Financial System and Economic Growth in Nigeria

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ABSTRACT

The financial system, which is the central nervous system of any economy, is important for the development of any nation. Despite the presence of various banks and other financial institutions in Nigeria, its economy has not attained a satisfactory level of economic growth when compared to other developed nations. The objective of this paper is to examine the relationship between financial intermediation and economic growth in Nigeria. The study used a time series data from 1991 to 2015. Data obtained were estimated using Johansen Co-integration test and the Error Correction Model. Findings revealed that the financial system has an insignificant impact on economic growth in Nigeria. This study therefore recommends that financial institutions should expand their stocks and assets to ensure better deepening by focusing on the real sector of the economy. In addition, the regulatory authorities like CBN and SEC need to focus on policies such as financial inclusion that will engender the positive impact of Nigeria's financial system on its economic growth using CPS as a measure of financial depth in Nigeria.

Keywords: Financial System, Economic Growth, Financial Deepening Hypothesis

1. Introduction

The Nigerian financial system is a conglomerate of various institutions, markets and regulators. According to the Central Bank of Nigeria (CBN) (1993), the financial system refers to the aggregation of financial arrangements, institutions, agents, that interact with each other and the rest of the world to foster economic growth and development of a nation. According to Nzotta (2004), the financial system serves as a catalyst to economic development through various institutional organizations. The system vigorously seeks out and entices the reservoir of savings and idle funds and assigns same to entrepreneurs, businesses, households and government, for investment projects and other purposes with a view of returns. This forms the basis for Economic development (Nzotta, 2004). According to Olofin and Afandigeh (2008), the Nigerian financial system can be broadly divided into two sub-sectors, the informal and formal sectors. The informal sector has no formalized institutional framework, no formal structure of rates and comprises the local money lenders, thrifts, savings and loans associations and all forms of associations.

A sound financial system is a good predictor of economic growth, capital accumulation, and technological change, while an unsound financial system would definitely have an adverse effect on the functioning of an economy's real sector. So also, a good economy that is well developed can create the demand for different types of financial arrangements, which would be well responded to by the financial system (Levine, 1997; and Ojo, 2010).

According to the CBN Annual Report and Statement of Account (2008), the Nigerian financial system comprises of different financial institutions which include: the Central Bank of Nigeria (CBN) , the Nigeria Deposit Insurance Corporation (NDIC), the Securities and Exchange Commission (SEC), the National Insurance Commission (NAICOM), the National Pension Commission (PENCOM), Deposit Money Banks, (DMBs), Discount Houses(DHs), Microfinance Banks (MFBs), Finance Companies (FCs), Primary Mortgage Institutions (PMIS), Development Finance Institutions (DFIs), Bureau-de-change (BDCs), Stock Exchange, Commodity Exchange and Insurance Companies.

A financial system provides linkage to different sectors of the economy and encourages high level of specialization, expertise, economies of scale and a

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favorable environment for the implementation of various economic policies of government intended to achieve non-inflationary growth, exchange rate stability, balance of payments equilibrium and high levels of employment (Gibson & Tsakalotos,1994; and Rajan and Zingales, 2003).

The financial system, which is the central nervous system of any economy, is important for the growth of any nation (Akinlo, 2007). Despite the presence of various Banks and other financial institutions, the Nigerian Economy has not attained a satisfactory level of Economic growth. Funds are mobilized inefficiently; the savings instruments and investment facilities offered by them are not quite attractive; and they prefer to render short term products and services that will provide quick profits, rather than to focus on long term development projects; and despite the volumes of profits declared by banks in Nigeria, the real sector continues to be weak thereby reducing the output level of the economy (Adebiyi, 2002; Oyejide , 2005; Adeoye , 2007; and Ojo, 2014). This study therefore evaluates the financial system and Economic growth of Nigeria.

2. Conceptual Issues and Review of Empirical Studies

A financial system is a driver for economic development in any nation. Ojo (2010) opined that financial modes and operations constitute an effective means of elevating the industrialization level of countries. According to Ofanson (2010), a financial system is a conglomerate of institutions, markets, instrument and operators that interact to provide financial services such as resource mobilization and allocation, financial intermediation and facilitation of foreign exchange transactions. The financial sector development is accruable to a lot of factors including the financial depth of the economy (CBN, 2009). A growing Economy thus, places more responsibility on the financial sector to mobilize the needed capital to facilitate production, generate employment and income (Nnanna and Dogo, 2008).

The Nigerian financial system is structured into formal (money and capital market institution) and informal (local money lenders, the thrifts and savings associations and so on) groups. In general the Nigerian financial system comprises the regulatory/supervisory authorities, bank and non-bank financial institutions. By the end of 2011, the system comprised Central Bank of Nigeria (CBN), the Nigeria Deposit Insurance Corporation (NDIC), the Securities and Exchange Commission (SEC), the National Insurance commission (NAICOM), the National Pension commission (NPC), 21 deposit money banks, 750 Microfinance Banks, 112 Finance Companies, 322 Bureau de change, one stock exchange with branch offices, one Commodity Exchange at Abuja, 91 Primary mortgage institutions, and 581 Registered Insurance Brokers (CBN, 2011).

Jhingan (2003) sees economic growth as a process whereby the real per capital income of a country increases over a long period of time. According to him, economic growth is measured by the increase in the amount of goods and services produced in a country. Economic growth is the increase of per capita gross domestic product (GDP) or other measure of aggregate income. It is often measured as the rate of change in GDP (Charles and Charles, 2007). When an Economy is producing more, businesses are more profitable, and stock prices rise, this gives companies capital to invest and hire more employees. And as more jobs are created, incomes rise; this gives consumers more money to buy more products and services, driving more economic growth (Mbat, 2000; and Nzotta and okereke, 2009).

Numerous studies have been conducted on financial system and Economic growth. Gershenkron (1962) argued that banks effectively finance industrial expansion than any other form of financing in developing Economies. Mbutor (2009) analyzed the channels of transmission of monetary policy in the Nigerian Economy. Using variables such as GDP, domestic prices, broad monetary aggregates and real effective exchange, findings revealed that the lending rates had the highest impact on GDP, in terms of time of impact; broad money supply had the fastest impact on GDP. He argued that the role of the banking system in propagating monetary impulses to the real sector should be recognized as critical.

Ayadi (2007) examined the Structural Adjustment, Financial Sector Development and Economic

Prosperity in Nigeria. Using the Spearman rank correlation, findings revealed that the extent of financial development depends on the volume of bank credit as well as the stock market capitalization. The study also employed the use of some of the variables identified by Beck, (2000) to test whether or not Economic growth and financial development co-move since the introduction of structural adjustment in Nigeria. Results revealed a lack of consistent relationship between financial system development and Economic growth in post-SAP Nigerian economy.

Gries (2009) investigated the direct and indirect causal interactions between financial deepening, trade openness and Economic growth for 13 Latin American and Caribbean countries. The study used Hsiao's version of Granger causality within an autoregressive (VAR) and Vector Error Correction Models (VECM) framework. Findings showed no evidence of finance led growth for Latin America and the Caribbean, and showed insignificant causal interaction between financing and growth in the Latin American region.

Odiambho (2004) studied the role of financial development on Economic growth in South Africa. The study employed Johansen-Juselius co-integration approach and Vector Error Correction Model. Findings revealed an overwhelming demand-following response between financial development and Economic growth. And the study totally rejects the supply leading hypothesis.

Nzotta and Okereke (2009) examined financial deepening and Economic development in Nigeria. Investigations revealed that four out of the nine variables; lending rates, financial savings ratio, cheque/GDP ratio and the deposit money banks GDP ratio had a significant relationship with financial deepening and concluded that the financial system has not sustained an effective financial intermediation, especially credit allocation and a high level of monetization of the economy.

Agu and Chukwu (2008) employed the augmented granger causality test approach developed by Toda and Yamamoto (1995) to ascertain the direction of causality between "bank-based" financial deepening variables and Economic growth in Nigeria. Results revealed that financial deepening and Economic growth are positively co-integrated.

Shittu (2012) examined the impact of financial intermediation on Economic growth of Nigeria. Investigation revealed that financial intermediation has a significant impact on Economic growth in Nigeria. Azege (2004) studied the empirical nexus between the level of development by financial intermediaries and growth. The study employed data on aggregate deposit money banks credit over time and gross domestic product to establish that a moderate positive relationship exists between financial deepening and Economic growth. He concludes that the development of financial intermediary institutions in Nigeria is fundamental for overall economic growth.

Olofin and Afangideh (2010) examined the financial structure and Economic growth in Nigeria by using annual data from 1970 to 2005. The study posited that financial structure has insignificant effect on output growth through bank credit and investment activities, but financial sector development merely allows these activities to positively respond to growth in output.

Ndebbio (2004) argued that the poor growth of output of any country is caused by shallow financial depth and the range of financial assets for that country. Koçukozmen (2009), studied financial development and Economic growth: a cointegration approach. Findings showed that there is no long term relationship between financial development and Economic growth.

This paper distincts itself by holistically considering the Nigeria's financial system and it also deviates from others in terms of its methods and measurements. Study also focuses on the period when major developments and reforms took place in the Nigerian financial sector.

The theory that underpins the findings of this study is the Shaw's Financial Deepening Hypothesis. According to Shaw (1973), with the development of the financial system, an alternate financial asset other than money becomes available as repositories of financial savings to be eventually used for investment

in productive resources. The savings and investments could take place through accumulation of non-money assets. Thus, in contrast to McKinnon's hypothesis, cash balances are not required to be accumulated prior to investment and hence, there are no complementarities. Therefore, financial liberalization would lead to better integration of formal and informal credit markets, which will result in efficient transfer of funds between savers and investors (Nyong, 2003). Economies of scale will also result in reducing cost of financial intermediation, information costs and lowering risks due to diversification (Nzotta, 2004).

Shaw (1973) underscores the developmental role of finance by distinguishing between nominal finance and real finance. With financial repression, nominal values in general rise at some buoyant rate and if deflated by any index of prices, their rise is less rapid. The nominal finance takes a high growth path while the real finance takes the lower one. Therefore, the finance in the real sense is partly shallow due to inflation. On the other hand, there are several indicators of financial deepening such as stocks (Ndebbio, 2007). Thus, with financial liberalization and removal of distortions in financial prices, liquidity increases. This theory has been adopted by Ogun (1986); Edo (1995); Oyejide (1998); Nzotta (2004); and Ndebbio (2007), among others.

3. Methodology and Data

This section focuses on the methodology used for this study. Data used for this study was obtained from the Central Bank of Nigeria (CBN) Statistical Bulletin. Data obtained spanned from 1991-2015. Multiple regression was used as a technique of data analysis using (E-Views 8.0) as well as Johansen's Multivariate Co-integration Test and Error Correction Estimates which shows the long run and short run relationship between the specified variables. The variables GDP and CPS were logged to bring them to a comparative level with other variables.

3.1 Model Specification

The model specified for this study is:

GDP=F (M2/GDP, INT, INFR, EXCR, CPS)……(1)

The econometric form of this equation is:

$\log GDP_t = B_0 + \log B_1 M_2t + B_2 INT_t + B_3 INFR_t + B_4 EXCR_t + \log B_5 CPS_t + e_t$……(2)

Where:

$\log GDP_t$ = log of Real Gross Domestic Product

$\log M2_t$ = used as log of Money Supply to GDP(m2/GDP)

$INTR_t$ = Interest rate

$INFR_t$ = inflation rate

$EXCR_t$ = Exchange rate

$\log CPS_t$ = log of Credit to private sector

B_0 =intercept of the relationship in the model

B_1-B_5 = coefficients of each of the independent variables

e_t = stochastic error term

3.2 Model Estimation

Several tests were conducted, among which include the Augmented Dickey Fuller Unit root test, Normality test, and Durbin-watson-to account for possible successive error terms. The t-statistic was used to depict the level of significance of each of the explanatory variables, and the F-statistic for the overall goodness of fit of the entire model. The R-squared also showed the forecasting power of the explanatory variables on the explained variables, among others.

4. Discussion of Results

Table 1: Results of Augmented Dickey Fuller Unit Root Test

Gdp=lgdp	-1.217987	-2.635542	-4.757579*	-3.752946	I(1)
Intr	-2.486046	-2.635542	-5.813647*	-3.752946	I(1)
Inf	-2.228719	-2.638752	-3.868855*	-3.752946	I(1)
Cps=lcps	-1.217987	-2.650413	-4.757579*	-3.752946	I(1)
Excr	-0.941530	-2.635542	-4.656903*	-3.752946	I(1)
M2/gdp	-1.902327	-2.635542	-4.477666*	-3.752946	I(1)

Source: E-View output. *significant at 1%

Table 1 shows the results of the Unit root test carried out to determine if the variables are stationary or not and to determine their order of integration (i.e. number of times they are to be differenced to achieve stationarity). The results indicate that all the series are stationary at first difference I(1). The findings from the first differencing indicate that all the variables are stationary, given that the McKinnon values are

greater in all cases than the ADF-test statistic. With this finding, the study proceeded to conduct a co-integration test.

4.2 Co-integration Test

Co-integration test was carried out on the models, using Johansen co-integrating test on the residual of the variables of the model. The result is shown in table 4.2 below.

Table 2: Results of Johansen Co-integration Test

None *	214.5802	95.75366	73.43701	40.07757
At most 1 *	141.1432	69.81889	45.90594	33.87687
At most 2 *	95.23728	47.85613	43.30961	27.58434
At most 3 *	52.92767	29.79707	29.74663	21.13162
At most 4 *	23.18104	15.49471	23.09281	14.26460
At most 5	0.088236	3.841466	0.088236	3.841466

Source: E-View output. *significant at 1% **significant at 5%

The results reported for the trace and maximum eigenvalue statistics in Table 2 shows that the null-hypothesis of no-cointegrating vector linking real GDP growth rate and its dependent variable is rejected at the 5 per cent level of significance. Both trace test statistics and maximum eigenvalue statistics reveal that there are, at most, five co-integrating equations which imply that there is a long run relationship between GDP (explained variable) and the explanatory variables applied in the study. In view of this, the study proceeded to estimate the error correction model (ECM).

4.3 ECM Model Estimation Result

After having found co-integration the researcher built an Error Correction Model including short term and long term relationships. The results are shown in table 3 as follows:

Table 3: ECM Regression Result

Variable	Coefficient	Std. Error	Prob.
D(INFR)	-0.379179	0.158956	0.0036
D(INTR)	0.256390	0.215780	0.1755
D(LCPS)	0.435000	0.190594	0.0000
D(EXCR)	-0.461052	0.230526	0.0447
D(M2/GDP)	0.523098	0.312087	0.1409
C	0.079405	0.073112	0.1852
U(-1)	-0.070976	2.123957	0.0145
R-squared		0.760200	
Adjusted R-squared		0.697400	
F-statistic		4.071378	
Prob(F-statistic)		0.000001	
Durbin-Watson stat		2.154703	

Source: E-View output, 2017.

From the result in table 3, the test of significance of the parameters shows that inflation rate (INFR), credit to private sector (CPS), exchange rate (EXCR) are significant at 1%, 1% and 5% respectively. While interest rate (INTR), and ratio of money supply to GDP is statistically not significant. The ECM (-1) has the expected sign and is highly significant which confirms the Johansen co-integration test which proves that the model variables are co-integrating on the long run. The result shows that Exchange rate is negatively related to economic growth (GDP) which implies that a percentage increase in exchange rate leads to a depression on investment, which in turn leads to a fall in economic growth and vice versa. The result also shows that a percentage increase in inflation rate will lead to GDP increasing by 37%. Also, credit to private sector has a significant effect on GDP and a 1% increase in CPS increases GDP by 43%.

The adjusted R square pegged at 69.7% implies that; Ratio of money supply to GDP (M2/GDP), Interest rate (INTR), inflation rate (INFR), Exchange rate (EXCR) and Credit to private sector (CPS) explained about 67.9% systematic variations in economic growth over the observed years in the Nigerian economy while the remaining 33% variation is explained by other determinant variables outside the model. The F-stat value is 4.071378 with an associated probability of 0.0000 shows that the overall model is statistically significant at 1% level. The durbin-watson result of 2.154703 which is close to 2 shows the absence of autocorrelation among the variables.

Table 4: Results on Test of Residuals

Jarquebera	Probability	Obs*R-squared	Probability
7.336153	0.255267		
		3.792060	0.1502

Source: E-View output, 2017.

The Jarquebera result (normality test) with probability value greater than 5% shows that the variables in the model are normally distributed while the Breusch-Godfrey Serial Correlation result (correlation test) with probability value greater than 5% also shows that the variables in the model are not correlated.

5. Conclusion and Recommendations

This study concludes that the financial intermediation of the Nigerian financial system has a positive but insignificant impact on the economic growth of Nigeria. It further submits that credit to private sector is a better measurement of financial deepening/system, as it enables productive investment to be carried out on the economy as when compared to broad money. This study therefore recommends that financial institutions should expand their stocks and assets to ensure better deepening by focusing on the real sector of the economy. In addition, the regulatory authorities like CBN and SEC need to focus on policies such as financial inclusion that will engender the positive impact of Nigeria's financial system on its economic growth using CPS as a measure of financial depth in Nigeria.

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