



## **BANKS' CREDIT AS AN INSTRUMENT OF ECONOMIC GROWTH IN NIGERIA**

**Dr. Ndubuisi M. NWARU<sup>1\*</sup> & <sup>2</sup>OKORONTAH, Chikeziem F.**

<sup>1</sup>Imo State University, Owerri, Imo State, Nigeria

<sup>2</sup>Rhema University, Aba, Abia State, Nigeria

\*Email: [Chizim4teen@yahoo.com](mailto:Chizim4teen@yahoo.com)

### **ABSTRACT**

This paper investigates the significance of banks credit in stimulating output (GDP) and the factors that prompt financial intermediation within the economy. It is a contribution to the existing literature on finance and growth applied to the Nigerian economy. Evidence from this work shows that the marginal productivity coefficient of bank credit to the domestic economy (proxies by credit to the private sector) is positive but insignificant. The implication is that bank's credit did not affect the productive sectors sufficiently for the later to impact significantly on the Nigerian economy. It was also observed that real output causes financial development, but not vice versa, and that export was not significant in driving financial development; but growth in financial sector was highly dependent on foreign capital inflows. With regards to this the paper recommends that a strong and comprehensive legal frame work that will aid in monitoring the performance of credit to the private sector and recovering debts owed to banks be established, so that banks will show willingness to lend to the private sector of the economy.

**Keywords:** Economic growth, Financial intermediation, Causality, Private sector, Financial sector

### **INTRODUCTION**

Economic agents of the economy require finance for different purposes; one main purpose is to promote economic activities. The issue of credit becomes necessary as these economic agents do not have the ability to raise the required capital for the execution of their plans. The availability of (bank) credit allows firms to increase production, output and efficiency, and in turn increase the profitability of banks through interest servicing (Agbala 2010).

Adeniyi (2006), recognized the role of credit in economic development and asserted that credits are obtained by various economic agents to enable them meet operating expenses. The debate on the intermediary role of banks in economic growth has dominated many discussions in literature. However, there seem to be a general consensus that there is a strong positive relationship between financial development and economic growth. The main divergent view is on the issue of causality. Alternative explanation has been empirically offered for the relationship that exists between financial intermediation and growth based on the direction of causation.

In essence, financial intermediation can be a causal factor for economic growth. According to the Bayoumi and Melander (2008), 92.5% reduction in overall credit causes a reduction in the level of GDP by around 1.5%. Similarly findings have also revealed that economic growth can also be a causal factor for financial development. This often occurs when the level of development within the economy is responsible for promoting the growth of the financial system (a reverse case of the situation earlier described above). Situations with bi-directional causality have also been observed too. One such study was by Demetriades & Hussein (1996) who studied 13 countries and observed all three situations described above. They therefore, concluded that the issue of causality is country specific rather than general as earlier postulated. Several studies (Odedokun, 1998; Ghirmay, 2004) lend support to this

postulation. The above discovery has made it rather important to examine the relationship between banks and the economy with a view to determining the direction of causality that exists amongst them. This study will help us to assess whether banks through their role of intermediation can be relied upon to stimulate the growth of the Nigeria economy.

**CONCEPTUAL DISCOURSE AND LITERATURE REVIEW**

**The concepts of Bank credit and Economic growth**

Under this sub-section, we deem it necessary to define and discuss some concepts which are fundamental to better understanding and appreciation of this discourse.

**Credit:** Credit is the system by which goods and services are provided in return for deferred rather than immediate payment; it may be provided by the seller, or by a bank or finance company. John Black, (2003). Spner, (1977), and Freear, (1980), all gave support that credit implies a promise by one party to pay another for money borrowed or goods borrowed and service received. However, our focus in this study is on banking system credit (Bank credit) which involves financing economic activities such as manufacturing, production, commerce et cetera, through the provision of loans and overdrafts by banks. According to CBN (2003), the amount of loans and advance given by the banking sector to economic agents constitute bank credit.

**Economic Growth:** Economic growth is defined as a positive change in the national income or the level of production of goods and services by a country over a certain period of time. This is often measured in forms of the level of production within the economy. Other possible measures include total factor productivity, factors of production such as technological change, human capital termed the Schumpeterian approach. Other measure of growth ranges from real per capita GDP; the rate of physical capital accumulation etc, (Odedokun 1998, King & Levine 1993 and Allen & Ndikumama 1998). Todara and Smith (2006) saw economic growth as a steady process by which the productive capacity of the economy is increased overtime to bring rising levels of national output and income. The main characteristics of economic growth are high rate of growth of per capita income or output, high rate of productivity, high rate of structural transformation, international flows of labour, goods and capital (Ochejele, 2007; Dewett, 2005; and Awanyanwu, 2010). Analysing the above definitions, we gathered that economic growth is a sustained increase in the economic variables of an economy mainly the “GDP” over a period of time.

**THEORETICAL LITERATURE REVIEW**

Early economists such as Schumpeter in 1934 identified banks’ role in facilitating technological innovation through their intermediary role.

The finance literature provides support for the argument that countries with better/efficient financial system grow faster while inefficient financial systems bear the risk of bank failure and consequently backward economy (Kasekewa 2008). One of the activities of financial institutions involves intermediating between the surplus and the deficit sector of the economy. Banks accept deposit from individuals and institutions thus transferring funds from the surplus sector to the deficit sector of the economy (Mishkin 2007). Though they are subject to certain regulations by the regulatory authorities, financial intermediaries still determine the rules for allocating funds, and as such they play a significant role in determining the type of activities, the level of job creation and the distribution of income.

The neoclassical framework for long-run growth (the slow model) comprises of a production function and a capital accumulation function. The production function refers to the inputs of capital (k) and labour (L) necessary to produce output (Y). It is assumed to have the Cobb-Douglas form and is given by

$$Y = f(K, L) = K^a L^{1-a} \dots\dots\dots 1$$

where ‘a’ is a number between 0 and 1. (Grame & Linda 2006)

According to Dewett (2005) “the most important function of the central bank is the control of credit. The control of credit means the regulation and control of bank loans and advances. The volume and nature of banks’ credit have a vital bearing on the state of the economy. In essence there is a strong relationship between economic growth and credit advancement he concluded.

## **EMPIRICAL LITERATURE REVIEW**

All economic units need liquidity (liquid funds). Thus every government directs and, or encourages banks to provide credit to economic sectors or entities that can put them to most productive use. There have been mixed conclusions over the issue of the relationship between economic growth and financial intermediation- the provision of credit facilities by the banks.

Mckinon (1973,), Geldmith (1969) and Shaw (1973) in their related studies strongly believed that there is a positive relationship between financial intermediation and economic growth. In the same vein, Greenwood and Jovanovich (1990) maintain that finance development lead to rapid growth. In their own study, Beneirenga and Smith (1991), explained that development of banks and efficient financial intermediation contribute positively to economic growth by channeling savings to high productive activities and reduction of liquidity risks. Some economists maintain that the existence of a relationship between finance and growth seems incontestable, what is debatable is the direction of causality between finance and growth.

The direction of causality has been described by Patrick (1966) as supply-leading and demand following hypothesis. When causal relation runs from financial development to growth, it is termed supply-leading because it is believed that the activities of the financial institution increase the supply of financial services which creates economic growth. Similarly, when the growth within the economy results in increase in the demand for financial services and this subsequently motivates financial development, then it is termed demand- following hypothesis.

Following the line of argument of the previous researchers was Demirguc-kunt & Levine (2008) who found strong evidence that financial development is important for growth. To them, it is crucial to motivate policy makers to prioritize financial sector policies and devote attention to policy determinants of financial development as a mechanism for promoting growth. The study conducted by Diego (2003) used panel estimation technique to assess the mechanism through which policy changes have influenced the growth performer of fifteen European Union economies also supports the above postulations. He came to this conclusion with the aid of two channels. First is the increase in the level of financial intermediation measured by the rise in the private credit to GDP. The second channel was the improvement in the quality and efficiency of the financial intermediation process proxies by the fall in the growth rate of the ratio of non-performing loans to total loans. Recent study by Habibullan and Eng (2006) conducted causality test analysis on 13 Asian developing countries. The result is in agreement with other causality studies by Calderon & Liu (2003), Fase & Abam (2003) and Christopoulos & Tsions (2004). They found that financial development promotes growth, thus supporting the old Schumpeterian hypothesis.

In furtherance to the above studies, a good number of other recent studies lend credence to a causal relationship between credit and economic growth. The IMF autumn 2008 global financial stability Report detected a statistically significant impact of credit growth on GDP growth. Specifically, it was revealed that “a credit squeeze and a credit spread evenly over three quarters in USA will reduce GDP growth by 0.8% and 1.4% points year-on-year respectively assuming no other supply shocks to the system.

Despite the above views, growth is at times seen as unrelated to banks. The postulates of this hypothesis, argue that economic growth is a causal factor for financial development. According to them, as the real sector grows, the increasing demands for financial service stimulate the financial sector (Gurley & Shaw, 1967). Similarly, Lucas (1988) believed that economists have badly overstressed the role of financial factors in economic growth. In essence, banks only respond passively to industrialization and economic growth. A re-examination by Favara (2003) of the analysis of Levine, Loayza & Beck (2000) used the panel estimation techniques and reported that relationship between financial development and economic growth is at best weak. To him there is no indication that finance spurs economic growth, rather for some specifications, the effect of financial development on economic growth is ambiguous and not robust to alternative dynamic specifications. This he attributed to the fact that financial development does not have a first order effect on economic growth; the link between them is not linear and if the dynamic specification and slope heterogeneity across countries are taken into account, the effect is negative. Also the stud

when bank deposit, private sector credit or domestic credit ratios are alternatively used as proxy for financial development causality runs from economic growth to financial development. They therefore concluded that growth seems to lead financial sector development. The work carried out by Nnanna, Englama and Odoko (2004), based on solow's analysis of the American data from 1909-1949, proved that 85% of economic growth within the period was attributed to technological change and 12.5% to the increased use of capital. This implies that financial institution had only minor influence on the rate of economic growth. It is observed that some who carried related studies on the Nigeria economy supports weak relationship between bank credit and economic growth. Nwanyanwu (2010) attributed the situation to the fact that banks exhibit apathy in lending to the private sector for production purposes., and Oluitan (2011) concluded that real output causes financial development but not vice versa. Some authors also postulate that there is a bi-directional relationship between finance and growth. Demetriades & Hussein (1996) conducted a study on 16 less develop countries between 1960 and 1990 with the aid of time series technique. They observed long run relationship for indicators of financial development and per capital GDP in 13 countries. However, they found bi-direction causality in six countries and reverse causality in six countries while South Africa showed no evidence of causation between the variables. Having evaluated these conclusions, this study will use a simple regression analysis to study the relationship, between economic growth and bank credit in Nigeria and by extension the direction of causality.

## METHODOLOGY

### Brief Note :

Several empirical studies have agreed that there exist a (linear) relationship between “credit and economic growth”. In order to examine this relationship, previous studies have used several analytical approaches. These include cross country growth regression used by king & Levine (1993);panel techniques used by Rioja & Value (2003) and time series used by Demetrades & Hussein (1996). On these approaches, Demetriades & Andrianova (2003) summarized that “ It is difficult to draw out any reliable policy implication from cross-country or panel regression and those conclusions that we may draw from time-series studies for individual country cannot be generalized”. In essence, time-series is more applicable for single country analysis hence this study intends to use time series method of estimation following the methods used by Ghirimay (2004), Tange (2003), Demetriades & Hussein (1996).This according to Demetriades & Andrianra (2003) allows the use of appropriate statistical procedures such as cointegration to test for the long run relationships, they also allow the use of statistical procedures that can shed light on the causality between two or more variables in both the long run and the short run.

### Data, Analytical Method and Model Formulation

Earlier in this paper, we established that our task is to examine whether “Bank credit is a significant instrument for generating growth within the Nigeria economy and that, we shall also verify the factors that are significant in determining the growth of credit in Nigeria. To achieve these objectives, we established an econometric procedure and data used was from 1985-2010. (Sourced from CBN Bulletin 2008, golden jubilee edition; CBN Annual report and statements of accounts) . We begin this procedure with the specification of the model and using the Philips peron unit root test to determine the order of integration of the variables. Variables are said to be co-integrated if they are affected by the same long run influence. Cointegratinon implies that  $y_t$  and  $x_t$  share similar stochastic trends, and since the difference  $e_t$  is stationary, they never diverge too far from each other (Carter 2007). Because the existence of a relationship between variables does not ascertain causality or the direction of influence (Gujoriti 2004), the test for causality was also carried out. In order to undertake this exercise, we use e-view computer package (version 6).

### Specification of the Model

$$\begin{aligned} \text{LRGDPG}_t &= \alpha_0 + \alpha_1 \text{LRCPSg}_t + e_t \dots\dots\dots 1 \\ \text{LRCPSg}_t &= \alpha_0 + \alpha_1 \text{LRGDPG}_t + e_t \dots\dots\dots 2 \end{aligned}$$

Where:-

LRGDPg = Log of real gross Domestic product growth

LRCPSg = log of real private sector credit growth.

$\alpha_0$  and  $e_t$  are the constant and the error terms respectively  $\alpha_1$  is the parameter to be estimated.

To avoid the bias of using bi-variate framework in estimation as stated by Lucas (1998) and Al-Yousif (1999) due to possible omission of variables, other variables such as exports and capital flows were introduced. Thus the models:

$$LRGDPg_t = \alpha_0 + \alpha_{11}LRCPSg_t + \alpha_{12}LRTXPg_t + e_t \dots\dots 1a$$

$$LRCPSg_t = \alpha_0 + \alpha_{21}LRGDPg_t + \alpha_{22}LRTXPg_t + \alpha_{23}LRFCIg_t + e_t \dots 2a$$

where:-

LRTXPg = log of Real total Export growth

LRFCIg = log of real foreign capital inflow growth.

Given the assumed relation, based on apriori reasoning the expected signs for the parameter estimates are:

$$\alpha_{11} \geq 0, \alpha_{12} \geq 0, \alpha_{21} \geq 0, \alpha_{22} \geq 0, \alpha_{23} \geq 0$$

## RESULTS

### Estimation and Interpretation of Results

We begin our empirical analysis by showing the degrees of association between RCPSg, RTXPg and RGDPg through the multiple regression analysis. Table 1 depicts the result of the OLS of model 1a, and it shows that statistically significant positive relationship exist between the RtXPg and RGDPg. The Real total export growth (RTXPg) is rightly signed and significant at 5.0 percent. One percent change in RtXPg will result in 0.35 percent increase in the growth rate of GPD. The RCPSg was not significant at 5.0 percent but was positive in the model implying also a right sign.

The coefficient of determination  $R^2$  indicates that about 89 percent of the changes in real gross domestic product growth (RGDPg) are explained by the variables. The joint significant of model 1a, F-statistic, which is 90.99994 shows that the model is statistically significant and can really explain the reasons for the change in the level of RGDPg.

Given the results, it is necessary to test its reliability that is whether it is not a spurious regression. This we did through the augmented Dickey-filler (ADF) unit root test. The results in (Table 2) indicates that the variables are stationary at second difference, that is 1(1), we therefore proceed with the co-integration test hence the ADF test has fulfilled the requirement that the series to be used must be integrated to the same order. Table 3 shows the result of the Johnson co-integration test. It shows that the values of trace statistic is more than the critical value at 5 percent in two of the three ... hypothesis, which indicates two co-integrating vectors or two cointegrating equation at the 0.05 level of significant. Since the variables are co-integrated, then there would be no loss of information, implying that there exists a long run relationship between RGDPg and the included variables.

**Table 1: Multiple regression result. (Model 1a)**

Variables	Coefficient	Std. error	t. statistic	Prob.
C	7.824133	0.370113	21.13983	0.0000
Log (RCPSg)	0.064329	0.051008	1.261169	0.2199
Log (RTXPg)	0.352885	0.057117	6.178265	0.000

R-squared =0.887808; Adj.R-squared =0.873049; F.statistic =90.99994; Prob.(f-stat) =0.00000

Durbin-watson ; stat =1.875691

**Table 2: Unit root test:**

Variables	1 <sup>st</sup> difference	Prob.	Order of integration
(RGDPg)	-5.736922	0.0001	1 (1)
(RCPSg)	-3.739328	0.0116	1 (1)
(RTXPg)	-5.334292	0.003	1 (1)

**Note:** The 5% critical value for ADF statistic at 1<sup>st</sup> difference is -3.020686

**Table 3: Johanson's co-integration test**

Hypothesized No of CELs	Trace Stat	0.05 Critical value	Prob **
None *	46.714w	29. 79707	0.0002
At most 1*	5.028838	3.841466	0.0249
At most 2	14.10751	15.49471	0.0800

Trace test indicates 2 co-integrating equations at 0.05 level of significance

\* Denote rejection of the hypothesis at 0.05 level

\*\*Maecinnon-Hang. Michelis (1999) P-values.

**Table 4: Pairwise Granger causality test:**

Null hypothesis	obs	f. stat	Prob.	Decision	Direction
RGDP does not granger cause RCPS	24	7.78962	0.0034	Reject	Causality
RCPS does not grange cause RGDP	-	1.43236	0.2657	Accept	No causality
RTXP does not granger cause RGDP	24	1.57415	0.2330	Accept	No causality
RGDP does not granger cause RTXP	-	3.81918	0.0501	Reject	Causality
RTXP does not granger cause RCPS	24	23.1761	0.7778	Accept	N0 Causality
RTXP does not granger cause RTXP	-	0.53235	0.5957	Accept	No. causality

The pairwise granger causality test represented in Table 4 shows that there are unidirectional causality from RGDPg to RCPSg, i.e PGDPg → RCPSg; this result agrees with what Patrick (1966) regarded as “demand- following hypothesis”. This postulate that economic growth is a causal factor for financial developement, meaning that, as the real sector grows, the increasing demand for financial services stimulate the financial sector (Robinson 1952).

**Factors Determining the Growth of Credit in Nigeria**

To establish the factors that drive credit growth model 2a which its result is represented in Table 5 is used. The result shows that real gross domestic product growth (RGDPg) is significant factor that leads growth in financial development. This also supports the result of the causality test (Table 4). It was found that real total export growth (RTXPg) is not a significant factor in determining the growth of credit. The poor relationship between total export and the financial sector development could be possibly explained from the basket of export items. Nigerian export is mainly crude oil which is done by multi-national companies that source for their funding from outside the country.

The model shows that foreign capital flow is highly significant in enhancing credit growth within the economy. It shows that one percent increase in real total capital flow will cause about 0.31 percent increase in real private sector credit. In essence, the effect of real total capital flow is a significant factor to the growth of credit within the economy. This result supports the findings of Arvan (2005) and Duentalf et al (2005) that foreign inflows are important in driving credit growth.

**Table 5 Model 2a regression result.**

Variables	Co-efficient	Std.error	t. statistic	Prob.
C	-18.07277	6.342486	-2.849478	0.0093
Log (RGDPg)	1.767769	0.723097	2.44418	0.0230
Log (RTXPg)	0.342111	0.305675	1.119200	0.2751
Log (RFCIg)	0.314643	0.101477	3.100627	0.0052

R-Square =.0.810860; Adj.R.Square =0.785068; f-statistic -31.43860; prob (f-stat) = 0.00000

Durbin-watson (DW) stat.=1.78239

In the two models  $R^2$  proved to be of good fit in explaining the change in the dependent variables. The DW statistic for model '1a' is preferable to Model '2a'. The result of model '1a' shows that credit to the private sector has no significant impact on Nigeria's GDP from 1985-2010. In other words, the variations in banks credit to the economy cannot be used to forecast the value of the Nigeria GDP. The two factors that drive or enhance the financial development are real gross domestic product and real foreign capital inflow as applied by this study.

## **DISCUSSION**

This study examined the significance of financial intermediation to the growth of the Nigeria economy. The modern economy is a credit economy. It has been found that credits constitute a powerful source of liquidity and are considered as the oil of the wheel of commerce and industry. This has been found to contain some truth as many authors such as Bencivenga and Smith (1991), Deigd (2003) etc maintained that development of bank and efficient financial intermediation contribute positively to economic growth. Our result was contrary to this conclusion.

We observed that, though credits have increased tremendously in recent times, its expected effect on domestic economy and output or GDP in particular is not significant. This finding supports the work carried out by Agbada (2011) and Nwanyanwa (2010) who both conclude that bank credit has not impacted significantly on the growth of the Nigeria economy. It was observed that while credits to the non-financial public enterprise and to government declined consistently, credit to the private sector has been on the increase. But great percentage of the credit (to the private sector) is channeled to commerce - mainly for importation of consumer goods, which attracts quick and high rate of turnover. As a result, the volume of loan actually given to investors is insignificant, and could not add meaningful contribution to the GDP. Regarding the factors that enhance financial development, it was discovered that real GDP real total capital flow are very significant. The insignificant relationship between exports and financial development is traced to the very insignificant percentage of exports being financed by the financial industry. A large percentage of the country's export is oil based and is dominated by foreign multi-nationals who source their funds from outside the country. Therefore, the intermediation role by banks in exports finance is negligible.

It was also discovered that causality runs from GDP to financial development, supporting the demand - following hypothesis described by Patrick (1966). The insignificant contribution of Banks' credit to GDP may be attributed to the fact that banks exhibit apathy in lending to the production sector of the economy due to high level of risk involved.

## **CONCLUSION AND RECOMMENDATIONS**

In view of these observations; the federal government, monetary and regulatory authorities are expected to put in place policies aimed at reversing the trend of a consumption based economy to a production based economy, so that the vision 20:20:20 could become a reality. It means that appropriate policies should be formulated to ensure that the production sector of the economy particularly small and medium scale enterprises (SMES) are funded. Banks in the country need to be made relevant to financing of oil-export which accounts for significant aspect of the country's total export. They should also be encouraged to give both short and long-term loans for production purposes as this will eventually lead to economic growth. It is also important to establish a strong and comprehensive legal framework that will aid in monitoring the performance of credit to private sector and recovering debts owed to banks (this will reduce bank risk in credit lending). Lastly the Central Bank of Nigeria should adopt direct credit control where preferred sectors like agriculture and manufacturing sectors should be favoured in terms of granting loans.

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