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IMPACT OF FINANCIAL INTERMEDIATION ON ECONOMIC GROWTH IN NIGERIA

JIMOH, ABDULRAZAQ TAIYE

Department of Finance, Faculty of Management Sciences, University of Ilorin, Ilorin, Nigeria. Tel.: +2348064363986 Email: jimadeyemi2006@yahoo.com

ABDULMUMIN, BILIQUEES AYOOLA

Department of Finance, Faculty of Management Sciences, University of Ilorin, Ilorin, Nigeria. Tel.: +2348063092997 Email: bilbash62@gmail.com

&

SANNI, IBRAHIM

Department of Accountancy Federal Polytechnic Offa, Kwara State, Nigeria. Tel.: +23435638537 Email: sanniibrahim007@yahoo.com

Abstract

Financial intermediation underscores the catalytic role of banks in economic growth and development of any nation. This is because financial intermediaries such as banks arise to alleviate market frictions like transaction costs, uncertainty about project outcomes and information asymmetries in their effort to mobilise funds and channel same to the most productive unit of the economy. However, the question of whether it is the size/volume or efficiency of financial intermediation that matters for the growth of developing economies like Nigeria, calls for empirical investigation. This study therefore assessed the impact of financial intermediation on economic growth of Nigeria. Data were obtained from CBN statistical bulletin and analyzed using ordinary least square (OLS) regression technique. The study found that all the intermediation variables except credit to private sector and reserve money positively and significantly related to GDP at 5% level of significance. It was concluded that both the size and efficiency of financial intermediation are necessary for the growth of Nigerian economy. The study recommends that deposit money banks in Nigeria should improve their monitoring of private sector credits for effective utilization; and that CBN should pursue monetary policy measures that will further the depth of the banking sector so as to allow more financial inclusion, foster healthy competition within the industry and ensure efficient intermediation.

Keywords: Banking, Financial, Intermediation, Growth, Nigeria

evolved to intermediate between the savers and borrowers such that some of these costs are reduced if not eliminated. What then is financial intermediation? According to Chukwu and Agu (2009), financial intermediation is a function of financial system that deals with mobilising savings from the surplus sector of the economy and promoting investment by granting massive credits to the deficit sector of the economy. Supporting this view, Abdulisalam and Ibrahim (2013) define financial intermediation as the process through which financial institutions, especially banks, transfer financial resources from surplus unit of the economy to the deficit ones. For the purpose of this study, financial intermediation is defined as the mobilisation of funds from savers and channelling the funds mobilised to the productive sector of the economy in an efficient manner that promote economic growth.

The role of financial intermediaries particularly banks in promoting economic growth has been extensively discussed in different economic literature. In fact, it has been argued that financial intermediation affects economic growth positively by acting on the saving rate or on the fraction of saving channelled to investment (Pagano, 1993). The overall economic effect is that financial intermediation leads to better aggregation of savings and therefore helps in capital formation and investment in the economy (Nwaeze et al 2014).

The contribution of intermediation function of financial intermediaries (banks in particular) can be much more appreciated under two aspects namely, the size/volume of intermediation and efficiency of intermediation. Studies have established some links between the volume of intermediation, and economic growth and in fact measured financial or banking sector development in relation to the size/volume of intermediation. An increased intermediation volume tends to increase real savings which in turn lead to higher economic growth, all other things being equal (Kabir & Hoque, 2007). Efficiency is another aspect that should be given adequate attention in the process of intermediation. This is because inefficient allocation of credit, according to Kabir and Hoque (2007) usually reflects wide margin in lending rates, lack of competition in the banking industry which are ultimately detrimental to the long run economic growth. An efficient banking sector is expected to function in a least-cost manner so as not to transfer high cost unto the economic agents (Clokun, Abor, Adjasi & Andoh, 2013). It may therefore be said that an efficient financial intermediation will exert a positive impact on economy.

Economic Growth: Meaning and Measurement

Improving the welfare of the citizenry is a major goal of economic growth, and this is the main reason why economic literature dwell more on factors that affect expansion of national economies. Economic growth has been defined as an increase in real national income, gross domestic product and real income per capital (Athenia & Alfred, 2014). It seems there is a consensus in literature as to the

Introduction

Banking sector, a major component of many financial systems, plays an important role in the growth of nations' economies. The importance of this sector is underscored by the intermediation function of banks which ensures efficient and effective allocation of resources for economic growth and development. In fact, it has been argued within the context of finance-growth nexus that financial intermediaries particularly banks mobilise savings, evaluate projects, manage risks, facilitate transactions and thus contribute to the growth of the economy (Kings & Levine, 1993). With financial intermediation, banks facilitate growth via reduction in transaction cost, information access cost as well as cost of financing investment and thus induce more investment. It may therefore be right to agree with economic literature that banking sector of any economy especially those with bank-based financial system, is a great facilitator of economic growth. For this, studies have been conducted on the role of banks in economic growth via financial intermediation.

One major limitation of most of the studies is their focusing on the size or volume of intermediation. The question here is on whether the size of the Nigerian banking sector matters in economic growth, or whether it is the efficiency of intermediation that determines the growth of Nigerian economy. This is because even if the sector is developed in size and volume of intermediation, inefficiency will normally result in high non-performing facilities, wide lending margins that reflect lack of competition in the banking industry, and if reforms fail to ensure efficient allocation of resources, it may be detrimental to the long-run economic growth. It is against this backdrop that the study is conducted to assess the impact of financial intermediation on economic growth in Nigeria.

This paper is structured in five sections. Literature review follows this section which details the conceptual issues, theoretical discussion and empirical evidence. Methodology employed for the study was discussed in section three. Results of data analysis and findings are spelt out in section four. Section five concludes the study.

Literature Review

Concept of Financial Intermediation: Meaning and Importance

Before the evolution of financial intermediaries, anyone who needs more than he could provide by himself would have to source from outside. This is known as direct or unintermediated finance (Nwaeze, Michael & Nwabakee, 2014). Modern economic and business transactions however become difficult with direct finance due to some inherent problems such as unattractive interest rate, crude and inhumane method of obtaining securities and many more. Financial intermediaries

conceptual definition of economic growth as many scholars have expressed similar opinion on the concept. Nnanna (2004) views economic growth as an increase over time in the net national product and that this growth is determined by availability of natural resources, technological progress, rate of capital formation among others. Building on this, Olutitan (2012) defines economic growth as a steady process that increases the productive capacity of the economy, over time in order to bring about rising levels of national output and income. Nwasee *et al.* (2014) posits that economic growth is a sustained increase in national income or output of a nation. This study therefore adopt the definition of economic growth as given by Nwasee *et al.* (2014) because an economy is said to be growing when there is a steady and sustained increase in the annual output of goods and services.

Economic growth as a microeconomic variable has been measured in different research works with proxies such as nominal GDP, real GDP, per capital income and so on. The GDP itself is the total value of goods and services produced within the country during a year. Thus a growth in GDP is likely to represent economic growth of such country. Real GDP is however preferred in measuring economic growth due its capability of removing any over or underestimation of GDP as may arise in the case of nominal GDP if there is inflation or deflation in the economy (Jhingan, 2011).

Financial Intermediation and Economic growth

Economists and researchers hold different views regarding the importance of financial intermediation for economic growth. It has been argued well-functioning banks spur technological innovation by identifying and funding those entrepreneurs with the best chances of successfully implementing innovative products and production processes. This positive impact of banks was supported by researchers like King and Levine (1993), Levine, Loayza and Beck (2000) and more recent work of Beck (2010) that better functioning financial intermediaries accelerate economic growth and that the level of this intermediation is conducted is a good predictor of future economic growth, capital accumulation and technological change. However it needs to be stressed here that some economists have observed that finance has no impact on growth. Their argument was that the role of intermediation has been overstressed in literature. Levine (1997) stated that the reason for this stand is that many of the foremost development economists failed to recognize finance or financial system as determinant of economic growth. The implication of this is to state the position of theoretical literature on the finance-growth nexus.

In the light of the above conflicting views, many studies have been conducted on the role of financial intermediaries in economic growth; and many of the recent works suggested a positive impact. Demirguc-Kunt and Levine (2008)

conclude that financial intermediaries (particularly banks) and markets matter for markets are positively linked with economic growth. Mahmood (2013) opined that that financial intermediation of banks fosters economic growth.

Financial Intermediation and Economic Growth in Nigeria

For steady increase in productive capacity of a nation towards achieving economic growth as posited by Olutitan (2012), banks, especially commercial ones assist a lot through their intermediation role. However, studies have shown that the banking sector in Nigeria has not been able to sustain efficient and effective process of intermediation especially in the area of credit allocation (Nzotta & Okerke, 2009). Similar report by Kehinde & Adejumo (2011) stated that even though the financial structure had enhanced the level of financial savings and thus affected the level of financial deepening positively, the financial system has not been efficient in resource allocation. They added that the process of intermediation in the system is not efficiently done. With inefficiency in financial intermediation, contribution of banking sector and the entire financial system to economic growth of Nigeria will most likely be affected. To facilitate efficiency of intermediation, series of reforms were adopted. The liberalization of interest rate in August 1987, effectively started banking reforms in Nigeria. It was aimed at enhancing the ability of banks to charge market-based interest which would guarantee efficient resources allocation (Azeze & Oke, 2012). Other reform measures include adoption of universal banking system, recapitalisation and consolidation of banks, establishment of Small Management Company of Nigeria (AMCON) (Olokoyo, 2013), introduction of Small and Medium Industries Equity Investment Scheme (SMIESIS) in 2001, adoption of Microfinance banking model, the cashless policy, among others (Chris & Onyinye, 2015).

The objectives of these reforms according to Soludo (2005), includes taking proactive steps to prevent imminent systemic crisis; creation of a sound banking system that depositors can trust; creation of banks that are investors-friendly and that can finance capital intensive projects; enhancement of transparency, professionalism, good corporate governance and accountability; and driving down the cost of banks. Realizing these objectives tends to promote efficiency of financial intermediation which in turn accelerates growth in the economy. An empirical evidence of this is provided by Ndadume (2014) that the consolidation exercise in the banking sector played a major role in the recent increase in economic growth to the average of 7% since 2006.

Theoretical Discussions

Finance-led Growth Theory

The finance-led growth theory according to King and Levine (1993), was credited to Schumpeter (1911) who argued that finance promotes growth because well-functioning banks successfully implement innovative and funding those entrepreneurs with the best chances of successfully implementing innovative products and production processes. This implies that a well-functioning financial system will supply the financial services needed for productive activities which in turn will generate economic growth. That is, the finance-growth nexus is a supply leading relationship where the financial sector leads economic growth by successfully identifying profitable projects that could be funded.

Linking the theory to this study, financial sector, especially banking sector in Nigeria is expected to facilitate economic growth through its intermediation role as suggested by the finance-led growth hypothesis. This will be so because financial intermediaries in Nigeria, particularly the banks exist to lower the market friction such as the information asymmetry and the resulting high transaction cost which may negatively affect the efficiency of financial intermediation. If the financial intermediaries are efficient in this regard, funds mobilised would be channelled to the most productive investments and resources are efficiently allocated.

Empirical Evidence

Several research works have been conducted both in the developed and developing economies on the finance-growth nexus. Some of these studies were carried out as validation test to the Schumpeter's claim that the services provided by financial intermediaries, most especially banks- mobilizing savings, evaluating projects, managing risk, monitoring managers, and facilitating transactions- are essential for technological innovation and economic growth and development. One of the early research works in this regard is King and Levine (1993) who conducted a cross-country analysis of 80 countries on the finance and growth relationship. With a panel design, the study focused on banks as major financial intermediaries and time series data were collected over the 1960-1989 period on GDP, bank credit to private sector, liquid liabilities of banks, and broad money (M2). The data were analysed using ordinary least square regression approach. The study found that liquid liability to GDP ratio and credit issued to private sector to GDP strongly and robustly correlated with growth, rate of physical capital accumulation and efficiency of capital allocation. That is the financial development indicators in the study are good predictors of future growth. The study therefore concluded that Schumpeter might be right in his theory. In the same vein, Levine *et al* (2000) studied financial intermediation and growth with the objective of ascertaining the influence of

financial intermediary development on economic growth. A panel dataset of 74 countries, covering period 1960-1995 were collected and used for the analysis. Using generalized method-of-moments (GMM) dynamic panel estimators, The result shows that three indicators- credit to private sector as a percentage of GDP, liquid liability as a percentage of GDP and the ratio of commercial bank asset to total bank assets have positive and statistically significant effect on real GDP. The study found that countries with higher level of credit to private sector tend to enjoy faster growth, and this led to the conclusion that a better functioning financial intermediaries exert a causal influence on economic growth.

Regarding developing countries, Dima and Opris (2013) examined the relationship between financial intermediation and economic growth in the developing economies. Data were collected for 28 countries from 2001 to 2010. Domestic credit provided by- banking sector and credit to private sector as percentages of GDP as well as broad money to GDP were used to proxy financial intermediation while GDP is used as a measure of economic growth. Spearman rank-order co-variance analysis was used to test the correlation between the variables and a high degree of correlation was found between the indicators. Testing the impact of financial intermediation on economic growth of these nations, OLS, GLM and Quantile Regression (QR) were applied. The result of the study indicates that financial intermediation influences economic growth as all the three proxies were found to be positive and significant at both 5% and 1% level of significance. However, Kabir and Hoque (2007) found a slightly different result with regards to credit to private sector (CPS) as a measure of financial intermediation. They found a negative effect of CPS on GDP growth in Bangladesh. The study also reported a significant positive impact of reserve money on economic growth while interest rate spread has an insignificant positive effect. More so, the findings of Dima and Opris (2013) cannot be generalised to all the developing economies as some other studies have given contrary reports. Apart from these cross-country studies, there have been numerous country-specific works affirming the finance-led growth hypothesis particularly in the developing economies. Sami, Yusuf and Cheong (2012) investigated the effect of financial sector innovation on economic growth in Malaysia over the period 1986 to 2011. The data for the study were collected from the IMF's international financial statistics. The analyses were conducted using co-integration test, vector autoregression (VAR), impulse response functions and variance decompositions (VDS) analysis. Findings of their study indicate that real output is more affected by the stock market and that the banking sector is not a major source of output variability.

Nwaeze *et al* (2014) investigated the extent to which financial intermediation impacts on economic growth of Nigeria. Ex-post facto design was adopted and time series data for twenty years period, 1992-2011 were collected and analysed using

OLS regression techniques. The result of their study shows that both total bank deposit and total bank credit exert a positive and significant impact on the economic growth of Nigeria which was proxied by real GDP. Emecheta and Ibe (2014) examined bank credit and its impact on economic growth in Nigeria using time series data from 1960 to 2011. Vector autoregressive (VAR) technique was used to analyse the effect of bank credit to private sector as a percentage of GDP and broad money (M2) to GDP ratio on the current GDP. The study finds that a significant positive relationship exists between bank credit to private sector and economic growth. This was in consonance with Nwaeze *et al* (2014). The finding of their study was however, in contrast with the earlier work of Chukwu and Agu (2009) who examined the causality between financial depth and economic growth in Nigeria. Using annual data from 1971 to 2008, Augmented Dickey-Fuller (ADF) test and regression analysis were applied for the data analysis. The results suggested a unidirectional causality between financial depth and economic growth, running from economic growth to financial depth (measured with private sector credit and broad money). From the foregoing, it is clear that studies on financial intermediation and economic growth remain inconclusive. This is due to the conflicting results and findings reported by researchers.

Methodology

This study employed ex-post facto design in obtaining, analyzing and interpreting data relating to the study. Both the dependent variable and independent variables are observed over the period of 1981 to 2014. The population of this study comprises all financial intermediaries in Nigeria such as banks, insurance companies, finance houses, pension funds, deposit money banks in Nigeria constitute the sample of the study. The sample was purposively selected due to the fact that they are the dominant institutions of financial intermediation in Nigeria. The choice of the banks was also informed by the availability of relevant data. Data on variables like real gross domestic product, liquid liability of banks, commercial bank credit to private sector, reserve money of commercial banks, deposit rates, and lending rates were collected from the Central Bank of Nigeria (CBN) statistical bulletin of 2014. Ordinary least regression (OLS) technique was used to analyse the data, after testing for multicollinearity and heteroscedasticity assumptions of the classical linear regression.

Results and Findings

Before conducting the regression two preliminary tests were carried out and their results are presented in the tables below. Table 1 displays the pair-wise correlation values for the independent variables to detect any possibility of perfect linear relationship between the variables before the OLS regression is conducted.

This is because OLS assumes the absence of multicollinearity among the independent variables for there to be a greater level of accuracy in the model estimation. It will be hazardous to apply a regression plagued with multicollinearity for the purpose of forecasting.

Table 1: Multicollinearity Test

	CP2GDP	LL2NGDP	DIR	RM2NGDP	IntSprd
CP2GDP	1.00				
LL2NGDP	0.49	1.00			
DIR	-0.31	-0.45	1.00		
RM2NGDP	0.28	0.38	0.06	1.00	
IntSprd	0.40	0.46	-0.11	0.33	1.00

Source: Author's Computation, 2015

Gujarati (2004) states that if pair-wise correlation coefficient between two regressors is in excess of 0.8, multicollinearity becomes a serious problem. From the above Table 1, it is clear that there is no perfect relationship between different pairs of the independent variables, which implies the absence of multicollinearity.

Table 2: Heteroscedasticity Test: Breusch-Pagan-Godfrey

F-statistic	2.603431	Prob. F(5,27)	0.0479
Obs*R-squared	10.73455	Prob. Chi-Square(5)	0.0569
Scaled explained SS	11.05202	Prob. Chi-Square(5)	0.0504

Source: Author's Computation, 2015

In the above Table 2, result of Breusch-Pagan-Godfrey test is shown to verify the fundamental assumption of homoscedasticity (i.e. error terms have the same variance) as one of the prerequisites for Ordinary Least Square method of regression analysis. If this assumption is violated, OLS result will be misleading and erroneous conclusion will be drawn. It is shown in the Table that F-statistic is statistically significant at 10%, which implies that there is absence of heteroscedasticity.

Table 3: Impact of Financial Intermediation of Economic Growth

GDPG	Coefficient	Std. Error	t-Statistics	Prob.
Constant	0.493762	2.827963	0.174600	0.8627
CP2GDP	-0.337787	0.198394	-1.702611	0.1001
LL2NGDP	0.529040	0.188522	2.806260	0.0092
DIR	0.286643	0.140463	2.040702	0.0512
RM2NGDP	-0.875907	0.394327	-2.221269	0.0349
IntSprd	0.229332	0.117784	1.947048	0.0620
R-Squared	0.648245			
Adjusted R ²	0.598660			
DW stat	2.191095			
F-statistic	9.725391			
Prob(F-statistic)	0.000087			

Source: Author's Computation, 2015

Table 3 presents the results of the model estimated to evaluate the impact of financial intermediation on economic growth in Nigeria. The Durbin-Watson stat of 2.19 indicates the absence of autocorrelation. This means that contemporary GDP growth rate is not influenced by its recent past and this is in fulfilment of fundamental assumption of classical linear regression. According to Table 4, there is a positive and significant relationship between the growth of gross domestic product (GDPG) and the quotient of liquid liabilities to nominal GDP (LL2NGDP) as supported by t-statistic of 2.81 and p-value of 0.0092. This implies that on the average, an increase of 1% in LL2NGDP would induce a rise of 0.53% in GDP growth. On the contrary the coefficient of credit to private sector divided by gross domestic product (CP2GDP) is negative and not statistically significant given a calculated p-value of 10% and t-statistic of -1.70. Although the ratio of liquid liability to GDP is significantly and positively related to GDP growth indicating the ability of banks to impact on GDP through their lending, credit to private sector as a percentage of GDP which is a more appropriate indicator of the volume intermediation through banks, is found not to be significant. This led to the acceptance of the hypothesis one that financial intermediation size has no significant influence on economic growth.

Similarly, GDP growth is significantly positively related to nominal deposit rate (DIR) such that an increase of 1% in DIR would bring about a surge of 0.27% in GDP growth. The significance of DIR coefficient (0.28) is affirmed by t-statistic of

2.04 and calculated p-value of 0.051. In the same vein, GDP growth has a significant direct association with interest rate spread (IntSprd). This indicates in partial terms that a rise of 0.23% in GDP growth is possible if interest rate spread increases by 1% given the significance level of 5%. Thus, hypothesis two was rejected as the study found that interest rate spread has significant effect on the growth of GDP. The coefficient of reserved money to GDP (RM2NGDP) shows a significant inverse correlation with GDP growth meaning that an increase of 1% in RM2NGDP would cause the GDPG to plummet by 0.87% all other things being equal. This is buttressed by t-statistic of 0.39 and calculated p-value of 0.035. The implication of this is that reserve money which comprises the currency in circulation (M0) plus required and excess reserves of banks has significant negative impact on the growth of the Nigerian economy. That is the more the reserve money, the lesser the ability of banks in performing their intermediation efficiently. In terms of goodness of fit of the model, an R-squared value of 0.65 suggests that 65% variations in GDP growth were explained by joint systematic variations in financial intermediation variables. Overall, with the F-statistic of 9.73, we would be inclined to accept the alternative hypothesis that all the financial intermediation variables are jointly significant in explaining significant impact on economic growth in Nigeria.

Results of the analysis show that liquid liability of commercial banks as a percentage of GDP has positive and significant influence on the growth of GDP. This implies that the ability of banks to mobilise more funds for productive use exerts positive impact on economic growth in Nigeria. The finding is in support of King and Levine (1993), Levine et al (2000), and Abdulsalam and Ibrahim (2013). The second independent variable, bank credit to private sector was found to be negative but statistically insignificant meaning that bank credit to private sector does not have positive influence on the growth of Nigerian economy. This was in conflict with Emecheta and Ibe (2014), and Dima and Opris (2013) who found that private credit has significantly positive impact on economic growth. The finding of this study is however in line with Kabir and Hoque (2007) that credit to private sector exerted negative effect on GDP. The result was also in consonance with Abdulsalam and Ibrahim (2013) who found a negative and significant effect of credit to private sector on economic growth in Nigeria.

The study also revealed that increase in nominal deposit rate of interest tends to bring about increase in the level of growth, all other things being equal. This is because more funds will be mobilised for productive investments as relationship between interest rate spread (spread) and GDP growth indicates inefficiency as well as less competition within the banking industry. In an efficient system, reduction in spread should result in efficiency of intermediation which brings about economic growth. The finding is also in partial support of Kabir and

Hoque (2007) who found that interest rate spread has positive but insignificant influence on the growth of GDP. On the impact of reserve money of banks on the growth of Nigerian economy, result depicted a significant inverse relationship. The implication is that banks may not be able to perform their intermediation role efficiently when large portion of their funds are in reserves. That is, an increase in reserve money implies fewer funds available for productive investment that will result in economic growth. This was however not consistent with Kabir and Hoque (2007) which reported a positive and significant relationship between reserve money and GDP growth.

Conclusion and Recommendations

Available statistics have shown that banks promote economic growth via financial intermediation process. For effective policy recommendations, the study deemed it fit to examine financial intermediation in terms of both the size and efficiency and its impact on economic growth in Nigeria. Findings of this study led to a conclusion that for the banking sector to accelerate economic growth in Nigeria; there is the need to develop the sector not only in terms of size or volume of financial intermediation but also in the efficiency of the process.

Based on the findings of the study and the conclusion drawn, it is recommended that deposit money banks in Nigeria improve their monitoring of private sector borrowers to ensure effective utilisation of loans. Banks are also enjoined to improve on their marketing strategies to boost their deposits base. Finally, the CBN should pursue monetary policy measures that will further the depth of the banking sector so as to allow for more financial inclusion, foster healthy competition within the industry and ensure efficient intermediation.

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