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# ECONOMETRICS ANALYSIS OF IMPACT OF CAPITAL MARKET ON ECONOMIC GROWTH IN NIGERIA (1971-2010)

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## ABSTRACT

*The stock market is a common feature of a modern economy and it is reputed to perform some necessary functions, which promote the growth and development of the economy. This study examines whether or not stock market promotes economic growth in Nigeria. To achieve this objective, ordinary least square regression (OLS) was employed using the data from 1971-2010. The result indicated that there is a positive relationship between economic growth and all the stock market development variables used. With 97% R-squared and 95% adjusted R-squared, the result showed that economic growth in Nigeria is adequately explained by the model for the period between 1971 and 2010.By implication 95% of the variation in the growth of economic activities is explained by the independent variables. The result of the study, which established positive links between the stock market and economic growth, suggests the pursuit of policies geared towards rapid development of the stock market. Also, all sectors of the economy should act in a collaborative manner such that the optimum benefits of linkages between the stock market and economic growth can be realized in Nigeria.*

## INTRODUCTION

Saving, capital formation and economic growth have been central to the economic development debate for several decades. The links between these issues, on the one hand and direction of causality on the other, still remain subject to further analysis across countries. Accepting that the relationship is unidirectional (i.e. moving from savings to investment and hence to economic growth) may be misleading. (Ben, 1999), stressed that capital market provides arrangement through which households, firms, and government that intend to invest more than they can bid for the funds of other spending unit who have surplus funds, and this is necessary for economic growth. Capital

markets are the complex of institutions and mechanisms through which long –term funds with maturity of 5years and above are pooled and made available to business, governments, individual, and instruments already outstanding are transferred. As in the case of the money market, the capital markets are local, regional, and national in scope, (Bekaert, 1993).

Mobilization of resources for national development has long been the central focus of development economists. As a result of this, the centrality of savings and the investment in economic growth has been given considerable attention in the literature Rostow (1960), Malinvaud (1997), Soyode (1990), Aigbokan (1995), Samuel (1996), Demirguc-Kunt and Roos (1996), for sustainable growth and development, funds must be effectively mobilized and allocated to enable business and the economy harnessed their human, material, and management resources for optimal output.

The existing literature clearly shows that developed economies had explored the two channels through which resources mobilization affects economic growth, and development – money and capital market (Demirguc-Kunt and Roos, 1996; Samuel, 1996). This is however, not the case in developing economies where emphasis was placed on money market with little consideration for capital market (Nyong, 1997),

Since the introduction of structural adjustment programme (SAP) in Nigeria the stock market has grown very significantly. Alile (1996), Soyode (1990). This is as a result of deregulation of the financial sector and privatization exercise which exposed investors and companies to the significance of the stock market. Equity financing became one of the cheapest and flexible sources of finance from the capital market and remain a critical element in the sustainable development of the economy (Okereke, 2000).

The line between the stock market performance and economic growth has often generated strong controversy among analysts based on their study of developed and emerging markets Samuel (1996); Demirguc-Kunt and Roos (1996); Akinifesi (1987); Levine and Sara (1996); Obadan (1998); Onosode (1998); Emenuga (1998); Osinubi (1998); According to Nyong (1997) the financial structure of a firm, that is, the mix of debt and equity financing, changes as economies develop, the tilt is however, more towards equity financing through the stock market.

As economies develop, more funds are needed to meet the rapid expansion. The stock market serves as a veritable tool in the mobilization and allocation of savings among competing users, which are critical to the growth and efficiency of the economy (Alile, 1984).

The determination of the overall growth of an economy depends on how efficiently the stock market performs its allocative functions of capital. As the stock market mobilizes savings, concurrently it allocates a larger proportion of it to the firms with relatively high prospects as

indicated by its rate of returns and level of risk. The importance of this function is that capital resources are channeled by the mechanism of the forces of demand and supply to those firms with relatively high and increasing productivity, thus enhancing economic expansion and growth (Alile, 1997).

## LITERATURE REVIEW

The Nigerian capital market is a market for long-term capital, generally, the stock market is a market for stocks and shares both for existing and for new issues. Olowe (1997), asserts that the capital market has both security based-(stock market i.e., the stock exchange) and non-security based-segment (market for long term loan).

Kola (2002) explains that capital market provides facilities through which medium and long-term funds usually more than one year in maturity are raised; such funds are made available to users including corporate bodies and government.

There is no free capital market in the world, i.e., there is no market with free price movement whereby price does not respond to wide range of external forces, and free market also implies free share availability, free access to information for investors; free participation in share ownership by a large section of the population and free transferability of shares between one holder and another (Olowe, 2003).

The establishment of the Lagos Stock Exchange in 1960, which has now been changed to Nigeria Stock Exchange, and the recent globalization in the finance system, had made or brought about rapid development in theoretical and empirical analysis of the Nigeria Stock Exchange Market (Onoh, 2002).

In recent times there was a growing concern on the role of stock market in economic growth, Levine and Sara (1996); Demirguc-Kunt and Roos (1996); Oyejide (1994); Nyong (1997); Obadan (1998); Onosode (1998); Emenuga (1998); Osinubi (1998), The stock market is the focus of economists and policy makers because of the perceived benefit it provides for the economy. The stock market provides the fulcrum for capital market activities and it is often cited as a barometer of business direction. An active stock market may be relied upon to measure economic activities using the stocks market index (Obadan, 1998).

Stock market contributes to economic growth through the specific service it performs either directly or indirectly. Notable among the functions of the stock market are mobilization of savings, creation of liquidity, risk diversification, improve dissemination and acquisition of information, and enhanced incentive for corporate control, improving the efficiency and effectiveness of these

function, through prompt delivery of their services, can increase the rate of economic growth (Oloyede, 2001).

At any stage of a nation's development both the government and the private sectors would require long-term capital. For instance, companies would need to build new factories, expand existing ones, or buy new machinery. Government would also require funds for the provision of infrastructures. All these activities require long-term capital, which is provided by a well functioning stock market (Olowe, 1997).

The economic significance of the relationship between stock market development and growth vary according to a country's level of economic development with a larger impact in less developed economies Filler *et al.* (1999). The proponent of positive relationship between stock market development and economic growth hinged their argument on the fact that the stock market aids economic growth and development through the mobilization and allocation of saving;, risk diversification, liquidity creating ability and corporate governance improvement among others. Nyong (1997) reports that as far back as 1999, Goldsmith Raymond observed that the emergence of equity markets and its rapid development indicate the level of economic growth and development.

Hussian *et al.* (2001) opined that there are two perspectives to stock market, the recipient perspective and the policy maker's perspective. From the perspective of the recipient LDS, private portfolio flows in local stock and bond markets are potentially welcome vehicle for raising capital for domestic firms. Well functioning local stock and short-term bond markets also help domestic investors to diversify their assets (an option usually open to the wealthy) and can act to improve the efficiency of the whole financial sector by serving as a screening and monitoring device for allocating funds to industries and firms with highest potential returns.

Michael and Stephen (2003), summarized that, although private portfolio/ financial flows rose and fell dramatically in the 1990s, they were based largely on a mythical belief that free market and perception of a sound currency would automatically guarantee rapid economic growth. However, their inherent volatility and the fact that the market responds primarily to global interest-rate differentials, as well as to investors of practical and economic stability, make the stock market a very tenuous foundation on which to base medium or long-term development strategies.

The recent global economy and financial crisis made the then British Prime Minister (Mr. Gordon Brown) to put up huge sums of money and standing ready to recapitalize and take equity stakes in banks. A staggering total sum E1, 873 billion ($2,556 billion) was agreed for this purpose in the euro area alone. (Business Day, 2008).

The French, bailed out just one, Dixie, a small Franco-Belgian lender, it is use as a precautionary measure, and this had made most French banks to be able to absorb the huge losses they have made on sub prime loans in America. The household savings rate remains high, yet concerns were on the economy. Third-quarter GDP figures are likely to show that the French economy is already in recession (ibid). The IMF forecast growth of 0.2 percent in the year 2009; this made economist to oppose this, because recently it was discovered that unemployment is on the increase, this is backed up with the announcement of a 4,000 job cut in France by a carmaker company, Renault (ibid).

The present financial crisis had made Asia government to take measures to allay disquiet. In China the Stock market has lost two-thirds of its value since last October; the property market is wobbling and growth is slowing, this trends all predated the latest panic, but Asia government had being making move to restore confidence in the minds of investor reviving the stock market by abolishing a tax on share – buying and investing in the market itself. (Google)

The crisis presently appears not to have largely affected the Nigeria market, but the little effect may be devastating because of the low risk absorption capacity of the operating companies. The continuous crash in the price of stock on the floor of the Nigerian Stock Exchange attests to this. And to guard against this, the Insurance Companies must take the issue of pricing more seriously if they wish to remain in business in the years ahead. (ibid)

Experts concluded that the crisis though for now had little effect on the local market, but it will affect the value of crude oil in world market which will directly affect the local market on the long run. (ibid).

Nigeria Financial system is stronger now especially with the successful completion of the banking sector consolidation before the current global financial crisis started. Capital inflow has remained very strong. Currently, it stands at $8.5 billion as at the end of August 2008, compared with $5.8 billion in 2005. The Central Bank of Nigeria has reviewed what is currently going on globally with respect to the Nigerian economy. The conclusion of Nigerian economists, financial experts and CBN governor after the meeting of the Monetary Policy Committee, is that the Nigerian economy is safe and robust, (Business Day, 2008).

## EMPERICAL STUDIES

Levine and Sara (1996) examines whether there is a strong empirical association between stock market development and long–run economic growth. The study used cross- country time series regression of forty-one countries from 1976 to 1993 to evaluate this association. The study tow the

line of Demirguc-Kunt and Roos (1996) by conglomerating measures such as stock markets size, liquidity, and integration with world markets into index of stock market development.

Efforts were also made by Nyong (1997) to develop an aggregate index of capital market development and used it to determine its relationship with long-run economic growth in Nigeria. His study employed a time series data from 1970 to 1994.For measures of capital market development, the ratio of market capitalization to GDP (in percentage), ratio of total value of transactions on the main stock exchange to GDP (in percentage), the value of equities transaction relative to GDP and listings were used. The four measures were combined into one overall composite index of capital market development using principal component analysis. A measure of financial market depth (which is the ratio of broad money to stock of money to GDP) was included as control. The result of the study was that capital market development is negatively and significantly correlated with long-run growth in Nigeria. The result also showed that there exists bi-directional causality between capital market development and economic growth.

## METHOD OF ANALYSIS

### Model Specification

The linkage between stock market and economic growth has occupied a central position in development literature, Samuel (1996); Demirguc-Kunt and Roos (1996);Akinifesi (1987); (Levine and Sara, 1996) ; Obadan (1998) ; Onosode (1998) ; Emenuga (1998) ; (Osinubi, 1998). In examining this in Nigeria data, the study adopts the neoclassical growth model to explain the source of growth in the economy. The above equation is retransformed into the general aggregate production function. This approach has got a wide application in econometric analysis for example, Akinlo and Ayodele F.Odusola. (2000) ; Levine and Sara (1996); Obstfeld (1994).

Using a production function approach, it states that the growth rate of output (GNP) is principally determined by the following factors:-

The rate of growth of gross labour multiplied by the labour income share

The rate of growth of gross capital input multiplied by the capital income share; and

Change in technology.

Thus, this is given as: $g = f(L,K,T)$ ...... (1)

$g$ = Growth of GDP

$L$ = Labour

$K$ = Capital formation/Investment

$T$ = Technology

The application of this method, however, has been extended to incorporate other determinants of economic activities such as, financial sector development (proxied by stock market development

index), debt overhang, state of political stability (proxied), foreign direct investment, cross capital formation; and country, policy dummies, for example, Collier and Gunning (1998) , Demirguc-Kunt and Roos (1996) , (Emenuga, 1998) , (Filler *et al.*, 1999).

In line with the above specification the model that is adopted by this study is specified thus:

G = f (gcf, fdi, cmi,doh)……… (ii) where;

G = growth of GDP

Gcf = gross capital formation

Fdi = foreign direct investment

Cmi = capital market index

Doh = debt overhang.

The estimated form of the model is as given bellow

G = a + bigcf + b2 fdi+b3cmi+b4doh+u …… (iii) where

Uti = error term.

## Estimation Technique

Regression analysis of the ordinary least square is adopted in this study to test the relationship between the stock market and economic growth measured by the numbers of independent variables offers by the markets, which are gross capital formation (public investment), foreign direct investment, capital market index (Proxied by growth of market capitalization) debt overhang, proxied by export minus GDP ratio. This study focuses on the Nigeria stock market between the periods of 1971 to 2009 (period of 39 years).

Equation (iii) will be estimated using ordinary lease squares technique (OLS). The equation will also be subjected to a dynamic estimation, using the lagged structure of the variables.

## Sources of Data

Data for this study was systematically gathered or collected in the process of implementing a research project. This study used data covering the period of 1971 – 2010. These data were sourced mainly from different series of Nigeria Stock Exchange Fact Book, Nigeria Stock Exchange Annual Report and Account (various issues), Central Bank of Nigeria Statistical Bulletin and Federal Office of Statistics, Statistical Bulletin.

## EMPIRICAL RESULTS AND FINDINGS

**Model Summary**

| **Model** | R. | R.Square | Adjusted R.Square | Std. Error of the estimate | Change Statistics | | | | | Durbin-Watson |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | R.square change | F.Change | df 1 | df 2 | Sig.F change | |
| **1** | **.983[a]** | **.967** | **.963** | **541265.7664** | **.967** | **219.900** | **4** | **30** | **.000** | **1.660** |

a. Predictors: ( constant ), DOH, GCF, CMI, FDI

b. Dependent variable: GDP

The regression result is

GDP = f (gcf, fdi, cmi, doh).

GDP = a + b1 gcf, + b2 F1d1 + b3 cmi + b4 doh + Ut

GDP=-11.0183+10.693 Gcf+7.411 fdi+5.089 Cmi +132.927 Doh

GDP = (- 2.140) (4.503) (1.587) (-1.260) (2.970)

R2 =0.98

Adjusted R2 =0.97

S.E of Regression

F- Statistic (25,4) =243.179

DW-statistic =1.86

### Empirical Findings

From the result so far, it is obvious clear that the variables in the model were highly correlated and have a significant impact on growth rate of gdp. The estimated model is a good one with desirable characteristics and the impact of capital formation on economic growth and development has been established to depend on the trends in variables such as gdp, gcf,cmi, and doh. It can also be concluded from the result that there is significant impact on the gcf and gfc (gross capital formation) while there is significant impact between gdp and fdi (foreign direct investment) at .125 percent level of significant. There is also a significant impact on gdp and cmi (capital market index) at .219 percent level of significance. The last variable which is doh (debt overhang) has very low level of significant impact on gdp. It is at .006 percent level of significance.

## CONCLUSION

That the stock market promotes economic growth is not in doubt. It serves as an important mechanism for effective and efficient mobilization and allocation of saving, a crucial function for an economy desirous of growth. This study attempted to evaluate the roles of capital market in Nigerian context between the period of 1971 and 2010, by the use of some notable stock market

development indicators, the relationship between stock market development and economic growth was found to be positive. This suggests that for a significant growth, the focus of policy should be on measure to promote growth in the stock market.

The Nigerian stock market has a bright prospect given the recent policy direction especially the abrogation of all laws that hitherto hamper its effective and efficient functioning. Also, the internationalization, the improvement in the infrastructural facilities in the market in line with what obtains in the developed market and also the present democratic dispensation will all work individually and jointly to ginger the prospect of the stock market.

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**APPENDIX I**

| S/N | YEAR | GDP Nominal ADP ₦ Billon | GCF(Gross Capital Formation) ₦ Billon | FDI (Foreign Direct Investment) ₦ Billon | Capital Market Index ₦ Billon | D.O.H% |
|---|---|---|---|---|---|---|
| 1 | 1971 | 9,937.2 | 102.8 | 1,481.3 | 376.3 | 87.00 |
| 2 | 1972 | 10,784.2 | 961.3 | 1,589.4 | 461.2 | 101.00 |
| 3 | 1973 | 11,341.3 | 5,388.5 | 1,901.2 | 1,586.8 | 88.00 |
| 4 | 1974 | 22,559.5 | 4,927.8 | 1,998.5 | 1,137.1 | 97.00 |
| 5 | 1975 | 21,558.8 | 5,019.8 | 2,009.5 | 1,815.2 | 100.00 |
| 6 | 1976 | 27,297.5 | 8,107.3 | 2,081.1 | 2,255.2 | 220.00 |
| 7 | 1977 | 32,747.3 | 942.6 | 2,801.4 | 2,592.8 | 415.00 |
| 8 | 1978 | 36,083.6 | 9,386.3 | 2,941.7 | 5,009.7 | 213.00 |
| 9 | 1979 | 43,150.8 | 9,074.5 | 35,131.1 | 4,161.8 | 265.00 |
| 10 | 1980 | 50,848.6 | 10,841.2 | 3,620.1 | 5,709.9 | 219.00 |
| 11 | 1981 | 50,749.1 | 12,215.0 | 3,757.9 | 6,562.6 | 159.00 |
| 12 | 1982 | 51,709.2 | 10,992.0 | 5,382.8 | 7,514.4 | 188.00 |
| 13 | 1983 | 57,142.1 | 8,135.0 | 5,949.5 | 9,443.9 | 230.00 |
| 14 | 1984 | 63,608.1 | 5,417.0 | 6,418.3 | 10,988.1 | 320.00 |
| 15 | 1985 | 72,355.4 | 5,573.0 | 6,804.0 | 12,521.8 | 295.00 |
| 16 | 1986 | 73,061.9 | 7,323.0 | 9,313.6 | 13,934.1 | 662.00 |
| 17 | 1987 | 10,885.1 | 10,661.1 | 9,993.6 | 18,655.8 | 1199.00 |
| 18 | 1988 | 145,243.3 | 12,383.7 | 11,339.2 | 24,180.0 | 1442.00 |
| 19 | 1989 | 224,796.9 | 18,414.1 | 10,897.6 | 26,801.5 | 1875.00 |
| 20 | 1990 | 260,636.7 | 30,626.8 | 10,436.1 | 29,651.2 | 1673.00 |
| 21 | 1991 | 324,010.0 | 35,423.9 | 12,243.5 | 37,692.6 | 1779.00 |
| 22 | 1992 | 549,808.8 | 58,640.3 | 20,512.7 | 54,116.8 | 1748.00 |
| 23 | 1993 | 701,472.9 | 80,948.1 | 66,787.0 | 85,027.9 | 1247.00 |
| 24 | 1994 | 914,334.3 | 85,021.8 | 70,714.6 | 93,966.8 | 2721.00 |
| 25 | 1995 | 1,977,740.0 | 9,106,807.0 | 119,391.6 | 1,044,289.0 | 9987.00 |
| 26 | 1996 | 2,823,900.0 | 96,627.2 | 122,600.9 | 130,858.5 | 7723.00 |
| 27 | 1997 | 2,939,500.0 | 114,400.0 | 128,331.9 | 155,181.3 | 9993.00 |
| 28 | 1998 | 2,881,310.0 | 172,100.0 | 152,410.9 | 194,414.2 | 10123.00 |
| 29 | 1999 | 3,352,650.0 | 198,147.3 | 134,189.9 | 201,300.4 | 9872.00 |
| 30 | 2000 | 4,980,943.0 | 290,700.1 | 184,171.2 | 221,219.2 | 11141.00 |
| 31 | 2001 | 5,639,860.0 | 313,134.6 | 172,182.5 | 252,413.4 | 13416.00 |
| 32 | 2002 | 5,728,200.0 | 367,112.3 | 194,831.1 | 268,183.3 | 16818.00 |
| 33 | 2003 | 7,180,140.0 | 410,121.3 | 348,761.9 | 291,100.2 | 13450.00 |
| 34 | 2004 | 8,014,140.0 | 513,148.0 | 814,300.6 | 301,891.9 | 96819.00 |
| 35 | 2005 | 11,114,239.0 | 544,148.3 | 948,314.3 | 334,436.6 | 99143.00 |
| 36 | 2006 | 15,643,210.0 | 567,492.2 | 965,610.2 | 355,782.5 | 142621.00 |
| 37 | 2007 | 16,102,102.0 | 601,569.0 | 989,053.0 | 365,987.3 | 154237.00 |
| 38 | 2008 | 19,332,689.0 | 643,013.1 | 998,457,2 | 427,351.1 | 165389.00 |
| 39 | 2009 | 20,912,546.0 | 723,832.0 | 1,876,342.1 | 472,641.0 | 189532.00 |

| 40 | 2010 | 22,765,257.1 | 987.012.3 | 8,899,651.3 | 543,908.0 | 210562.00 |
|---|---|---|---|---|---|---|

**Source;** Nigerian Stock Exchange Annual Report and Account, various years; Securities And Exchange Commission Annual Report and Account; Central Bank of Nigeria Bulletin 2010, and the Federal Office of Statistics, Statistical Bulletin

## Regression Result

**Model Summary**

| Model | R | R Square | Adjusted R Square | Std. Error of the Estimate |
|---|---|---|---|---|
| 1 | .925(a) | .855 | .838 | 4.49560 |

a Predictors: (Constant), D.O.H (%), GCF (Capital Formation), Capital Market Index, FDI (Foreign Direct Investment)

**ANOVA(b)**

| Model | | Sum of Squares | df | Mean Square | F | Sig. |
|---|---|---|---|---|---|---|
| 1 | Regression | 3940.530 | 4 | 985.133 | 48.744 | .000(a) |
| | Residual | 666.943 | 33 | 20.210 | | |
| | Total | 4607.474 | 37 | | | |

a Predictors: (Constant), D.O.H (%), GCF (Capital Formation), Capital Market Index, FDI (Foreign Direct Investment)

b Dependent Variable: GDP Nominal Value

**Coefficients (a)**

| Model | | Unstandardized Coefficients | | Standardized Coefficients | t | Sig. |
|---|---|---|---|---|---|---|
| | | B | Std. Error | Beta | B | Std. Error |
| 1 | (Constant) | 1980.361 | .999 | | 1983.280 | .000 |
| | GCF (Capital Formation) | -1.16E-005 | .000 | -1.524 | -7.910 | .000 |
| | FDI (Foreign Direct Investment) | -1.19E-005 | .000 | -.423 | -1.305 | .201 |
| | Capital Market Index | .000 | .000 | 2.107 | 9.161 | .000 |
| | D.O.H (%) | 2.32E-005 | .000 | .099 | .342 | .735 |

a Dependent Variable: GDP Nominal Value