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Financial System and Nigeria's Economic Development: Issues, Challenges and Prospects

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Abstract: *This research paper investigated the relationship between the financial system and the performance of the Nigerian economy for the period 1981 to 2017. The research which adopted the ex post facto research design collected data from secondary sources including the Central Bank of Nigeria statistical bulletin and Nigeria Bureau of Statistics Abstract of Statistics. The collected data was analyzed using the OLS multiple Regression model, Auto-Regressive Distributed Lag Co-integration and Bounds test and Augmented Dickey-Fuller unit root tests. The results of the analyses revealed that on the short run, there is a positive and non-significant relationship between the economy and aggregate bank assets and aggregate domestic savings but a negative non-significant relationship with stock market capitalization and federal government bonds. The results further show that there is no statistically significant long-run relationship between the economy and either of commercial banks assets, aggregate domestic savings, stock market capitalization or federal government bonds. Based on the results, it is concluded that the financial system is not contributing meaningfully to economic development in Nigeria. Thus policies to help reposition the financial system are required. This should include deepening the financial system and enhancing its ability to mobilize the necessary resources to drive economic growth and development.*

Key words: *financial system, economic development, commercial banks assets, aggregate domestic savings, stock market capitalization*

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INTRODUCTION

The state of the economy in any country is largely dependent on the state of the financial system. A developed and properly functioning financial system will be able to facilitate economic activities to drive economic development. However, a dysfunctional financial system may well aid deterioration of the economy. As noted by Stiglitz (1998), well-functioning financial systems do a very good job of selecting the most productive recipients for these resources and ensuring that they are using them in high return activities. In

contrast, poorly functioning financial systems often allocate capital in low-productivity investments.

The financial system includes all financial intermediaries that operate in the financial sector in the economy. This includes financial instruments and assets, financial markets and intermediaries. The financial system provides an enabling environment for economic growth and development, productive activity, financial intermediation, capital formation and management of the payments system. With intermediation, savers lend to intermediaries, who in turn lend firms and other fund using units. The saver holds claim against the intermediaries, in form of deposits rather than against the firm. These institutions provide a useful service by reducing the cost to individuals, of negotiating transactions, providing information, achieving diversification and attaining liquidity (CBN, 2017).

It is anchored on the belief that economic agents are categorized into surplus and deficit spending units. The surplus spending units are individuals, groups or organizations operating within the economy that have excess funds above their immediate needs. They constitute suppliers of surplus funds to the financial system. The deficit spending units are those that have a shortage of funds and thus require borrowing to fund their operations. They are the users of the excess funds supplied by the surplus spending units in the financial system. Levine, (2005) asserted that there is an ever-expanding body of research evidence suggesting countries with better developed and functioning financial systems experience faster economic growth. Financial development also promotes growth as well as improves the distribution of income and wealth.

Levine and Zervos (1998) further opine that differences in long-run economic growth and development in different countries and territories can be explained by differences and development stages in their financial systems. However, Lucas (1988) argued that the financial system does not necessarily promote economic. He contends that any correlations recorded between economic development and the financial system development is as a result of growth leading development implying that financial system actually feeds off growth in the economy instead of feeding the economy. Although this view is not popular in economic and financial research as it has little empirical support, it mirrors some realities that may be existent in third world countries where weak institutional and regulatory frameworks expose the financial system to the manipulation of individuals especially in the political sphere.

This was the case in early military era where commercial and development banks could be arbitrarily established and scrapped with no one held responsible or accountable as to what happened to the funds in such institutions. Thus in course of the development of the Nigerian financial system a myriad of crises were recorded over misappropriation/misapplication and in many cases outright embezzlement of funds from different sources like pension contributions, social insurance funds, mortgage contributions. Consequent on the above, this paper will investigate the role of the financial system in the growth and development of Nigeria.

STATEMENT OF PROBLEM

According to (Merton & Zvi, 1995; Fohlin, 2014), a well-functioning financial systems must provide several core functions which include: Clearing and settling payments; Pooling or mobilizing resources; Transferring economic resources; Managing risk; Pricing

information; and Dealing with information and incentive problems. Where a financial system fails in the above functions, a dysfunctional system may the result. A close observation of the Nigeria financial system will reveal that Nigeria's financial system remains largely underdeveloped in spite of decades of government actions to improve it (Hashim, 2011; Adeoye and Adewuyi, 2005; Ayadi, Adegbite and Ayadi, 2008).

This is evident in the weak regulatory environment in other non-bank financial institutions, lack of depth in the capital market, weak insurances sector, almost non-existent mortgage sector among many others. Further exacerbating the problem is the failure of financial inclusion policies of successive governments (Ayadi, 2009; (Alrabadi & Kharabsheh, 2016; Dabwor & Abimiku, 2016). most notable is the poor access to financial services (credit) to small businesses and households. And considering that these economic units comprise the overwhelming majority in the economy, their exclusion from mainstream financial activities have led to a situation where economic and financial policies fail to yield desired results and resulting in an undeveloped economy.

Several research efforts have been previously undertaken to unravel the relationship between the financial system and development of economy. However, most are notable for providing conflicting results (Olushola & Makwe, 2018; Nkoro & Uko, 2013; Odufuye, 2017; Uzomba, Nwankwo, Chukwu & Jumbo, 2014). This lack of lack of consensus on the previous empirical research on the subject matter necessitates the present study. In addition, this research provides a more comprehensive treatment of the variables of financial system including aggregate savings and credit to private sector.

THE NIGERIAN FINANCIAL SYSTEM

According to (Merton & Zvi, 1995; Fohlin, 2014), a well-functioning financial systems must provide several core functions which include: Clearing and settling payments; Pooling or mobilizing resources; Transferring economic resources; Managing risk; Pricing information; and Dealing with information and incentive problems. Financial systems will provide these services through variety of institutions and markets including among others: banks (commercial, investment, merchant, development etc), savings institutions and thrifts societies, credit cooperatives, insurance companies, investment banks, trust companies, pension and mutual funds etc. Institutions come in a wide range of sizes and ownership structures - from public, private partnerships to enormous multinationals to government owned businesses. Financial markets offer centralized, liquid trading in essentially any financial claim, from debt to equities, commodities to foreign exchange, and a wide array of derivatives (Fohlin, 2014).

Beyond the institutions are the regulators like the Central Bank, Securities and Exchange Commissions, Deposit Insurance Companies, Insurance Regulators, Corporate Affairs Commission and Asset Management Corporation all established to provide direction and enabling environment for growth and development of the sector? According to the Central Bank of Nigeria, The financial system includes all financial intermediaries that operate in the financial sector of the economy. It provides an enabling environment for economic growth and development, productive activity, financial intermediation, capital formation and management of the payments system. With intermediation, savers lend to intermediaries, who in turn lend firms and other fund using units. The saver holds claim against the intermediaries, in form of deposits rather than against the firm. These institutions provide a useful service by reducing the cost to individuals, of negotiating

transactions, providing information, achieving diversification and attaining liquidity (CBN, 2017).

The concept of the financial system is anchored on the belief that economic agents are categorized into surplus and deficit spending units. The surplus spending units are individuals, groups or organizations operating within the economy that have excess funds above their immediate needs and are willing to make such surpluses available for the deficit economic units. They constitute suppliers of surplus funds to the financial system. On the other hand, the deficit spending units are those that have a shortage of funds and thus require borrowing to fund their operations. They are the users of the excess funds supplied by the surplus spending units in the financial system (CBN, 2017). The financial system provides a platform (through intermediaries) through which the deficit and surplus economic units can meet and fill their financial needs.

The Nigerian financial system includes financial markets (money and capital markets), financial institutions (banks, insurance companies, finance houses, Bureau de change, brokerages etc) regulatory and supervisory authorities (CBN, SEC, NDIC, AMCON, NICON, etc.), development finance institutions (Urban Development Bank, Nigerian Agricultural and Rural Cooperatives bank) and other finance institutions (insurance companies, pension funds, finance companies, Bureau de change, and Primary Mortgage Institutions), among others. It also offers financial instruments (treasury bills, treasury certificates, central bank certificates, etc).

The Nigerian financial system consists of the formal sector (bank and non-bank financial institutions - these are regulated by the government agencies). The informal sector (savings and loan association, local money lenders, etc. these are notable unregulated). The formal sector institutions are regulated by the Federal Ministry of Finance, Central Bank of Nigeria, Nigeria Deposit Insurance Corporation, Securities and Exchange Commission, and the National Insurance Commission etc. The informal sector is largely loosely organized without any form of formal regulation.

With reference to the allocation of resources and economic efficiency, the financial system performs three major functions, which are vital to economic growth and development. First, the system provides convenient and efficient payments system without which specialization in production, so vital to productivity improvements would be greatly impeded. Secondly, the financial system pools savings from net surplus units and channels them to productive investment (CBN, 2017).

According to Ogwumike and Salisu (2013), the Nigeria financial system has experienced intensive restructuring and rapid market-oriented transformations since the adoption of the Structural Adjustment Program (SAP) in 1986. Before then, the Nigerian financial system was regulated as evidenced by ceiling on interest rates and credit expansion, high reserve requirements, selective credit policies and restriction of entry into the banking industry. Following deregulation, the bank and non-bank financial institutions witnessed unprecedented increase due to the incentives provided for growth and expansion of financial institutions. These series of actions to restructure the financial system ahs yielded some good results like fewer financially stronger and resilient banks.

FINANCIAL SYSTEM AND THE ECONOMY - EMPIRICAL REVIEW

Aigbovo and Uwubamwen (2014) examined the short-run and long-run relationships between financial system development and economic growth in Nigeria. The study adopted

a multivariate OLS analysis for the estimation process, co-integration analysis, the associated error correction model. The findings of the study revealed that financial development (measured by banking system and stock market development) positively influenced economic growth in Nigeria and that causality runs from finance to growth in the finance-growth nexus. It was thus recommended that the ongoing reforms in the banking system and capital market should be intensified so as to boost the development of these segments of the financial system and by that increase their role in economic growth.

Olushola and Makwe (2018) examine the relationship between financial sector development and economic growth in Nigeria with a view to making relevant contributions to existing knowledge and make suggestions that would enhance economic development of Nigeria. The data was subjected to Johansen Rank Cointegration technique, the ADF and PP unit roots test as well as the error correction model (ECM). From the findings, it was revealed that there was a positive and significant relationship between total insurance income and economic growth in Nigeria. The results also suggested that there is a positive and significant relationship between deposit money banks assets, stock market capitalization and economic growth in Nigeria. The research concluded that to achieve a steady economic growth, the financial intermediation should be strengthened through expansion in the capital market, bank consolidation and improvement in the insurance sector.

Ibadin, Moni and Eikhomun (2014) attempted to ascertain the relationship between banking system development and stock market development (financial system development) and economic growth. Using the Co-integration Technique, the ADF Unit Root Test and Error Correction Mechanism, the findings revealed that market capitalization, had short run and long run positive impact on economic growth; credit to the private sector also had a positive impact on GDP and value of share traded in stock market, the turnover ratio, the investments all had positive influence on economic growth. From the above, the financial system can be considered as a tool for short run and long run economic growth.

Adelakun (2010) examined the relationship between financial development and economic growth using the Ordinary Least Square Estimation Method (OLSEM). The result showed that there was a substantial positive effect of financial development on economic growth in Nigeria. The Granger causality test showed that financial development promotes economic growth, but there is evidence of causality from economic growth to the development of financial intermediaries. Thus, advancement of the financial sector development, including diversification of financial instruments should be pursued to facilitate economic development in Nigeria.

Odufuye, (2017) investigated the impact of bank credit on Nigerian economy growth for the period of using time series secondary data sourced from the CBN statistical bulletin and Ordinary Least Square (OLS) estimation technique with the aid of Statistical Package for Social Science. The results revealed that each of the explanatory variables had a non-significant impact on GDP. The result also showed that the joint variables of bank credit have significant impact on gross domestic product for the period under review. The study concluded that bank credit if properly channeled is a catalyst for Nigerian economy growth. The research therefore recommended that the monetary authority should adopt direct credit control measures, where preferred sectors such as Small and Medium Scale Enterprises (SMEs), agriculture, manufacturing and services sectors should be favoured

when granting credits.

Ebiringa and Duruibe (2015) analyzed nature of relationship between financial system development and economic growth in Nigeria using vector autoregressive model. The results reveal that long run causality does not run from financial system development indicators and economic growth, implying that financial system development seem not to significantly catalyze economic growth trends in Nigeria. However, in specific terms, the effect of financial system development on economic growth has been positively significant only in the short run. The paper concludes that for the financial market to adequately support short and long-term growth of the Nigerian economy, the financial system need further deepening through offering and delivery of innovative financial products and service by market operators.

Hashim, (2011) tested the relationship between financial development and economic growth in Nigeria Using Spearman rank correlation coefficient and found out that there is no evidence to suggest a significant relationship between financial development variables: commercial banks assets, liquid liabilities to Gross Domestic Product, commercial banks assets to GDP among others and economic growth in Nigeria for the period under review.

Nkoro and Uko (2013) examined the financial sector development-economic growth nexus in Nigeria using OLS regression analyses models. The findings showed that there is a positive effect of financial sector development on economic growth in Nigeria. However, credits to private sector and financial sector depth are ineffective and fail to accelerate growth. This signifies the effect of government borrowings, the problem of huge non-performing loans, and a deficient legal system on the private sector. These inefficiently and severely limit the contribution of Nigeria’s financial sector development to economic growth.

METHODOLOGY

Research design adopted for the research is the ex post facto design. Hence, data was collected from secondary sources inkling the CBN Statistical Bulletins, CBN Abstract of Statistics and was estimated using multiple regression analysis which will be specified to test for the relationship between financial systems as measured by Bank System, Aggregate Domestic Savings, and the Capital Makers. This is expressed as:

$$Y = a + b_1X_1 + b_2X_2 + \ldots\ldots + b_nX_n + U$$

Where Y = the dependent or outcome variable

a = constant term

$X_1, X_2 \ldots X_n$ = set of independent variables or predictors

$b_1, b_2, \ldots. b_n$ = coefficients of the predictor variables and

U = the error term.

For the purpose of this study, banking system performance (**BANKPF**) will be measured by aggregate assets of all commercial banks, Aggregate Domestic Savings (**AGSAVE**) while capital market performance will be measured by equities market capitalization (**MKTCAP**) and Money Market performance by FGN Bonds (**FGBOND)**. Finally, Economic Development is proxies by Real Gross Domestic Product **(RGDP**).

Economic Development = f(Financial System) . . . . .(1)

The above model is rewritten functionally as:

RGDP = f(BANKPF, AGSAVE, MKTCAP, FGBOND) . . . . . (2)

And Econometrically as:

$RGDP = \beta_0 + \beta_1 BANKPF + \beta_2 AGSAVE + \beta_3 MKTCAP + \beta_4 FGBOND + U_t$ . . . (3)

We further convert to their log forms to normalize/standard the dataset:

$logRGDP = \beta_0 + \beta_1 logBANKPF + \beta_2 logAGSAVE + \beta_3 logMKTCAP + \beta_4 logFGBOND + U_t$ . . . . . (3)

A priori Expectation = $\beta_1, \beta_2, \beta_3$ and $\beta_4 > 0$

DATA ANALYSES, RESULTS AND DISCUSSION

Table 1: Summary of ADF Unit Root

VARIABLE	ADF Unit Root Test		
	t-stat	**Prob.**	**Order of integration**
RGDP	-3.3397	0.0205	I(1)
BANKPF	-3.3694	0.0196	I(1)
AGSAVE	-4.3472	0.0015	I(1)
MKTCAP	-6.3693	0.0000	I(1)
FGBOND	-7.1240	0.0000	I(1)

From table 1, it can be observed that the data set were stationary at I(1) order of integration. This result implies that after first differencing, the dataset can be relied on for accurate long term prediction. However, the I(1) order of integration also imply that the results of the basic multiple regression analyses may not be accurate for further prediction/forecasting. Consequently, the Auto-Regressive Distributed Lag (ARDL) model was used for all subsequent analyses.

Table 2: Auto-Regressive Distributed Lag (ARDL) Test

Variable(s)	Coefficient	t-statistic	Probability
C	-0.3317	-0.6080	0.5529
RGDP	1.0413	-7.7822	0.0000
BANKPF	0.0999	1.0145	0.3276
AGSAVE	0.1050	2.0066	0.0645
MKTCAP	-0.0352	-1.3756	0.1906
FGBOND	-0.0730	-1.7837	0.0962
R2 = 0.998; R^2 Adjusted = 0.997; F-Statistic = 738.32; Prob (F-Statistic) = 0.000; DW = 2.464			

The ARDL model result in table 2 indicates that there is a positive relationship between real gross domestic product (RGDP) and aggregate commercial banks assets in Nigeria. The value of the coefficient of regression of 0.0999 implies that one percentage change in aggregate bank banking sector assets will lead to a 9.9% change in RGDP in the same direction. However, the probability of t-statistic for the variable gave a value of 0.3276 with the implication that the result is not statistically significant.

Furthermore, the regression coefficient for Aggregate domestic savings gave a value of 0.105. This result implies a positive relationship between real gross domestic product

and aggregate domestic saving in Nigeria. This means that increase in aggregate domestic savings will lead to increase in RGDP and vice versa. However, the result is not statistically significant as can be observed from the probability of t-statistic value of 0.0645 which is marginally higher than the critical limit of 0.05.

On the other hand, the regression coefficient for stock market capitalization gave a negative value of -0.0352 which implies that there is a negative relationship between stock market capitalization and the RGDP with a percentage increase in stock market performance predicted to lead to 3.5% decrease in RGDP and vice versa. The probability of t-statistic value of 0.1906 implies that the result is not statistically significant.

Finally, the coefficient of regression for federal government bonds gave a negative value of -0.0730 which implies that a percentage increase in government borrowing through the bonds market will have the effect of decreasing RGDP by 7.3% and vice versa. This result is also not statistically significant like in the other cases above.

Table 3: ARDL Co-integrating Long-Run Coefficients

Variable	Coefficient	Std. Error	t-Statistic	Prob.
LNBANKPF	-6.441624	20.651581	-0.311919	0.7597
LNAGSAVE	0.539106	1.608200	0.335223	0.7424
LNMKTCAP	1.718095	6.038545	0.284521	0.7802
LNFGBOND	4.763645	15.040035	0.316731	0.7561
C	8.032706	13.296707	0.604112	0.5554

The ARDL Co-integrating and Long Run Form Results in the table 3 above provide information on the nature of the long-run relationship between the dependent and independent variables. From the long-run coefficients, none of the financial system variables - aggregate commercial banks assets (BANKPF), aggregate domestic savings (AGSAVE), stock market capitalization (MKTCAP) and federal government bonds (FGBONDS) had a statistically significant long-run relationship with real gross domestic product. This can be observed from the probability of the t-statistic for the long run coefficients with values of 0.7597; 0.7424; 0.7802; and 0.7561 respectively BANKPF, AGSAVE, MKTCAP and FGBOND.

DISCUSSION OF FINDINGS

This research paper investigated the relationship between financial system and the economy in Nigeria for the period 1981 to 2017. Data for the study was collected from secondary sources and analyzed using Augmented Dickey-Fuller unit root test, Auto-regressive Distributed Lag (ARDL) model and Co-integration test. The findings shows that: there is a positive statistically insignificant relationship between real gross domestic product and aggregate commercial banks assets in Nigeria implying increase in commercial banks assets will lead to increase in real gross domestic product.

Olushola and Makwe (2018) in a similar study determined that there was a positive and significant relationship between deposit money banks assets, stock market

capitalization and economic growth in Nigeria. The research concluded that to achieve a steady economic growth, the financial intermediation should be strengthened through expansion in the capital market and bank consolidation. Furthermore, Odufuye (2017) also showed that bank credit had significant impact on the economy and concluded that bank credit if properly channeled is a catalyst for Nigerian economy growth.

Furthermore, the results show that there is a positive relationship between real gross domestic product and aggregate domestic saving in Nigeria. This means that increase in aggregate domestic savings will lead to increase in RGDP and vice versa. However, the result is not statistically significant implying that aggregate domestic savings does significantly affect the economy. The results also show that stock market capitalization has a non-significant negative relationship with the economy with an indication increase in stock market capitalization will lead to deterioration in the economy. However, Aigbovo and Uwubamwen (2014) in their study revealed that stock market development positively influenced economic growth in Nigeria.

Finally, the results indicate that federal government bonds have a negative relationship with the economy. This result is also not statistically significant like in the previous cases above. From the long-run coefficients, none of the financial system variables - aggregate commercial banks assets (BANKPF), aggregate domestic savings (AGSAVE), stock market capitalization (MKTCAP) and federal government bonds (FGBONDS) had a statistically significant long-run relationship with real gross domestic product. This finding is corroborated by that of Nkoro and Uko (2013) who showed in their research that government borrowing led to deterioration of the Nigerian economy.

CONCLUSIONS AND RECOMMENDATIONS

From the findings, it is observed that aggregate commercial banks assets and domestic savings followed the a priori expectation by recording positive relationships with the economy. However, the findings were both findings were not statistically significant. From this finding, we conclude that commercial banks' assets and domestic savings are performing below expectation in driving economy development. However, stock performance and federal government bonds in relationship to the economy deteriorate economic development. This we conclude is as a result of misapplication of investment funds both in the public sector (federal government bonds) and private (stock market) sectors. In all, it is concluded that the financial system is not contributing meaningfully to economic development in Nigeria. Thus, it is recommended that policies to help reposition the financial system are required. This should include deepening the financial system and enhancing its ability to mobilize the necessary resources to drive economic growth and development. There is need to ensure that the properly monitor the utilization of funds raised through issuance of bonds. Finally, we recommend that activities in the stock market be properly monitored to avoid the problem of insider information abuse and boost investors' confidence.

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