RESEARCH ARTICLE

DOES FINANCIAL SECTOR DEVELOPMENT CAUSE ECONOMIC GROWTH? EMPIRICAL EVIDENCE FROM NIGERIA

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ABSTRACT

The debate in economics whether financial development causes economic growth or whether it is a consequence of increase in economic activity seems unending. This paper examined the effect as well as the causal relationship between financial sector development and economic growth in Nigeria. This study focused on two focal variables, depth of the financial sector (M2/GDP) ratio of broad money stock to GDP and level of financial intermediation ratio of private sector credit to the GDP PC/GDP. Ensuring data stationarity using Phillips-Perron test permitted OLS and Granger causality to ascertain relationships, effects and causal relationship. Findings suggest positive long run relationship between government consumption and trade openness while the measures of financial development show negative relationships with economic growth. The outstanding results are true for the two major indicators we used M2/GDP and PC/GDP to capture the development of the financial sector, showing that they actually deepen the financial sector but failed to cause economic growth in Nigeria.

INTRODUCTION

The importance of the financial system to economic development is not quite clear-cut. Some researchers such as Hicks (1969) hold the view that the financial system plays crucial role in the mobilization of capital for industrialization. On the other hand, there are those who have a contrary view. For example, Robinson (1952) argues that economic development creates demand for certain financial instruments. The financial system only responds to the demand created as a result of economic development. The theoretical argument that supports the link between financial development and growth is that a well polished financial system performs several critical functions to enhance the efficiency of intermediation by reducing information transaction and monitoring costs. A polished financial system enhances investment by identifying and funding good business opportunities, mobilizes savings, enables trading, hedges and diversifies risks and facilitates the exchange of goods and services, thus resulting in a more efficient allocation of resources, rapid accumulation of physical and human capital as well as faster technological progress which result in economic growth. The success of the financial system throughout the world has been predicted on the initiation of financial sector reforms such as the introduction of market-based procedures for monetary control, the promotion of competition in the financial sector and relaxation of restrictions on capital flows. In the early seventies in Nigeria, as a result of the prevailing economic paradigm at that period, the sector was highly regulated with

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government holding major shares in most of the banks. For instance in 1986, the liberalization of the banking industry was a major component of the Structural Adjustment Programme (SAP) which government put in place to drive the economy from austerity measure to prosperity measures. In 2004, consolidation exercise in banking sector played a role in the National Economic Empowerment and Development Strategy (NEEDS) which was used to drive the economic agenda of the ruling government then. The purpose of creating reforms is to create a more efficient and stable system which will facilitate optimum performance in the economy. This provide foundation for implementing effective stabilization policies and successfully mobilizing capital and putting it to effective use, thus lead to achieveing higher rates of economic growth (Johnson and Sundarajan, 1999). Nigeria is a veritable case for investigating the link between financial development and Economic growth for at least two reasons. One, there has been considerable increase in tempo in the activities of the financial market capitalization. Nigeria has achieved much in terms of both financial development indicators and GDP growth rate among the emerging markets, (Odedokun, 1996). The aforementioned observation motivates this paper to explore the possible role of financial development in promoting the remarkable growth of the Nigeria economy. Secondly, Nigeria has an interesting history of finance sector reforms, such as recapitalization, mergers and acquisition, capital controls and deflationary policy which has taken place (Erdal, Okon and Sehiye, 2007). The focus of this study is mainly to examine the causal relationship between financial sector development and Nigeria economic growth, thus addressing the country's specific dimension to finance-growth debate. The number of

years used is considerably longer than the previous studies in scope. More so, the effects of different measures of financial sector development on economic growth are examined thereby providing a comprehensive empirical investigation of finance-growth nexus in Nigeria. The study also made serious efforts to address the endogeneity issue and provide the framework for examining the possibility of the impact of economic growth on financial development. The predisposition of the paper is to empirically investigate the nature of relationship between financial sector development and economic growth in Nigeria. That is to find out whether it is demand-driven or supply-driven. Other vital objectives include the identification of the specific channels through which the financial sector affect economic growth while at the same time examine the effect of various financial measures on each other. The remainder of this paper is structured as follows: Section two deals with the literature review while section three describes the methodology adopted, followed by a discussion of results in section four and five concludes.

Literature review

Theoretical Background

The role of financial sector in economic growth has intrigued macro-economists and financial economists for many years. Many econometric studies such as the ones by Fermandez and Galetovic (1994) and Arestis and Demetriades (1996) have led to conflicting results on casualty with some indicating reverse casualty and others resulting in insignificant parameters. In 1996, twelve countries were used as case study by Arestis and Demetriades. The result was that the direction of casualty depends on the variable used and that each country exhibit different results. These results confirm the hypothesis that institutional considerations and policies of countries do play a role in relationship between finance and growth. Generally, literature on financial development and economic growth has documented two views for the finance-growth nexus: supply leading and demand-following. Patrick (1966) identified two possible directions of causality between financial development and economic growth.

These relationships were labeled as the supply-leading and demand following. The supply leading view postulates a positive impact of financial development on economic growth, which means that creation of financial institutions and markets increases the supply of financial services and thus leads to economic growth. Patrick (1966) advocated for a supply leading strategy that ensures the creation of financial institutions and the supply of their assets, liabilities and related services in advance of demand for them. The supply-leading finance performs two functions: to transfer resources from traditional (non-growth) sectors to modern (high-growth) sectors, and to promote and stimulate an entrepreneurial response in these modern sectors. He argues that supply leading finance would exert a positive influence on capital by improving the composition of the existing stock of capital, allocate efficiently new investments among alternative uses, and raise the rate of capital formation by providing incentives for increased saving and investment. The supply-leading finance will cause economic development through the transfer of scarce resources from savers to investors according to the highest rates of return on investment. The McKinnon-Shaw hypothesis supports the supply-leading argument of Patrick

(1966). McKinnon (1973) suggests a complementarity relationship between the accumulation of money balances (financial assets) and physical capital accumulation in developing countries. He considers an outside model of money demand. The author argues that due to underdeveloped financial markets in most developing countries, there are limited opportunities for external finance and all firms are confined to self-finance. Given that investment expenditures are lumpier than consumption expenditure, potential investors must first accumulate money balances prior to undertaking relatively expensive and indivisible investment projects. The demand-following view postulates a causal relationship from economic growth to financial development. Patrick (1966) argues that the creation of modern financial institutions, their financial assets and liabilities and related financial services are a response to the demand for these services by investors and savers in the real economy. Thus, economic growth creates a demand for developed financial institutions and services as a result of higher demand for financial services.

As such, an increasing demand for financial services might induce an expansion in the financial sector as the real economy grows (i.e. financial sector responds positively to economic growth). This line of reasoning is also supported by Gurley and Shaw (1967) and Goldsmith (1969). Patrick (1966) however argues that the causal relationship between financial development and economic growth varies according to the stages of the development process. He suggests that the supply-leading pattern dominates during the early stages of economic development. As financial and economic development proceed, the supply-leading characteristics of financial development diminish gradually and are eventually dominated by demand following financial development.Akinlo and Egbetunde (2010) examined the long run and causal relationship between financial development and economic growth for ten countries in sub-Saharan Africa.

The results show that financial development Granger causes economic growth in Central African Republic, Congo Republic, Gabon, and Nigeria while economic growth Granger causes financial development in Zambia. However, bidirectional relationship between financial development and economic growth was found in Kenya, Chad, South Africa, Sierra Leone and Swaziland. In Zambia emphasis needs to be placed on economic growth to propel financial development. Kıran, Yavuz and Güriş (2009) investigated the long-run relationship between financial development and economic growth for a panel of 10 emerging countries over the period 1968–2007 by employing the recently developed panel data unit root tests and the Pedroni panel data cointegration techniques. The empirical results indicate that the long-run relationship exists between financial development and economic growth. Furthermore, conditional on finding cointegration, the paper extends the literature by employing the Pedroni Panel Fully Modified Ordinary Least Squares (FMOLS) procedure to generate consistent estimates of the relevant panel variables. The results support that financial development has a positive and statistically significant effect on economic growth. Perera and Paudel (2009) studied the causal relationship between financial development and economic growth in Sri Lanka over the period 1955 to 2005. After considering the time series characteristics of six measures of financial development, Johansen cointegration

and the appropriate Error Correction Model are used to investigate the causal relationship between financial development and economic growth. The findings suggest that broad money causes economic growth with two-way causality. The major finding of this study does not strongly support the view that financial development boosts economic growth. Using a Vector Autoregression (VAR) approach, Guanghua and Jianhong (2006) examined the impact of financial development on economic growth in China. They found that financial development comes as the second force (after the contribution from labor input) in leading economic growth in China. This study has supported the view in the literature that financial development and economic growth exhibit a two-way causality and hence is against the so-called "finance-led growth" hypothesis.

Saibu, Nwosa, and Agbeluyi, (2011) examined effects of financial development and foreign direct investment on economic growth in Nigeria. The study modified the standard endogenous model to incorporate foreign direct investment and financial development as the determinant of growth in the long run. Using time series data from 1970 to 2009, the study tested for the time series properties of the variable and adopted the Autoregressive Distributed Lag (ARDL) technique to estimate the model. The results showed that financial development and foreign direct investment had negative effects on economic growth in Nigeria. The result also showed that financial market liquidity and not the size of the financial market matter for economic growth in Nigeria. Odeniran, and Udeaja, (2010) examined the relationship between financial sector development and economic growth in Nigeria by testing the competing finance-growth nexus hypothesis using Granger causality tests in a VAR framework over the period 1960-2009. Four variables, namely; ratios of broad money stock to GDP, growth in net domestic credit to GDP, growth in private sector credit to GDP and growth in banks deposit liability to GDP were used to proxy financial sector development.

The empirical results suggest bidirectional causality between some of the proxies of financial development and economic growth variable. Specifically, we find that the various measures of financial development granger cause output even at 1% level of significance with the exception of ratio of broad money to GDP. The perceived relationship between financial development and economic growth is estimated econometrically using the Ordinary Least Square Estimation Method (OLSEM). The result showed that there is a substantial positive effect of financial development on economic growth in Nigeria. The Granger causality test showed that financial development promotes economic growth, but there is evidence of causality from economic growth to the development of financial intermediaries. Thus, advancement of the financial sector development, including diversification of financial instruments should be pursued to facilitate economic development in Nigeria (Adelakun, 2010). The causal relationship between financial development and economic growth in Jordan was investigated through the validity of Patrick's (1966) proposed hypotheses; the Supply-Leading (i.e. financial development causes economic growth) and the Demand-Pulling (i.e. economic growth cause financial development), using Granger's causality, co-integration, and vector error correction techniques. The results indicate the existence of a long-run equilibrium between financial

development and economic growth. In addition, there is a one-directional causality relationship from financial development to economic growth in both the long- and short run. This result suggests that financial development in Jordan is expected to play an important role in the future in determining the economic growth (AL-Naif, 2012). Muhsin, and Pentecost (2000) examined the causal relationship between financial development and economic growth in Turkey. Muhsin, and Pentecost (2000) developed five alternative proxies for financial development and Granger causality tests applied using the cointegration and vector error correction methodology (VECM). The empirical results show that the direction of causality between financial development and economic growth in Turkey is sensitive to the choice of proxy used for financial development. For example, when financial development is measured by the money to income ratio the direction of causality runs from financial development to economic growth, but when the bank deposits, private credit and domestic credit ratios are alternatively used to proxy financial development, growth is found to lead financial development. On balance, however, for Turkey, growth seems to lead financial sector development. Research on Nigeria finance-growth dynamics are not only limited in number but restricted in scope in terms of the measure of financial development.

Ndebbio (2004), using an ordinary least square regression framework finds that financial sector development weakly affect per capital growth of output. He attributed the result to shallow finance and the absence of well functioning capital markets. The finding of Nnenna (2004) was more disturbing. Using ordinary least square regression technique, she concluded that financial sector development did not significantly affect per capital growth of output. Also, Nzotta and Okereke (2009), based on two stages least analytical framework for a period starting from 1986 to 2007, concluded that financial deepening did not support economic growth in Nigeria. However, Afangideh (2009), using three stage least square estimation technique on a data spanning 1970-2005, found that a developed financial system alleviates growth financing constraints by increasing bank credit and investment activities with resultant rise in output. The empirical studies suggest three types of causal direction between finance and growth. First is Harrod-Domar growth model which lead to a hypothesis of one way causality from financial development to economic growth. Second is that there is unidirectional causality from growth to finance. Such findings confirms Shan et al (2001) conclusion that economic growth causes China's financial development. The third is that causal direction, the co-evolution (bidirectional causality) between economic growth and financial development hypothesized in both former and recent literature (Gurley and Shaw 1960, 1967: Bencivanga and Smith 1991) cannot be ruled out.

METHODOLOGY

To investigate the causal link between financial development and economic growth for Nigeria, we used a simple regression model developed by De Gregorio (1995) and as applied by Abuduroluman (2003) and Johannes, Njong and Cletus (2011). The financial development variable is included in an endogenous growth model. The model is expressed as follows:

$$\text{Log GDP}_1 = B_1 \text{Log FD}_1 + B_2 \text{Log xi} + \text{Hi}$$

Where
GDP$_1$ =An indicator of economic development
FD$_1$ =An indicator of financial development
Xi =A set of control variables
Hi =The error term

The Johnson method of co-integration will be used for the estimation. This method consists of three steps: first, the orders of integration of the series are determined using either the dickey-fuller test or Phillip-Perron test. The second step consists of testing the eventual existence of a co-integration relationship linking the variables. The third stage permits the test of the causality between the variables.

Unit Root Test

A time series is considered to be stationary if it's mean and variable are independent of time. If the time series is non-stationary, that is, having a mean and or variance changing over time, it is said to have a unit root. If a time series is non-stationary, the regression analysis carried out in a conventional way will produce spurious results. A spurious regression occurs when after regressing a time series variable on others, the test statistics show a positive relationship between these variables even though no such relationship exists. A non-stationary time series can be converted into a stationary time series by differencing. If a time series becomes stationary after differencing one time, then the time series is said to be integrated of other one and denoted by (i). Similarly, if a time series has to be differenced a time to make it stationary, then it is called integrated of order d and written as i(d). As the stationary time series needs not to be differenced, it is denoted i(o). We tested for the order of integration using the augmented dickey-fuller test (ADF). The test is based on the following three models.

$$\Delta xi = Pxt - 1 + \Sigma\Phi\Delta xt - jt\mu$$
$$\Delta xt = Pxt - 1 + \Sigma\Phi\Delta xt - j + bt + \mu$$
$$P$$
$$\Delta xt = Pxt - 1 + \Sigma\Phi\Delta xt - j + bt + C + \mu$$
$$J-2$$

The principle of this is, if the Ho hypothesis that P =1 is accepted in any of the three equations, then the process is not stationary. The value P of lags is determined with the aid of the Akaike information criterion. The lag chosen corresponds to the one that minimizes this criterion.

Causality Test

Granger (1969) defines causality between two variables y and x as follows: y causes x if the predictability of x increases when y is taken into consideration. The procedure used for the test of causality is that of the P-order vector auto-regressive representation.

$$Y_{11} = C_1 + \Pi_{11}(L)Y1t_1 + \Pi_{12}(L)Y2t_1 + \mu_{11}$$
$$Y_{21} = C_2 + \Pi_{21}(L)Y1t_1 + \Pi_{22}(L)Y2t_1 + \mu_{21}$$

Where c_1 and c_2 are constants and Π_{11} represents polynomials of order P-1. L is the lag operator. As such, Y_{21} does not granger cause Y_{11} when the Ho hypothesis is accepted, that is if the polynomial $Y_{21}(L) = 0$. This formulation supposes that the variables are stationary. Granger (1988) also showed that when the series are integrated of order 1, the model is underspecified and the causality test can lead to false conclusions. However, the causality test of Granger limits itself to the direction of causality.

Data Description and Sources

Indicators of Economic Growth

The endogenous variable of our model is the GDP per capita that reflects the degree of development of the economy. The aggregate has also been used by Levine (1997) and Aburoluma (2003). We obtained the data from the Central Bank of Nigeria Statistical Bulletin.

Indicator of Financial Development

The two main functions of a financial system are to mobilise and allocate financial resources. In order to capture the development of the financial sector with respect to these two functions, we make use of the following two indicators that have also been used by other authors (King and Levine, 1993, Younes and Chitioui, 2006).

i) Size of the financial sector (LLI): This indicator captures the total size of the financial sector with respect to the whole economy. This is also known as the depth of the financial sector. This is equal to Currency plus Demand and Interest bearing liabilities of banks and the other financial intermediaries divided by GDP. Users of financial depth hypothesize that the size of financial intermediaries is positively related to the provision of financial services (King and Levine, 1993. Younes and Chtiouli, 2006).

ii) Bank Credit allocated to private enterprises by the financial sector (BPCRE): This indicator captures the allocative efficiency or the level of financial intermediation of the financial sector. Theory hypotheses a positive relationship between allocative efficiency and growth.

Control Variables

Referring to the works of Younes and Chtioui (2006). Control variables are made up of the main determinants of economic growth and they include the following.

i) The Size of the Government (GOVC): We use government consumption measured by recurrent expenditure to proxy for the size of the government. This may have either a negative or positive impact depending on the magnitude of the negative effects caused by the financing effects of the consumption.
ii) Openness of the Economy (OPEN): Trade openness is measured as the sum of exports and imports on GDP, we expect a positive sign from this variable.

Table 1: Apriori Expectations

Variables	Expected Sign
Depth of the financial sector (M2/GDP)	+
Level of financial intermediation (PC/GDP)	+
Openness of the economy (TT/GDP)	+
SIZE OF GOVERNMENT (Recurrent expenditure)	+

The above Table shows the expected relationship between the independent variables and GDP. All are expected to relate positively with economic growth.

Findings

Financial intermediation as proxied by the depth of the financial sector and level of financial intermediation in

Nigeria has evolved overtime. Apparently, fig. 1 shows the depth of financial deepening and level of financial intermediation in the post SAP (Structural Adjustment Programme) period to the end of 2010.
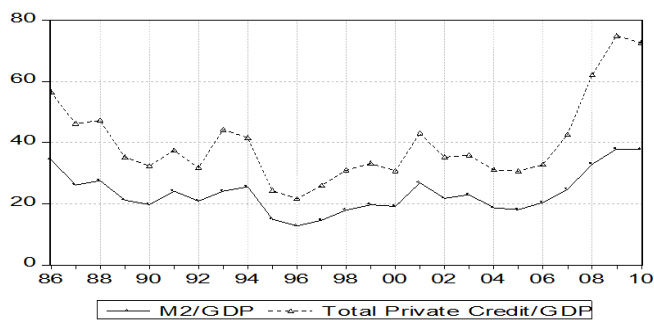

Fig. 1. Graphical Representation of M2 and Total Private Credit

Source: Author's Eview output

In the graph, the upper line represents M2, while the below line represents private credit. X-axis represents the percentage increase or decrease, while y-axis represents years from 1986-2010 in geometrical progression of even numbers. In the year 2009 M2 reached the highest point of about 76 percent and the lowest point in the year 1996 at about 24%. While the 2nd proxy which is private credit reach its highest point in the year 2010 and the lowest in 1996 at the level of about 18%.

Unit Root Test Result

To guard against spurious result, this study took caution by checking the properties of the variables via the PP test. The result is presented below.

Table 2: Philips-Perron Unit ROOT Test Result

Variable	1% critical value*@level	PP Test statistic @ level	Status	1% critical value*@	PP Test Statisti (t*)
NLGDP	-3.7343	-2.458398	1(0)	-3.7497	-4.037382
TC/GDP	-3.7343	-0.871078	1(1)	-3.7667	-6.341277
M2/GDP	-3.7343	-1.859915	1(0)	-3.7497	-4.874506
TT/GDP	-3.7343	-4.615226	1	-	-
NLSGOV	-3.7343	-1.069093	1(1)	-3.7667	-8.014483

Source: Author's Eview output

A non-stationary time series can be converted into a stationary time series by differencing (Johannes et al, 2011). The above table reports that TT/GDP Philip Peron statistics is static at level at -4.615226 < -3.7343 (critical value at 1%). Consequently, NLGDP (Natural Log GDP), TC/GDP (Total Private credit/GDP), M2/GDP (Broad Money/GDP) and NLSGOV (Natural Log size of Government) were non-stationary at level but were however converted into stationarity time series at 1st and 2nd differences. Given that their PP test statistic 1st difference and 2nd difference < critical values at 1%, we conclude that there is no unit root with the time series. Therefore, the time series are stationary. To further confirm the stationarity of the time series after differencing we plotted them graphically as shown below. Fig. 2 above confirms no unit root as the time series no longer increase upward as time changes. It shows the time series now has a constant mean and constant variance which implies the differenced series of "M2/GDP, PC/GDP, nlGDP, and GOVSIZE" achieves stationarity and hence, further analysis.
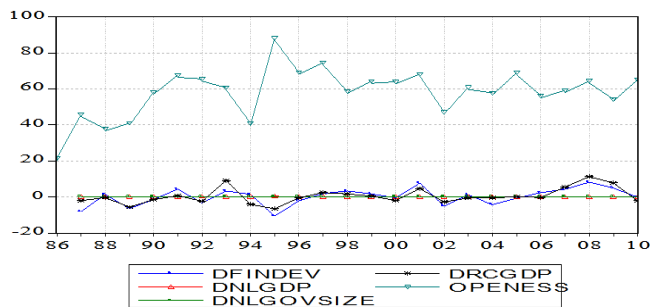

Fig. 2. Graphical Representation of Differenced Time Series.

Further Analysis

Table 2: Actual Orbservation

Variables	Expected Sign
Depth of the financial sector (M2/GDP)	-
Level of financial intermediation (PC/GDP)	-
Openness of the economy (TT/GDP)	+
SIZE OF GOVERNMENT (Recurrent expenditure)	+

Table 3: Regression Analysis

Dependent Variable: DNLGDP				
Method: Least Squares				
Date: 10/26/12 Time: 09:35				
Sample(adjusted): 1987 2010				
Included observations: 24 after adjusting endpoints				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
DFINDEV	-0.012528	0.003277	-3.823373	0.0011
DNLGOVSIZE	0.126934	0.138841	0.914237	0.3720
DRPCGDP	-0.001736	0.003551	-0.488816	0.6306
OPENESS	0.000399	0.000834	0.478475	0.6378
C	0.074980	0.051323	1.460932	0.1604
R-squared	0.721855	Mean dependent var		0.109404
Adjusted R-squared	0.663298	S.D. dependent var		0.078205
S.E. of regression	0.045379	Akaike info criterion		-3.164476
Sum squared resid	0.039126	Schwarz criterion		-2.919048
Log likelihood	42.97371	F-statistic		12.32740
Durbin-Watson stat	1.397787	Prob(F-statistic)		0.000041

Source: Author's Eview output

The regression correlation result above does not support evidence of positive relationship between depth of the financial sector and economic development (broad money (M2) as a ratio of GDP (M2/GDP), a standard measure of financial development and second proxy level of financial intermediation (credit extended to the private sector as a ratio of GDP (PC/GDP) in Nigeria. This is in line with the findings of Saibu, Wosa and Agbeluyi (2011) whose results showed that financial development had negative effects on economic growth in Nigeria. Notwithstanding the lack of positive relationship, the regression result suggests that depth of the financial sector and economic development (broad money (M2) as a ratio of GDP (M2/GDP), a standard measure of financial development is statistically significant as $t_c = 3.82$ in absolute values is $> t^* = 2$. This suggests that depth of the financial sector and economic development (broad money (M2) as a ratio of GDP (M2/GDP), a standard measure of financial development has a statistically significant effect on economic growth. However, the level of financial intermediation (credit extended to the private sector as a ratio of GDP (PC/GDP) shows no evidence of significant effect on economic growth as $t_c = 0.48$ in absolute values is $< t^* = 2$. The Granger causality test shows no causal link between the depth of the financial sector and economic development (broad money (M2) as a ratio of GDP (M2/GDP), a standard

Table 4: Granger Causality

Pairwise Granger Causality Tests			
Date: 10/26/12 Time: 09:37			
Sample: 1986 2010			
Lags: 2			
Null Hypothesis:	Obs	F-Statistic	Probability
DFINDEV does not Granger Cause DNLGDP	22	1.11909	0.34948
DNLGDP does not Granger Cause DFINDEV		0.32481	0.72706
DRPCGDP does not Granger Cause DNLGDP	22	1.00431	0.38702
DNLGDP does not Granger Cause DRPCGDP		2.38465	0.12222

Source: Author's Eview output

measure of financial development and second proxy level of financial intermediation (credit extended to the private sector as a ratio of GDP (PC/GDP) in Nigeria. This is evidenced with the probabilities of the two measures of financial development at 0.34948 and 0.38702 > 0.05 (5%) significance level. As a result, we accept that financial development does not cause economic growth. This study supports the findings of Perera and Paudel (2009) whose major finding of the study of the causal relationship between financial development and economic growth in Sri Lanka over the period 1955 to 2005 does not strongly support the view that financial development boosts economic growth; Muhsin, and Pentecost (2000) who examined the causal relationship between financial development and economic growth in Turkey and found on the balance that growth seems to lead financial sector development; Nzotta and Okereke (2009) who concluded that financial deepening did not support economic growth in Nigeria. Given the argument of Patrick (1966) the causal relationship between financial development and economic growth varies according to the stages of the development process, he suggests that the supply-leading pattern dominates during the early stages of economic development. As financial and economic development proceeds, the supply-leading characteristics of financial development diminish gradually and are eventually dominated by demand following financial development. However, this may not be attributable to Nigeria as the evidences of poor general infrastructure, high unemployment rate and inflation, lack of modest growth in GDP that abound in the country suggests that the country cannot be classified under any developmental process.

Conclusion and Policy Implications

In this study we have empirically investigated the effect and the causal relationship between financial development and economic growth in Nigeria. In controlling for variables like government consumption, trade openness which we discovered as fundamental factors in growth equations, we were able to establish a positive long run relationship between government consumption and trade openness while our measures of financial development shows a negative relationship with economic growth. The outstanding results are true for the two major indicators we used M2/GDP and PC/GDP to capture the development of the financial sector, showing that both of them actually deepen the financial sector but failed to cause economic growth in Nigeria. These results are very crucial as they support the ongoing reforms in the financial sector. However, the findings from this paper indicate that the current reforms in the Nigerian banking sector should not be emphasized unilaterally. Rather, attention should be given to the complimentary and coordinated development of financial reforms and changes in the real sector of the economy for the country to translate the positivity of the financial sector into the real sector to achieve

economic growth. Furthermore, on efficiency in resource allocation, regulatory authorities should provide a good legal and accounting as well as institutional environment. This will allow the easy circulation of information and the enforcement of contracts and permit financial institutions to better assess the risk they are taking and monitor their investments. This study strongly contributes to the literature by providing additional evidence in favour of the stand of literature that attributes a positive and important role of the financial sector in the growth process. In financial development and economic growth process theory, this paper postulates four distinguishable factors which are not mutually exclusive but have effects on financial activity and development on overall economic performance. The first is the provision of an inexpensive and reliable means of payment, followed by number two, which is volume and allocation effect in which financial activity increases resources that could be put into investment while improving the allocation of resources. Thirdly, is a risk management effect by which the financial system helps to diversify liquidity risks, thus enabling the financing of riskier but more productive investments and innovations (Greenwood and Jaranovic, 1990: Becirengo and Smith 1991). The fourth one is an informational effect on about how possible investment and capital is made available, ameliorating but not totally eliminating the effects of asymmetric information (Levine 2004).

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