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Financial Sector deepening and capital Formation in Nigeria

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ABSTRACT
This study empirically examined Financial Sector deepening and capital Formation in Nigeria. Gross fixed capital formation refers to the total value of investments in physical assets such as machinery, equipment, and infrastructure, which are crucial for economic growth and development. The data were extracted from the Central Bank of Nigeria statistical Bulletins and the reports of the National Bureau of Statistics (NBS). This study used annual data for the period 1990-2022. Econometric procedures were adopted in the course of this research work, Ordinary least square method (OLS) was employed for estimation of the relationships between the dependent variable and the explanatory variables. Unit root tests using Augmented Dickey Fuller to test for stationarity of the time series to avoid spurious regression. Our findings reveal that while credit to the private sector significantly stimulates capital formation, other factors such as national savings, capital market performance, interest rates, broad money supply, and total deposits do not exhibit statistically significant relationships with capital formation. The study recommends that SMEs are often considered the backbone of many economies, including Nigeria's. Enhancing access to credit for SMEs can spur entrepreneurial activity, job creation, and overall economic growth. Implementing financial literacy programs can help educate individuals on the importance of savings and investment, encouraging a culture of saving among the population. Enhance regulatory oversight and enforcement to ensure transparency, fairness, and investor protection in the capital markets. Central banks should pursue a balanced monetary policy approach that considers both inflationary pressures and the need to support economic growth and employment. Maintain prudent monetary policies aimed at controlling inflation and preserving macroeconomic stability, which can contribute to confidence in the currency and financial system. Develop targeted deposit mobilization strategies, such as incentive-based savings programs and digital banking solutions, to attract deposits from a broad base of customers.
Keywords: Capital Formation, Financial Deepening, Manufacturing, small and medium scale enterprises.

1. INTRODUCTION

Nigeria, situated in the heart of West Africa, stands as one of the continent's economic powerhouses, boasting a diverse economy encompassing agriculture, oil and gas, manufacturing, telecommunications, and financial services. With a population exceeding 200 million people and a gross domestic product (GDP) that consistently places it as one of Africa's largest economies, Nigeria's economic trajectory holds significant implications not only for its citizens but also for the broader African continent and the global economy (Ihenacho P. Wachukwu C. & Marshal Iwedi, 2023). It holds the rank of 27th globally in nominal GDP and 24th in purchasing power parity. Despite its abundant human and natural resources and considerable economic promise, Nigeria grapples with significant poverty levels, as noted by Ugbede (2021) and Weli, Okereke, and Nnamdi (2021).

A robust financial system plays a crucial role in driving economic growth by facilitating savings mobilization, fostering information dissemination, enhancing resource allocation efficiency, and facilitating risk management and diversification, which ultimately stimulates growth in the real sector (Levine, 1997). There's a widely held belief that a more developed financial system is inherently more stable and less susceptible to fragility. This belief stems from the observation that deep and liquid financial systems, equipped with diverse instruments, are better able to absorb shocks compared to shallow ones (Sahay et al., 2015). The onset of the 2007/2008 Global Financial Crisis (GFC) prompted a re-evaluation of the implications of financial development, particularly financial deepening, for both financial stability and economic growth. This re-evaluation was prompted by the fact that the crisis originated in developed economies with sizable and robust financial sectors.

The financial sector of Nigeria, like many other aspects of its economy, has undergone substantial transformations over the years. Historically characterized by a relatively underdeveloped banking system, limited access to credit, and weak regulatory frameworks, Nigeria's financial sector has seen remarkable growth and evolution. This transformation has been largely driven by both internal and external factors, including demographic shifts, technological advancements, policy reforms, and changes in global economic dynamics.

Capital formation, which encompasses investments in tangible assets like machinery, equipment, and infrastructure, relies heavily on adequate financing. The deepening of the financial sector provides a spectrum of financing options tailored to the diverse needs of businesses. According to Beck et al. (2000), a robust financial sector offers avenues such as loans, bonds, and equity financing, thus enabling businesses to embark on substantial capital projects with confidence.

Capital formation acts as an indicator of the level of investment in a country, Capital formation is the needed catalyst to promote production and economic activities in a country (Paschal Ojimadu, Chibueze Aniebo, and Callistus Ogu, 2016). Factors such as financial market conditions, banking sector regulations, and monetary policy interventions also play a significant role in shaping the relationship between private sector credit and fixed capital formation.

While Nigeria's financial and economic systems have shown significant improvements over time, the correlation between the growth of the financial sector and economic performance remains a contentious issue. This complexity underscores the multitude of initiatives undertaken across the nation to engage various stakeholders, particularly those in the informal sector. Nevertheless, the industry remains underdeveloped with a limited market scope (Olofin & Afandigeh, 2008). Its precise size and impact on the economy continue to be subjects of debate. The fluctuating ratio of broad money to GDP in Nigeria has had repercussions on the expansion of the financial system. Starting at 17.732% in 2005, it surged to 43.266% in 2009 before declining to 21.021% in 2010. Since then, it has stabilized at an average of around 20%. Moreover, the credit-to-private-sector ratio to GDP in Nigeria experienced fluctuations: from 3.7% in 1960, it rose to 12.22% in 1980, dropped to 4.95% in 1990, saw increases to 8.24% and 19.62% in 2000 and 2009 respectively, declined again to 10.60% in 2012, and stood at 12.13% in 2020. By comparison, the global average in 2020 was 60.26% (World Bank, 2020). This juxtaposition highlights that despite advancements in the Nigerian financial sector, there is still considerable room for improvement.

In Nigeria, the relationship between financial sector deepening and capital formation remains a pressing issue. Despite notable advancements in the financial sector over time, the extent to which these developments contribute to capital formation is unclear. There is a lack of comprehensive understanding regarding the impact of financial sector deepening on the mobilization and allocation of capital within the Nigerian economy. Furthermore, the volatility observed in key financial indicators, such as the ratio of broad money to GDP and the credit-to-private-sector ratio, raises concerns about the stability and effectiveness of the financial system in fostering capital formation. As such, a thorough examination of the relationship between financial sector deepening and capital formation is necessary to address existing gaps in knowledge and inform policy decisions aimed at promoting sustainable economic growth in Nigeria.

2.0 LITERATURE REVIEW

The relationship between financial sector deepening and capital formation in Nigeria has been a subject of growing interest in both academic and policy circles. This section reviews relevant literature that examines the macro-level effects of financial sector deepening on capital formation in Nigeria.

2.1 Financial Deepening

Financial deepening, characterized by the expansion and sophistication of financial markets and institutions, is a subject of significant research in economic literature. Scholars have extensively studied its definition, determinants, and implications for economic development.

Researchers define financial deepening as the process of increasing financial intermediation, marked by the growing role of financial institutions in facilitating savings mobilization and investment allocation. Various measures, such as the ratio of broad money supply to GDP or private credit to GDP, are employed to gauge the extent of financial deepening.

Several factors influence financial deepening. Economic growth and institutional quality play crucial roles, with theory suggesting a mutually reinforcing relationship between financial development and economic growth. Additionally, technological innovation, such as mobile banking and microfinance, has expanded financial access, particularly in developing countries.

The implications of financial deepening are diverse. Deeper financial systems facilitate increased investment, which contributes to capital accumulation and economic growth. Access to financial services also empowers low-income individuals and households, potentially reducing poverty. However, financial deepening may pose risks to financial stability without adequate regulation and supervision.

Empirical evidence on the relationship between financial deepening and economic development is mixed. While some studies find a positive association between financial deepening and economic growth, others emphasize the importance of institutional quality and regulatory frameworks in mediating this relationship.

2.2 Capital Formation

Capital formation, a fundamental concept in economics, refers to the process of increasing the stock of capital goods and productive capacity within an economy. This process involves the accumulation of physical, financial, human, and intangible assets, all of which contribute to enhancing the productive capacity and economic growth of a nation.

Researchers have extensively studied capital formation and its determinants, implications, and relationship with financial deepening. Financial deepening, in this context, refers to the expansion and sophistication of financial markets and institutions within an economy.

Numerous studies have highlighted the importance of financial deepening in facilitating capital formation. Financial markets and institutions play a crucial role in mobilizing savings and allocating funds for productive investment. As financial systems become more developed and efficient, they provide individuals and businesses with greater access to credit and capital, which stimulates investment in physical assets such as machinery, infrastructure, and technology.

Empirical evidence suggests a positive relationship between financial deepening and capital formation. Beck, Demirgüç-Kunt, and Levine (2000) find that countries with deeper financial systems tend to have higher levels of investment and capital accumulation. Similarly, Rousseau and Wachtel (2011) provide evidence that financial deepening positively impacts capital formation and economic growth, particularly in developing countries.

Furthermore, the quality of financial institutions and regulatory frameworks influences the effectiveness of financial deepening in promoting capital formation. Claessens, Demirgüç-Kunt, and Huizinga (2001) emphasize the importance of sound financial regulation and supervision in ensuring the stability and efficiency of financial markets, which are essential for fostering capital formation.

While financial deepening plays a significant role in promoting capital formation, its impact may vary depending on the institutional context and the level of economic development. Some studies suggest that the benefits of financial deepening may be more pronounced in countries with well-functioning legal and

institutional frameworks that protect property rights, enforce contracts, and ensure the rule of law (Levine, 1997).

In conclusion, capital formation is a multifaceted process crucial for economic development, encompassing the accumulation of various forms of capital. Financial deepening acts as a catalyst for capital formation by enhancing the efficiency and accessibility of financial markets and institutions. However, the effectiveness of financial deepening in promoting capital formation depends on the quality of financial regulation and institutional environment.

2.3 Empirical Literature

Ndako (2017) investigated the relationship between financial development, investment, and economic growth in Nigeria using the Johansen Vector Auto Regression (VAR) framework, as well as the endogenous and exogenous Johansen cointegration structural break frameworks. The study established a long-term relationship between financial development, investment, and economic growth in Nigeria. Additionally, it illustrated that investment serves as a crucial pathway through which improvements in financial systems affect economic growth.

Similarly, Arcand, Berkes, and Panizza (2015) examined the relationship between financial depth, measured by private credit to GDP ratio, and capital formation using panel data for a large sample of countries. Their findings suggested that deeper financial systems are associated with higher levels of investment and capital formation, particularly in developing economies.

In a more recent study, Khan and Qayyum (2018) investigated the impact of financial deepening on capital formation in Pakistan. Employing the Autoregressive Distributed Lag (ARDL) approach, they found a significant positive relationship between financial deepening, proxied by the ratio of domestic credit to the private sector to GDP, and capital formation, suggesting that improvements in financial intermediation stimulate investment and capital accumulation in the economy.

Contrary to these findings, some studies have highlighted potential nonlinearities or threshold effects in the relationship between financial deepening and capital formation. For example, Cheng and Degryse (2010) explored this relationship using a sample of European countries and found evidence of a nonlinear relationship, indicating that the impact of financial deepening on investment and capital formation may vary depending on the level of financial development.

Akinlo and Egbetunde (2010) investigated the impact of financial sector development on economic growth and capital formation in Nigeria. Using time series data spanning from 1970 to 2007, they employed the Johansen cointegration test and the Vector Error Correction Model (VECM) framework. Their findings indicated a positive and statistically significant relationship between financial sector development, measured by indicators such as broad money supply and credit to the private sector, and capital formation, suggesting that improvements in financial intermediation contribute to higher levels of investment and capital accumulation in Nigeria.

Similarly, Afolabi and Yaqub (2013) examined the relationship between financial deepening and capital formation in Nigeria using quarterly data from 1981 to 2010. Employing the Autoregressive Distributed Lag (ARDL) approach, they found evidence of a positive and significant long-run relationship between financial deepening, measured by the ratio of private sector credit to GDP, and capital formation, indicating that a more developed financial sector stimulates investment and capital formation in the Nigerian economy.

Another study by Adeniran (2017) focused on the impact of financial sector reforms on capital formation in Nigeria. Using annual data from 1981 to 2013 and employing the Autoregressive Distributed Lag (ARDL) bounds testing approach, the study found a positive and significant long-run relationship between financial sector reforms, proxied by variables such as banking sector reforms and financial liberalization measures, and capital formation, suggesting that policy interventions aimed at enhancing financial sector efficiency and development can foster investment and capital accumulation in Nigeria.

The Effect of Bank Credit on Industrial Output in Nigeria by Sheu Suleiman, Owoye Oluwatosin (2019). This empirical study explores the effect of bank credit on industrial output in Nigeria. Using time-series

data analysis and econometric techniques such as Granger causality tests and vector autoregression (VAR) models, the authors examine the dynamic relationship between bank credit allocation, industrial output, and gross fixed capital formation. The findings suggest a significant positive impact of bank credit on industrial output, highlighting the role of credit allocation in stimulating investment in fixed capital and promoting industrial growth in Nigeria.

These empirical reviews provide comprehensive insights into the macro-level effects of financial sector deepening on capital formation in Nigeria, employing various econometric techniques and data analysis methodologies to examine the dynamics and implications of financial allocation for economic growth and development.

3.0 RESEARCH METHODOLOGY

The research design adopted in this study falls within the paradigm of an Ex-post facto design type. Data collection for this research was conducted using secondary sources. Specifically, information was sourced from the Central Bank of Nigeria (CBN) Statistical Bulletin spanning a period of thirty-two (32) years, from 1990 to 2022. In conducting this research, econometric techniques were utilized. Specifically, the Ordinary Least Squares (OLS) method was employed to estimate the relationships between the dependent variable and the explanatory variables. Unit root tests, specifically the Augmented Dickey-Fuller test, were conducted to assess the stationarity of the time series data, aiming to prevent spurious regression.

Furthermore, to ascertain the presence of a long-run equilibrium relationship among the variables, cointegration tests were performed. Additionally, an Error Correction Model (ECM) was estimated to capture short-run relationships between the variables. These procedures were crucial in ensuring robust analysis and interpretation of the empirical results.

3.1 Model Specification

To empirically analyze the impact of financial sector deepening and capital formation in Nigeria within the period under review, this study adopts the model of Afolabi and Yaqub (2013) and edited thus: applying Gross fixed capital formation as the explained variable, while the explanatory variables are; Credit to private sector, National Savings, Capital Market performance, Interest rate, Broad Money Supply and Total Deposit.

The functional model is specified as follows:

GCF= (CPS, NS, CAPM, INTR, M2, TD) 3.5

$$GCF = \alpha_0 + \beta_1 CPS + \beta_2 NS + \beta_3 CAPM + \beta_4 INTR + \beta_5 MS + \beta_5 TD + \mu_t \quad 3.6$$

A' priori Economic Expectation: $\alpha_{1-6} > O$

Where

CPS	= Credit to private sector
GCF	= Gross Domestic Fixed Capital Formation
NS	= National Savings
CAPM	= Capital market performance.
INTR	= Interest Rate
M2	= Broad Money Supply
TD	= Total Deposit
α_0	= Intercept Terms
$\beta_1 - \beta_5$	= coefficients

A-prior Expectation of the Result

The explanatory variables are expected to have positive and direct effects on the dependent variables. That is a unit increase in any of the variables is expected to increase Capital Formation. This can be expressed mathematically as $\beta_1, \beta_2, \beta_3 > 0$.

4.0 DATA PRESENTATION AND ANALYSIS

Table 1: Summary of Descriptive Statistics

	GFCF	CPS	NS	CAPM	INTR	M2	TD
Mean	46.67257	4825.212	2971.068	5049.940	11.82342	5153.387	799.3181
Median	287.4900	480.7708	331.4292	386.1500	10.04500	753.7047	108.5106
Maximum	16908.13	22521.93	15067.12	21904.04	28.02000	25079.72	5123.800
Minimum	10.08000	8.570050	6.562600	5.000000	5.460000	14.47117	0.340100
Std. Dev.	5466.235	7416.464	4558.248	7235.740	5.151428	7536.495	1473.183
Skewness	1.372016	1.333422	1.388389	1.127328	1.310424	1.337830	1.860982
Kurtosis	3.184595	3.240348	3.495469	2.731859	4.323095	3.431295	4.864149
Jarque-Bera	11.97599	11.35222	12.59698	8.162669	13.64742	11.62986	27.43611
Probability	0.002509	0.003427	0.001839	0.016885	0.001088	0.002983	0.000001
Sum	127895.5	183358.1	112900.6	191897.7	449.2900	195828.7	30374.09
Sum Sq. Dev.	1.11E+09	2.04E+09	7.69E+08	1.94E+09	981.8767	2.10E+09	80299933
Observations	32	32	32	32	32	32	32

Source: Extract from E-view 10.0

The table above shows the descriptive statistics of the variables in the analysis. The mean value of the variables GFCF, CPS, NS, CAPM, INTR, M2 and TD, are 46.67257, 4825.212, 2971.068, 5049.940, 11.823, 5153.387 and respectively. The mean measures the average value of the series. It is derived by summing the values of the series in the current sample and dividing by the number of observations, which in this case is 32. The median of the variables GFCF, CPS, NS, CAPM, INTR, M2 and TD, are 287.49, 480.771, 331.43, 386.15, 10.05, 753.71, and 108.51, respectively and this shows the variables in the middle when the data is arranged in either ascending or descending order. The maximum and minimum statistics of GFCF are 16908.13 and 10.08; CPS are 22521.93 and 8.57001; NS are 15067.12 and 6.562600; CAPM are 21904.04 and 5.0000; INTR are 28.02000 and 5.460000; M2 are 25079 and 14.47117 and TD are 5123 and 0.340100.

The standard deviation of GFCF, CPS, NS, CAPM, INTR, M2 and TD are 5466.215, 7416.464, 4558.248, 7235.740, 5.151428, 7536.495 and 1473.183 respectively. The standard deviation measures the level of dispersion or spread of the series around the mean. Therefore, the higher the value of the value, the higher the deviation of the series from the mean and vice versa. The values of the skewness statistic show that all the variable are positively skewed because their values are greater than zero. The kurtosis of a normally distributed variable is 3, if it exceeds this value the distribution is said to be peaked (leptokurtic) relative to normal, on the other hand, if it is less than 3 it is assumed to be flat (platykurtic) relative to normal. In the case of this variables used in this study, it is relative to normal.

Jarque-Bera is used to test whether a series is normally distributed and the probability value is used to determine this. If the probability value obtained from the test statistic is not significant (i.e., greater than 5% level of significance) we accept the null hypothesis and this means the series is normally distributed. Also, the sum of all the variables as well as the sum of the square deviation are shown in the table.

4.1 Hypotheses Testing

To test the hypotheses, we will use probability criteria, if:

p > 0.05: Accept HO.

p < 0.05: Reject HO

Table 2: Extracting for testing hypothesis

Variable	Co-efficient	t-Statistics	Prob.*	Decision
CPS	0.576457	1.784871	0.0041	Reject
NS	0.223221	0.429692	0.6704	Accept
CAPM	0.023356	-0.245814	0.8074	Accept
INTR	-30.23874	-0.759477	0.4533	Accept
M2	-0.054057	-0.172754	0.8640	Accept
TD	0.418554	1.013611	0.3186	Accept

Source: Extract from E-view 10.0

Credit to Private Sector (CPS): Coefficient: 0.576457; t-Statistics: 1.784871; Probability: 0.0041; Decision: Reject.

Interpretation: The coefficient indicates that there is a positive relationship between credit to the private sector and capital formation. The t-statistic is significant at the 1% level, indicating that the relationship is statistically significant. Therefore, we reject the null hypothesis that there is no relationship between credit to the private sector and capital formation in Nigeria.

National Savings (NS): Coefficient: 0.223221; t-Statistics: 0.429692; Probability: 0.6704

Decision: Accept

Interpretation: The coefficient suggests a positive relationship between national savings and capital formation, but the t-statistic is not significant at conventional levels (p-value > 0.05). Therefore, we accept the null hypothesis that there is no statistically significant relationship between national savings and capital formation in Nigeria.

Capital Market Performance (CAPM): Coefficient: 0.023356; t-Statistics: -0.245814; Probability: 0.8074; Decision: Accept

Interpretation: The coefficient implies a positive relationship between capital market performance and capital formation, but the t-statistic is not statistically significant (p-value > 0.05). Hence, we accept the null hypothesis that there is no significant relationship between capital market performance and capital formation in Nigeria.

Interest Rate (INTR): Coefficient: -30.23874; t-Statistics: -0.759477; Probability: 0.4533

Decision: Accept

Interpretation: The coefficient suggests a negative relationship between interest rates and capital formation. However, the t-statistic is not significant at conventional levels (p-value > 0.05). Therefore, we accept the null hypothesis that there is no significant relationship between interest rates and capital formation in Nigeria.

Broad Money Supply (M2): Coefficient: -0.054057; t-Statistics: -0.172754; Probability: 0.8640

Decision: Accept

Interpretation: The coefficient indicates a negative relationship between broad money supply and capital formation, but the t-statistic is not statistically significant (p-value > 0.05). Therefore, we accept the null hypothesis that there is no significant relationship between broad money supply and capital formation in Nigeria.

Total Deposit (TD): Coefficient: 0.418554**;** t-Statistics: 1.013611**;** Probability: 0.3186

Decision: Accept

Interpretation: The coefficient suggests a positive relationship between total deposits and capital formation. However, the t-statistic is not significant at conventional levels (p-value > 0.05). Therefore, we

accept the null hypothesis that there is no significant relationship between total deposits and capital formation in Nigeria.

4.5 DISCUSSION OF RESULTS

The findings from the regression analysis examining the relationship between financial sector deepening and capital formation in Nigeria provide valuable insights into the dynamics of the country's economy. Below is a discussion of these findings:

Significance of Credit to the Private Sector (CPS):

The significant positive relationship between credit to the private sector and capital formation suggests that access to credit plays a crucial role in driving investment and economic growth in Nigeria. This finding underscores the importance of a well-functioning financial sector that can efficiently channel funds to productive investments, particularly in the private sector. This result is in line with the findings of Adeniran (2017), who further recommended that policymakers may consider measures to enhance credit availability and improve the ease of access to financing for businesses and entrepreneurs to stimulate capital formation and economic development.

Limited Impact of National Savings (NS) and Capital Market Performance (CAPM):

The lack of significant relationships between national savings, capital market performance, and capital formation indicates that these factors may not exert a considerable influence on investment decisions and overall economic activity in Nigeria. While national savings represent a potential source of funds for investment, the findings suggest that other factors such as credit availability might be more influential. This finding is in line with Afolabi and Yaqub (2013) who suggested that the performance of the capital market, while important for mobilizing investment capital, may not directly translate into increased capital formation in the economy.

Interest Rate (INTR) and Broad Money Supply (M2):

The non-significant relationship between interest rates and capital formation implies that changes in borrowing costs may not have a substantial impact on investment decisions in Nigeria. This finding could reflect various factors, including the presence of other constraints on investment or the effectiveness of monetary policy transmission mechanisms. Similarly, the lack of significance for broad money supply suggests that the overall liquidity in the economy may not be a primary determinant of capital formation.

Role of Total Deposits (TD):

Although the relationship between total deposits and capital formation is positive, the lack of statistical significance indicates that the level of deposits held by banks may not directly drive investment and economic growth in Nigeria. This finding suggests that factors beyond the availability of bank deposits, such as credit demand and investment opportunities, may be more influential in shaping capital formation decisions. This study goes in tandem with Paschal Ojimadu, Chibueze Aniebo, and Callistus Ogu (2016)

CONCLUSION

In conclusion, the analysis of the relationship between financial sector deepening and capital formation in Nigeria reveals several important insights. While credit to the private sector emerges as a significant driver of capital formation, other factors such as national savings, capital market performance, interest rates, broad money supply, and total deposits do not exhibit statistically significant relationships with capital formation.

This suggests that while traditional measures such as credit availability play a crucial role in stimulating investment and economic growth, other factors may have limited direct impact in the Nigerian context. These findings underscore the need for targeted policies aimed at enhancing credit access and fostering a conducive environment for private sector investment.

RECOMMENDATION

1. SMEs are often considered the backbone of many economies, including Nigeria's. Enhancing access to credit for SMEs can spur entrepreneurial activity, job creation, and overall economic growth.
2. Implementing financial literacy programs can help educate individuals on the importance of savings and investment, encouraging a culture of saving among the population.
3. Enhance regulatory oversight and enforcement to ensure transparency, fairness, and investor protection in the capital markets.
4. Central banks should pursue a balanced monetary policy approach that considers both inflationary pressures and the need to support economic growth and employment.
5. Maintain prudent monetary policies aimed at controlling inflation and preserving macroeconomic stability, which can contribute to confidence in the currency and financial system.
6. Develop targeted deposit mobilization strategies, such as incentive-based savings programs and digital banking solutions, to attract deposits from a broad base of customers.

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