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Financial Sector Development and Nigeria's Performance in the Global System

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ABSTRACT

Financial sector development and Nigeria's performance in the global economy has been the focus of the paper. With data covering the period between 1980 and 2010, using the Ordinary Least Square (OLS) cointegration techniques with its implied Error Correction Mechanism (ECM), the study reveals from the cointegration test results that a long run relationship exists among the variables. The parsimonions ECM results in the study showed the increasing global relevance of liquidity ratio, money supply, bank loans and interest rate in financial sector development policy making in Nigeria. Thus the result indicates that a high interest rate is detrimental to the development process in Nigeria. The cointegration test showed a long run relationship among the variables. Policies to reduce the interest rate and increase the liquidity ratio in Nigeria are therefore recommended.

INTRODUCTION

Financial sector of any economy is usually consistent with financial packages or systems whose synchronizing roles generally have long been recognized in the development literature to play an important function in economic growth of an economy. In discussing financial sector development the role of macroeconomic variables that pertain to financial resources and their interrelationships cannot be set aside One of the salient features of Nigeria's growth drive is a conscious development of the financial sector to the extent that in the early years closely following her attainment of independence, , the sector was highly regulated with government holding controlling shares in most of the banks as a result of the prevailing economic paradigm at that time. In 1986, the liberalization of the banking industry was a major component of the Structural Adjustment Programme (SAP) put in place at that time to drive the economy from austerity to prosperity. The Soludo-led consolidation exercise between 2004 and 2009 in the banking industry took a leading role in the nation's financial planning process. Consequently, the National Economic Empowerment and Development Strategy (NEEDS), which was in place at that time to drive the economic agenda of the government was envisaged to be the economic barometer for gauging and propelling the economy,(Soludo,2004). In 2009, as part of the broad economic measures to respond to the adverse effects of the global financial and economic measures to respond to the adverse effects of the global financial and economic crisis, the Central Bank of Nigeria in conjunction with the fiscal authorities used the NEEDS and other related strategies for economic management of Nigeria's resources.

The orthodox practice in banks' intermediation role of deposit creation considers funds flow mechanics from the surplus (sellers) unit to the deficit (buyers) unit in the financial sector investment process and as catalyst or pivot of economic growth. If the mechanics is not properly addressed in a liberalized, global openness policy setting the domestic economy becomes depressed in trade deficit and exchange rate disability, thus lending credence to dependency theory (Eriemo, 2009). McKinnon (1973) and Shaw, (1973), collectively emphasized this phenomenon in their pioneering insight that the financial sector could be catalyst of economic growth it if is developed and healthy. Accordingly, the benefits accruable from a healthy and developed financial system relate to savings mobilization and efficient financial intermediation functions of the financial institutions, savers and borrowers are linked up and this reduces transaction and search costs. Second, they create liquidity in the economy by borrowing on short-term and lending on long-term. Third, they reduce information costs, provide risk management services and reduce risks involved in financial transactions. Fourth, the intermediaries bring the benefits of asset diversification to the economy. Fifth, they mobilize savings from atomized individuals for investment, thereby solving the problem of indivisibility in financial transactions. Finally, mobilized savings are invested in the most productive ventures irrespective of the source of the savings.

Pursuant to the above stated roles of the a healthy and developed financial system Nigeria clearly advocated financial liberalization in her structural adjustment programme (SAP) under the guise of the financial sector reform with intent to making the financial sector more efficient to compete favourably with its counterparts

especially those found in the advanced, technologically-driven economies such as those of the United States of America and United Kingdom**.** Such benefits of financial intermediation if well-guided, could translate into the economy-wide benefits which motivate financial reforms where the systems were considered undeveloped. Such economy-wide benefits include increase in the size of domestic savings channeled through the formal financial sector; improvement in the level of efficiency of financial intermediation; and the enhancement of the effectiveness and efficacy of monetary policy.

The financial system of the pre- 1986 reform period even including the first civilian regime was essentially totalitarian catering for the needs of planned development in a mixed-economy framework where the Government sector had a predominant role in economic activity with all the coerciveness it cared to employ. As a result of this draconian role arrogated the government he environment in the financial sector in these years was thus characterized by segmented and underdeveloped financial markets coupled with paucity of instruments. By the end of the 1970's and early 1980's, the financial system was considerably over-stretched. The directed and concessional availability of bank credit with respect to certain sectors resulted in not only distorting the interest rate mechanism, but also adversely affected the viability and profitability of banks. The lack of recognition of the importance of transparency, accountability and prudential norms in the operations of banking system led also to a rising burden of non-performing assets (Ebodaghe, 1996; Obadan 2004)

One of the landmarks in financial resources mobilization is creation and maintenance of efficient flow of funds from surplus to deficit units. On this score, it noteworthy to mention that many depository institutions during the pre-reform period showed glaring inability to maintain an efficient flow of funds within the economic system. Many banks in Nigeria do not only have weak balance sheets by any reasonable standard, but they are also highly exposed to additional deterioration in their capital positions due to their significant involvement in high-risk lending and others moral hazards (Ebodaghe, 1996; Obadan, 2004). The sharp practices of some banks coupled with unsoundness of others culminating in widespread financial sector distress and losses to depositors as well as macroeconomic imbalance led to financial distress of the monetary authorities.

THEORETICAL AND EMPIRICAL LITERATURE

At the theoretical front in this study is the imbuement and the adoption of the eclectic but classical thinking pioneered of the Mundell-Flemming apparatus orchestrated by). McKinnon (1973) and Shaw, (1973) A substantial body of empirical work on finance and growth assesses the impact of the operations of the financial system on economic growth, whether the impact is economically large, and whether certain components of the financial system, e.g. banks and stock markets, play a particularly important role in fostering growth at certain stages of economic development. Consequently, the existence of well-developed money market and credits in any economy no doubt would provide the necessary impetus for the take-off stage in bank resources mobilization for economic growth. There is also the view by development economists and policy makers that a well developed stock market is crucial for the mobilization of financial resources for long term investment and thus constitutes one of the major pillars of economic growth. Along this thinking brings to bear the unallurd needs of the financial sector reform(Patrick ,1966,Hussarin 1996), Patrick postulates from his study, a bi-directional relationship between financial development and economic growth while Hussarin(1996) posits tha. Ever since, a large empirical literature has emerged to test this hypothesis (Levine, 1997). Two trends in this respect as emerged in the literature. The first tests the relationship between economic growth and financial development, adopting a single measure of financial development and testing the hypothesis on a number of countries using either cross-section or panel data techniques (Erdal, et al, 2007).

The second trend examined the hypothesis for a particular country using time series data/technique, as done by Murinde and Eng (1994) for Singapore; Lyons and Murinde (1994) for Ghana; Odedokun (1998) for Nigeria; Agung and Ford (1998) for Indonesia; Wood (1993) for Barbados, and James abd Warwick (2005) for Malaysia. The mounting empirical research, using different statistical methods and data have produced remarkable results. First, the results have shown that countries with well-developed financial systems tend to grow faster, especially those with large, privately owned banks that channel credit to the private sector, and or liquid stock exchanges. The level of banking development and stock market liquidity exert positive influence on economic growth.

Central to the argument of McKinnon Shaw is the idea of financial sector liberalization which the central bank of Nigeria (CBN) embanked on in 1986 and 2004 when SAP and increase in the capital base of bank, were made. The idea was to allow the market to determine the rate of interest and increase the competitiveness of banks in

the country. In particular, Nigerian financial sector was under serious repression in the 1970s, but was liberalized in 1986 with SAP.

Empirical results of studies on the impact of financial reforms on economic growth have been along the two theories discussed above. Thus, the McKinnon Shaw group, led by the international monetary fund (IMF) and world bank argued that financial liberalization significantly matters for a developing countries, because it is associated with economic growth, growth in savings and investment. Hussarin (1996) posited that in three years following financial reform savings and investment in Egypt increased 6 percent of Gross Domestic Product (GDP) over the level that it would have occurred in the absence of financial liberalization. Seek and Elmic (1993) examined the determinants of financial savings in nine and twenty-one African countries over the periods 1974-1989. The econometric tests yielded positive and significant repression hypothesis. Azam (1996) also had a positive and significant estimates for real interest rate, thereby lending credence to the financial repression hypothesis. Azam (1996) also had a positive and significant impact on economic growth as result of financial reform in Kenya. Edo (2004) observed that financial reforms adequately explain growth trend in the Nigerian economy, therefore lending credence to the McKinnon-slaw hypothesis.

Over the last two decades, the literature has shown a growing body of new empirical approaches to treating the causality pattern based on time series techniques Gupta (1984); Jung (1986); Murinde and Eng (1994); Demetriades and Hussein (1996); Arestis and Demetriades (1997); and Kul and Khan (1999).

In these studies, the focus is one the long-run relationship between financial sector development and real sector growth, using frameworks of bivariate and multivariate vector auto-regressive (VAR) models for different country samples. The outcome was that the causality pattern varies across countries according to the success of financial liberalization policies implemented in each country and the level of development of the financial integration. The Nigerian economy has from the mid-1980s been moving towards increased liberalization, greater openness to world trade and higher degree of financial integration. This paper takes a different stand by……This policy stance and other reform measures, particularly the banking sector consolidation exercise of 2004/05 have led to enormous build-up of capital from both domestic and cross-border sources.

Nigeria is, therefore, a veritable case for investigating the link between finance and growth for at least two reasons. First, there has been considerable increase in the activities of the financial markets prior to the recent global financial crisis, particularly with regard to private sector credit and stock market capitalization.

Model Specification and Statistical Procedure

The model used in assessing financial sector development and Nigeria's performance in the global system takes the form whose structural representation is as stated below:

$$LGDP = \alpha_0 + \alpha_1 LLR + \alpha_2 LMS + \alpha_3 LJNT + \alpha_4 LBLOAN + ut$$

$$\alpha_1 \alpha_2, \alpha_4 > 0, \alpha_3 < 0$$

where

GDP = Gross Domestic Product

MS = Money Supply

LR = Liquidity ratio

INT = Interest rate

BLOAN = Bank Loan

L = Natural logarithm

Ut = error term

The cointegration tests with its implied Error Correction Mechanism were used. The analysis commended with the unit root test.The augmented DickeyFuller (ADF) unit root test used to test whether the variables are stationary or not and their order of integration. The result of the ADF unit root test is shown in table 1 below:

Table 1: ADF Unit root test result

Variables	Level Data	First Diff	1% CV	5% CV	10% CV	Order of Integration
MS	1.63	5.72*	-3.69	-2.97	-2.62	I (1)
LR	-2.87*	-5.16	-3.69	-2.97	-2.62	I (0)
INT	-2.08	-4.94*	-3.69	-2.97	-2.62	I (1)
GDP	1.37	5.08*	-3.69	-2.97	-2.62	I (1)
BLOAN	-2.32	-5.19*	-3.69	-2.97	-2.62	I (1)

NB: * Indicates significance at the 1% level

The result of the ADF unit root test indicates that all the variables except the LR were originally not stationary, but they however became stationary after the first difference was taken. The liquidity ratio was stationary at the levels probably because it is a ratio variable. A long run relationship exists among the variables. The Johansen cointegration test result is shown in table 2

Table 2: Johansen Cointegration test

Unrestricted Cointegration Rank Test

Hypothesized No. of CE(s)	Eigenvalue	Trace Statistic	5 Percent Critical Value	1 Percent Critical Value
None **	0.827898	95.06827	68.52	76.07
At most 1	0.560385	45.79764	47.21	54.46
At most 2	0.362615	22.78564	29.68	35.65
At most 3	0.303406	10.17498	15.41	20.04
At most 4	0.001838	0.051519	3.76	6.65

*(**) denotes rejection of the hypothesis at the 5%(1%) level
Trace test indicates 1 cointegrating equation(s) at both 5% and 1% levels

Hypothesized No. of CE(s)	Eigenvalue	Max-Eigen Statistic	5 Percent Critical Value	1 Percent Critical Value
None **	0.827898	49.27064	33.46	38.77
At most 1	0.560385	23.01199	27.07	32.24
At most 2	0.362615	12.61066	20.97	25.52
At most 3	0.303406	10.12346	14.07	18.63
At most 4	0.001838	0.051519	3.76	6.65

*(**) denotes rejection of the hypothesis at the 5%(1%) level
Max-eigenvalue test indicates 1 cointegrating equation(s) at both 5% and 1% levels

The trace statistic and the max-eigen statistic indicate one cointegration equation each. This permits us to estimate the parsimonions and the overparameterize ECM result which forms the basis of the next section.

The overparameterize ECM result is shown in table 3 below:

Table 3: Overparameterize ECM

Variable	Coefficient	Std. Error	t-Statistic	Prob.
DLBLOAN	0.199661	0.183500	1.088071	0.2949
DLBLOAN(-1)	1.968604	0.755297	2.606397	0.0207
DLBLOAN(-2)	0.271563	0.194219	1.398231	0.1838
DLMS	8.383643	2.937176	2.854321	0.0090
DLMS(-1)	5.467151	1.949433	2.804483	0.0141
DLMS(-2)	-1.560408	1.550622	-1.006312	0.3313
DLINT	1.749359	0.901105	1.941349	0.0726
DLINT(-1)	0.680103	1.135168	0.599121	0.5587
DLINT(-2)	-1.611393	0.571559	-2.819294	0.0097
DLLR	0.173256	0.056385	3.072751	0.0044
DLLR(-1)	-0.606497	0.878018	-0.690757	0.5010
DLLR(-2)	-0.130903	0.771773	-0.169614	0.8677
ECM(-1)	-0.009746	0.002347	-4.152274	0.0002
C	-1.686572	0.931940	-1.809743	0.0918

R^2 = 0.66, F statistic = 21.58, DW = 2.06, AIC = 2.54 KC = 3.21

The parasimonions ECM result was gotten by eliminating insignificant variables from the overparameterize ECM result. The parasimonions ECM result is shown in task 4 below:

Table 4: Summary of Parsimonions ECM result: Modelling : DLGDP

Variable	Coefficient	Std. Error	t-Statistic	Prob.
DLBLOAN(-!)	0.525107	0.155080	3.386038	0.0025
DLMS	0.012916	0.004531	2.850531	0.0091
DLINT(-2)	-0.714930	0.087195	-8.199216	0.0000
DLLR	0.407183	0.059263	6.870795	0.0000
ECM(-1)	-0.685214	0.077328	-8.861098	0.0000
C	0.055727	0.364112	0.153049	0.8798

R^2 = 0.73, AIC = -2.77, SC = -3.06, DW = 2.17

a. The result showed that the bank loan which is an important global indicator of financial sector development has significantly influenced the level of economic growth in Nigeria. The result showed that an increase in bank loan by 1 percent increased the level of economic growth by 53 percent. The level of money supply has also significantly influenced the level of economic growth in Nigeria. However, the elasticity is below expectation. The interest rate, which is another global indicator of financial sector development, has also significantly improved the level of economic growth in Nigeria. The high elasticity of interest rate which is negatively signed indicates the detrimental effect of high interest rate on the level of economic growth in Nigeria. The liquidity ratio has also significantly influenced the level of economic growth. The result showed that an increase in the liquidity ratio by 1 percent increased the level of

economic growth by 4 percent. In Eriemo(2010) the crucial importance of interest rates setting and liquidity for optimal resource mobilization in the financial sector operations were emphasized in which banks are advised not to always set high interest rate, e.g. trying to earn maximum interest income because of the problems of adverse selection and moral hazard forecast difficulty by borrowers.The result of the cholesky variable decomposition is shown in table 5 below:

Table 5: Cholesky Variance Decomposition

Variance Decomposition of LGDP:

Period	S.E.	LGDP	LBLOAN	LINT	LLR	LMS
1	0.701022	100.0000	0.000000	0.000000	0.000000	0.000000
2	0.810602	74.83059	19.74249	0.007675	3.523459	1.895786
3	0.885575	63.04458	19.29406	0.017481	11.77114	5.872740
4	0.903011	60.85219	19.58093	0.180802	13.61021	5.775869
5	0.980463	52.44000	16.74391	0.394085	24.73366	5.688342
6	1.038970	46.73574	15.06904	1.083336	31.71479	5.397094
7	1.101954	41.55390	13.41182	1.011432	37.77312	6.249728
8	1.182128	38.04645	11.86319	1.956892	42.58699	5.546482
9	1.267497	33.62600	10.51329	1.905138	48.47737	5.478202
10	1.348972	30.40407	9.856279	2.559756	52.19152	4.988378

Variance Decomposition of LBLOAN:

Period	S.E.	LGDP	LBLOAN	LINT	LLR	LMS
1	0.827181	5.229961	94.77004	0.000000	0.000000	0.000000
2	1.385683	13.73861	64.07027	13.25856	3.057848	5.874710
3	1.698144	11.19178	52.16840	11.91423	19.65496	5.070631
4	2.100573	10.34506	52.44130	14.64351	18.68371	3.886425
5	2.546818	13.16166	47.72549	13.98349	22.47812	2.651237
6	3.062842	14.50837	43.60628	14.61558	25.35416	1.915610
7	3.483074	13.90937	43.01054	14.45604	27.11820	1.505854
8	3.965115	14.76115	40.83176	15.01901	28.16873	1.219352
9	4.400545	15.07060	39.06957	15.10192	29.75733	1.000581
10	4.839311	15.18646	38.30391	15.13952	30.51954	0.850567

Variance Decomposition of LINT:

Period	S.E.	LGDP	LBLOAN	LINT	LLR	LMS
1	0.196205	5.451030	0.706620	93.84235	0.000000	0.000000
2	0.272334	8.013730	7.305016	84.11869	0.137495	0.425067
3	0.324004	6.596924	5.220946	82.31279	5.065530	0.803810
4	0.409048	6.463216	6.532933	78.78256	3.354340	4.866948
5	0.466040	8.916869	5.274827	76.58242	5.367213	3.858667
6	0.536971	10.34591	4.108511	76.75602	4.878483	3.911071
7	0.587072	13.43727	3.455267	74.94107	4.698650	3.467743
8	0.640908	13.33470	3.155675	75.32846	4.492736	3.688434
9	0.688431	15.28855	2.835923	73.93184	4.330744	3.612949
10	0.737274	16.53525	2.593132	73.16612	4.054275	3.651224

Variance Decomposition of LLR:

Period	S.E.	LGDP	LBLOAN	LINT	LLR	LMS
1	0.223843	9.055956	3.721643	3.547159	83.67524	0.000000
2	0.292397	10.52048	6.496809	4.059927	78.75998	0.162800
3	0.351131	8.461616	6.587781	3.976787	80.85016	0.123659
4	0.420140	5.910640	4.669021	2.784454	86.02483	0.611055
5	0.489637	4.362873	7.110562	2.143620	85.85306	0.529883
6	0.553662	3.499857	9.196513	2.006534	84.80706	0.490037
7	0.626786	2.862253	8.886557	1.907041	85.86164	0.482509
8	0.687009	2.412132	9.160805	2.048792	85.97331	0.404960
	0.748763	2.207279	9.466978	2.031855	85.92591	0.367982
	0.812732	2.210056	9.838539	2.225643	85.41321	0.312547

	0.085803	0.574466	16.80308	16.36888	0.445026	65.80855
	0.130881	26.53321	17.11801	7.090687	0.878502	48.37959
3	0.226134	46.39432	10.94100	5.533670	2.530851	34.60015
4	0.308266	60.58164	5.959575	3.581862	4.357911	25.51901
5	0.382241	65.71946	4.276679	2.730828	6.192710	21.08032
6	0.468294	67.88820	3.021724	1.830860	9.174192	18.08502
7	0.549084	68.65551	2.370670	1.335106	11.23914	16.39957
8	0.636213	69.16743	2.251576	0.996365	12.93253	14.65209
9	0.725104	69.32804	2.387064	0.806046	14.51117	12.96768
10	0.[illegible]946	68.71421	2.570088	0.695652	16.11398	11.90607

The result of the variance decomposition shows that order than shocks to GDP which explained about 100 percent of shocks to it, shocks to liquidity ratio explained a significant proportion of changes in the Gross Domestic Product. Shocks to liquidity ratio explained about 12 percent of changes in the Gross Domestic Product in the 4th period which increased to about 43 percent in the 8th period and 52 percent in the last period. Shocks to bank loan and money supply also explains some percentage of changes in the level of economic growth also explained changes in bank loans, interest rates, liquidity ratio and money supply.

The Vector Error Correction (VEC) result is shown in table 6 below:

Table 6: VEC Result

Cointegrating Eq:	CointEq1				
LGDP(-1)	1.000000				
LBLOAN(-1)	-0.121716 (0.03557) [-3.42217]				
LINT(-1)	-0.588548 (0.13480) [-4.36615]				
LLR(-1)	1.495078 (0.26527) [5.63608]				
LMS(-1)	-0.888689 (0.05564) [-15.9732]				
C	-5.474012				
Error Correction:	D(LGDP)	D(LBLOAN)	D(LINT)	D(LLR)	D(LMS)
CointEq1	-1.403210 (0.57539) [-2.43870]	2.676548 (0.67894) [3.94222]	-0.139654 (0.16104) [-0.86718]	0.074886 (0.18373) [0.40759]	-0.315494 (0.07043) [-4.47975]

The VEC result indicates that the money supply equation constitutes the true cointegration equation. The rest were either not statistically significant or wrongly signed.

The Diagnostic test result is shown in table 7 below:

Table 7: Diagnostic test result

Jarque-bera

Jorque-bera	3.60	Probability	0.17

Brensch-Godfrey Serial Correlation LM test

F statistic	3.72	Probability	0.24

White Heteroskedasticity

F statistic	0.44	Probability	0.91

The Jarquel-bera normality test showed that the errors are normally distributed and the Brensch-Godfrey serial correlation test indicates that the errors are not serially correlated. The white heteroskedasticity test indicates that the errors are homoskedastic. The result of the Cumulative Sum of Recursive Residuals (CUSUM) and the Cumulative sum of squares of Recursive Residuals (CUSUMQ) test are shown in figure 1 and figure 2 below:

Figure 1: CUSUM result

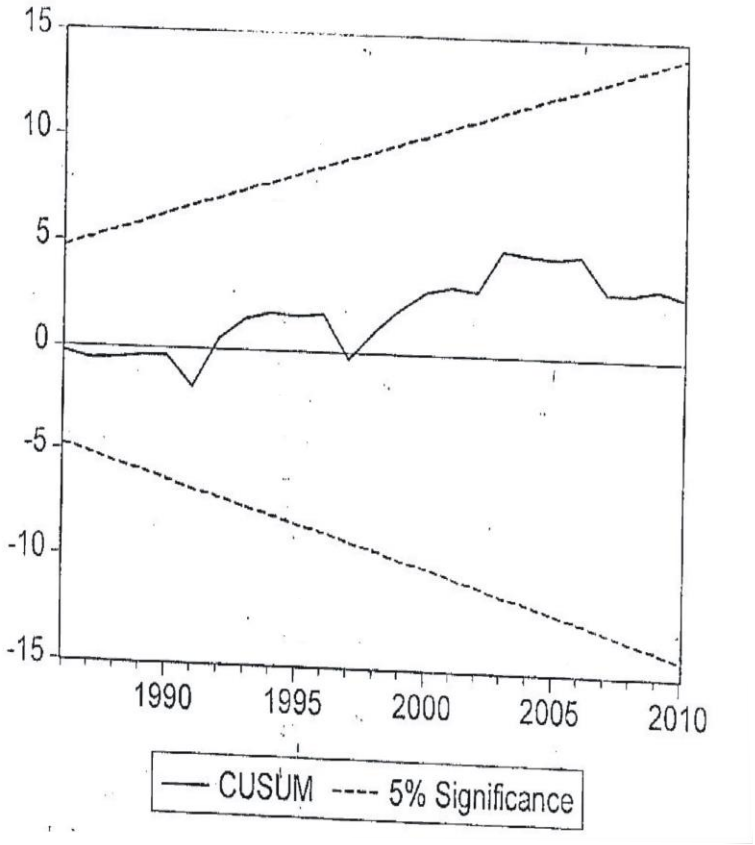
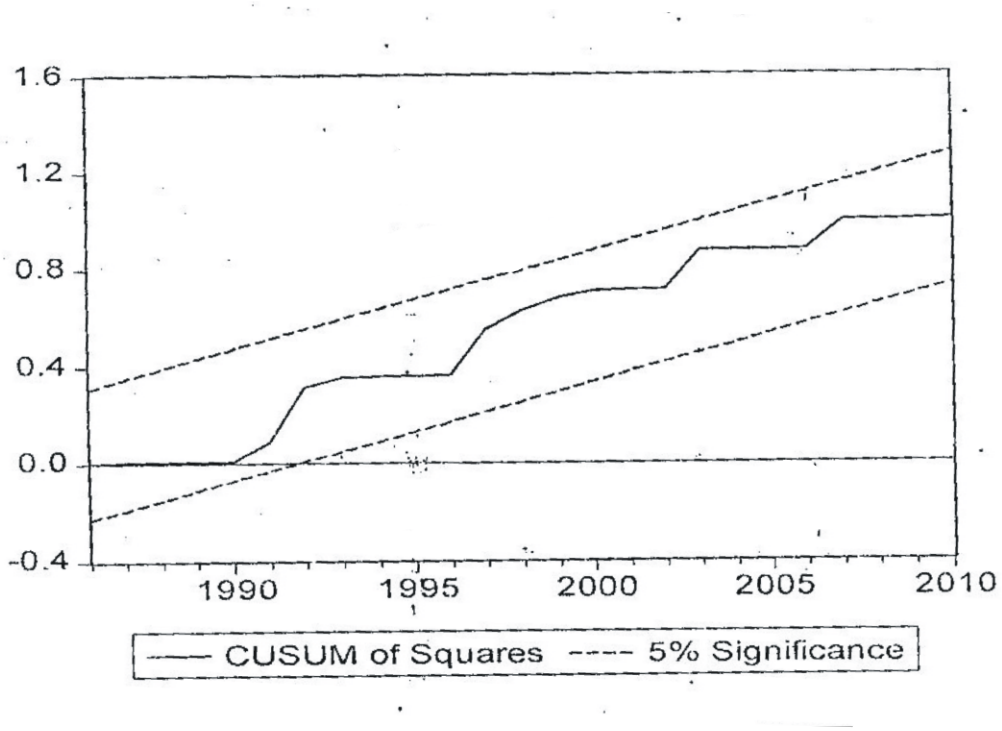
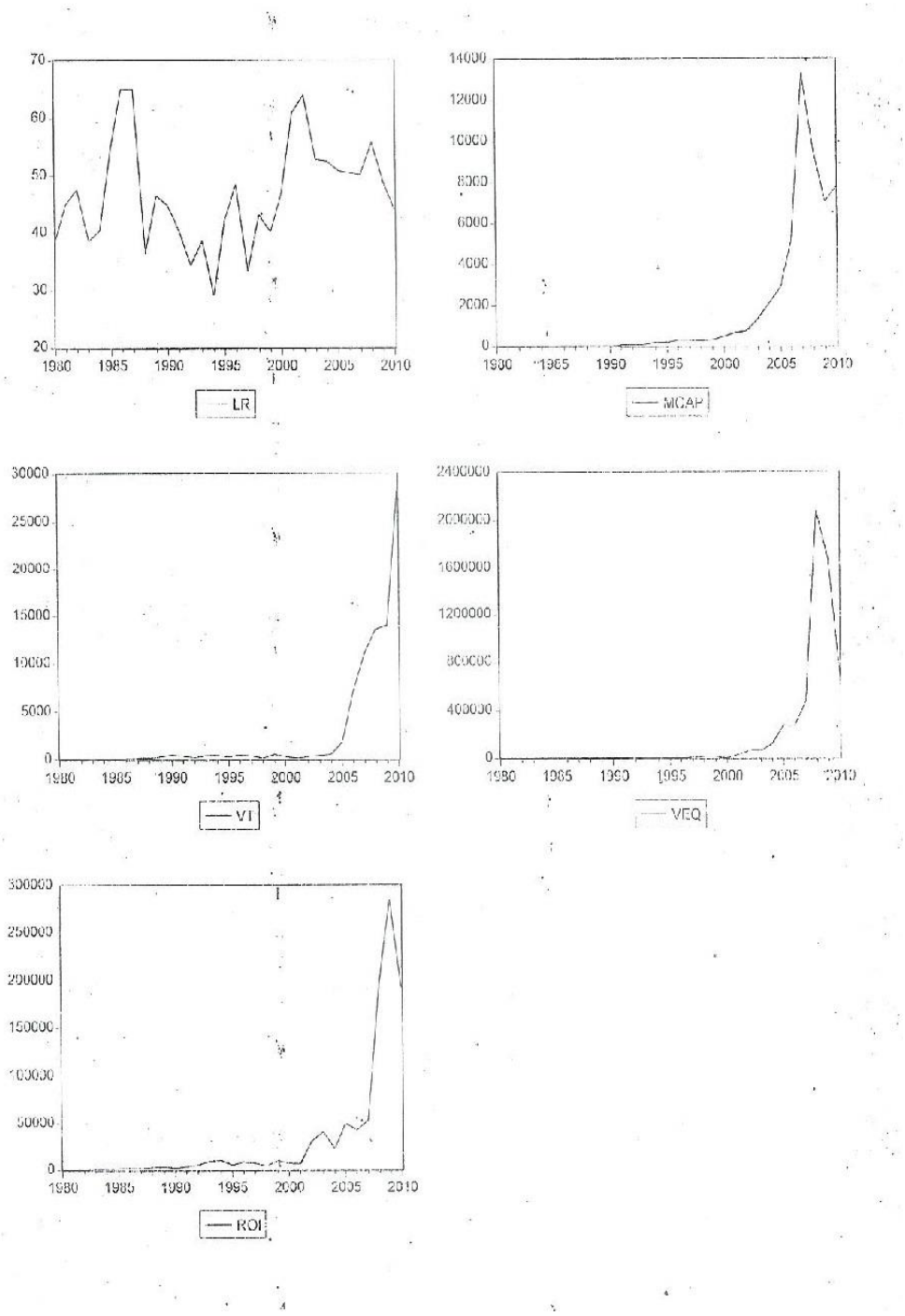


Figure 2: CUSUM Q stability test



The CUSUM and CUSUM Q tests indicate model stability. This is because the CUSUM and CUSUM Q lines fall in between the 5 percent lines.

Figure 2 :Trends in Variables as they Interrelate



Further on the results, the above figures illustrate how the time series property of the cointegrating variables behaves linearly. The trends clearly shows the behavior of the variables

CONCLUSION

This study examined the empirical relationship between financial sector development and Nigeria's performance in the global system. Using data from 1980 - 2010, the parsimonions ECM results in the study showed the increasing global relevance of liquidity ratio, money supply, bank loans and interest rate in financial sector development policy making in Nigeria. Thus the result indicates that a high interest rate is detrimental to the

development process in Nigeria. The cointegration test showed a long run relationship among the variables as indicated by the CUSUM and CUSUMSQ stability tests. The long run relationship between financial development and economic growth shows that the former is significant in promoting real income. Hence, policies should be directed towards promoting a more competitive environment that enhances service delivery among financial institutions. Policies to reduce the interest rate and increase the liquidity ratio in Nigeria are therefore recommended too

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