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Impact of Financial Development and Economic Freedom on Economic Growth in Nigeria

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Abstract

This article examined the impact of financial development and economic freedom on economic growth in Nigeria from 1995 to 2018. The paper deviates from the finance-growth literature by including economic freedom in the model with foreign direct investment and trade openness as control variables. The autoregressive distributed lag (ARDL) bounds testing approach was used to determine if a long-run relationship among the variables. The results show that the variables are cointegrated in the long-run. The domestic credit to the private sector significantly enhances growth in the short-run but is insignificant in the long-run. In the short-run, economic freedom contributes positively to economic growth but it is insignificant in the long-run. It was also discovered that foreign direct investment and trade openness relates positively and significantly with economic growth. To achieve accelerated and sustained economic growth, more access to credit to the private sector will help drive the growth process. There is the need to promote greater economic freedom through respect for the rule of law, enforcement of property rights and ease of doing business.

Keywords: Economic Growth, Financial Development, Economic Freedom
JEL classification: **O4, O16, O43, K22**

Contribution to/Originality Knowledge:
This paper contributes to the understanding of Nigeria's economy growth through the interaction of financial development and economic freedom in the short-run and long-run. The originality of this study lies with the data, methodology and results obtained.

1.0 Introduction

Globally, economic growth has been given keen consideration because of the impact it has on the well-being of society. But what drives growth has been a subject of debate. Many factors such as social, economic, institutional, and political have been considered to be drivers of economic growth, yet no consensus has been reached (Baro, 2003; Boldeanu & Constantinescu, 2015; Upreti, 2015). After the Second World War, policymakers attempted to achieve economic growth through foreign aid (Yiew & Lau, 2018). In the 1980s the liberalization and economic reform policies through the structural adjustment programme of the World Bank were thought to be the solution to the global growth crises but was insufficient because of the flawed policy design and implementation (Oppong, 2014). The neoclassical economics was also inadequate in addressing the growing problem (Engel, 2010). And in the new millennium, there has been a steady rise in countries growing their economies through institutions (Acemoglu & Robinson, 2010).

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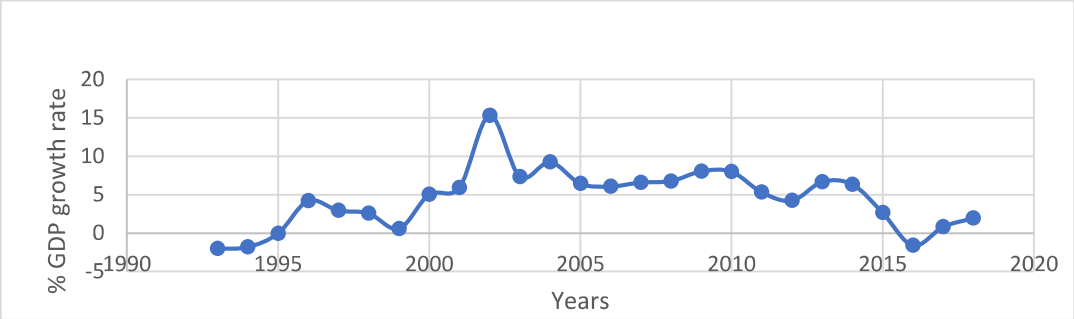
Nigeria's economic growth experience since the 1990s has been volatile. From 1993 to 1995, Nigeria experienced a negative growth rate. This may be as a result of political instability that engulfed the country as a result of the annulment of the 1993 Presidential elections and the consequent withdrawal of capital by foreign investors (Akinkunmi, 2017). By 2002, with the new civilian administration, Nigeria recorded an all-time highest GDP growth rate of 15.3%. According to the World Bank Development Indicators (2018), between 2003 and 2014, Nigeria had a growth rate of 7%. The fall in oil prices between 2014 and 2016 made the GDP growth rate plummet to 2.7% in 2015. Nigeria recorded a recession from 2016 to 2017. In 2018 there were signs of recovery with an average growth rate of 1.9%. This is shown in Figure 1.

Figure 1: Nigeria's GDP Growth Rate



Source: World Bank Development Indicators (2018)

Numerous empirical works emphasize financial development as a vital contributor to economic growth (Al-Yousif, 2002; Levine, Loayza & Beck, 2000; Rousseau & Wachtel, 2011). Nyoni and Bonga (2018) review the determinants of economic growth in Nigeria using a sample of 27 studies conducted about Nigeria's economic growth. The outcome shows that the main determinants of economic growth in Nigeria are population growth, inflation, foreign direct investment, interest rates, exports, private and public investment. An appraisal of the financial sector reform and its causal effect on the economic growth of Nigeria was done by Manasseh, Asogwa, Agu and Aneka (2014). The study used a generalized linear regression method and causality test with quarterly data from 1981q1 to 2010q4. The results showed a bidirectional relationship between banking sector domestic credit and per capita GDP, unidirectional causality running from foreign direct investment to per capita and a unidirectional causality running from per-capita GDP to domestic credit to the private sector. Oluwole (2014) used the ordinary least squares (OLS) regression to determine the effect of money and capital markets on financial development and economic growth in Nigeria from 1981 to 2010. It was found that banking system credit to the domestic economy and money supply had a positive and significant effect on GDP growth.

In this paper, financial development indicator was combined with an institutional variable, economic freedom, to determine their effect on economic growth. A robust financial system plays a vital role in financing businesses through access to credit, efficient and effective allocation of resources and channelling of surplus funds to investors, thereby creating a multiplier effect for job creation, income, consumption and ultimately the overall growth of the economy. For an economy to grow, there should be a sense of economic freedom whereby individuals are at ease and have the right to embark on any legitimate business of their choice with adequate government protection and regulation. Economic freedom will stimulate growth and will serve as a thrust for investors to invest.

Based on the available data, this paper seeks to answer three questions: Do the financial sector and economic freedom promote Nigeria's economic growth? What kind of relationship exists between the

financial sector, economic freedom and economic growth? How fast can the variables converge to equilibrium in an event of a disturbance?

Our contributions are two-fold. First, the autoregressive distributed lag (ARDL) model used presents short-run and long-run estimates simultaneously, thereby creating a means for objective analysis across time. Second, this study deviates from the finance-growth literature by incorporating the index of economic freedom in the model.

A rise in Nigeria's GDP means more productivity and more people being employed. This increases the wealth of the nation and a rise in revenue generation to the government through tax, which can be used to enhance the economy. Therefore, this study is most significant because it will present facts that will be relevant to the policymakers in promoting economic growth.

The remaining of the paper is structured as follows. Section 2 consists of a review of relevant literature on financial development, economic freedom, foreign direct investment and trade openness. Section 3 presents data and the methodology. The results and discussion are presented in section 4.

2.0 Literature Review

Although, over the past years, there have been several economic and financial literature, which have examined and provided insights into the relationship between financial development and economic growth; still the consensus reached varies due to the following reasons: in terms of a group of countries, the variables used, econometric techniques used and time coverage. Song, Chang and Gong (2020) used a panel cointegration and established a relationship between corruption, economic growth and financial development for 142 countries, covering the period 2002 to 2016. Their findings show a long-run relationship among the variables. They also found economic growth has a positive impact on financial development. There was a unidirectional causal relationship running from economic growth to financial development for developing countries but not for developed countries. They concluded that it will be important for developing countries to improve their economic growth policies which will go a long way to promote their financial development but developed countries will have to find a different channel. Mishra (2020) examined how financial development impacts Indian's economic post-reform period using the Johansen and Juselius cointegration approach.

Quarterly data was used from 1991 to 2015. The result shows that financial development plays a vital role in enhancing economic growth. Gregorio and Guidotti (1995) stressed that for financial development to achieve the goal of economic growth of a country, priority must be placed on the efficiency of investment and not the amount of investment. Liang and Jian-Zhous (2006) argued that for a developing country like China to enjoy the impact of financial development into achieving a sustainable economy, it is necessary to establish an efficient financial system. Ndebbio (2004) used OLS regression to determine the relationship between economic growth and financial development in Nigeria. Their results show that there is no relationship between economic growth and financial development. To investigate the effect of financial development on economic growth conditions and well-developed institutions in Tunisia, Oussama, Ahmed and Fatma (2017) used the generalized method of moment (GMM) covering the period 1980 – 2014. It was established that financial development and economic freedom have a positive impact on economic growth. Similarly, Sghaier (2018) used a panel GMM to investigate the relationship between financial development, institutions and economic growth in four North African countries (Tunisia, Morocco, Algeria and Egypt).

It was found that financial development has a positive effect on economic growth and that institutions serve as a complement to financial development. Olowofeso, Adeleke and Udoji (2015) examine the

impact of private sector credit on economic growth in Nigeria by using the Gregory and Hansen cointegration test which accounted for structural breaks and endogeneity problems. Quarterly data was used from 2000q1 to 2014q4. They discovered that a cointegrating relationship exists between economic growth and its selected determinants, however with structural breaks in 2012q1. The error correction model confirmed a positive and statistically significant effect of private sector credit on output but a rise in prime lending rate has hampered growth. Akintoye and Aworinde (2019) inquired about the impact of institutions and infrastructures on economic growth in Nigeria using the bounds testing cointegration approach. Their outcome shows a long-run relationship, also, population and institutions contribute positively to the growth and that public infrastructure has a negative significant impact on growth. Gbenga, James and Adeyinka (2019) examined the relationship between domestic credit to the private sector and gross domestic product in Nigeria using ordinary linear regression. It was established that a positive and significant relationship exists between domestic credit to the private sector and economic growth. They recommend that financial institutions give more credit to the private sector to stimulate growth.

Tiwari and Mutascu (2011) analyse the impact of foreign direct investment (FDI) on economic growth in some selected Asian countries. The other explanatory variables included were gross capital formation, labour force and exports. It was discovered that FDI and exports boost economic growth. Similarly, labour force and capital contribute a greater role in the growth of Asian economies. Inekwe (2013) appraise the nexus between Nigeria's economic growth, employment and FDI in the manufacturing and service sectors. The results show that FDI in the manufacturing sector has a negative relationship with economic growth. While in the service sector, FDI relates positively with economic growth.

The conclusion is that FDI inflow to the service sector will boost economic growth and should be encouraged. FDI to the manufacturing sector is a reflection of the poor business environment. Ayanwale (2007) examine the relationship between non-extractive FDI and economic growth as well as factors that drive FDI in the Nigerian economy. The outcome of the study suggests that FDI in Nigeria is driven by market size, infrastructure development and stable macroeconomic policy. In the same way, FDI enhances economic growth in Nigeria. Specifically, FDI in the communication sector has the highest likelihood of growing the economy. FDI in the manufacturing sector relates negatively with economic growth. Azman-Saini, Law and Ahmad (2010) used a threshold regression to find whether the financial market determines the FDI, growth relationship in 91 countries. Their results infer that FDI will lead to growth only if financial market development is beyond a certain level. But until then, no growth from FDI. Dinh, Vo, The Vo and Nguyen (2019) examined the short-run and long-run effects of foreign direct investment on economic growth for 30 developing countries using the vector error correction model and fully modified OLS. The study found that FDI contributes to the rise in economic growth in the long-run but had a negative impact in the short-run.

In contrast to conventional views about the growth effect of trade barriers. Yanikkaya (2003) used a cross country regression to a panel of 100 countries. The results show that trade barriers are positively associated with economic growth most especially in developing countries. Hye and Lau (2015) developed a trade openness index and used it to analyse the link between trade openness and the economic growth of India. The outcome suggests that in the short-run trade openness index has a positive effect on economic growth. However, in the long-run, it hurts growth. Merale, Luljeta and Mihai (2015) examine the effects of trade openness on the economic growth of South-East European countries using GMM. Other control variables include income per capita, human capital, gross fixed capital formation, FDI and labour force. The results found that trade openness relates positively to

economic growth. Trade openness is more favourable to growth in countries with higher initial income per capita, FDI and gross fixed capital formation.

3.0 Data and Methodology

In this study, we examine the effect of financial development and economic freedom on economic growth according to the model of Hussain and Haque (2016) with modifications for time series and inclusion of financial and control variables. The model is presented as follows:

$$GDP_t = \beta_0 + \beta_1 DCP_t + \beta_2 EF_t + \beta_3 FDI_t + \beta_4 TOP_t + u_t \qquad (i)$$

Where GDP is the annual percentage growth rate of real GDP

DCP is the domestic credit to the private sector as % of GDP

EF is economic freedom

FDI is the foreign direct investment

TOP is trade openness

The data for GDP growth rate, domestic credit to the private sector, foreign direct investment and trade openness were obtained from the world development indicators of the World Bank. Economic freedom was obtained from the index of economic freedom published by the Heritage Foundation and the World Street Journal. The data consist of annual data for all the variables from 1995 to 2018. However, the e-views statistical package was used to convert the data into monthly data for large samples which will enhance better results.

The GDP growth rate is the annual percentage growth rate of real GDP derived from constant currency units. Domestic credit to the private sector refers to financial resources provided to the private sector by financial corporations such as loans, purchases of non-equity securities and trade credits and other receivable that establish a claim for repayment. Foreign direct investment is the investment equity flows in an economy. It consists of equity capital, reinvestment of earnings and other capital. Trade openness is the sum of exports and imports of goods and services.

According to the Heritage Foundation and the World Street Journal (2020), economic freedom is the fundamental right of every human to control his or her labour and property. In an economically free society, individuals are free to work, produce, consume and invest in any way they please. In economically free societies, government allow labour, capital and goods to move freely and refrain from coercion or constraints of liberty beyond the extent necessary to protect and maintain liberty. The index ranks economic freedom in four main areas of rule of law, government size, regulatory efficiency, open markets. Each of these areas is ranked on a scale of 0 to 100. A country's overall score is derived from its average score. If the average score is close to 100, the country is said to be experiencing economic freedom. If the average score is close to zero the country does not operate in an economically free society.

To investigate the relationship between the variables in Nigeria, the ARDL bound testing technique was utilized. The ARDL was developed by Pesera, Shin and Smith (2001). This model has several advantages. Firstly, it captures the dynamic effects of the lagged variables and by including a sufficient

number of lags serial correlation in the errors can be eliminated. Secondly, the ARDL model can simultaneously determine the short-run and long-run coefficients of the explanatory variables.

Equation (i) can be presented in the ARDL form as shown

$$\Delta(GDP_t) = \delta_0 + \sum_{i=1}^{k} \delta_1 \Delta(GDP_{t-1}) + \sum_{i=0}^{k} \delta_2 \Delta(FDI_{t-i}) + \sum_{i=0}^{k} \delta_3 \Delta(DCP_{t-i}) + \sum_{i=0}^{k} \delta_4 \Delta(TOP_{t-i}) + \sum_{i=0}^{k} \delta_5 \Delta(EF_{t-i}) + \beta_1(GDP_{t-1}) + \beta_2(FDI_{t-1}) + \beta_3(DCP_{t-1}) + \beta_4(TOP_{t-1}) + \beta_5(EF_{t-1}) + v_t \quad (ii)$$

Where Δ and v_t are the first difference operator and white noise term, respectively. k is the optimal lag length, δs and βs are the short-run and long-run coefficients.

A suitable lag order selection criterion is adopted based on the Akaike Information Criteria (AIC) and the Schwarz-Bayesian Criterion (SBC). The criterion that gives the minimum value is optimum and will be adopted. The bounds testing process based on a joint F-statistics with a null hypothesis of no cointegration is used. The value of the calculated F-statistic is compared with the lower and upper critical values. If the calculated F-statistic is greater than the critical value for the upper bound I(1), we can conclude that there is cointegration which means rejecting the null hypothesis and estimating the long-run error correction model. If the calculated F-statistic is lower than the critical value for the lower bound I(0), then we conclude that there is no cointegration, hence no long-run relationship. If the F-statistic falls between the lower bound I(0) and the upper bound I(1), the test is inconclusive.

Suppose a cointegration relationship is found between the variables, both long and short-run models can be estimated with equation (iii) and (iv)

$$GDP_t = \delta_0 + \sum_{i=1}^{k} \delta_1 GDP_{t-1} + \sum_{i=1}^{k} \delta_2 FDI_{t-1} + \sum_{i=1}^{k} \delta_3 DCP_{t-1} + \sum_{i=1}^{k} \delta_4 TOP_{t-i} + \sum_{i=1}^{k} \delta_5 EF_{t-i} + v_t \quad (iii)$$

$$\Delta GDP_t = \delta_0 + \delta_1 ECT_{t-1} + \sum_{i=1}^{k} \delta_2 \Delta GDP_{t-1} + \sum_{i=1}^{k} \delta_3 \Delta FDI_{t-i} + \sum_{i=1}^{k} \delta_4 \Delta DCP_{t-i} + \sum_{i=1}^{k} \delta_5 \Delta TOP_{t-i} + \sum_{i=1}^{k} \delta_6 \Delta EF_{t-i} + v_t \quad (iv)$$

The variable ECT in equation (iv) is the error correction term that is derived from the long-run model. It shows the speed of adjustment of the variables to long-run equilibrium. It should be statistically significant with a negative sign.

4.0 Results and Discussions

Table 1 is the unit root result for stationarity of the variables according to the augmented Dickey-Fuller test and Philips-Perron. Both tests confirm that the variables are a mixture of I(0) and I(1), making them suitable for the ARDL bounds test.

Table 1 Unit Root Test

	ADF Unit Root Test		PP Unit Root Test	
variables	t-statistics	Order of integration	t-statistics	Order of integration
GDP	-2.91	I(1)	-4.52	I(1)
DCP	-2.90	I(0)	-3.00	I(1)
EF	-3.51	I(1)	-4.36	I(1)
FDI	-3.89	I(0)	-3.46	I(0)
TOP	-16.85	I(1)	-16.85	I(1)

Augmented Dickey-Fuller (ADF); Philips-Perron (PP); Result significant at 5% level
Source: Author's computation

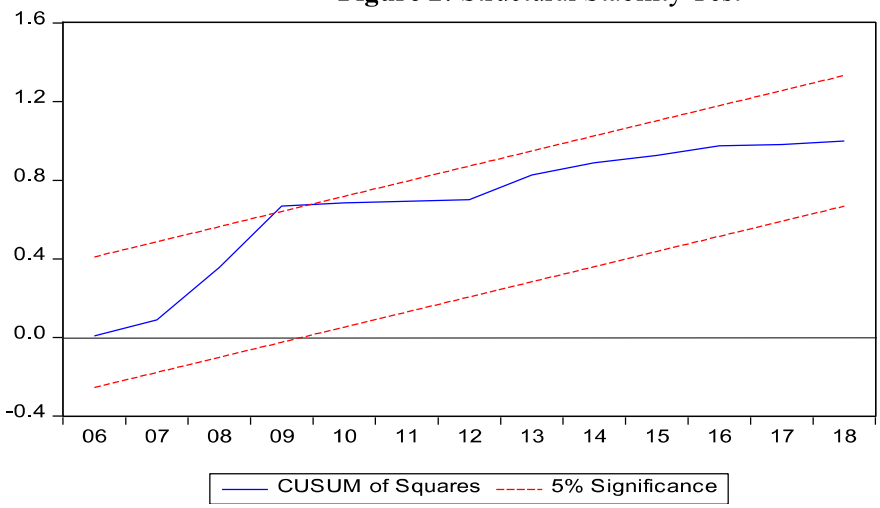
Some diagnostics tests to determine the suitability of the data and the model were conducted. From the lag order selection test, an optimal lag length of 1 is based on the AIC criterion which has the minimum value in the class of other criteria such as the SIC and HIC. To determine whether residuals are serially correlated, the Breusch-Godfrey serial correlation LM test was performed. The results concluded by rejecting the null hypothesis which implies our residuals are not serially correlated. The Breusch-Pagan-Godfrey test for heteroskedasticity revealed that the variances of the residuals are the same across observations. Ramsey RESET test was employed to check for model misspecification. The model is free from misspecification errors since the probability level is greater than the 5% significance level. Furthermore, the structural stability of the model was tested using the CUSUM of square test proposed by Brown, Durbin and Evans (1975). The result shows there is no deviation from the 5% significance plot which signifies the model is stable. The summary of the diagnostic results is presented in **Table 2** and **Figure 2.**

Table 2 Diagnostic Test

	χ^2	F statistics	Probability
Breusch-Godfrey serial correlation	3.14		0.093
Breusch-Pagan-Godfrey heteroskedasticity	49		0.883
Ramsey RESET		2.62	0.125

Source: Author's computation

Figure 2: Structural Stability Test



The cointegrating relationship between the variables was tested using the bound testing technique. The result is presented in **Table 3**.

Table 3. ARDL bounds test result

F-statistics 3.867		
Significance level	Lower bound I(0)	Upper bound I(1)
5%	2.56	3.49
$k = 4,\ \ n = 286$		

k represents the number of independent variables, n is the number of observations

From the result, at the 5% significance level, the F-test statistics is greater than the critical upper bound value. This suggests that there is cointegration between the variables. It implies that economic growth, financial development and economic freedom are cointegrated with each other which means they will behave together in the long-run. Changes from the financial sector as well as changes to an economically free society will affect individuals.

The results of the short-run and long-run coefficients are displayed in **Table 4**. The coefficient of the error correction term (ECT) is significant at 1%. It has a value of -0.04, which is the speed of adjustment back to equilibrium. It has a low but moderate speed of adjustment. On average 4% of disequilibrium from the previous months corrects back to long-run equilibrium in the present month.

Table 4. Short-run and Long-run coefficients

Variables	Coefficients	Probability values
	Long-run coefficients	
DCP	0.197	0.156
EF	0.034	0.125
FDI	6.281**	0.018
TOP	0.189**	0.003
c	20.542	0.042
	Short-run coefficients	
ECT(-1)	-0.04***	0.003
D(GDP(-1))	0.879**	0.020
D(DCP)	0.057***	0.006
D(DCP(-1))	0.527	0.450
D(EF)	0.006**	0.024
D(FDI)	0.084**	0.012
D(TOP)	0.001*	0.068
D(TOP(-1))	0.010	0.732
C	0.274	0.077

Source: Author's computation
*** p<0.01, ** p<0.05, * p<0.1; ECT is the error correction term.

There is a significant and positive relationship between D(GDP) and D(GDP(-1)), which implies that a one-period previous value of GDP is accountable for economic growth in the next period. A 1% increase in domestic credit to the private sector in the short-run will promote growth by 5.7%. It is statistically significant at 1%. However, in the long-run credit to the private sector does not influence economic growth. In the short-run, a 1% rise in economic freedom is associated with a 6% increment in economic growth. In the long-run economic freedom does not significantly support economic growth. In the short-run and long-run FDI positively affect economic growth. It is statistically significant at the 5% level. For trade openness, in the short-run and long-run an open economy can increase growth. This is significant at 5% and 10% levels respectively.

The objective of this study is to determine the impact of financial development and economic freedom on economic growth in Nigeria. Three questions were asked in the introduction, and our analysis provided answers to those questions. Firstly, domestic credit to the private sector in the short-run is significant in promoting growth. However, it is insignificant in the long-run. Economic freedom in the short-run contributes significantly to economic growth but not it is insignificant in the long-run. Secondly, there exists a long-run relationship between financial development, economic freedom and

economic growth. And lastly, the variables on average converge at 4% back to their long-run equilibrium in the short-run.

To achieve accelerated and sustained economic growth, the provision of credit to the private sector will help drive the growth process. There is the need to promote greater economic freedom to achieve long term growth. The rule of law and property rights should be obeyed by all. The courts should always be seen as a fair arbiter in enforcing contract rights.

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