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Financial Structure and Economic Growth: Evidence from Nigeria

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Keywords : financial structure, economic growth, nigeria.

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FINANCIALSTRUCTUREANDECONOMICGROWTHEVIDENCEFROMNIGERIA

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Financial Structure and Economic Growth: Evidence from Nigeria

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I. Introduction

The search for ways of bettering the standard of living of citizens through enhanced sustainable development has opened new corridors for alternative view points on paradigms of economic growth and development[1]. These alternative view points and paradigm for sustainable development have led to postulation of new developmental theories by economists all aiming at ensuring sustainable development. Sustainable growth and development entails that development which meets the needs of the present without compromising the ability of future generations to meet their own needs[2]. However, in most developing economies including Nigeria, the needs of future generations are really not adequately articulated in policies. Again, the implementation and management of these policies leave so much to be desired.

There appears to be a general consensus on the link between sustainable growth and development and finance[3]. The important role of finance in the process of economic growth and development could be traced to the works of Bagehort (1873)[4], Schumpeter (1911)[5] and Hicks (1969)[6]. Bagehort (1873) and Schumpeter (1911) have argued strongly on the pro-motive role of finance in the economic growth and development process. They posit that the industrial revolution in England was the result of a functioning financial system that was instrumental in mobilizing and allocating long-term capital to the productive enterprises of the country. Hick (1969) has also posited that a well functioning financial system provides intermediation services to productive entrepreneurial activities that spur technological, innovative, and productive activities which lead to growth (Hick, 1969).

A nation's financial system is much more than just an intermediary that insures the optimal allocation of savings to investment. The efficiency of such a system is endogenously achieved if the financial structure of that economy makes greater use of the resources available for development. This fact was buttressed by King and Levine (1993b)[7] when they posit that;

…better financial structures stimulate faster productivity growth and growth in per capita output by funneling society's resources to promising productivity-enhancing endeavours…

It is against the importance of finance in enhancing economic growth and development especially in developing economies, that we questioned whether financial structure has positive and significant impact on economic growth and development in Nigeria. This paper seeks to provide evidence-based answers to the question. It is divided into five sections. Section one is the introduction, section two reviews

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related literature in this area. Section three contains our methodology, while section four discusses the results of our findings. Lastly, in section five, we provided recommendations based on evidence, inclusive of our conclusion.

II. Review of Related Literature

There is no gainsaying that the financial systems, all over the world, play an important role in the development and growth of the economy. In Nigeria, the financial system comprises financial institutions, financial markets, financial instruments, rules, conventions, and norms that facilitate the flow of funds and other financial services within and outside the national economy[8]. In a nutshell, it consists of banks and non-bank financial institutions regulated by the Central Bank of Nigeria (CBN), Nigeria Deposit Insurance Corporation (NDIC), Securities and Exchange Commission (SEC), the National Insurance Commission (NIC), and the Federal Mortgage Bank of Nigeria (FMBN) as well as the Federal Ministry of Finance.

The Central Bank of Nigeria was established by Act of 1958 and commenced operations on 1st July 1959. The Act, which has undergone several amendments, was re-enacted as the CBN Act No 24 of 1991. In addition to the CBN Act, the Banks and other financial Institutions Act No 25 of 1991 was also promulgated to complement the operations of the CBN in enhancing growth of the Nigerian Banking sector. The Nigerian Deposit Insurance Corporation was established by Decree No. 22 of 15th June 1988 and took off in February 1989 with the mandate of insuring depositors' liability in Nigerian Banks. The regulatory organ of the Nigeria Capital market is the Securities and Exchange Commission, formerly called Capital Issues Commission which was established by SEC Act of 27th September 1979 and strengthened by SEC Decree of 1988 to regulate the activities of the Nigerian Capital Market. At the apex of the Insurance sub-sector is the National Insurance Commission (NAICOM), which replaced the Nigerian Insurance.

Supervisory Board, established by Decree No. 62 of 1992. This body is responsible for the regulation of activities in the Nigerian Insurance Industry. The Federal Mortgage Bank of Nigeria (FMBN) is at the apex of mortgage financial institutions in the country. The FMBN was established by Decree No. 7 of 1977 and it took over the assets and liabilities of the Nigerian Building Society, which was performing the statutory regulatory mortgage role before then.

The Nigerian financial system has undergone remarkable evolution in terms of ownership, structure of its institutions, the number of instruments traded, and the regulatory framework within which the system operates[9]. This evolution could be traced to three major periods vis-a vis the Pre-SAP Era (between 1970 and 1986), the SAP Era (between 1986 and 1993) and the Post-SAP Era (the period following the termination of SAP till date). While the Pre – Sap Era witnessed the emergence of wholly owned Nigerian financial institutions and was characterized by minimal competition and poor capitalization. The SAP Era was characterized by an economic reform package designed to liberalize the economy with emphasis on the financial system. The reforms brought about the removal of various administrative controls and ushered the country into a progressive move towards a market-oriented economy. The Post-Sap Era witnessed a brief period (1994) of renewed regulation and subsequently, the period of guided deregulation. At the outset of this era, the financial industry witnessed serious waves of distress that caused crisis of confidence in the industry. The Failed Banks (Recovery of Debts) and Financial Malpractice in Banks Decree was promulgated in 1994 to sanitize the banking industry. A further notable feature of this era was the consolidation policies introduced both in the Nigerian Banking sector as well as in the Insurance Sector in 2004 and 2005. All these changes were all aimed at ensuring a more effective and efficient financial system[10].

As stated earlier, the earliest establishment of the finance-growth nexus in literature could be traced to the earlier works of Bagehort (1873) and Schumpeter (1911) in which they contend that finance plays an important role in promoting economic growth and development. In this way, it is expected that a well functioning financial system will provide intermediation services to productive entrepreneurial activities which will spur technological, innovative, and productive activities that increase growth. Following this work of Bagehot (1873) and Schumpter (1911), Gurley and Shaw (1955)[11], Goldsmith (1969)[12] and Hicks (1969), McKinnon (1973)[13] and Shaw (1973)[14] have also emphasized the important role, financial intermediaries and financial markets play in the growth process of nations.

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Recent empirical and theoretical studies have also been conducted in several jurisdictions on the relationship between finance and economic growth. Prominent among such works is the work of King and Levine (1993a)[15]. In a study of 80 countries over the period 1960-89 in which they controlled for other factors that affect long-run growth, their results showed that initial level of financial development is a good predictor of the subsequent rates of economic growth. Benhabib and Spiegel (2000)[16], Levine, Loayza and Beck (2000)[17], Rioja and Valev (2004)[18] also point to the same same conclusion that financial development has a positive impact on economic growth, however, these studies are often conducted at aggregate and level as such are unable to account for the complexities of individual nations.

Literature examined in this study indicates that financial development is a necessary causal factor of economic growth, although the strength of the evidence varies across countries and across proxies used to measure financial development[19]. Also, it has been argued that evidence of a dampening effect from financial deepening on cyclical fluctuations in the short-run has strong effects in the long-run. However, the expected growth benefit from financial development, in the long-run is slow to materialize[20].

The determinants of financial development are thus co-integrated in the long-run suggesting that financial development, private capital stocks and the labor force exert a positive impact on economic development whereas the accumulation of public capital appears to curtail output expansion in the long-run[21]. No No wonder, measures suggested are that government policy should be geared towards strategically increasing money supply and promoting efficient capital market that will enhance overall economic efficiency, create and expand liquidity, mobilize savings, capital accumulation, transfer of resources from traditional sectors to growth inducing sectors; and also promote competent entrepreneurial response in various sectors of the economy[22].

On the impact of financial structure on economic growth, it is suggested that financial structure increases the performance of the economy, through such studies used bank-level data for a large number of developed and developing countries (Ang, 2007).

Countries that have underdeveloped financial systems tend to grow slower than developed economies; hence, financial structure per se does not have an independent effect on economic growth[23]. It is evident therefore, that in countries' with legal systems that more effectively protect the rights of outside investors, greater financial development enhances economic growth[24]. It is thus, important to develop models that not only are better able to mimic the actual relationships between economic growth determinants and financial structure but also that will allow the impact of government policies on the financial system to be explicitly analyzed[25].

Empirical evidence also exists that suggest weak evidence in support of an employment growth channel linking financial structure to subsequent economic growth, thus implying that, job creation is not consistently a major channel through which financial structure stimulates income growth[26]. The corollary therefore, is that the macroeconomic benefits of financial structure accrue primarily to those already working, rather than to new workers hence no direct evidence suggests that an expanding financial structure plays an important supporting role in economic growth [27].

For meaningful studies on the impact of financial structure and economic growth, proxies of financial structure should be positively correlated with economic growth. This will ensure that, the channels of transmission mechanism of financial development to growth are efficient in financial sector development rather than in the quantum of investment. Viewing from the perspective of discussions on the Nigerian financial system, financial development and economic growth, it is still not conclusive from empirical literature on what impact financial structure might have on economic growth and development, most especially in a developing economy like Nigeria. There is still a paucity of literature on the finance-growth nexus in the country thus, the gap which this study seeks to fill is providing an empirical study that will examine the impact of financial structure on economic growth in Nigeria.

III. Methodology

This study adopts the ex-post facto research design. The study covered the period, 1988 to 2011.

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The choice of 1988 as the base year is due to availability of data for all the model proxies, thus ensuring uniformity. The adoption of ex-post facto research design hinges on two reasons; the study relied on historic data obtained from the Central Bank of Nigeria Statistical Bulletin from 1988 – 2011, as such the event under investigation had already taken place. Also, the researcher does not intend to control or manipulate the variables[28]. This research design, also called causal comparative research, is used when the researcher intends to determine cause-effect relationship between the independent and dependent variables with a view to establishing a causal link between them[29]. Data used are, therefore, of secondary nature.

The endogenous growth theory[30] which assumes away population growth and technological change and states that growth is driven by capital accumulation formed the basis for this study. The choice of the model is based on, theoretical perspectives of the finance-growth nexus, that financial development enhances economic growth, hence, in this case the aggregate financial structure has a positive and significant effect on economic growth. Therefore, economic growth is mathematically expressed as a function of financial structure as denoted in (i):

$$Y_t = f(TFS_t) \qquad (1)$$

where:

Y_t = Economic Growth at time t

TFS_t = Total Financial structure at time t

Expanding Equation (i) to accommodate indicators of total financial structure, we have:

$$gdppcgr = \alpha + \beta_1 tfa/gdp + \beta_2 dcpbs/gdp + \beta_3 mcap/gdp + \beta\ tvst/gdp + \beta\ insp/gdp \qquad (2)$$

where;

α = Equation Constant

β1..β5 = Coefficient of Total Financial Structure

gdppcgr = Gross domestic product per capita growth rate (%)

tfa/gdp = Total Financial Assets percentage of gross domestic product

dcpbs/gdp = Domestic credit provided by the banking sector percentage of gross domestic product

mcap/gdp = Market capitalization percentage of gross domestic product

tvst/gdp = Total value of shares traded percentage of gross domestic product

insp/gdp = Insurance premium percentage of gross domestic product

The specific objective of this study is to determine the impact of total financial structure on economic growth. Three (3) core sectors of the Nigerian financial sector were used to represent the total financial structure viz banking, stock market, and insurance sectors; based on available data. Following similar studies in previous literature such as Demirguc-Kunt and Levine (1999) and Guha Deb and Mukherjee (2008), the growth rate of Nigeria's gross domestic product per capita was adopted as the index of economic growth. This measures the penetration of total of goods and services produced in Nigeria that directly go into the lives of ordinary Nigerians. The bank-based indicators of the total financial structure are represented by total financial assets as a percentage of GDP and domestic credit provided by the banking sector as a percentage of GDP which measures financial opportunities available to investors. It is expected that both proxies should have positive and significant impact on economic growth. The market based indicators of total financial structure used in this study are market capitalization as a percentage of gross domestic product and the total value of shares traded as a percentage of gross domestic product. While the formal proxy assumes that the overall market size is positively correlated with the ability of the market to mobilize capital and diversify risk on an economy-wide basis[31], the latter measures the organized trading of firm equity as a share of national output and therefore should positively reflect liquidity on an economy-wide basis and complements the market capitalization ratio[32]. Again, it is expected that both proxies will have positive impact on economic growth. Insurers collect

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32. Guha Deb, S. and J. Mukherjee (2008), "Does Stock Market Development Cause Economic Growth? A Time Series Analysis for Indian Economy" International Research Journal of Finance and Economics Issue 21, pp 1450-2887.

premium for their risk transfer and indemnification services. Thus, in this study, insurance penetration is measured by total insurance premium as percentage of GDP. This measure captures the role of insurance in an economy[33]. It is expected that, the coefficients of parameters for insurance penetration to be positive implying a positive impact on economic growth.

IV. Results and Analysis

This section presents and analyzes the results. Table 4.1 presents the descriptive statistics of the measurement indicators.

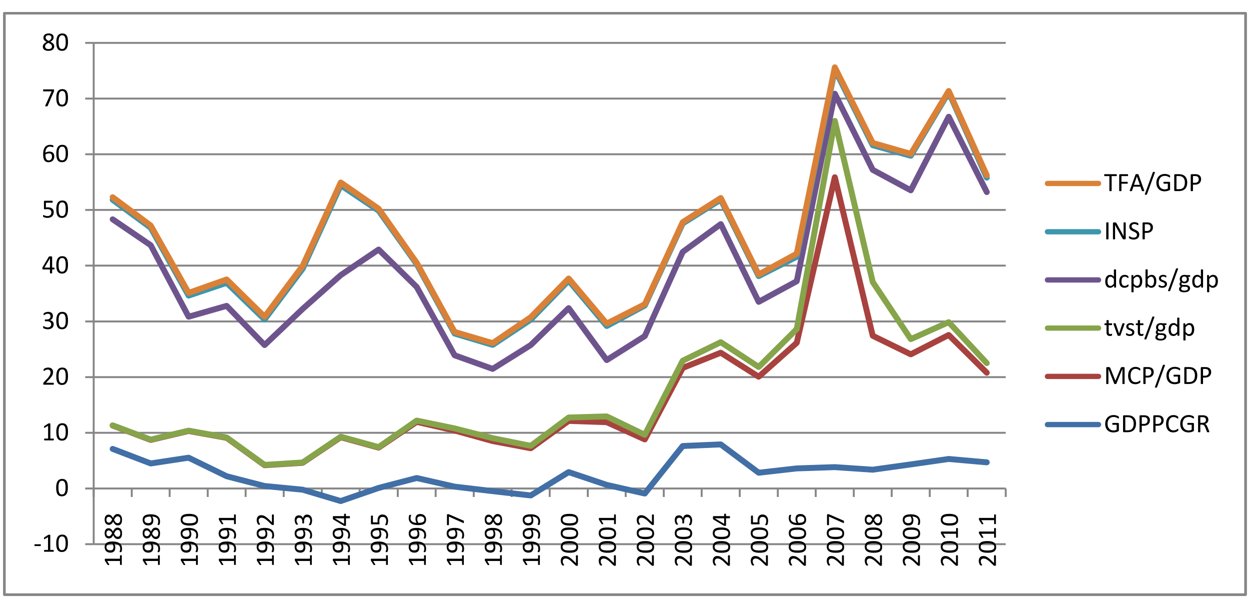
Table 4.1 : Descriptive Statistics

	GDPPCGR	MCAPGDP	TVSTGDP	DCPBSGDP	INSPGDP	TFAGDP
Mean	2.667150	13.31866	1.584228	21.89165	5.137825	0.392917
Median	2.872155	10.07444	0.534636	20.83450	4.403850	0.410000
Maximum	7.897959	52.04102	10.10976	37.02163	16.13480	0.590000
Minimum	-2.248560	3.729704	0.016776	4.909461	2.583700	0.220000
Std. Dev.	2.885401	10.29288	2.695900	9.143040	2.588442	0.106014
Skewness	0.159231	2.308351	2.504521	0.076962	3.350549	0.030214
Kurtosis	2.057489	9.356054	8.190316	2.177788	14.89147	1.913754
Jarque-Bera	0.989744	61.71337	52.02989	0.699726	186.3117	1.183582
Probability	0.609649	0.000000	0.000000	0.704785	0.000000	0.553335
Observations	24	24	24	24	24	24

Source : Authors'

As indicated in tables 4.1, the mean value of Nigeria's per capita income growth rate from 1988 to 2011 in Nigeria was 2.67%. The year with the highest per capita income growth rate was in 2004 when it grew by 7.90% per cent while the least growth in per capita income was recorded in 1994 when the gross domestic product fell by 2.25% from the previous year rate. This fall may not be unconnected with the sanctions placed on the then military regime in Nigeria by the international community due to the annulment of the historic June 12 election in 1993. Overall the growth rate of Nigeria's per capita income showed fluctuations over the period of the study. As revealed from table 4.1, there was a positive skewness of gross domestic product (0.16) indicating that the degree of departure from symmetry of the distribution was positive. Also, the kurtosis value of 2.06 reveals that the degrees of peakedness of gross domestic product within the period of this study were not normally distributed as it tended to deviate from the mean. Figure 4.2 presents the model proxies performance in a graphical format.

Figure 4.1 : Graphical Presentations of Model Proxies



Source : The Authors

33. Arena, M. (2006), "Does Insurance Market Activity Promote Economic Growth? A Cross-Country Study for Industrialized and Developing Countries", World Bank Policy Research Working Paper 4098.

a) Unit Root Test

Time series data are prone to problems of spuriousness if the data are not stationary. Thus in other to eliminate this problem, the unit root test was carried out[34]. The first stage in the unit root test was to determine the stationarity of the variables under study. It has been asserted that if a times series data is non-stationary, all the usual regression results will suffer from spurious regression[35]. Hence, the Augmented Dickey Fuller unit root was used to test the stationarity of the time series data. Table 4.2 presents our results.

Table 4.2 : Augmented Dickey-Fuller Unit Root Test

ADF Test Statistic	-7.519565	1% Critical Value*	-3.8067
		5% Critical Value	-3.0199
		10% Critical Value	-2.6502
*MacKinnon critical values for rejection of hypothesis of a unit root.			

Source : The Authors

The result reveals that all values were stationary at 1%, 5% and 10%. This can be seen by comparing the observed values of the ADF test statistics with the critical values of the test statistics at the 1%, 5% and 10% level of significance. More results are presented in table 4.3.

Table 4.3 : Correlation Matrix

	GDPPCGR	MCAPGDP	TVSTGDP	DCPBSGDP	INSPGDP	TFAGDP
GDPPCGR	1.000000					
MCAPGDP	0.252666	1.000000				
TVSTGDP	0.233355	0.874906	1.000000			
DCPBSGDP	0.192364	-0.425249	-0.359324	1.000000		
INSPGDP	-0.490913	-0.064603	-0.136905	0.133193	1.000000	
TFAGDP	-0.176374	-0.100676	-0.011773	0.023946	0.206764	1.000000

Source : Authors'

As revealed from table 4.3, market capitalization has a positive relationship with economic growth. Thus, 1% increase in economic growth in Nigeria over the period is due to 0.26% increase in market liquidity of the Nigerian Stock Exchange, This may be attributed to increased confidence of Nigerian investors in the ability of the market to enhance liquidity. The total value of shared traded ratio which measures the organized trading of firm's equity as a share of national output on an economy-wide basis as well as complementing market capitalization indicated from the correlation results, shows there was a positive relationship between total values of shares traded ratio and economic growth. Domestic credit provided by the banking sector as revealed from the correlation matrix had a positive relationship with economic growth. This shows that Nigerian banks have been able to provide funds for investment which had translated into growth of the Nigerian economy. It was also revealed from the correlation matrix that insurance penetration and size of the financial system has negative relationship with economic growth. Table 4.4 display our regression results.

Table 4.4 : Regression Results

	Dependent Variable: GDPPCGR				
	Included observations: 24				
Variable	Expected Sign	Coefficient	Std. Error	t-Statistic	Prob.
MCAPGDP	+	0.172064	0.090680	1.897487	0.0731
TVSTGDP	+	-0.206360	0.374349	-0.551251	0.5879
DCPBSGDP	+	0.152955	0.049211	3.108148	0.0058
INSPGDP	+	-0.581659	0.200572	-2.899997	0.0092
TFAGDP	+	0.778182	3.543709	0.219595	0.8285
R-squared		0.442178	Mean dependent var		2.667150
Adjusted R-squared		0.324742	S.D. dependent var		2.885401
S.E. of regression		2.371052	Akaike info criterion		4.747596
Sum squared resid		106.8158	Schwarz criterion		4.993024
Log likelihood		-51.97115	Durbin-Watson stat		1.501953

34. Gujarati, D.N. and Porter D.C (2009), Basic Econometrics Fifth Edition, Singapore: Mcgraw-Hill International Edition.

35. Granger C.W.I and P. Newbold (1977), "Spurious Regressions in Econometrics", Journal of Econometrica, Vol 2, pp 111-120.

Model Equation:

$$Gdppcgr = 1.000 + 0.172Mcapgdp - 0.206tvstgdp + 0.153Dcpbsgdp - 0.582inspgdp + 0.778Tfagdp$$

(0.0731)* (0.5879) * (0.0058) * (0.0092) * (0.8285) *

*Note : * (p-values)*

As revealed from table 4.4, the two indicators of bank-based financial structure (domestic credit provided by the banking sector as a percentage of gross domestic product and total financial assets as a percentage of gross domestic product) had positive impact on economic growth. While domestic credit provided by the banking sector was found to be significant, total financial asset ratio was non-significant at 5% level of confidence. The impact of market-based financial structure (market capitalization ratio) was found to be positive though had non-significant impact on economy growth, while the total value of shares traded ratio (another measure of market-based financial structure) was negative and non-significant at 5% level of confidence. The insurance penetration as revealed from the regression results indicates that its impact on economic growth was negatively significant at 5% level of confidence.

V. Implications, Conclusion and Recommendations

The results from this paper reveal some interesting aspects of the Nigerian economy. While some sectors exerted greater impact on economic growth, other aspects of the Nigerian financial sector did not show any significant impact on the variable. The impact of the insurance sector on economic growth was found to be negatively significant. Unfavourable macro-economic environment; poor regulatory framework; market suspicion of insurance companies, among others[37], has been blamed as contributing to the poor state of the industry. For the industry to take its place in enhancing economic growth, government needs to create a conducive macro-economic environment for the practice of insurance and reinsurance as it is the lack of these that has led to reduced international interest in the Nigerian insurance industry[38].

Bank-based financial indicators proved to have positive impact on economic growth within the period of the study. The Nigerian banking sector has proved to contribute significantly to economic growth in Nigeria. This may be connected to the various reform policies over the years put in place by the monetary authorities most notably in 2005 through the consolidation exercise and the subsequent post-consolidation reforms all aimed at ensuring a well functioning and effective financial system. A well functioning financial system creates an enabling environment for the mobilization of household savings, allocation of resources efficiently, assisting in diversifying risk, and enhancing the flow of liquidity, reduction of information asymmetry and transaction cost as well as providing an alternative to raising funds through individual savings and retained earnings. The post-consolidation reforms in Nigeria's banking sector have increased focus on risk management procedures and healthy corporate governance among the Nigerian banking industry.

These have subsequently strengthened and repositioned the banking industry in contributing effectively and efficiently to the development of the Nigerian economy through its intermediation functions[39].

The capital market is a network of specialized financial institutions, series of mechanisms, processes and infrastructure that, in various ways, facilitate the bringing together of suppliers and users of long term capital for investment in socio-economic developmental projects[40]. It has been shown that large stock markets can decrease the cost of mobilizing savings, thus facilitating investment in most productive techno-logies[41] and at the same time the stock market liquidity enables investors to trade equity easily is crucial for growth[42]. Findings of this study reveal that, market capitalization ratio had positive though non-significant impact while the total value of shares traded ratio was negative. This indicates that the confidence level of investors on the ability of the capital market to provide the much needed liquidity which investors craved for has not been fully realized. Greater efforts should therefore, be made by regulators such as the Nigerian Stock Exchange (NSE) and the Securities and Exchange Commission (SEC) to ensure that confidence of operators as well as investors are enhanced in the system. This will encourage investor to invest in the market which will obviously lead to increased pro-ductivity by various sectors of the Nigeria economy.

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