FINANCIAL INTERMEDIARIES AND CAPITAL MARKET DEVELOPMENT IN NIGERIA

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Abstract: This study investigates the impact of financial intermediaries on capital market development in Nigeria employing co-integration. To capture the activities of financial intermediaries, five proxies were used to explain financial intermediaries which include credit to the private sector to GDP, broad money supply and total bank savings while on the other hand, market capitalization was used to capture capital market development covering the period of 1981 to 2016. The result revealed that in the long run, credit to private sector and money supply will lead to an increase in capital market development while banks total savings and government expenditure results to a decrease in capital market development in the long run. The study recommends that the Central Bank of Nigeria should ensure that the domestic credits provided by the banking sector are directed into their appropriate uses and government expenditure be directed to productive sectors and recurrent expenditure be reduced by government. Credit facilities should also not be restricted to the large-scale manufacturing industries only, but it should also be extended to small and medium scale enterprises.

I. INTRODUCTION

In modern economies, different models of financial systems exist, hence the financial systems were classified by Allen and Gale (2001) as "German type," where there is domination of financial intermediaries and "American type," predominantly dominated by financial markets. In the case of the Nigeria financial system, it may be classified as a bank-based system given the important role of banks in the economy (Ferreira da Silva, 2002; Aigbovo and Uwubamwen, 2014). In developing country like Nigeria, the bank based and market-based financial intermediation exists; however, IMF (2003) asserted that countries with less developed financial system usually rely on the banking sector. Hence, the

role of the domestic capital market as part of the financial system as a means to allocate savings and investment has been very limited.

The importance of a vibrant financial system cannot be overemphasized as it will increase efficiency by preventing the unnecessary liquidation of asset, financing consumption with premature liquidation of producing asset and reduce shock in income (Fulgheiri and Rovelli 1998). The financial system exists to channel funds from agents with surpluses to agents with deficit, thereby allowing savings to be invested in firms (Allen *et al.*, 2001). IMF (2003) observed that the financial system contributes to economic performance through mobilizing savings and allocating them efficiently, hence mitigating market imperfection and promoting good corporate governance.

Aside from this, the financial system exists to share risk, acquire and use available information to allocate resources efficiently. This process is often referred to as financial intermediation while the agents serving as the middlemen are called financial intermediaries. These intermediaries can be banks, insurance companies and the stock market. The role of the financial system and institutions should not be seen separately as they both mediate between the household and firms and have increased intermediation between the household and market and firms and market (Allen *et al.*, 2001).

Earlier studies have emphasized the important role expected of financial intermediaries in stimulating capital market growth of countries in Sub Sahara Africa including Nigeria (Yartey, 2008). Despite the huge presence of various intermediaries in Nigeria, the Nigerian capital market is not fully developed; however, the country's Stock Exchange is increasingly active. The volume and Value of traded securities in the Nigeria capital market between 2007 and 2010 grew in excess of 6.3% and 3.9% respectively; listed stocks rose from 288 in 2005 to 294 in 2010 while total market capitalization for the period declined by about 11.4%. The decline in market capitalization may be attributed to the price losses and the global economic crisis. Annually, the capital market grew by 74% in 2007, dipped by 45% and 33.7% in 2008 and 2009 respectively, grew again by 18.9% in 2010, dipped again in 2011 by 16.3% before recovering by an estimated 33% in 2012 (Egene, 2012). The All Share Index also demonstrated a decline of about 29.8% within the period (Central Bank of Nigeria Economic Report, 2010). According to the SandP Dow Jones Indices (2017), the Nigerian bourse grew by 42% in 2017, making the stock market the third-best performing capital market in the world after Argentina and Turkey. To complete the top five stock market for 2017, Hong Kong and the United States capital market occupied fourth and fifth position respectively. The Argentinian market soared high by 73%, Turkey also jumped up by 43%, Hong Kong grew by 35% and the United States stock market improved by 25%. With the global performance, the NSE was able to close gap in the All-Share index (ASI) from losses suffered in 2015 and 2016, which could be attributed to foreign exchange problem and decline in global oil price (Ilo, Elumah and Sayanolu 2018).

Gurley and Shaw (1960) as cited in Fulgheiri *et al.,* (1998) posit that one of the main functions of financial intermediaries is transforming illiquid liabilities issued by the firms in a more liquid form or instrument which is held by customers. Although, De Gregorio and Guidotti (1995) opined that it is the efficiency that influences growth and investment and not the volume of financial investment in the financial

intermediation process, while Edgeworth (1988) asserted that financial intermediaries effeiciently produce liquid assets due to the diversification in the pool of funds while Ziorklui, (2001) contends that higher savings and capital accumulation can be achieved with improved financial intermediation.

The supply of funds through loans and advances or through the purchase of securities is also an essential economic function of financial intermediaries (Goldsmith 1958). The question to ask then is whether the loans and purchases of securities have helped improve the capital market. Chotaliya and Trivedi (2014) assert that financial intermediary brings the buyers and sellers together and channelizes the resources in a productive way. Efficient financial intermediation channelizes savings and allocates optimally for productive uses. Financial intermediaries provide range of services ranging from traditional brokerage activities to qualitative asset transformation (Bhattacharya and Thakor, 1993)

The significance of capital market as a resource managing channel of financial intermediation has been recognized by the researchers, academicians, and policy makers as a primary determining factor for economic growth (Kolapo and Adaramola, 2012; Odetayo and Sajuyigbe, 2012; Chinwuba and Amos, 2011; Afees and Kazeem, 2010; Flavia and Petru-Ovdiu 2010; Osamwonyi, 2005 and Agarwal, 2001). The capital market is seen as driver or lubricant that keep turning the wheel of the economy to growth and development because of its imperative function of not just mobilizing long term funds and channeling them to productive investment but also efficiently allocating these funds to projects offering the best returns to fund owners (Adeusi, Sulaiman and Azeez, 2013). This allocative function is critical in determining the overall growth of the economy (Donwa and Odia, 2010).

Anyanwu (1998) asserts that the activities of the capital market affect liquidity, acquisition of information about firms, risk diversification, savings mobilization and corporate control. Therefore, by altering the quality of these services, the activities of stock markets can affect the rate of economic growth (Equakun, 2005). This account for why it is so necessary to formulate policies for the market that would assist in facilitating economic growth. Osaze (2000) sees the capital market as the driver of any economy to growth and development because it is essential for the long-term growth capital formation. It is crucial in the mobilization of savings and channelling of such savings to profitable self-liquidating investment.

The capital market not only provides the funds required for investment but may also efficiently assist in managing the fund. Okereke-Onyiuke (2000) posits that the cheap source of funds from the capital market remains a critical element in the sustainable development of the economy. She enumerated the advantages of capital market financing to include the fact that funds are held for medium and long term period or in perpetuity, and funding of state and federal government projects without pressures and ample time to repay loans. It is against this backdrop that this study examines the impact of financial intermediaries on Nigeria capital market development. This paper is significant as it will enlighten the Central Bank on how its various policy measures are affecting the financial intermediaries and the capital market at large which will further guide the policy makers in designing and implementing financial policies as well as expose an inherent weakness in the monetary policy measures of the Central bank of Nigeria.

II. LITERATURE REVIEW

Extant literatures on financial sector development have concentrated on its effect on economic growth both in developed and developing economies. For instance, Afonso, Feireria, Freitas, Nobregas and Pinheiro (2002); Chee and Nair (2010); Waheed and Yonus (2010); Mehran (2012); Ali (2013); Kafingura (2013); Nkoro and UKo (2013); Ohwofasa and Aiyedogbon (2013); Ogege and Boloupremo (2014); Pradham Tripathy, Pandey and Bele (2014); Sahoo (2014); Akinlo and Apanisile (2014) revealed that a positive relationship exists between financial sector development and economic growth.

While some of the studies considered stock market development and economic growth Afonso *et al.*, (2002); Kafingura (2013); Nkoro and Uko (2015); Pradham *et al.*, (2014); Sahoo (2014); others examined banking sector indices of financial development on economic growth (Waheed, *et al.*, (2010); Mehran (2012); Ali (2013); Ohwofasa *et al.,* (2013); Ogege and Boloupremo (2014); Ayadi, (2015) while others combined both stock market development indices and banking sector development indices (Afonso, *et al.*, (2002); Chee and Nair (2010); Kafingura (2013); Nkoro and Uko (2013); Sahoo 2014; Pradham *et al.*, (2014)). From the foregoing, it is observed that there are scanty studies on the relationship between financial intermediaries and stock market development, especially in developing countries while Demirguc-Kunt and Levine (1996); Yartey, (2008) in their study revealed that financial intermediary has a positive effect on stock market development.

Demirguc-Kunt and Levine (1996) examined the link between stock market and financial intermediary development in developing countries and found that most stock market indicators are highly correlated with financial intermediary development while countries with well-developed stock markets tend to have well-developed financial intermediaries. Yartey, (2008) studied the development of stock market in Africa using 13 countries from 1991-2001. The study examined the impact of domestic saving and investment, stock market liquidity, macroeconomics stability and financial intermediary development on stock market development. The study employed panel data technique. The result shows that financial intermediary development has a positive relationship with stock market development implying that stock market and financial intermediaries are complements. It was also found that institutional quality is an important determinant of stock market development in Africa.

Uremadu (2008) adopted the ratio of total value traded of stocks to the size of the economy as a measure of Nigeria stock market development and performance covering the period between 1977 and 2002. The result shows that banking systems credit to the economy and government expenditure has positive and significant impact on stock exchange trading values. However, inflationary pressures and high-interest rate (Minimum rediscount rate) negatively and significantly affect the liquidity of the market. Olowe (2008) opined that because of the dominant size of the banking system, the introduction of universal banking could affect other participants in the financial system. In fact, his study showed that insurance stock earned excess cumulative abnormal returns with the introduction of the universal banking system in Nigeria in January 2001. This implies that the operations and events in the banking system could affect the capital market. While Levine (1986) concluded that it is the ease at which shares can be traded (liquidity) that is more important in the mobilization of the stock

market in promoting economic growth rather than the size or volatility of the stock market.

Ilo (2007) submits that liquid stock market are capable of promoting a more efficient resource allocation, savings, more profitable long term investments and making investments less risky than the relatively illiquid capital market. Datar (2000) also alluded to this fact that market liquidity indicates the ability of stock markets to absorb temporary fluctuations in demand and supply with undue interruptions in prices. He, therefore, concluded that it should be considered an important indicator of the state of the market.

Ilo (2007) further submits that liquidity and market capitalization play a central role in determining the capacity of stock exchanges. Stressing further that the degree of liquidity of any stock market is one of the fundamental parameters for accessing the attractiveness or otherwise of any stock exchange by different categories of investors. Conversely, Levine and Zervos (1998) posits that high liquidity suggests low transaction cost and that a large stock market is not automatically a liquid market, since a large but inactive market will have large capitalization but low turnover. Anyanwu (1998) cited in Ilo (2007) stressed that liquid stock market makes investments less risky and more attractive because they allow savers to acquire securities with ease and sell them quickly if they need cash or need to alter their portfolio.

III. METHODOLOGY

This study examines the impact of financial intermediaries on capital market development in Nigeria using time series data from 1981-2016 obtained from the CBN bulletins, National Bureau of statistic, and NSE Statistical Bulletins. The study period is significant as different programmes, policies and laws were made in the financial system during this period. Among which is the structural adjustment programs; recapalization, automation of the stock market among others.

This relationship is thus modelled as presented in equation (1); financial intermediation is proxied by the operations of the deposit money banks. It is hypothesized that the more active the level of financial intermediation in the banking sector, in a bank based economy like Nigeria, the higher the rate of development of the capital market segment of the financial system. As stated by Adegbite and Oke (2008), the ratio of money supply to GDP (MS/GDP) often called financial depth measures the size of financial intermediaries and will be included in the model used in this study.

Also, credit to the private sector as a ratio of GDP (CPS/GDP) is included in the model since a financial that channels loanable funds to the private sector are more involved in intermediation than the one that channels funds to government and its parastatals (Adegbite et al., 2008). Also, the mobilization of saving is a cardinal role of banks especially the accumulation of small savers money, hence, the need to include total savings of banks as a ratio of GDP (TS/GDP) to capture banks mobilization role. The capital market development, on the other hand is measured using the turnover ratio i.e total volume traded as a ratio of gross domestic product, this according to Adegbite et al., (2008) measures the value of equity transactions relative to the size of the economy is an indicator of the efficiency of the capital market (TVT/GDP).
TVT/GDP=f (MS/GDP, TS/GDP, CPS/GDP, MPR, GE/GDP)…………………………..(1)
The econometric design for the model is:

$TVT/GDP_t = \beta_0 + \beta_1 MS/GDP_t + \beta_2 TS/GDP_t + \beta_3 CPS/GDP_t + \beta_4 MPR_t + \beta_5 GE/GDP_t + U$ ………..(2)

Where:

TVT/GDP_t: total value of stock traded as a ratio of GDP at time t

MS/GDP_t: Money supply as a ratio of GDP at time t

TS/GDP_t: Total Savings as a ratio of GDP at time t

CPS/GDP_t: Credit to Private firm as a ratio of GDP at time t

MPR_t: Monetary Policy Rate at time t

GE/GDP_t: Government Expenditure as a ratio of GDP at time t

U_t = Disturbance Term

β_1 = Intercept

$\beta_2 - \beta_4$ = Coefficient of the Independent Variables.

IV. EMPIRICAL ANALYSIS AND INTERPRETATION

This section presents the properties of the data used for this study in order to understand the variables as well as the suitability for this study. It will assist in drawing inference under the test of the hypothesis.

4.1 Descriptive Statistics of Research Variables

The table below presents the summary statistics for the variables under the study.

Table 4.1 shows that the value of stock traded relative to the size of the economy (VT/GDP) is about 10.66 percent, while the banking sector credit to the private sector relative to the size of the economy (CPS/GDP) is about 12.84 percent. This suggests that the level of financing of the economy by capital sector is 10.66% while the banking sector is about 12.84%, hence, the Nigerian financial system can be described as being bank–based which is based on the comparative figures of stock market and financial intermediaries development indicators.

It was also revealed the value of stock traded on the stock exchange market is relatively unstable and fluctuates, this is indicated by the figure of the standard deviation. It was also discovered that all the variables are positively skewed and the variables produces extreme outliers based on the kurtosis value.

4.2 Unit Root Test

Before testing for causality or cointegration, it is essential to conduct the Augmented Dickey-Fuller (ADF) tests so as to determine the order of integration for each of the variables. This study conducts the unit root test to determine

Table 1: The Descriptive Statistics of variables

	VT/GDP	CPS/GDP	MS/GDP	TS/GDP	MPR	GE/GDP
Mean	10.66069	12.84335	17.25827	8.824452	12.98571	10.81584
Median	3.615168	10.91669	16.56882	7.927881	13.00000	11.36910
Maximum	69.11100	36.89332	37.95685	23.24536	26.00000	20.25320
Minimum	0.443673	5.917133	8.577088	3.335644	6.000000	4.728088
Std. Dev.	15.01282	6.547699	5.838363	3.826307	4.267672	3.271397
Skewness	2.411707	1.877912	1.655927	1.700355	0.702819	0.345191
Kurtosis	8.939809	6.880788	6.868021	7.231178	3.984020	3.947942
Obs	35	35	35	35	35	35

Sources: Authors' Computation (2018)

the order of integration of the series. This is reported in Table 2 below:

Table 2 : Unit root Test

Variable	T-Stat	Prob.	Order
TVT/GDP	-2.1143	0.2405	I(1)
D(TVT/GDP)	-5.1657	0.0002	
CPS/GDP	-1.8996	0.3285	I(1)
D(CPS/GDP)	-5.8297	0.0001*	
TS/GDP	-2.2065	0.2077	I(1)
D(TS/GDP)	-6.2538	0.0000*	
MS/GDP	-2.0750	0.2554	I(1)
D(MS/GDP)	-5.4703	0.0001*	
MPR	-3.0304	0.0420**	I(0)
GE/GDP	-2.9914	0.0458**	I(0)

Sources: Authors' Computation (**Note:** significant level: * 1%. ** 5%, ***10%)

Table 3: Bond Test

Test Statistics	Value	K	Pesaran Critical Value Bound 5%	
			10 Bound	II Bound
F-statistics	10.4994	3	3.79	4.85

Sources: Authors' Computation

Table 4.2 above shows that VT/GDP, CPS/GDP, TS/GDP and MS/GDP are not stationary at level stationary at first difference while MPR and GE/GDP are stationary at level. It, therefore, means that the variables considered in this study are multileveled integrated and integrated of order one and zero, thus a long-run linear combination is suspected amongst them. Hence, Auto-Regression Distributive Lag (ARDL) to cointegration was used to capture the long run effect among the variables. The choice of the ARDL is consistent with the statistical properties that are integrated of order with few that are stationary at level. There is no I(2) series that could make difficult the interpretation of the value of the F-statistics developed by Pesaran, Shin and Smith (2001).

Table 3 shows the bound test carried out to investigate the long run effect of financial intermediation and capital market development in Nigeria. The value of the F-statistic is 10.4994 which lie above the lower bound critical value 4.85 at 5% level of significance. This implies that long run relationship exist between financial intermediation and capital market development.

Table 4 above revealed the extent to which financial intermediaries have responded to the development of capital market contexts

Table 4 : Long Run Coefficients

Dependent Variable: VT/GDP				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-20.2363	10.14361	-1.994989	0.0555***
CPS/GDP	0.5623	0.943922	0.595714	0.5560
MS/GDP	3.0614	0.983549	3.112666	0.0041*
TS/GDP	-2.7171	1.498707	-1.813027	0.0802**
MPR	0.03198	0.525034	0.060915	0.9518
GE/GDP	-0.517560	0.699157	-0.740263	0.4651
R-squared	0.644159			
Adjusted R-squared	0.582808			
F-statistic	10.49943			
Prob. F-statistic	0.000008*			

Sources: Authors' Computation:
Note: significant level: * 1%. ** 5%, ***10%

in the long-run. It was shown that one percent increase in credit to the private sector to gross domestic product (CPS/GDP) result in 56% increase in capital market development. Similarly, money supply as a ratio of gross domestic product (MS/GDP) have a significant positive effect on capital market development, this suggests that the volume of money supplied by government in the economy is expected to lead to development in the capital market.

On the other, total saving of banks as a ratio of gross domestic product has a negative effect on capital market development implying that a one percent increase in total saving of banks result to about 271% decrease in capital market development while government expenditure as a ratio of gross domestic product which is used to proxy the activities of government also depicted a negative coefficient, suggesting that a one percent increase in government expenditure brings about 52% decrease in capital market development.

Furthermore, the r-squared shows that the explanatory variables bring about 64% variations in capital market development in Nigeria. This suggests that the operation or activities of financial intermediaries in the economy cause about 64% changes in the development of capital market. The F-statistics also suggest that in the long run, financial intermediation has a significant effect on capital market development.

The coefficient of the ECM is correctly signed but statistically insignificant, suggesting that approximately 28% of disequilibria from the previous year's shock do not converge back to the long-run equilibrium in the current year, hence, there is no short run effect of financial intermediaries on capital market development. Furthermore, the result shows that a period lag of value of stock traded (VT/GDP), total saving (TS/GDP) and monetary policy rate (MPR) will bring about a positive effect on the capital market development which is insignificant except (TS/GDP) at 1%. This suggests that total

Table 5: Short Run Effect of Financial Intermediaries on Capital Market Development

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-5.859476	9.975759	-0.587371	0.5643
D(VT/GDP(-1))	0.369402	0.318399	1.160186	0.2611
D(VT/GDP(-2))	-0.847386	0.439349	-1.928731	0.0697***
D(CPS/GDP(-1))	-1.673326	1.293800	-1.293342	0.2122
D(CPS/GDP(-2))	-3.010089	1.441479	-2.088195	0.0513***
D(MS/GDP(-1))	-2.032280	1.708908	-1.189227	0.2498
D(MS/GDP(-2))	0.828665	1.675069	0.494705	0.6268
D(TS/GDP(-1))	7.675248	2.456029	3.125063	0.0058*
D(TS/GDP(-2))	3.596664	2.746617	1.309489	0.2068
MPR	-0.012219	0.817547	-0.014946	0.9882
MPR(-1)	0.553181	0.790687	0.699621	0.4931
GE/GDP	0.258500	0.871698	0.296548	0.7702
GE/GDP(-1)	-0.326057	0.979475	-0.332890	0.7431
ECM(-1)	-0.280377	0.357816	-0.783578	0.4435

Source: Authors Compilation, (2017)
Note: Significant level: * 1%. ** 5%, ***10%

Table 6: Post Diagnostic Test

	F-statistic	Prob
Normality Test: Jarque-Bera	0.0700	0.9655
Breusch-Godfrey Serial Correlation LM Test:	1.4340	0.2674
Heteroskedasticity Test: Breusch-Pagan-Godfrey	1.4208	0.2325

Source: Authors Compilation, (2018)

saving accumulated by banks, the performance of the stock market in the previous year and monetary policy rate of the CBN result to the development of the capital market. Conversely, a period lag of money supply (MS/GDP), a period lag of credit to private sector (CPS/GDP) and government expenditure (GE/GDP) result to a fall in capital market development. Hence, money supply, credit to private-sector and government expenditure at this level does not support the development of capital market implying that as more monies are pumped into the economy by the government and loans were given out to bank customers, a large sum of the funds were not be used for investment in the capital market thereby bring about a negative effect on capital market development.

A closer examination of the table above also revealed that only MS/GDP and TS/GDP at two periods lag contributes positively to the capital market development, however, they are insignificant. This implies that money supply will bring about increase in investment on the capital market and that an increase in total saving will spur capital market growth in the short run. However, based on the ECM parameter, the study concludes that financial intermediaries do not have a significant effect on capital market development in the short run.

The Breusch-Godfrey Serial Correlation Test was carried out to examine whether the variables are serially correlated, the result in table 6 shows that the probability value of F-statistic is not significant at 5% (0.26) as such, the study reject the null hypothesis

that there is presence of serial correlation among the variables. Also, the normality test was carried out to check if the residuals are normally distributed. The result of the Jarque-Bera Statistics suggests that the residuals are normally distributed given the probability value of 96%. Thus, the diagnostics indicate that the residuals are normally distributed, homoscedastic and serially uncorrelated which implies that the result of this study is not spurious and can be relied on for policy-making.

V. SUMMARY AND CONCLUSION

This empirical work employed ARDL approach to cointegration model to investigate the impact of financial intermediaries on capital market development in Nigeria. To capture the activities of financial intermediaries, three proxies were used to capture the activities of financial intermediaries; they include credit to the private sector to, money supply, total bank asset, while on the other hand, total value of stock traded was used to capture capital market development covering the period of 1981 to 2015.

The study revealed that credit to the private sector results in an increase in capital market development. Uremadu (2008) also concluded that banking systems credit to the economy have positive and significant impact on stock exchange trading values. Similarly, money supply significant positive effect on capital market development, this suggests that the volume of money supplied by government in

the economy is expected to lead to development in the capital market in the long run.

On the other, total saving of banks has a negative effect on capital market development implying that banks total savings reduces capital market development while government expenditure brings about a decrease in capital market development. This is dissimilar to the earlier study of Uremadu (2008) also concluded that government expenditure has positive and significant impact on stock exchange trading values. The study suggests that financial intermediaries have significant effect on stock market development in Nigeria in the long run. This is similar to the result obtained by Demirguc-Kunt and Levine (1996); Yartey, (2008) who revealed that financial intermediary has a positive effect on stock market development.

As observed from our result, credit to the private, has a positive insignificant impact on capital market development. In order to reverse this trend, there is a need for banking institutions to revise the modalities for lending to the private sector and not just fund real assets but finance investment in financial asset which will promote capaital market development. Also, the Central Bank of Nigeria should ensure that the money supply into the economy are used judicious and ensure that domestic credits provided by the banking sector are directed into their appropriate uses. Credit facilities should not be restricted to the large-scale manufacturing industries only, but it should also be extended to small, medium scale enterprises and inventors in the capital market as this will go a long way in stimulating development of the capital market and economic growth.

Based on the above conclusion, this study recommends that government should restore confidence to the market through regulatory authorities which will bring about transparency, fair trading transactions and dealing in the stock exchange, encouraging more foreign investors to participate in the market and also to increase investments instruments such as derivatives, convertibles, swap and option in the market.

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