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Full Length Research Paper

Financial sector performance and economic growth in Nigeria

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Towards the end of 2010, banking halls in Nigeria were crowded with people. Following the Central Bank of Nigeria's advice, banks were updating records of their clients. The essence was for the banks to be better informed about their clients and their sources of funds with a view to eliminating or limiting the problem of money laundering in Nigeria. This is only one of several policies or reforms that the financial sector in Nigeria has gone through in recent times. The numbers of banks were pruned down through the recapitalization programme, non-performing microfinance banks were weeded out, and five bank chiefs were accused of mismanagement and replaced. The Nigerian Stock Exchange also experienced difficulties leading to the exit of its Chief Executive Officer. Practically, every aspect of the Nigerian financial system has in recent times experienced one form of reform or challenge but these are the sources of capital formation for the real sector in Nigeria. In view of these how well has the sector performed its role as a driver of economic growth? This work using data obtained from the Central Bank spanning 24 years was able to establish that there is a positive relationship between the performance of the sector and economic growth in Nigeria.

Key words: Financial sector, economic growth, performance.

INTRODUCTION

The importance of the financial sector in any economy cannot be over-emphasized given the symbiotic relationship between the sector and the rest of the economy. In this era of globalization, efficient financial sectors are essential to attract gains from the world market, and as well insulate the domestic economy from external shocks. The financial system could also responds to the demand created as a result of economic development in the domestic economy. Theoretically the role of the financial sector can be summarized as follows: (i) the financial sector generates wealth in the economy and facilitate the exchange of goods and services, (ii) it facilitates the process of resource mobilization (iii) it mobilizes savings and changes the term structure of savings (iv) it channels savings into productive investments (v) it promotes the integration of the domestic economy into the global financial system (vi) it improves the efficiency and productivity of investments (vii) it enables and enhances the smooth implementation of macroeconomic policies (viii) it acts as catalyst for rapid economic growth and development.

Research problem

The financial sector consists of a group of related institutions, market instrument and operations that interact within an economy to provide financial services. The financial sector is linked to the real sector of the economy. The real sector of an economy consists of all other economics units that are involved in the production of goods and services. These economic units include

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households, business firms, ministries and parastatals among other productive outfits. These units produce goods and services that are exchangeable or marketable. The returns from such exchange go to the financial sector as deposits in banks or instruments in corporate activities in the form of claims, development stocks and other financial claims.

Therefore, the growth of the real sector could be determined by the financial sector performance and this could impact on economic growth. But the financial system has been affected by several bouts of reforms and challenges. A number of banks were pruned down through the recapitalization programme. Among the recapitalized banks five Chief Executives were accused of fraud and replaced. Microfinance banks and insurance companies had their capital base reviewed. More recently, the Central Bank of Nigeria and its monetary policy committee reviewed the interest rates upward to dampen the rate of inflation in Nigeria. (Ogboi, 2011:12). These are among several other reforms in the sector. More so, according to the Manufacturing Association of Nigeria (MAN) cited in Amaefule (2011), Nigeria lost 1.9 million manufacturing job spaces between 2002 to 2009, owing to harsh operating environment including finance related problems.

Research question

The aforementioned problem statement led to the following research question as follows:

1. How is this dynamism affecting the Nigerian economy?
2. Is there truly a relationship between the Nigerian financial system and economic growth in Nigeria?
3. How well has the Nigeria financial system performed its roles and how does that impact on economic growth in Nigeria?

Research objective

The objective of this research is: To examines the relationship between financial sector performance and economic growth in Nigeria between 1985 to 2008.

LITERATURE REVIEW: COMPOSITION OF NIGERIA FINANCIAL SECTOR

There are four vital components of a financial system, namely: financial institutions, financial markets, the regulatory authorities and financial instruments. The system in Nigeria has undergone remarkable changes in terms of ownership structure, the depth and breath of instruments employed, the number of institutions established, the economic environment and the regulatory framework within which the system operates currently. The Nigeria financial system include banks, capital markets, insurance, Pension asset managers and other financial institutions with the central bank as the apex institution According to Central Bank of Nigeria (2008) at the end of 2008, there were 805 financial institutions in Nigeria including banks. These are discussed below briefly.

The Central Bank of Nigeria (CBN)

The Central Bank of Nigeria is the apex regulatory authority of the Nigeria financial system. The Central Bank of Nigeria (C.B.N) was established in 1959, under the colonial Banking Act, which conferred on it a number of functions and powers, including powers to control the operation of commercial banks (Gbosi, 2009).The colonial Banking Act was amended and consolidated in the series of Central Bank Acts and Banking Decree of 1979. Specially, under the Decree, the principal objectives of the CBN are the issue of legal tender (currency) in Nigeria, the maintenance of external reserves to safeguard the international value of the local currency, and a sound financial system in Nigeria. Under the 1958 Act, the CBN was designed to ensure the control over monetary policy. It was, however, recognized that within this framework, the Bank will not be completely independent of the government, although it could be independent within the government. This therefore, made the formulation and execution of monetary policy in Nigeria a very difficult task. In view of this several banking decree were promulgated in 1991. The new decrees superseded CBN currency conversion Act of 1967 and its amendment. The promulgation of Decree No.24 of June 20, 1991 was also an important landmark in the history of CBN. This is because of the expanded powers conferred on the CBN to execute its primary functions. The Bank and Other financial institutions Decree (BOFID) No. 25 of 1991 was also promulgated to strengthen the CBN's supervisory activities. The BOFID supersedes the Bank Act of 1969 and its amendments. It has also made it easier for the CBN to promote monetary stability and soundness of the financial system. By the CBN Decree, the CBN is subject only to the authority of the president of the Federal Republic of Nigeria. The promulgation of the 1991 Decree has tremendously enhanced the legal powers of the CBN to deal with the problems of banks. This is very clear in its role of controlling the pace and direction of monetary and financial activities in Nigeria.

The central Bank of Nigeria like the Bank of England or the U.S. Federal Reserve Bank performs several functions in the economy. These include services functions and monetary management. The major functions of the CBN are discussed below: first, the CBN is responsible for currency issue and distribution. This function is very important because economic transactions to a large extent are cash oriented in Nigeria. Another important function of the C.B.N is its role as banker of banks. The CBN has the statutory function of acting as banker to other banks within and outside Nigeria; third, is its role of supervision of banks in Nigeria in order to promote a sound financial system. Fourthly, it serves as a financial adviser to the Federal Government. It is the organ of government for maintaining monetary stability. As an operator in the financial market, it serves as an important link between the government and the business community. Fifth; it also provides the forum for cheque clearing, the inter-bank clearing is a key feature of efficient banking system. Sixth, the CBN also acts as banker to the Federal Government specifically; the Bank undertakes most of the Federal Government banking activities within and outside Nigeria. It is also involved in managing the country's foreign reserves.

The banking subsector

The banking subsector includes deposit money banks, microfinance banks, primary mortgage institutions, trustees and trust companies. Deposit money (commercial) banks are the dominant operators in the industries; they are the largest in terms of size and profitability. These are currently 24 of such banks in Nigeria. Micro finance are banks are financial institutions established to provide credit, banking and other financial services to designated convenient areas or communities. Currently, there are 757 microfinance banks in Nigeria. These community banks were converted to microfinance banks in 2007. Micro-finance banks are established to provide financial access to the poor who are traditionally not served by the conventional financial institutions, this is because the formal financial system provides services to about 20 percent of economically active population, the other eighty (80) percent are excluded from access to financial services, (CBN, 2008). Primary mortgage institutions also known as savings and loans companies are specialized institutions which collect household savings and originate mortgage loans. There are currently about 90 primary mortgage institutions in Nigeria. Trustee and Trust companies are typically subsides of banks. They provide funds and management services for organizations or individuals who set up trust funds. There other services include portfolio management, investment advising, property management and custodial services for non-pension funds.

Insurance industry

Insurance companies represent the second largest sector in the Nigeria financial services industry. There are over a hundred insurance companies operating in Nigeria. The minimum capital requirements is N2 billion for life Insurance Companies and N8 billion for companies that provides non-life insurance. Insurance brokers also fall under this group. These companies are registered with the National Insurance Corporation of Nigeria (NICON). Out of this number, only a few control a significant proportion of life and license premium income of the industry. There are also reassurance companies within the insurance industry. There are currently 5 reassurance companies in Nigeria. In September 2005, the Federal Ministry of Finance and NICON increased the minimum capital base for reassurance business in Nigeria to N10 billion starting from February 2007. Insurance agents are representatives of Insurance companies on commission. There are over 500 registered insurance agents in Nigeria.

Capital market

The capital market is a network of financial institutions and infrastructure that interact to mobilize and allocate long-term funds in the economy. Specifically, the market affords business firms and government the opportunity to sell stocks and bonds to raise long term funds from the savings of other economic agents.

The sourcing of long-term funds through the capital market is essential for self-sustained economic growth as prescribed by the Harrod-Domar model. An active capital market aids the mobilization of savings for economic growth and development. It also encourages the efficient allocation of resources through changes in wealth ownership. In this regard, it acts as a catalyst in creating a healthy private sector and facilitates the promotion of rapid capital formation. Within the capital market, there are issuing houses which provide residual banking services and act as intermediaries in capital market activities. They operate between the company whose shares are being sold, the regulatory authorities and the publics. Issuing houses are registered with the Securities and Exchange Commission (SEC). Many of the issuing houses in Nigeria are affiliates of banks. In Nigeria, stock-brokers are also involved in capital market activities. There are 581 licensed stock-brokers in Nigeria.

Other financial institutions

Other financial institutions are discount houses, finance companies, bureau de change, development financial institution and pension fund agencies in Nigeria. Many of the private equity firms are offshoots of foreign firms. Discount houses specialize in trading money market securities with the specific purpose to provide liquidity and play market-making roles for short term market instruments. Presently, there are 15 discount houses and 112 finance companies in Nigeria; however, finance companies do not accept deposits. Bureau de changes were established in Nigeria in 1989. These are companies that carry out foreign exchange business on small scale basis. At the end of 2008, there were 126 licensed bureau de change in Nigeria, (CBN 2009). Development Finance Institutions (DFTs) are usually government owned financial institutions established to finance certain developmental programmes of the government usually in agriculture, commerce, manufacturing, industrial sectors, etc. There are according to National Bureau of Statistics (NBS, 2009) 6 Development finance institution in Nigeria.

Pension fund managers

The pension fund managers were established for employees in Nigeria as a contributory pension scheme for payment of retirement benefits of employees to whom the scheme applies. Under this Act, all employees in the public service of the Federation, and the private sector are involved except the Military, the judges and top political office holders. Firms employing less than five people may also be exempted.

Prior to the enactment of the pension reform Act 2004, pension schemes in Nigeria had been bedeviled by many problems. The public service operated an undefended and ill-defined benefits scheme and the payment of retirement benefits were budgeted annually. The annual budgetary allocation for pension was often one of the most vulnerable items in the budget implementation in the light of resource constraints. The key objectives of the new scheme include:

1. To ensure that every person who worked in either the public service of the Federation, or private sector receives his retirement benefits as and when due.
2. To assist individuals by ensuring that they save to cater for their livelihood during old age and thereby reducing old age poverty.
3. To ensure that pensioners are not subjected to untold suffering due to inefficient and cumbersome process of pension payment.
4. To establish a uniform set of rules, regulations and standards for the administration and payments of retirement benefits for the public service of the Government and the private sector.
5. To stem the growth of outstanding pension liabilities.

Pension fund administrators (PFAs) have been duly licensed to open retirement saving accounts for employees, invest and manage the pension funds in a manner as the commission may from time to time prescribe, maintain books of accounts on all transactions relating to the pension fund managed by it, provide regular information to the employees or beneficiaries and pay retirements benefits to employees in accordance with the provision of the Pension Reform Act 2004. Before it is issued with an operating license, the pension fund administrators (PFAs) must be a limited liability company with the sole objective of the management of pension funds. To discourage frivolous applications and to ensure credibility, such company must have a paid up share capital of N150,000,000 and demonstrate professional capacity to manage pension funds and administer retirement benefits.

Functions of the financial system

The value of the financial system in our daily lives may be appreciated by reviewing its role as stated hereunder.

Savings function

The financial system provides a conduit for mobilizing public savings. Bonds, stocks, and other financial claims sold in the money and capital market provide a profitable, relatively low-risk outlet surplus spenders, which flow through the financial markets into investment, so that more goods and services can be produced thus, improving social welfare. When savings flows decline, investment and living standards begin to fall.

Wealth function

For those who choose to save, the financial instruments sold in the money and capital markets provide an excellent way to store wealth until the funds are needed for spending. Although, it is possible to store wealth in other media e.g. like houses, automobiles, clothes etc), these items are subject to depreciation or risk. However, bonds, stocks and other financial instruments do not wear out over time and usually generate income; moreover, their risk of loss is much less than other forms of stored wealth (Ezrim 2005).

For any individual, business firm or government, wealth (w) is the sum (∑) of the value of all individual assets (A) held. That is:

$$W_t = \sum_t A_{it} \quad (1)$$

Wealth is built up over time by a combination of current savings plus income earned on previously accumulated wealth. In symbol this can be stated as:

$$\Delta W_t = S_t + r_t . W_{t-1} \quad (2)$$

Where ΔW_t represents the change in wealth in the current period, S_t is the volume of current savings, r_t is the current average rate of return on accumulated assets, and W_{t-1} is the initial value of accumulated wealth (assets) held. Therefore wealth holdings represent stored purchasing power that will be used in future periods as income to finance purchase of goods and services and to increase society's standard of living (Ezrim, 2005).

Thus, as Equation 3 below reminds us, income emerges from the wealth function of the financial system. Income (Y_t) is created by the rate of return (r_t) that current wealth holdings (W_t) generate for their owners.

$$Y_t = W_t.r_t \quad (3)$$

Increased consumption spending (C_t) and to new saving (S_t):

$$Y_1 = c_t + S_T \quad (4)$$

Resulting in higher standard of living for those who hold wealth in income- generating forms.

Liquidity function

For wealth stored in financial instruments, the financial system provides a means of converting those instruments into cash with little risk of loss. Thus, the world's financial markets provide liquidity (immediately spendable cash) for savers who hold financial instruments but are in need of money (see Jhingan, 2003). In modern societies, money consists mainly of deposits held in banks and is the only financial instrument, possessing perfect liquidity. Money can be spent as it is without the necessity of converting it into some other forms.

However, money generally earns the lowest rate of return of all assets traded in the financial system, and its purchasing power is seriously eroded by inflation. That is why savers generally minimize their holdings of money and hold other higher-yielding financial instruments until they really need spendable funds. Of course, money is not the only means of making purchases of goods and service. In many less developed economics around the world, the exchange of one good or service for another-perform the same services as money.

Credit function

In addition to providing liquidity and facilitating the flow of savings into investment, to build wealth, financial markets furnish credit to finance consumption and investment spending. Credit consists of loan of funds in return for a promise of future payment. Consumers need credit to buy daily needs, houses, repair the faulty automobiles and retrieve outstanding debts.

Firms draw on their lines of credit to stockholders, governments borrow to construct buildings and other public facilities and to cover routine cash expenses until tax revenue flow in.

Payment function

The financial system also provides a mechanism, for making payments for goods and services. Certain financial assets including current accounts and Negotiable Order of Withdrawal (NOW) accounts, serve as a medium of exchange in making payments. Credit cards issued by banks, credit unions etc are also widely accepted as a convenient means of payment. Plastic cards and electronic means of payment, including computer terminals in homes, offices and stores and digital cash, are likely to displace cheque and other pieces of paper as popular means of payment in the future. Indeed, electronic means of payment are in wide spread use today and are growing rapidly in the wider world especially in advanced economies.

Risk protection function

The financial market, offer its clients indemnity against life, health, property and other risks. This is achieved through the sale of insurance policies. The funds generated through the sale of policies also help to boost the activities in the money and capital markets in Nigeria.

Policy function

Finally in recent times, the financial markets have been the key channel through which government has carried out its policy of attempting to stabilize the economy and avoid inflation. By manipulating interest rates and the availability of credits, government can affect borrowing and spending plans of the public, which in turn, influence the growth of jobs, production, and prices.

The Financial Sector and Economic Growth

This work attempts to identify the impact of the Nigerian financial system on economic growth between 1985 and 2008, a period of 24 years. To do this we need to specify a model, source for data, analyse the data and explain the results. These have been done as shown subsequently.

Model specification

Thus, the contribution of the financial sector (CFS) can be stated as follows:

CFS=f(C,B,CM,I,PF,OF)…………………………………(1)

where CFS = cummulative contribution of the financial system,

Table 1. Annual GDP and Financial Sector Output (1985 to 2008).

Year	GDP (₦ million)	Financial sector (₦ million)
1985	67,908.60	108.90
1986	69,147.00	117.70
1987	105,222.80	127.40
1988	139,085.30	138.50
1989	216,797.50	124.70
1990	267,550.00	103.10
1991	312,139.70	476.70
1992	532,613.80	834.00
1993	683,869.80	1,664.90
1994	899,863.20	3,042.70
1995	1,933,211.60	6,927.60
1996	2,702,719.10	7,867.60
1997	2,801,972.60	13,397.80
1998	2,708,430.90	15,397.00
1999	3,194,015.00	21,261.90
2000	4,582,127.30	41,318.50
2001	4,725,086.00	52,858.10
2002	6,912,381.30	59,290.00
2003	8,487,031.60	90,423.50
2004	11,411,066.90	98,672.30
2005	14,572,239.10	109,743.50
2006	18,564,594.70	120,624.70
2007	20,657,317.70	129,727.40
2008	23,842,170.70	141,238.90

Source: CBN statistical bulletin, Golden Jubilee Edition, 2009.

C = contributions of the Central Bank,
B = contribution of the Banking Sector,
CM =contributions of the Capital Market,
I = contribution of the Insurance Industry,
PF = contribution of the Pension Fund Managers,
OF= contribution of the Other Financial Institutions.

Because this work attempts to confirm the impact of the financial sector on economic growth and also because of data constraint this work adopts a simple regression model where contribution of the financial sector (CFS) is aggregated as follows:

$$GDR = F (CFS) \quad (2)$$

This can be restated as follows in econometric terms:

$$GDP = a_0 + a_1 \, cfs + u \quad (3)$$

or

$$Y = \hat{a}_0 + \hat{a}_1 x + e \quad (4)$$

Where:
Y = Gross Domestic Product (dependent variable); GDP
$\hat{a}_0 = a_0$ = estimated value of the intercept,
x = CFS = value of the contribution of the financial sector, to national income (independent variable),
e = u = Error or random or stochastic term.

DATA AND ANALYSIS

Table 1 presents a time series data on the annual gross domestic product and contribution of the financial sector in Nigeria as obtained from the Central Bank bulletins. Using Equation 4 shown earlier, the result of the regression is as follows:
At 95% level of significance the understated degree of freedom (Appendix for details)
n-k (that is, 24-2) = 22

Where:
n = number of observation (24 years)
k = number of parameter (2)
$t^* \hat{a}_0 = 0.069$
$t^* \hat{a}_1 = 19.384$
The regression result can be presented in a compact form thus:
$Y = 31.124 + 0.142 X_1$
S(â) (448.309 (0.0073))
t(â) 0.069) (19.374)
$R^2 = 0.945$
r × y = 0.972

$t_{0.025}$ = t-table = 2.074

Tables in the appendix give details of regression results. Table (a) is the descriptive statistics showing the mean and standard deviation of the variables (Economic Growth and Financial Sector Performance). Table (b) shows that there is a 97.2% relationship between the financial sector and gross domestic product used as proxy for economic growth within the period under review. Table (c) is the model summary while (d) defines the level of statistical significance. All these are reflected and given clearer definition in the compact form; Y =31.124 + 0. 142X which shows that first, there is a positive relationship between the financial sector performance and economic growth in Nigeria ($a_1 > 0$), which is in line with economic theory. From the model the calculated t value is greater than the hypothetical t value showing that the result is significant at 5%.

CONCLUSION AND RECOMMENDATION

With an r^2 of about 94%, the explanatory model is high and can be inferred that there is a positive relationship between the financial system and economic growth in Nigeria especially within the period under consideration. This result aligns well with the apriori expectation and confirms the importance of the sector to the development of Nigeria. There is therefore need to provide a suitable operating environment for the sector to perform its services in Nigeria. Policies to reduce insider frauds, round tripping and other abuses must be put in place and constantly be modified, updated to meet the increasing ingenuity of negative minded staff and executives in places of trust. Policies that will provide congenial atmosphere for these institutions to thrive will also help the economy greatly.

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APPENDIX

Regression (Data set)

Descriptive statistics

Variable	Mean	Std. Deviation	N
GDP	5.4326E6	7.14875E6	24
FIN SEC	38144.6417	49065.80740	24

Correlations

		GDP	FIN SEC
Pearson Correlation	GDP	1.000	0.972
	FIN SEC	0.972	1.000
Sig. (1-lailed)	GDP	0.000	0.000
	FIN SEC	0.000	0.000
N	GDP	24	24
	FIN SEC	24	24

Variables entered/removed[b]

Model	Variable entered	Variable removed	Method
1	FIN SEC[a]		Enter

[a]All requested variables entered; [b]Dependents variable GDP

Model Summary[b]

	Change statistics					
Model	R Square change	F. change	df1	df2	Sig. F change	Durbin Watson
1	0.945	375.359	1	22	000	.462

[b]Dependent variable GDP

ANOVA[b]

Model		Sum of squares	df	Mean square	F	sig
1.	Regression	1.110E.15	1	1.110E.15	375.358	000[a]
	Residual	6.508E.13	22	2.958E.12		
	Total	1.175E.15	23			

[a]Predictors (Constant), FIN SEC; [b]Dependent Variable GDP

Coefficient[b]

	Unstandard coefficient		Standardized coefficients		
Model	**B**	**Std. Error**	**Beta**	**1**	**Sig**
1 (Constant)	31123.658	448309.226	-	.069	945
FIN SEC	141.606	7.309	972	19.374	000

Coefficient[a]

	Correlations			Collinearity statistics	
Model	**Zero-order**	**Partial**	**Part**	**Tolerance**	**VIF**
1. FIN SEC	.972	.972	.972	1.000	1.000

[a]Dependent variable GDP

Collinearity diagnostic

Model	dimension	Eigenvalue	Condition index	Variance proportions	
				(Constant)	**FIN SEC**
1.	1	1.622	1.000	19	19
	2	378	2.071	81	81

[a]Dependent variable GDP

Residuals statistics[a]

	Minimum	Maximum	Mean	Std. deviation	N
Predicted value	45723.2813	2.0031E7	5.4326E6	6.94803E6	24
Residual	4.34864E6	3.81071E6	00000	1.68209E6	24
Std. predicted value	-775	2.101	000	1.000	24
Std residual	2.528	2.216	000	978	24

[a]Dependent variable GDP