Financial Sector Development and Macroeconomic Performance in Nigeria

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Abstract— The study investigates the nexus between financial sector development and macroeconomic performance in Nigeria. Key indicators of financial sector development namely. Banking sector and Capital market performances and macroeconomic performance indicators such as economic growth, unemployment rate, inflation rate among others are used in the study. Vector Auto-Regression VAR and descriptive statistics are used to analyse the data which span through 1995 to 2018. The results show that Nigerian financial sector development is strongly influenced by external shocks especially oil price and this has limited its influence on macroeconomic performance of Nigeria. Credit rationing function of the financial sector that could have engendered improved investment and output are not performed very well owing to external shocks influence which makes the financial sector highly vulnerable and fragile. It is recommended that financial sector development that will support economic diversification in Nigeria should be encouraged to have improved macroeconomic performance.

Keywords— Financial sector development, macroeconomic performance, oil price shocks

I INTRODUCTION

Within the last three decades, the Nigerian financial sector has been characterized by relative fragility and instability with intermittent incidences of liquidity challenges, bank distress, bail out, declining all-share index and eroding investors' confidence. Although, several efforts have been made by policy makers and financial sector regulators towards stabilizing and strengthening the financial sector, the macroeconomic performance of the Nigerian economy has continued to raise questions about the effect of financial sector development on the macroeconomic performance of Nigeria.

According to World Bank (2005), the financial sector is a crucial sector of any economy, affecting its business environment, investment, economic prospects, and social dimensions, including poverty. It provides services to the rest of the economy through mobilizing and channeling of financial resources from excess sectors to the deficit sectors. It impacts on macroeconomic performance mainly through growth as it finances investment opportunities that propel increased GDP and job creation. Vulnerabilities in the sector often lead to financial crises, economic slowdowns, and fiscal costs (Levine, 2005). The extent to which the sector is developed and managed determines the level of impacts it has on the economy (Esther, 2005). According to Schmukler (2003), the availability and efficient uses of a nation's financial resources are evident in its effects on the real sectors and manifests in major macroeconomic performance.

However, the question is, has the financial sectordevelopment in Nigeria over the years positively influenced the macroeconomic performance of Nigeria via reduction of unemployment, promotion of investment and increase in the overall economic growth of the country?

This study will briefly take an empirical perspective of providing answer to this question by firstly exploring some stylised facts on some important financial sector development and macroeconomic indicators in Nigeria within the last three decades..

II LITERATURE REVIEW

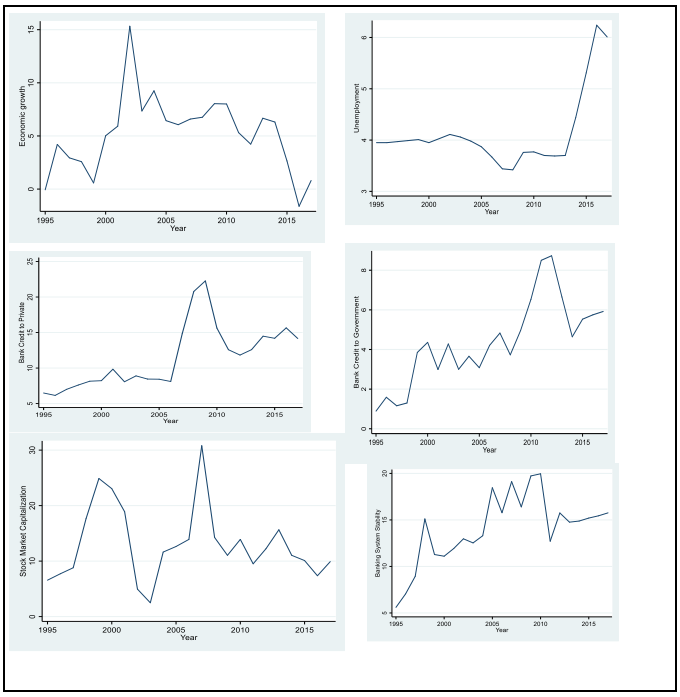
LITERATURE

Stylized Facts on the Trends of some Financial Development and Macroeconomic Indicators in Nigeria

Figure 1 shows the trends of key indicators of financial sector development and macroeconomic performance of Nigeria within the last three decades

The diagram above shows the trend of major indicators of financial sector development and macroeconomic performance in Nigeria. It is evident from the figure, that for the past two and a half decades, all these indicators have been very unstable. This is one of the major characteristics of economic instability and financial sector fragility that is common to Nigeria as a country. However, some indicators share common movements in terms of their trends between 1995 and 2017.

Figure 1: Trends of financial sector development and macroeconomic performance indicators



Sources: Authors Computation

It is evident from the study that Nigerian economic growth has been falling during this period especially since year 2001. Immediately after the democratic dispensation in 1999 there was a significant rise in the growth of the economy which peaked in year 2000. According to Victor & Samuel (2014), this initial upward movement was attributed to the fresh confidence both foreign and local investors reposed in the institutions of the country after enthronement of democracy. This was also boosted by the rising oil price in the international market then.

However, the diagram also showed that during this period, the unemployment rate was high but afterwards it starts falling and along the line as we approach 2007 the country witnessed its lowest unemployment rate of about 3.4% within the last two and a half decades. An interesting thing about this scenario is that during the period, especially at the inception of the democratic dispensation bank credit was government driven hence the effect on unemployment was not noticeable but growth was high. This implies, that the growth then was not an inclusive one but rather driven by government expenditure and oil price that was rising. It is further evident from the figure that as the credit to the private sector surges, unemployment rate started falling gradually. At this point, banks were beginning to reduce loans to government and attention was shifted to the private sectors. This was a product of various entrepreneurship program instituted and supported by the CBN then through the empowerment of the Bank of Industry and other development banks.

In the same year 2007 when the country experienced her lowest unemployment rate in more than two decades, bank credit to the private sector then was 14.84% while bank credit to the government was 4.8%. However, prior to 2009, the economy witnessed a peak in most of the financial development indicators, the market capitalisation was at the highest, the bank credit to the private sector was at the peak and it was realised that at the period, the growth of the Nigerian economy hit the highest rate of 8.04% within the last one decade.

More evidently is the trough of 2016 that is common to all the indicators, the economic growth was falling astronomically until it proceeded to recession during the period. Both bank credit to the private sector and government were at their lowest points within the last one decades. In addition, the stock market indicator was at the lowest point and interestingly the unemployment rate reached the unprecedented highest level. The implication of this situation at this period was the two negative growth rates recorded in both first and second quarters of 2016 when the economy was finally pronounced recessed.

The implication of this result is that positive trends of financial sector development coincided with decreasing trends of unemployment but this failed to coincide with economic growth because it appears the growth of the economy was more oil driven than financial sector development. Again, the review of these indicators indicates that unemployment in Nigeria is more driven by bank credit to the private sector as against credit to the government. The financial system was also shown to be mostly unstable during the period of high unemployment and lowest growth rate. The financial sector of the economy equally showed highest level of stability when the credit to the private sector was impressive.

III METHODOLOGY

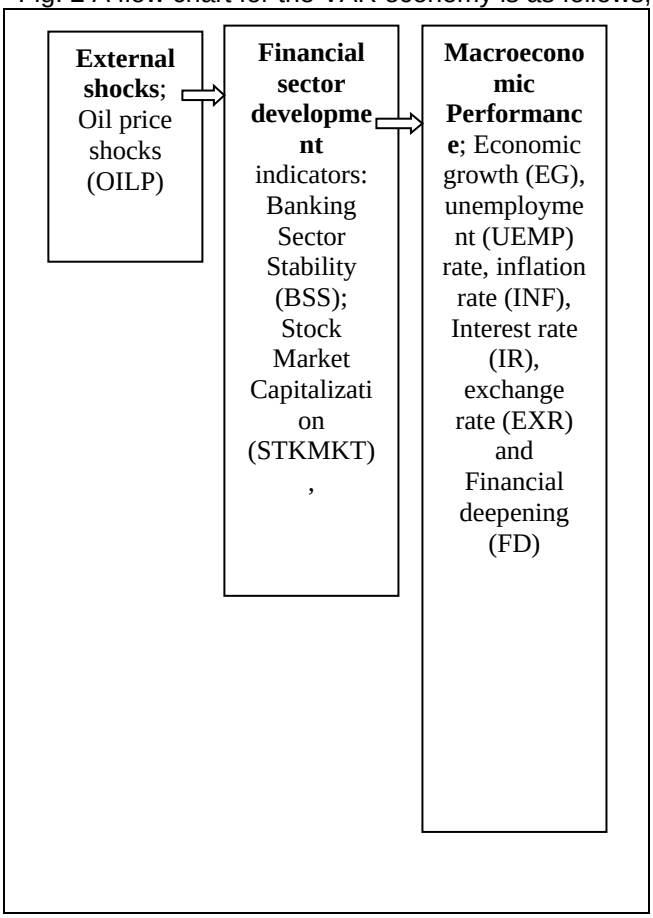
The unrestricted Vector Auto-Regression VAR analysis is utilised to explore these relationships. The VAR offers an avenue to avoid the problem of endogeneity that is very common to most estimating techniques including the linear regression. Both impulse response functions and the variance decomposition analysis of the variables are discussed under this section.

The VAR

The flow chart briefly describes the VAR framework for the Nigerian economy. It shows the arrangement of the interactions among the variables included in the VAR model.

VAR models are seen as independent large scale macro econometric model that do not rely on unrealistic assumptions (Elbourne, 2007). The foremost theoretical framework of VAR analysis as proposed by Sims (1980) used Choleski decomposition to get impulse responses.

Fig. 2 A flow chart for the VAR economy is as follows;



Source: Author's concept, 2020

The construction of our VAR model follows the conventional method where the initial model is specified thus:

$y_t = A_1 y_{t-1} + A_2 y_{t-2} + \dots\dots\dots + A_p y_{t-p} + \mu_t$ .....(1)

Where:

y_t represents an (nx1) vector containing n endogenous variables, A_i*(i=1, 2….p)* are (n x n) matrices coefficients, and μ_t is an (n x 1) vector containing error terms.

Though the error is $\mu_t \sim iid\, N(0, \Omega)$ but errors do possess tendency of correlating contemporaneously in all the equations. There exist pn^2 Parameters in the A matrices**.** Equation 1 can be written in other form with the usage of the lag operator L which is selected through $L^k x_t = x_{t-k}$. the equation becomes:

$A(L)y_t = \mu_t$.....(2)

Where: $A(L) = A_0 L^0 - A_1 L^1 - A_2 L^2 - \dots\dots\dots - A_p L^p$, A_0 = I (identity matrix) it is required that *A(L)* lies outside the unit circle for stationarity to be ensured.

Generalized Impulse Response Function for VAR

The generalized impulse response function refers to the reaction of any dynamic system in response to some external shocks or changes. In a VAR framework, the impulse response function traces out the reaction of the endogenous variable to shocks to each of the other individual variables. To assist this study, the impulse response function will be used to investigate the interaction between oil price and macroeconomic variables in Nigeria. The process through which the external shocks transmit in the economy will be the focus in our context and the cumulative impulse response function to help in the interpretation of the overall effects of shock upon dependent variable in a given period.

According to Stock and Watson (2001) the analysis of the impulse response function traced out the effects of a one-unit shock to a variable's error term on the dependent variables that made up the VAR model. Wouter (2011) identifies three types of structural shocks as; productivity shock, preference shock and monetary policy shock. According to his definition, "the impulse response function gives the J^{th}-period response when the system is shocked by a one-standard-deviation shock through a sequence of shock and alternative series of shocks". Impulse response function can be analyzed in different ways but this study follows the multivariate extension of factorization technique of the Cholesky Orthogonalisation approach as it is consistent with previous studies of Cheng (2006) that are related to this study.

Variance Decomposition for VAR

This is another application of multivariate time series analysis that will be used in the interpretation of VAR and is known as Forecast Error Variance Decomposition (FEVD). It explains how each variable contributes to other variables in a regression model by determining the rate at which the forecast error variance of each variable is explained by the exogenous shocks to other variables and further considers the portion of the observed variation that is attributed to the orthogonalised shock in a variable. According to Stock and Watson (2001) the variance decomposition explains the fraction of the observed variable that can either be ascribed to those variables being affected by shock or that of another endogenous variable. The application of this analysis will assist in analysing the behaviour macroeconomic variables in Nigeria to oil price shocks.

IV RESULTS AND DISCUSSION

This aspect discusses the empirical; results and interpret the results to engender main findings of the study for inferential purposes.

Impulse Response Functions IRF

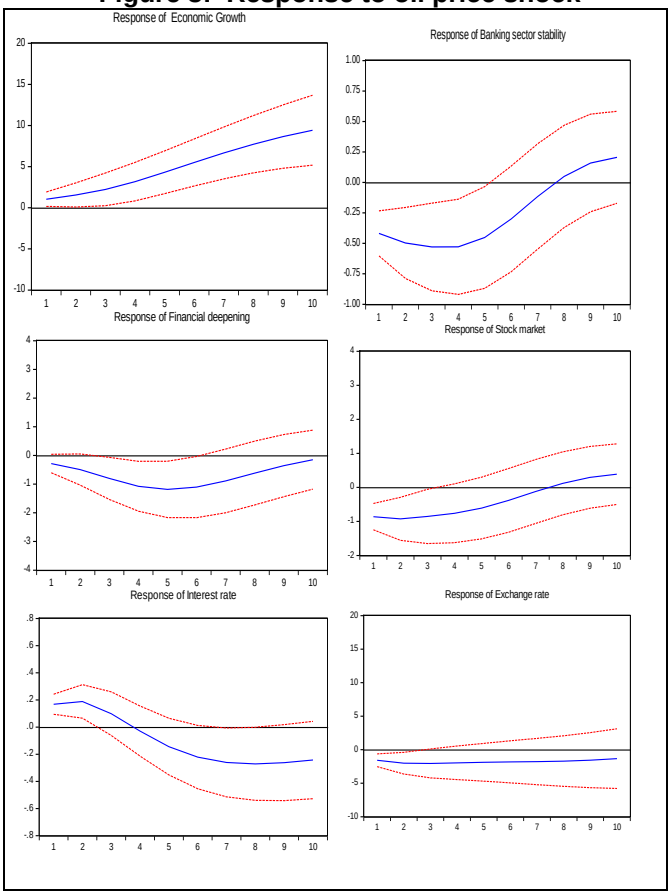
The impulse response function IRF explains the responses of major indicators to some important shocks of interest in the VAR model. The shocks represent one percent standard deviation of the variables or 1% innovation of the variable.

Impulse Response of Oil Price Shocks

Oil was identified from the literature as exogenous variable in the VAR model described for Nigeria. The reason behind this is the fact that Nigeria is an oil dependent economy. Oil price is not controlled by

Nigeria but internationally fixed. Hence, Nigeria is highly vulnerable to oil price movements. The impulse response of oil price is shown in the figure 3.

Figure 3: Response to oil price shock

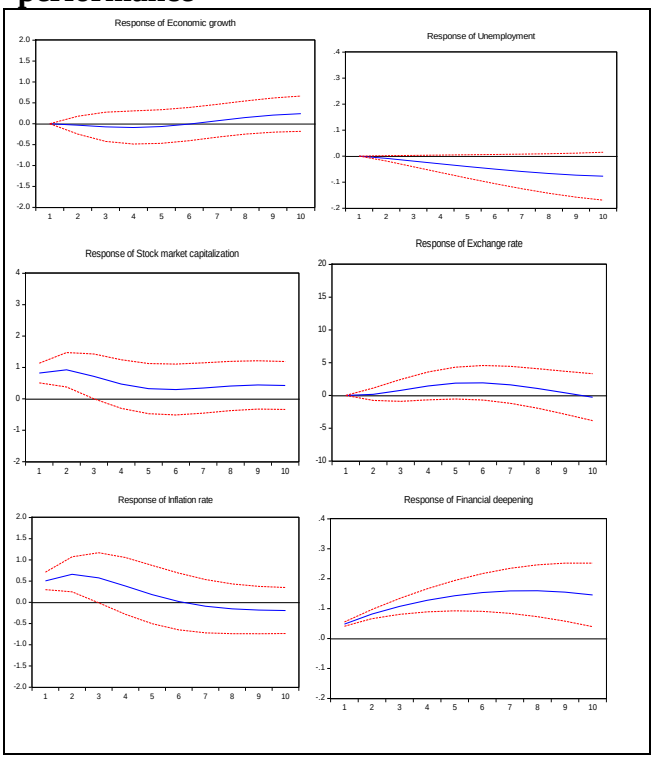


Source: Author's Computation

Figure 3 describes the dominance of oil price in the Nigerian economy. The figure indicates that almost all the key variables used respond significantly to oil price shocks. For instance, it is evident form the diagram that whenever there is a one percent positive standard deviation in oil price, the Nigerian economic growth increases significantly. This result further underscores the important role played by oil in the Nigerian economy. This positive response is also extended to the financial development indicators used in the VAR model. The banking sector stability also responds significantly and sharply to oil price shocks. This implies that the financial sector development proxy by the stability of the entire banking system in Nigeria responds significantly to oil price shocks as well. The second variable used to represent financial sector development is the stock market capitalization. In the same vein, the result indicates that stock market performance responds positively and significantly to oil price shocks. This is evident form the result that both banking sector and stock market performances which are used to proxy financial sector development in Nigeria both respond significantly to oil price movements in Nigeria.

However, variables that are used to proxy macroeconomic performance of Nigeria are also shown to respond significantly to the shock from oil price. For instance, it causes financial deepening (ratio of money supply to the GDP) to respond significantly as well as exchange rate and interest rate. It should be noted that the oil price shocks caused the exchange rate to fall which means that the Naira appreciates whenever there is oil price shocks. The implication of this is that there is presence of "Dutch Disease" in Nigeria. This scenario shows that value of naira is mainly determined by oil price fluctuations, which is an indication that Nigerian economy is not broad-based. Appreciation in naira is not dependent on the performance of the real sector of the Nigerian economy but oil price fluctuations.

Fig. 4 Impulse response of banking sector performance

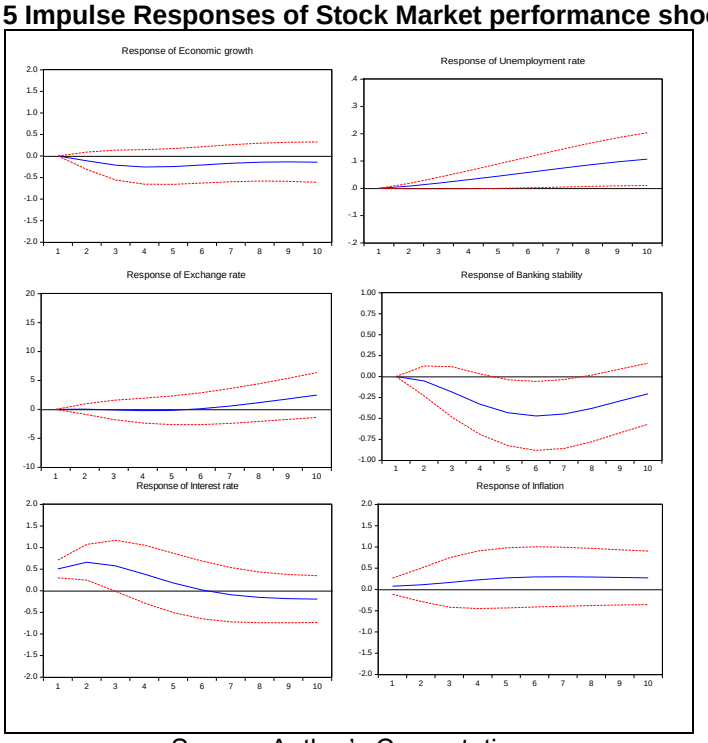


Source: Author's computation

The responses of the macroeconomic variables to financial sector development in Nigeria is shown in figure 4. The result indicates that some important macroeconomic variables failed to respond significantly to the financial sector development shock as proxy by banking sector stability. Of great importance among them is the economic growth. Economic growth showed no significant response to the shock from banking sector stability. In addition both unemployment rate and exchange rate fail to respond significantly to the shock as well. The implication of this result is that the financial sector development in Nigeria might not affect the economic growth of Nigeria significantly. The financial development in Nigeria has not been able to influence the Nigerian's rising unemployment rate. However, money supply and inflation rate respond significantly to the shock. This is evident from the inflation rate targeting policy of the CBN which prioritizes stemming the tide of rising inflation rate. Notwithstanding, it appears that control of inflation by the CBN has not contributed significantly to the growth of the economy.

In the same vein, the stock market performance has been shown as well to be greatly influenced by the shocks from the banking sector. This is an indication that the two variables used to proxy financial sector development influence themselves significantly. However, important revelation from this result is that the financial sector development in Nigeria does not motivate economic growth.

Fig. 5 Impulse Responses of Stock Market performance shocks



Source: Author's Computation

The results in figure 5 are an indication that the results under the banking stability shocks is repeated under the stock market shocks. The results show that Nigeria economic growth does not respond significantly to the shocks form the stock market. The same result goes for unemployment rate, exchange rate and inflation rate. The implication is that the current level of development in the Nigerian capital market has no significant influence on the macroeconomic performance of Nigeria. Notwithstanding, banking sector performance responds significantly to the shock from the stock market. The same result goes for the interest rate but this has not translated to improved macroeconomic performance of Nigeria.

Variance decomposition of variables

The variance decomposition explains the contribution of different shocks in the VAR model to the behavior of all the variables in the system. The importance of the variance decomposition is that it explains the roles of each of the variables in the behaviors of one another.

Table 1: Variance decomposition of Nigerian economic growth.

Periods	OILP	EG	UEMP	EXR	FD	BSS	STMK	INF	IR
3	2.318806	92.79144	1.254846	1.047303	0.936331	0.105701	0.203562	1.141247	0.200760
6	10.70101	68.88437	7.086297	6.395757	0.724851	0.341084	0.486446	2.200295	3.179887
9	17.15169	43.49394	9.517781	15.57543	1.522246	0.530355	3.756944	1.558814	6.892797
12	19.59030	26.92671	6.768519	21.55831	4.097646	0.406070	11.57412	2.276025	6.802294

The results from table 1 further underscores the importance of oil in the economic growth of Nigeria. The results show that the variables that contribute the largest shock to the behavior of Nigeria economic growth is oil price. This is followed by exchange rate, thus it implies that apart from the own shocks, the variables that influence the behavior of Nigeria economic growth most in the VAR model for the Nigeria economy are oil price and exchange rate. However, the financial development proxy by the banking sector and stock market performance indicators do not contribute significantly to the behavior of Nigerian economic growth.

Periods	OILP	EG	UEMP	EXR	FD	BSS	STMK	INF	IR
3	4.404605	1.825065	87.92349	0.827676	0.013601	1.821156	1.972077	0.016080	1.196249
6	2.110194	6.384675	76.27575	3.363137	0.513963	5.021056	0.839005	0.049555	5.442669
9	0.955128	11.53766	62.86557	4.785259	2.027490	7.481875	0.471681	0.372460	9.502878
12	0.905373	16.39382	50.90772	5.034784	4.128472	8.983065	0.442396	0.969724	12.23465

Results on table 2 explains the variance decomposition of unemployment rate as a macroeconomic performance indicator in Nigeria. It is evident from the variance decomposition that only the economic growth of the country contributes much to the behavior of unemployment rate in Nigeria. The key variables of financial development namely the banking and stock market performances fail to influence unemployment rate behavior significantly. Other macroeconomic variables that have relative or moderate effect on unemployment are interest rate and exchange rate. This result further shows that the financial sector development in Nigeria during the years under review that is from 1995 to 2018 has not influenced unemployment rate in Nigeria positively and significantly.

Periods	OILP	EG	UEMP	EXR	FD	BSS	STMK	INF	IR
3	22.98564	2.714719	1.845262	15.60949	8.074070	42.47443	1.205052	2.049586	3.041749
6	24.55214	3.525516	2.024785	9.804999	5.400710	27.94282	10.66279	4.264288	11.82196
9	21.53442	3.047367	1.764983	8.594371	4.840711	25.95873	16.08589	4.221915	13.95162
12	21.59710	2.883692	1.672998	8.082026	4.514168	27.10688	15.98776	3.935443	14.21994

The leading variables that dictate the behavior of the banking sector stability in Nigeria are oil price, interest rate and stock market. The result is consistent with what was obtained under the impulse response analysis where it was establish that the two indicators of financial sector development, that is, stock market and banking sector performances affect themselves symbiotically. However, the greatest determinant of the behavior of the banking sector stability in Nigeria is oil price. This result further underscores the importance of oil in dictating the pace of major macroeconomic framework of Nigeria. Interest rate, which is an important monetary policy instrument, is also shown to be an important variable that influences the behavior of the banking sector in Nigeria.

Periods	OILP	EG	UEMP	EXR	FD	BSS	STMK	INF	IR
3	16.00177	2.287223	0.024087	2.762433	3.284590	12.67619	48.88930	0.017727	14.05668
6	14.32646	11.14937	2.264758	4.187134	7.339092	16.69279	33.65774	0.085705	10.29695
9	11.93224	12.62183	8.174640	3.737617	6.817427	15.36385	30.66930	0.755005	9.928086
12	11.45256	11.06370	12.31000	5.288605	5.787907	13.20229	29.42365	1.981385	9.489903

The major determinants of the behavior of the stock market as shown from table 4 are oil price, banking sector performance and interest rate. The implication of the result is that oil price continues to dominate the behavior of the financial sector development in Nigeria as shown by its influence again on the stock market performance. Share prices have to do with interest rate hence the significant influence of interest rate on the behavior of stock market in Nigeria is also understandable. The symbiotic influence between the banking and stock market performance in Nigeria also remain germane to financial sector development in Nigeria.

Major findings worthy of noting

1. Financial sector development in Nigeria is highly vulnerable to external shocks especially oil price movement. This is due to the fact that the country is highly oil dependent and oil contributes more than 75% of the foreign exchange earnings. The earnings are managed by the Central Bank and used to influence the financial sector performances.
2. Financial sector development in Nigeria failed to influence significantly key macroeconomic variables in Nigeria such as economic growth and unemployment rate during the period under review. Both performances of the banking sector and stock market failed to contribute meaningful impact to the Nigerian economic growth.
3. Macroeconomic variables that are mostly responsive to financial sector development in Nigeria are inflation rate and financial deepening (money supply/GDP). This is because of the inflation targeting policy of the CBN, which has consistently been leading to contractionary monetary policy in a bid to stem the tide of rising inflation. Ironically, the rising interest rate which is to curtail inflation has been very harsh to the Nigerian investment climate.
4. Credit to the private sector corresponds to reduction in unemployment rate unlike the credit to the Government. The analysis revealed that credit to the private sector leads to more job creation than credit to the government. However, substantial part of bank credit in Nigeria over the years has been to the Government.

V CONCLUSIONS

It can be concluded from the study that the development in the financial sector of Nigeria has failed to influence macroeconomics performance of the country positively within the last three decades. Various banking and capital market reforms embarked upon during this period have shown no significant influence on the macroeconomic performance of Nigeria. This is evident from the fact that Nigerian economic growth is more dependent on external perturbations like oil price shocks. However, the financial sector in Nigeria that could have assisted in the diversification of the economy by providing funds for the tradable or the real sector of the economy so that it can be less dependent on oil has not been able to perform this function effectively.

Different policies of CBN in the past which usually dictate the pace and direction of the financial sector development have been counter-productive in influencing the macroeconomic performance of the country positively. For instance, the CBN appears to be tackling inflation from a monetary perspective alone by raising the monetary tightening (increasing interest rate). Evidence from this research shows that monetary authorities' obsession with interest rates as a tool for fighting inflation may be misleading because it presupposes that inflation is on the whole a monetary phenomenon. This study, however, reveals that the response of macroeconomic variables to certain shocks suggests that inflation in Nigeria may be driven by structural rigidities. Hence, financial sector development in Nigeria should have been the one that encourages investment rather than the one discouraging investment via excessive interest rate. In South Africa and some developing countries in Africa, their monetary policy rate is less than 6% while Nigeria that needs diversification via promotion of investment through the real sector of the economy currently has monetary policy rate of 13.5%.

Finally, findings in this study have further shown the prevalence of Dutch Disease in Nigeria and it is an important factor preventing the financial sector development in the country from influencing positively Nigeria macroeconomic performance. This is evident in the effects of oil price shocks on output and exchange rate. The implication of this on the tradable sector of the oil producing country like Nigeria is that it affects the domestic factors prices and thus squeezing out the tradable sector. This portends more negative effects on their macroeconomic performances. However, literatures have shown that these implications are more severe on the tradable sector that is less capital intensive. Unfortunately, this is characteristic of the Nigeria tradable sector. It is again imperative that the kind of financial sector development needed in Nigeria is the one that will aid diversification by reducing the cost of capital and promote investment in the tradable and non-tradable sectors of the economy. This will go a long way to limit the dependence of the economy on oil sector that has continued to perturb the economy incessantly and thus makes Nigerian financial sector development sterile in contributing positively to the macroeconomic performance of the country.

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