

Financial Market, Monetary Policy and Economic Growth: Evidence from Nigeria

Okolie, Jonathan Ibekwe

Business Administration Department
Enugu State University of Science and Technology
Enugu State - Nigeria

Okolie, David Ogomegbunam

Accountancy Department
Renaissance University
Ugbawka – Enugue State

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Abstract

This study examined the impact of financial market and monetary policy on the Nigerian economy since Nigeria introduced democratic rule in 2001 to 2020. Financial market was proxied by total market capitalization, while monetary policy was proxied by money supply, and interest rate the moderator variable. The ADF unit root was adopted to test the level of stationarity of the variables, and all the variables attained stationarity either at first difference or at second difference. The study adopted the regression analysis as the data analysis method. Findings from the study revealed that: Market capitalization, a proxy for financial market had positive and significant impact on Gross Domestic Product, a proxy for the Nigerian economy, Money supply, a proxy for monetary policy had positive and significant impact on Gross Domestic Product, a proxy for the Nigerian economy and Interest rate, a moderator variable had a positive but not significant impact on Gross Domestic Product, a proxy for the Nigerian economy. The study therefore recommends that: Government should restore confidence in the financial market by showing true commitment and sincerity of purpose in the capital market probe, there is need for a diversified investment instruments in the capital market whereby debt and derivative instruments will assume as much prominence as ownership instruments and Government should do everything possible to provide a safe and conducive investment climate by nipping in the bud, the prevalent activities of terrorist and kidnappers. This will not only encourage the Nigerian investors, but also attract foreign investors into the Nigerian capital market.

Keywords: Financial: Market: Monetary: Policy: Economic: Growth

1. INTRODUCTION

The financial market is a marketplace where buyers and sellers participate in the trade of assets such as equities, bonds, currencies, and derivatives. Financial markets are typically defined by having transparent pricing, basic regulations on trading, costs and fees and market forces determining the prices of securities that trade. The financial market is essentially divided into money and capital markets. In the last two decades, studies on the capital market have received considerable attention from contemporary finance and economic literature resulting from its role in the provision of long-term, non debt financial capital which enables companies to avoid over-reliance on debt financing, thus improving corporate debt-to-equity ratio and also in the mobilization of resources for national growth (Chigbu, 2014).

According to Onwe (2013), the financial market is created to move funds from surplus economic units to deficit economic units in order to produce goods and services and to make investment in new equipment and facilities so as to facilitate the growth of the economy and improve the standard of living of its citizens. It is generally recognized that financial market plays a catalytic role in the process of economic growth and development. The financial system of any nation is a function of the size of its economy. A growing economy places more responsibilities on the financial sector to mobilize the needed capital to facilitate production, generate employment and income. An economy that does not experience growth on sustained basis is likely to have a very passive financial sector as there are no incentives for investment. Through the process of growth, financial market offers a wide range of portfolio options for savers and issuable instruments for investors, a function often referred to as financial intermediation (Oke, 1989).

Chigbu (2014) posits that there has been a growing concern on the role of capital market in economic growth and thus the capital market has been the focus of economic policies and policy makers because of the perceived benefits it provides for the economy. The capital market provides the fulcrum for stock market activities and it is often cited as a barometer of business direction. An active capital market may be relied upon to measure changes in the general level of economic activities (Obadan, 1998).

However, Ogbole (2010) argued that the Nigerian economy has been plagued with several challenges over the years. In spite of many, and frequently changing, monetary and other macro-economic policies, Nigeria has not been able to harness her economic potentials for rapid economic development. Monetary policy as the name implies is one of the major economic stabilization weapons which involve measures designed to regulate and could control the volume, cost, availability and direction of money and credit in an economy to achieve some specific macro-economic policy objective. It is a deliberate attempt by the monetary authority (Central Bank) to control the money supply and credit condition for the purpose of achieving certain broad economic objective. It is also the control of money and Bank credit thereby regulating cost of credit such a way it will affect aggregate demand in a direction that would continue to the achievement of healthy balance of payment, price stability and job opportunity (Anyawu, 1993)

Consequently, this study is an attempt to examine the impact of the capital aspect of the financial market and monetary policy on the Nigerian economy.

Statement of the Problem

Despite the popular belief that democracy promotes economic activities which in turn engenders economic growth, the growth of the capital market in Nigeria is still very small in relation to the size of the economy. CBN (2007) has it that a comparative analysis of equity market capitalization of the Nigerian capital market with some countries in North and South America, Asia, Europe and Africa shows that the Nigerian market is relatively very small. Worse still are the attendant ugly consequences of the capital market meltdown, characterized by the crash of the market capitalization from a high record of N13.5 trillion in early 2008 to less than N4.5 trillion in the corresponding period of 2009.

This development necessitated an investigation by the House of Representatives, through its committee on Nigerian capital market, of the circumstances surrounding the 2009 crash of the Nigerian capital market, and this investigation is otherwise known as the capital market probes. However, given these scenarios, one begins to wonder if the Nigerian capital market has really fared well in terms of its impact on the growth of the Nigerian economy since the return to civilian administration in Nigeria. Suffice it to re-state here that no past study focused on this very important period (beginning from 1999), which this study covers. What is seen in other related works is a combination, in varying degrees, of periods of military and civilian rule.

Objectives of the Study

The main objective of the study is to examine the impact of the financial market and monetary policy on the Nigerian economy. However, the specific objectives are:

1. To determine the impact of Market Capitalization on the Nigerian economy.
2. To analyze the impact of money supply on the Nigerian economy.
3. To assess the impact of interest rate on the Nigerian economy.

2. REVIEW OF RELATED LITERATURE

According to Levine and Zervos (1998) the capital market is expected to encourage savings by providing individuals with an additional financial instrument that may better meet their risk preferences and liquidity needs. Better savings mobilization may increase the savings rate. Capital markets also provide an avenue for growing companies to raise capital at lower cost. In addition, companies in countries with developed stock markets are less dependent on bank financing, which can reduce the risk of a credit crunch. Stock markets therefore are able to positively influence economic growth through encouraging savings amongst individuals and providing avenues for firm financing.

Kumar (1984) notes that the capital market contributes to economic growth through the specific services it performs either directly or indirectly. Notable among the functions of the stock market are mobilization of savings, creation of liquidity, risk diversification, improved dissemination and acquisition of information, and enhanced incentive for corporate control. Improving the efficiency and effectiveness of these functions, through prompt delivery of their services can augment the rate of economic growth. At any stage of a nation's development, both the

government and the private sectors would require long-term capital which is provided by a well functioning stock market.

Sule and Momoh (2009) specifying the channels for growth through the capital market opine that it provides opportunities for companies to borrow funds needed for long-term investment purposes. It also provides avenue for the marketing of shares and other securities in order to raise fresh funds for expansion of operations leading to increase in output/production. It creates a means of allocating the nations real and financial resources between various industries and companies. Sule and Momoh (2009) argues further that through the capital formation and allocation mechanism the capital market ensures an efficient and effective distribution of the scarce resources for the optimal benefit to the economy and it reduces the over reliance of the corporate sector on short term financing for long term projects and also provides opportunities for government to finance projects aimed at providing essential amenities for socioeconomic development.

Obstfeld (1994) notes that the capital market may also affect economic activities through the creation of liquidity. Liquid equity market makes available savings for profitable investment that requires long-term commitment of capital. Without liquid capital market there would be no industrial revolution. This is because savers would be less willing to invest in large, long-term projects that characterized the early phase of industrial revolution. Closely related to liquidity is the function of risk diversification. Stock markets can affect economic growth when they are internationally integrated. This enables greater economic risk sharing. Because high return projects also tend to be comparatively risky, stock markets that facilitate risk diversification encourages a shift to higher-return projects and the resultant effect is a boost in the economy leading to growth through the shifting of society's savings to higher-return investments.

According to Filler et al. (1999) the nature and economic significance of the relationship between capital market development and growth vary according to country's level of economic development with a larger impact in less developed economies. The proponents of positive relationships between stock market development and economic growth base their argument on the fact that the stock market aids economic growth and development through the mobilization and allocation of savings, risk diversification, liquidity creating ability and corporate governance improvement among others.

Using the liquidity argument, Bencivenga et al. (1996) reasoned that the level of economic activities is affected by the capital market through its liquidity creating ability. The logic of this reasoning is that profitable investment requires long-term capital commitment; often investors are not willing or are reluctant to trade their savings for a long gestation period. With liquid equity markets, risks associated with investment are reduced, making it more attractive to investors. Thus, the easy transfer of capital ownership facilitates firms' permanent access to capital raised through equity issues. Therefore, as liquid market improves the allocation of capital, the prospect for long-term economic growth is enhanced. Also, savings and investment are increased due to reduction in the riskiness of investment facilitated by stock market liquidity.

However, an alternative view on capital market and long term economic growth by Demirgüç-Kunt and Levine (1996) observed that there are some channels through which liquidity can deter growth: Firstly, savings rate may be reduced, this happens when there is increasing returns on investment through income and substitution effect. As savings rate falls and with the existence of externality attached to capital accumulation, greater stock market liquidity could slow down economic growth. Secondly, reducing uncertainty associated with investment may impact on savings rate, but the extent and the direction remain ambiguous. This is because it is a function of the degree of risk-averseness of economic agents. Thirdly, effective corporate governance often touted as an advantage of liquidity of stock market may be adversely affected. The ease with which equity can be disposed off may weaken investors' commitment and serves as a disincentive to corporate control and vigilance on the part of investors thereby negating their role of monitoring firm's performance. This often culminates in stalling economic growth.

Rouseau and Wachtel (2000) advanced four reasons for the importance of capital market on financial institutions even when equity issuance is a relatively minor source of funds. First, an equity market provides investors and entrepreneurs with a potential exit mechanism. According to them, venture capital investments will be more attractive in countries where an equity market exists than one without an adequately functioning public equity market. Secondly, capital inflows and Portfolio flows tend to be larger to countries with organized and liquid markets. Thus, the existence of equity markets facilitates capital inflow and the ability to finance current account deficits. Thirdly, the provision of liquidity through organized exchanges encourages both international and domestic investors to transfer their surpluses from short term assets to the long-term capital market, where the funds can provide access to permanent capital for firms to finance large, indivisible projects that enjoy substantive scale economies. Thus, given this scenario the importance of domestic resource mobilization cannot be underestimated. Finally, the existence of a stock market provides important information that improves the efficiency of financial intermediation generally.

Atje and Jovanovic (1993) present a cross country study of capital market and economic growth over the period 1980-1988. They found a significant correlation between average economic growth and stock market capitalization for 40 countries. Harris (1997) re-examined the empirical relationship between capital market and economic growth using appropriate instruments for investment. In contrast to Atje and Jovanovic (1993), he found no hard evidence that the level of capital market activity helps to explain growth in per capita output.

A study of the Ghana Stock Exchange carried out by Osei (2005) interestingly revealed that stock market performance granger-causes economic growth in Ghana economy. The study did not find a reverse causality, but rather a unidirectional relationship. This upheld the fact that economic growth does not predict stock market development in Ghana. However, the researcher attributed this unidirectional causality to the low level of income as evidenced in most developing economies.

Similar to the result obtained by Osei (2005) and Nzue (2006) also attempted to investigate the relationship between the development of the Ivorian capital market and the country's economic performance. His empirical results suggested that gross domestic product and stock market

development were cointegrated when the control variables were included in the analysis. That is, there is a long-run relationship between these variables taken together. The result also indicated a unidirectional causality running from capital market development to economic growth. From the afore discourse it would be recalled that various researchers has posited that bi-directional causation is evident in developed economies while unidirectional causation exist in developing economies. It therefore becomes necessary to examine the directional effect of causation between capital market and economic development.

Irving, (2004) considered the links between capital market and overall socio-economic development to be tenuous, nonexistent or even harmful. He advised African countries not to devote further scarce resources and efforts to promoting stock exchange, since there are many weightier problems to address in Africa: high poverty levels, inadequate social services and undeveloped infrastructure. Even if the resources were available, stock markets could expose already fragile developing economies to the stabilizing effects of short-term, speculative capital inflows. Demirguc-Kunt and Asli (1996) examined the relationship between capital market earning and economic growth, they found out that there is a positive relationship but not a very strong one.

Levine and Zervos, (1996) examines whether there is a strong empirical association between capital market development and long-run economic growth. The study was similar to that of Demirgüç-Kunt and Levine (1996) by conglomerating measures such as stock market size, liquidity, and integration with world markets, into index of stock market development. The growth rate of Gross Domestic Product (GDP) per capita was regressed on a variety of variables designed to control for initial conditions, political stability, investment in human capital, and macroeconomic conditions; and then include the conglomerated index of stock market development. The finding was that a strong correlation between overall stock market development and long-run economic growth exist. This means that the result is consistent with the theories that imply a positive relationship between stock market development and economic growth.

In another research, Levine and Zervos (1998) used pooled cross-country time series regression of 47 countries from 1976 to 1993 to evaluate whether stock market liquidity is related to growth, capital accumulation and productivity and found the slope coefficients of the explanatory variables to be positive.

3. METHODOLOGY

The research design adopted in this work is the *ex post facto* research design. Research design could be described as a way that allows a researcher to provide solution to the problem of who to study, what to study, when to study and how to generate data in a research situation. According to Kothari (2004), a research design is the arrangement of condition for collections and analysis of data in a manner that aims to combine relevance to the research purpose with economy in procedure. Onwumere (2005), stated that a research design is a kind of blue print that guides the researcher in his/her investigation and analysis. Research design is needed because it facilitates the smooth sailing of the various research operations, thereby making research as efficient as possible yielding maximal information with minimal expenditure of effort, time and money.

Consequently, the *ex-post facto* research design was adopted to enable the researcher make use of secondary data to analyze the impact of financial market and monetary policy to the Nigerian economy. The dependent and independent variables were observed over the period, 2001 to 2020. The data for this study were secondary in nature. The data were collected from the publications of the Central Bank of Nigeria: CBN statistical bulletin.

The Model specification for the purpose of the study is specified and estimated as:

$$GDP = f(MCAP, M2, IR) \quad (1)$$

The econometric specification is thus; $GDP = \beta_0 + \beta_1 MCAP + \beta_2 M2 + \beta_3 IR + U$ (2)

Where: GDP = Gross Domestic Product (A proxy for the Nigerian economy)

MCAP = Market Capitalization (A proxy for financial Market)

M2 = Money Supply (A proxy for monetary policy)

IR = Interest rate (A moderator variable)

U = error term

β = Coefficient of the variable

4. DATA PRESENTATION AND ANALYSIS

Data Presentation

The data used for the analysis are presented as follows:

Table 4.1

Years	GDP	MCAP	M2	IR
2000	5,307.36	300.00	628.95	21.32
2001	6,897.48	472.30	878.46	17.98
2002	8,134.14	662.50	1,269.32	18.29
2003	11,332.25	764.90	1,505.96	24.85
2004	13,301.56	1,359.30	1,952.92	20.71
2005	17,321.30	2,112.50	2,131.82	19.18
2006	22,269.98	2,900.06	2,637.91	17.95
2007	28,662.47	5,120.90	3,797.91	17.26
2009	32,995.38	13,181.69	5,127.40	16.94
2010	39,157.88	9,562.97	8,008.20	15.14
2011	44,285.56	7,030.84	9,411.11	18.99
2012	54,612.26	9,918.21	11,034.94	17.59
2013	62,980.40	10,275.34	12,172.49	16.02
2014	71,713.94	14,800.94	13,893.22	16.79
2015	80,092.56	19,077.42	15,154.64	16.72
2016	89,043.62	16,875.10	16,238.52	16.55
2017	94,144.96	17,003.39	18,525.22	16.85

2018	101,489.49	16,185.73	21,624.63	16.87
2019	113,711.63	21,128.90	22,363.43	17.58
2020	127,762.55	21,904.04	25,079.72	16.91

Source: CBN Statistical Bulletin, 2020

1.2 Unit Root Test

The unit root test was carried out on each of the variables to ensure the stationarity of the model variables. The test results are shown in the appendix. The unit root test for GDP shows that the GDP data were not stationary at level and first difference, however, it was stationary at second difference. The unit root test for MCAP shows that the MCAP data were not stationary at level and first difference, however, it was stationary at second difference. The unit root test for M2 shows that the M2 data were not stationary at level and first difference, however, it was stationary at second difference. The unit root test for IR shows that the IR data were not stationary at level, but stationary at first difference.

4.3 Analysis of Result

TABLE 4.2: REGRESSION RESULT

Dependent Variable: GDP

Method: Least Squares

Date: 11/05/2022 Time: 19:10

Sample (adjusted): 2001 2020

Included observations: 20 after adjustments

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	1167.495	8990.540	0.129858	0.8983
MCAP	0.824826	0.329100	2.506306	0.0234
M2	4.103964	0.287461	14.27657	0.0000
IR	140.8276	452.2070	0.311423	0.7595
R-squared	0.993771	Mean dependent var	51260.84	
Adjusted R-squared	0.992603	S.D. dependent var	39032.41	
S.E. of regression	3356.919	Akaike info criterion	19.25229	
Sum squared resid	1.80E+08	Schwarz criterion	19.45144	
Log likelihood	-188.5229	Hannan-Quinn criter.	19.29117	
F-statistic	850.9182	Durbin-Watson stat	1.197669	
Prob(F-statistic)	0.000000			

Source: Researcher's E-View Results

The E-View result shows that MCAP positively and significantly had an impact on GDP with a probability value of $0.0234 < 0.05$, 1167.495 coefficient and 0.129858 t-Statistics. M2 positively and significantly had an impact on GDP with a probability value of $0.0000 < 0.05$, 0.824826 coefficient and 2.506306 t-Statistics. IR positively and insignificantly had an impact on GDP

with a probability value of $0.7595 > 0.05$, 140.8276 coefficient and 0.311423 t-Statistics.

On the whole, MCAP and M2 were statistically had positive and significant impact on GDP while IR statistically had positive but not significant impact on GDP. The R-squared value of 0.99, 99% and Adjusted R-square of 0.99, that is 99% shows that the model was a good fit.

Decision: Since Market Capitalization had positive and significant impact on Gross Domestic product, therefore we reject the null hypothesis (H_0) accept the alternative hypothesis. Since Money Supply had positive and significant impact on Gross Domestic product, therefore we reject the null hypothesis (H_0) accept the alternative hypothesis. However, since interest rate had positive and not significant impact on Gross Domestic product, therefore we accept the null hypothesis (H_0) reject the alternative hypothesis.

Discussion of Findings

Our findings show that total market capitalization and money supply are all joint predictor of economy. The total market capitalization and money supply exert significant and positive influence on the Nigerian economy. The implication of the result is that an increase in market capitalization and money supply will significantly increase GDP, and this is supported by Osinubi and Amaghionyeodiwe (2003), Abu (2009), Agarwal (2001), Chinwuba and Amos (2011), who in their different studies, found that capital market has positive impact on economic growth in Nigeria.

This position, conversely, slightly disagrees with Obamiro (2005) and kolapo and Adaramola (2012), who argue that the positive impact of capital market on economic growth is significant. However the positive coefficients of MCAP and M2, show that total market capitalization and money supply respectively if increased, have the capacity to trigger economic growth. Another implication of our result is that the total value of stock exert an insignificant negative influence on GDP growth rate. This confirms with the position of Ilaboya and Ibrahim, (2004), that the significant effect suggests that majority of key investor prefer to invest in the financial market of the economy other than the capital market.

5. CONCLUSION

This study examined the impact of financial market and monetary policy on the Nigerian economy since Nigeria introduced democratic rule in 2000 to 2020. Financial market was proxied by total market capitalization, while monetary policy was proxied by money supply, and interest rate the moderator variable. The ADF unit root was adopted to test the level of integration of the variables, and all the variables attained stationarity either at first difference or at second difference. Market capitalization, a proxy for financial market had positive and significant impact on Gross Domestic Product, a proxy for the Nigerian economy. Money Supply, a proxy for monetary policy had positive and significant impact on Gross Domestic Product, a proxy for the Nigerian economy. Interest rate, a moderator variable had a positive but not significant impact on Gross Domestic Product, a proxy for the Nigerian economy.

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