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CAPITAL MARKET DEVELOPMENT AND ECONOMIC GROWTH POST-FINANCIAL LIBERALIZATION

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Abstract: Financial liberalization has greatly influenced capital market development, which, in turn, affects economic growth. This paper examines the relationship between capital market development and economic growth in the post-financial liberalization era. It explores the theoretical framework, empirical evidence, and policy implications of financial liberalization on economic growth through capital market expansion. The paper also evaluates the risks and challenges associated with financial liberalization and offers policy recommendations for sustainable economic growth.
Key words: Financial Liberalisation, Capital Market, Economic Growth and Sustainability

Introduction

The development of capital markets is crucial for economic growth, particularly in the aftermath of financial liberalization. Financial liberalization refers to the deregulation of financial markets, removal of capital controls, and increased participation of foreign investors. This process enhances capital allocation efficiency, liquidity, and investment opportunities, leading to higher economic growth. However, it also introduces risks such as financial instability and capital flight. This paper investigates the impact of financial liberalization on capital markets and how it influences economic growth. The primary purpose of financial liberalization is to create an effective financial system that will boost and increase resource allocation efficiency, create financial stability, preserve consumer confidence in the system and enhance financial inclusion. Theoretically, financial liberalisation should help in promoting economic growth by encouraging more private investment in the economy's significant sectors and an increase in savings through an increase in the real deposit rate. With a liberalised financial market, enormous growth in the stock market is expected so that once the equity culture is established, it will be a dependable source of economic growth and development (Ogbebo, Oguntodu & Olayinka, 2017). Trade restrictions such as entry barriers, bank interest rate limits, mandatory reserve requirements, and how to allocate credit are all subject to liberalisation. With the removal of these constraints,

the economy will be opened to foreign investors who will easily access the Nigerian market and further improve foreign trade.

Capital markets are classified as non-bank financial institutions, and it is expected that the market should be influenced by financial liberalisation. Capital markets are essential because they finance the economy, disperse risk, and encourage monetary and economic stability. Capital markets in the United States finance a large portion of the economy through loans and equity for non-financial businesses (Center Forward, 2020). The capital market as a location for long-term capital includes investments in stocks, bonds, and money raised both domestically and abroad. Liberalisation of the capital markets is an example of a structural policy that influences both the type of shocks the economy experiences and how the economy reacts to these shocks (Joseph, Shari & José, 2008). The capital market is made up of both primary and secondary markets. The exchange of existing securities or previously-issued securities take place in the secondary market, while new issues of stocks and other securities are conducted (traded) in the primary markets. It may be inferred that the capital market has a significant impact on Nigeria's economy because long-term funds are raised by Nigerian enterprises from it through the issuance of shares, debentures, and bonds. Stock market liberalisation means removing policies that have repressive tendencies in the market (Adeyeye, Aluko, Fapetu & Migiro, 2017).

Theoretical Review

The relationship between financial liberalization, capital market development, and economic growth is supported by various economic theories:

a. **Theory of Financial liberalization:** Ronald McKinnon and Edward Shaw first propagated the financial liberalization theory in 1973. The duo sought an alternative to financial repression. Financial liberalization refers to removing a number of constraint to make the financial sector of developing economies measure up to that of developed economies. In 1973, both Ronald McKinnon and Edward Shaw posited in their books that government should come up with policies that could seek interest rates deregulation, removal of credit restrictions, opening up the domestic financial system to foreign capital inflows, free access to the banking industry, ease the entry of foreign banks, private ownership of banks and exchange rate removal. This theory highlighted three forms of financial liberalization: domestic financial sector, stock market and capital account.
b. **McKinnon-Shaw Hypothesis**: Financial liberalization enhances savings and investment by allowing market-driven interest rates (McKinnon, 1973; Shaw, 1973).
c. **Endogenous Growth Theory**: Capital market development facilitates investment in technology and innovation, leading to long-term economic growth (Romer, 1990; Lucas, 1988).
d. **Efficient Market Hypothesis (EMH)**: Liberalized financial markets enhance price discovery and risk diversification, increasing economic efficiency (Fama, 1970).

Empirical Review

Empirical studies provide mixed findings on the impact of financial liberalization on capital market development and economic growth:

Ilugbusi, Ajala, Akindejoye and Ogundele (2020) investigated the relationship between financial liberalization and economic growth in Nigeria from 1986 to 2018. The study revealed that long and short-run relationship exists between financial liberalization and economic growth. The study also found that prime lending rate has insignificant positive relationship with economic growth while credit to private sector has significant positive effects on economic growth. Also, the ratio of private investment to gross domestic product, exchange rate and savings deposit rate had insignificant negative impact on economic growth.

Sulaiman, Oke and Azeez (2012) empirically examined the relationship between financial liberalization and economic growth in Nigeria from 1987 to 2009. The study estimated data obtained with the Johansen Co-integration test and Error Correction Mechanism. The study revealed that the variables have a long-run equilibrium relationship and that financial liberalization had a growthstimulating effect on Nigeria.

Akintola, Oji-Okoro and Itodo (2020) investigated the link between financial sector development and economic growth in Nigeria. The study considered the independent contributions of the money, capital and foreign exchange markets to economic growth, using quarterly data between the first quarter of 2000 and fourth quarter of 2019. Findings has shown that financial deepening, banking system liquidity and all share index had positive and significant impact on the real output growth in the long run, while exchange rate spread was steady with falling levels of gross domestic product.

Ikeora, Igbodika and Jessie (2016) evaluated the effect financial liberalization has on economic growth in Nigeria using data from 1987 to 2013. Formulated hypotheses were tested with the aid of OLS multiple regression analysis, and the findings revealed that the variables do not have unit roots and that there was a long-run equilibrium relationship between financial liberalization and economic growth in Nigeria. Also, the non-existence of a causality relationship between financial liberalization and economic growth in Nigeria was confirmed by the result.

Igbinosa (2012) studied the impact of financial liberalization on the growth of the Nigerian economy in Nigeria. Data obtained for the study from 1981 to 2009 were analyzed with multiple regression analysis, and findings revealed that a significant positive relationship exists between financial development and economic growth while interest rate had an insignificant negative relationship with Nigerian economic growth.

Qazi and Shadida (2013) investigated how financial liberalization impacted Pakistan's economic growth from 1971 to 2007. The study used the autoregressive distributed lag (ARDL) estimation technique and the results from the test carried out showed the relationship between long-run growth with financial liberalization indicators that could promote economic growth.

Catao and Terrones (2015) examined the impact of financial openness on economic growth using panel data obtained from developed and developing countries between 1960 and 2007. Findings from this study has reveal an intertemporal balance between economic growth and openness and that greater dominant openness appears to have short-run negative but long-run positive effects on output growth. Also, the study's result showed that financial globalization has a strongly negative long-run impact but no significant short-run impact on output growth.

Fidel, Fabio and Andrew (2016) investigated the role of capital market imperfection for investment decisions to ascertain if the introduced financial reform in the 8os successfully relax the constraint in the financial system of Ecuador. The model takes into account both a ceiling on leverage as well as rising borrowing costs as leverage levels rise. The study found that capital market imperfection has significant effect of small and young firm in the country but has no effect on large and old firms. The study failed to provide proof that the financial reforms has relaxed the constraints in the financial system of Ecuador.

Research Methodology

Research Design

This study employed *ex-post facto* research design. This is because *ex-post facto* research design involves repeated observations of the same units over a period (1985 to 2021). *Ex-post facto* research design also seeks to determine the cause-effect relationship between the dependent and independent variables of the study.

Sources of Data:

The study obtained data from the Statistical Bulletin of the Central Bank of Nigeria (CBN) from 1985 to 2021

Method of Data Analysis

Analyzing the data, the study employed descriptive statistics, correlation matrix, Augmented Dickey-Fuller unit root test, cointegration test, Engle-Granger Cointegration test of the error term at level and Error Correction Mechanism to numerically estimate the coefficients in the models.

Model Specification

The theory of Financial Liberalisation propounded by Mckinnon (1973) and Shaw (1973) underpins this study and two specified models were specified based on the views of Ogbebor, Oguntodu and Olayinka (2017) which shows the relationship between financial liberalisation and capital market growth. The specified models were modified to include some variables:

Model 2 is specified in a functional form as stated below:

VLT= f(MSS, CPS, INT, CRR, EXR, FDI) ……...….(1)

Equation (1) can re-written in an explicit form as:

$VLT = \beta_o + \beta_1 MSS + \beta_2 CPS + \beta_3 INT + \beta_4 CRR + \beta_5 EXR + \beta_6 FDI + \mu$ ……(2)

Where: VLT = volume of transaction (proxy for capital market liquidity)

MSS = broad money supply as ratio to GDP (proxy for financial deepening)

CPS = private sector credit as ratio to GDP (proxy for credit allocation decisions)

INT = Interest rate (proxy for interest rate ceiling)

CRR = Cash reserve requirement

EXR = Exchange rate

FDI = Foreign direct investment

U_t = Error term

β_0 = Intercept

$\beta_1, \beta_2, \beta_3, \beta_4, \beta_5, \beta_6$ = Coefficients to be estimate

4. Data Presentation and Analysis

Presentation and Analysis of Data

This sub-section presents a descriptive analysis of the variables used. These descriptive statistics provide a historical background for the behaviour of our data. The descriptive statistics are presented in Table 1. The variables examined here are market capitalisation (proxy for capital market efficiency) (MCA), broad money supply as a ratio of GDP (MSS), private sector credit (CPS), Interest Rate (INT), cash reserve requirement (CRR), exchange rate (EXR), foreign direct investment (FDI) and value of transactions (VLT). MCA, MSS, CPS, INT, CRR, EXR, FDI and VLT were available from 1985 to 2021.

Descriptive Statistics

Table 1: Results of Descriptive Statistics

	CPS	EXR	FDI	INT	CRR	MCA	MSS	VLT
Mean	7434.921	120.3435	425.5418	18.09544	48.11200	8021.086	16.41224	471.3326
Median	1043.540	120.9650	229.0122	17.59120	45.91200	1321.300	13.02100	120.4330
Maximum	39211.13	420.6560	1128.069	29.80210	104.2220	43214.84	44.42100	2230.880
Minimum	13.07000	0.821000	0.332600	9.250340	26.39120	6.623000	8.461200	0.230210
Std. Dev.	10459.94	111.0123	479.0145	4.145321	15.12547	11232.11	7.091276	587.2121
Skewness	1.354134	0.932378	0.483492	0.527346	1.572322	1.529126	1.721198	1.202124
Kurtosis	3.954265	3.232331	1.712342	4.132343	6.674234	4.829323	7.331257	4.052190
Jarque-Bera	12.732370	5.452302	4.014324	3.695324	36.06121	19.58233	47.32177	10.72305
Probability	0.003444	0.063223	0.134219	0.157320	0.000000	0.000216	0.000000	0.021743
Sum	276067.1	4452.820	16325.01	669.3320	1779.720	291281.2	609.3400	17230.01
Observations	37	37	37	37	37	37	37	37

Source: Author's Computation using Data from CBN 2021 Statistical Bulletin

The result shows that credit to the private sector on average is 7.5 trillion and its maximum is 39.5 trillion while its minimum is 13.1 billion. Also, the result shows that exchange rate on average is N120.3/1$ and its maximum is N420.7/1$ while its minimum is N0.89/1$. From Table 1, the result shows that foreign direct investment on average is 455 billion and its maximum was 1.36 trillion while its minimum was 0.339 billion USD. The result shows that interest rate and liquidity ratio are on average 18.1% and 48.1% while the maximum are 29.8% and 104.2% while the minimums are 9.25% and 26.39% respectively. The result shows that market capitalisation on average was 8.1 trillion and its maximum was 43.12 trillion while its minimum was 6.6 billion. From Table 1, the result shows that the broad money supply on average was 16.5 trillion, its maximum was 44.5 trillion while its minimum was 8.46 billion. The result shows that volume of transactions in the stock market on average was 471 billion and its maximum was 2.35 trillion while its minimum was 0.23 billion.

Jacque Bera normality test was carried out to show whether the distribution follows normality condition. With the null hypothesis of normal distribution, Jacque Bera result shows that normality test, skewness is zero and excess kurtosis is zero, against the alternative hypothesis of non-normal distribution. If the probability value as presented in 1 exceeds 5%, then the null hypothesis of normal distribution is accepted, otherwise the null hypothesis of normal distribution is rejected. Hence, an observation of Table 1 above shows that given the acceptance criteria, we fail to reject interest rate (INT), exchange rate (EXR) and foreign direct investment (FDI) as their probability values are greater than 5%, implying that it is normally distributed. However, the null hypothesis of normal distribution is rejected for market capitalisation (MCA), broad money supply as a ratio of GDP (MSS), private sector credit as a ratio of GDP (CPS), Cash reserve requirement (CRR) and value of transaction (VLT) as their probabilities are less than 5%, implying they are not normally distributed.

Table 2: Correlation Matrix Result

	CPS	EXR	FDI	INT	CRR	MCA	MSS	VLT
PS	1.00							
EXR	0.94	1.00						
FDI	0.71	0.71	1.00					
INT	-0.40	-0.32	-0.31	1.00				
CRR	0.14	0.32	0.13	-0.12	1.00			
MCA	0.95	0.92	0.77	-0.44	0.14	1.00		
MSS	0.92	0.82	0.71	-0.32	-0.01	0.91	1.00	
VLT	0.71	0.62	0.76	-0.33	0.02	0.72	0.72	1.00

Source: Author's Computation using Data from CBN 2021 Annual Statistical Bulletin

Table 2 shows that there is no perfect correlation between the explanatory variables as the highest degree of relationship between the explanatory variables are 0.93 and this is between credit to private sector and exchange rate; and broad money supply and credit to private sector and it is not perfect as the correlation coefficient is not 1. Unit Root Test The study used Augmented Dickey-Fuller (ADF) test to examine the stationarity of the time

series and test the null hypothesis of unit root. It is expected that the series do not contain unit root in order to find relationship that exist among the variables in the long run. The test is carried out at level, and first difference using 5% Mackinnon Critical value.

Table 3: Augmented Dickey-Fuller (ADF) Unit Root Test Result

		At Level			At First Difference			
Variable	Method	ADF statistics	5% critical value	Prob	ADF statistics	5% critical value	Prob	Order
CPS	ADF	5.25	-2.932	1.0000	-5.20**	-2.961	0.0000	I(1)
EXR	ADF	2.72	-2.923	1.0000	-3.32*	-2.958	0.0168	I(1)
FDI	ADF	-1.52	-2.933	0.4812	-6.82**	-2.941	0.0000	I(1)
INT	ADF	-0.66	-1.953	0.4422	-5.96**	-1.941	0.0000	I(1)
CRR	ADF	-1.35	-1.953	0.1721	-6.48**	-1.981	0.0000	I(1)
MCA	ADF	2.88	-2.942	1.0000	-4.68**	-2.938	0.0011	I(1)
MSS	ADF	0.93	-2.941	0.9922	-2.74**	-1.931	0.0098	I(1)
VLT	ADF	-2.12	-2.921	0.2343	-5.84**	-2.927	0.0000	I(1)

* Implies significant at 5% meaning that the variable is stationary at that order

** Implies significant at 1% meaning that the variable is stationary at that order

Source: Author's Computation using Data from CBN 2021 Statistical Bulletin

From Table 3, the ADF reported market capitalisation, broad money supply as a ratio of GDP, private sector credit as a ratio of GDP, interest rate, liquidity ratio, exchange rate, foreign direct investment and value of transactions in the Stock Exchange to be stationary at first difference. This finding implies that the series contains no unit root at the level and at first difference; hence, their seasonal variation has been corrected for, making them fit for regression.

Co-Integration Test

Engle Granger Cointegration Test

We employ Engle-Granger's (1987) co-integration test to determine if the variables in the system are co-integrated. The Engle-Granger procedure needs an estimation of the cointegrating regression equation. Thus, if there are n series, Yt1. . . Ytn, the co-integrating regression is given by: $Yt1 = \beta 0 + \Sigma\, \beta jYtj + \varepsilon\, t$. The residual from the regression is tested for the presence of a unit root using the tau statistic and z-statistic. If the residuals, εt from the regression are I (0), i.e. stationary at level, then variables are said to be co-integrated and hence interrelated with each other in the long-run. The long-run relationship and test the stationarity of the error term were regressed. It is expected that the error term should be stationary at level for co-integration to exist. Then, the test for the stationarity of the error term was done and the result obtained is given in Table 4.

Table 4: Engle Granger Cointegration test of the error term at level

Model	Dependent	tau-statistic	Prob.*	z-statistic	Prob.*
Model One	ECM01	-6.6231**	0.0239	-39.04334**	0.0078
Model Two	ECM03	-5.83251*	0.0239	-38.2398**	0.0092

* Implies significant at 5%; the model is co-integrated

Source: Author's Computation using Data from CBN 2021 Statistical Bulletin

Table 5: Model Two Method: Error Correction Model Result Dependent Variable: D(LOG(VLT))

ECM Regression				
Case 2: Restricted Constant and No Trend				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
D(MSS)	0.041424*	0.013421	2.944594	0.0243
DLOG(CPS)	0.909438**	0.285422	3.243233	0.0027
D(INT)	-0.016325**	0.005656	-5.934200	0.0000
D(CRR)	-0.005239**	0.004459	-6.135801	0.0000
D(EXR)	-0.006438	0.006512	-1.875622	0.0743
DLOG(FDI)	0.049934	0.108704	0.478451	0.6450
CointEq(-1)*	-0.419548**	0.082105 -	4.734439	0.0001
R-squared		0.823349		
Adjusted R-squared		0.728454		
Ramsey RESET t-stat		1.179564		
Ramsey RESET Prob.		0.25143		
Breusch-Pagan-Godfrey f-stat		0.423323		
Breusch-Pagan-Godfrey Prob.		0.94456		
Durbin-Watson stat		2.115545		
Breusch-Godfrey serial t-stat		2.411322		
Breusch-Godfrey serial prob		. 0.1143		
Jarque-Bera t-stat.		3.034459		
Jarque-Bera prob.		0.21443		

* Implies significant at 5%

** Implies significant at 1%

Source: Author's Computation using Data from CBN 2021 Annual Statistical Bulletin

Discussion of Findings

The result from Table 5 shows that broad money supply, credit to private sector and interest rate all positively and greatly impact market capitalisation. This implies that increases in broad money supply, credit to private sector and interest rate increase market capitalisation. Then, the implication of this result is that an increase in the supply of money in the economy, the amount of credit available to the private sector and increase in the interest rate increase the total value of all the companies' shares of stock in the Nigerian Stock Exchange. Cash reserve requirement and exchange rate have negative and significant effect on market capitalisation, while foreign direct investment has positive and insignificant effect on market capitalisation. This result implication is that both cash reserve requirement and exchange rate had impacted adversely on the performance of the Nigerian capital market overtime. The result showed that an increase in cash reserve requirement and exchange would lead to a decrease in market capitalisation, while foreign direct investment proved statistically insignificant to the model. Considering the statistical properties of the ECM result reported in Table 5, the R-squared value of 0.83 indicates that about 83% variation in stock market capitalisation is explained in the model by the explanatory variables. This confirms that all the independent variables jointly have a significant influence on the dependent variable. The DurbinWatson statistic of 1.95 indicates that absence of serial correlation is associated with the regression result as this can be approximated as 2.

The Ramsey (Regression Specification Error Test) RESET in Table 5 was used to examine the stability of the ARDL model. The Ramsey RESET tests for specification error in terms of omitted variables, incorrect functional form and correlation between the explanatory variables and the error term. The Ramsey RESET tests the null hypothesis of unbiasedness and consistency, producing a zero-mean vector against the alternative of specification error. The result showed that the probability is greater than 5%, thereby failing to reject the null hypothesis; the model is free from specification error. The Jarque-Bera statistics in Table 5 test for the normality distribution of the equation, against the alternative hypothesis. The probability of the Jarque-Bera test concludes that the equation is normally distributed as the probability value is greater than 5%. In the model for Table 6, the error correction term ECM01(-1) is well specified and correctly signed. The coefficient of the ECM01(-1) is approximately -0.4195. It means that about 41.95 percent departure from long-run equilibrium is corrected in the short run. The negative sign in the ECM01(-1) confirms the co-integrating relationship. Hence, about 41.95% of the variations in the short-run converged.

Conclusions and recommendations

Conclusion

Capital market development plays an important role in economic growth, especially in the post-financial liberalization era. While financial liberalization can enhance investment opportunities and economic efficiency, it also poses significant risks. A well-regulated and institutionally strong financial system is essential for maximizing the benefits of financial liberalization while mitigating potential downsides. Future research should focus on the long-term impact of financial liberalization on economic resilience and sustainable growth Broad money supply and credit to private sector have positive effect on both market capitalisation and volume of

transactions. The two variables also proved statically significant to the models. It can therefore be concluded that broad money supply and private sector credit have positive and significant effect on capital market growth in Nigeria. Also, cash reserve requirement and exchange rate have negative and significant effect of both market capitalisation and volume of transactions. It is concluded that cash reserve requirement and exchange rate have negative and significant effect on capital market growth in Nigeria. Interest rate have significant positive effect on market capitalisation and significant negative effect on volume of transaction of stock. The two hypotheses specified are rejected because the probabilities of the coefficients of broad money supply, credit to private sector, interest rate, cash reserve requirement and exchange rate are statistically significant and thus, we reject the null hypotheses and accept the alternatives. Therefore, the financial sector liberalisation has a significant effect on the efficiency and liquidity of the Nigerian capital market. It is recommended that monetary authority in Nigeria must continually improve on the monetary policy to control the money supply in the economy and reduce the interest rate to enhance capital market expansion. High interest rate will reduce spending, stock market participation and decrease stock prices but when interest rate rise, spending will increase and stock prices will rise. Also, the Nigerian government should encourage more exports to create a positive relationship between exchange rate and stock prices. This will make local currency depreciate and local firms will become more competitive, leading to an increase in stock prices.

Policy Recommendations

In order to maximize the benefits of capital market development post-financial liberalization, policymakers should:

- **Strengthen Financial Regulation**: Implement robust regulatory frameworks to prevent financial instability (Claessens & Laeven, 2005).
- **Enhance Institutional Quality**: Develop transparent governance structures and investor protection mechanisms (Acemoglu et al., 2005).
- **Promote Financial Inclusion**: Ensure broad-based access to capital markets to foster inclusive economic growth (Beck et al., 2007).
- **Implement Gradual Liberalization**: Adopt phased liberalization strategies to mitigate risks associated with sudden capital market exposure (Henry, 2007).

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