bishop and Thompson (1991) report large efficiency gains in formerly state-owned British enterprises. Similar results were reported in a more comprehensive study by Megginson, Nash and Van Randenborgh (1994) who for a sample of 61 firms drawn from 18 countries and 32 industries, report efficiency gains after privatization. The set of measures explained above and discussed in more detail by Pam et al. (in this issue) will further develop the capital market and lay the foundations for weathering the storms of recessions when they occur.

6 Concluding Remarks

The current economic recession in Nigeria has its origin in weak demand resulting from low growth internationally. The country is facing an economic recession with few such historical antecedents in which inflation and unemployment have combined to make a solution rather complicated. This poses a special challenge for policymaking. In addition to a host of other steps, government needs to employ fiscal measures of taxes and expenditure in the arsenal of economic policy. On the basis of review of literature, this paper has argued that a number of preconditions are required to make fiscal policy an effective policy tool for getting out of the current recession and fostering growth. First, distortionary taxes such as progressive income taxes could be injurious for growth, as established empirical evidence has shown. Second, distortionary expenditure should be avoided, which means that supporting ailing state enterprises could spell fiscal disaster, despite obvious political appeals. Third, development of the financial markets is necessary in order to make fiscal tools for effective. In the case of the capital market, the current wave of innovations aimed at fostering its development is in tandem with the need to make fiscal tools work better. One commonly suggested reason why fiscal tools are less effective is the apparent insensitivity of investment to fiscal actions. Developing the capital market is one of the ways of making investment responsive to changes in the fiscal environment. Capital market development therefore is a necessary condition for making fiscal measures more potent tools of lifting this country out of recession.

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