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The Role of Banks in Capital Formation and Economic Growth: The Case of Nigeria

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Abstract: *This study investigates the role of banks in capital formation and economic growth: The case of Nigeria for the period 1980-2009. The economies of all market-oriented nations depend on the efficient operation of complex and delicately balanced systems of money and credit. Banks are an indispensable element in these systems. This study employed the Ordinary Least square method in carrying out the research. The explanatory variables employed include Commercial Banks Deposit Liability (BDL), Maximum Lending Rate (MLR), Commercial Banks' Credit (CBC) and Investment by banks in Nigeria (BINV). The dependent variables are Gross Fixed Capital Formation (GFCF) and Gross Domestic Product (GDP), which is a measure of a nation's economic performance – economic growth in this instance From the various test carried out it was find out that Commercial Banks Deposit Liabilities is elastic to Gross Fixed Capital Formation in Nigeria. This positivity of the coefficient of Commercial Banks Deposit Liabilities is in conformity to the economic a priori expectation of a positive impact of Commercial Banks Deposit Liabilities on Gross Fixed Capital Formation. Also, the regression result shows that Commercial Banks Credits (CBC) has a positive impact on Gross Fixed Capital Formation (GFCF). It is therefore recommended that efforts should be made by the monetary authorities to effectively manage the banks' maximum lending. This policy thrust will most likely result into increased investment activities which will enhance capital formation in Nigeria needed for its real sector investments and industrial growth.*
Keyword: *deposit liability; credit; capital formation.*

Introduction

The Nigerian banking industry is majorly composed of Deposit money banks, development banks and the Central Bank of Nigeria (CBN), which is the apex bank. The apex bank exercises supervisory and regulatory authority over the banking industry. The Central Bank of Nigeria was established by the Central Bank of Nigeria Ordinance 1958 following the report of J. B. Loynes. The bank commenced operations on 1st July, 1959 (CBN Ordinance). Banks have always been perceived as engine of growth in an economy because they perform a resources allocation function, by mobilizing and channeling resources from surplus economic units to deficit units. They help in stimulating the level of economic activities in various sectors of the economy, thus increasing the level of utility and want to the individual and the community at large.

The relevance of banks in the economy of any nation cannot be overemphasized. They are the cornerstones, the linchpin of the economy of a country. Economic activity cannot be smooth sailing without the continuing flow of money and credit. The economies of all market-oriented nations depend on the efficient operation of complex and delicately balance systems of money and credit. Banks are an indispensable element in these systems. They provide the bulk of the money supply as well as the primary means of facilitating the flow of credit." Consequently, it is submitted that the economic well being of a nation is a function of advancement and development of her banking industry [3,8].

The financial deregulation in Nigeria that started in 1987 and the associated financial innovations have generated an unprecedented degree of competition in the banking industry. The deregulation initially pivoted powerful incentives for the expansion of both size and number of banking and non-banking institutions. The consequent phenomenal increase in the number of banking and non-banking institutions providing financial services led to increased competition amongst various banking institutions, and between banks and non-banking financial intermediaries.

Apart from the keen competition with the range of financial activities, banks have also faced problems associated with a persistent slowdown in economic activities, severe political instability, virulent inflation, worsening economic financial conditions of their corporate borrowers and increasing incidence of fraud and embezzlement of funds. Another major problem banks have had to content with is the inconsistency in monetary and regulatory policies. The surveillance and regulatory measures of the Central Bank of Nigeria (CBN) have unfortunately been unable to keep the pace with the rapidity of the charges in the financial system.

All these factors – deregulation, competition, innovation, economic recession, political instability, escalating inflation, and frequent reversal in monetary policy have combined to create a challenging and precarious financial environment for banks. Consequence of the new financial environment has been rapidly declining profitability of the traditional banking activities. Thus, in a bid to survive and maintain adequate profit level in this highly competitive environment, banks have tended to take excessive risks. But, then the increasing tendency for greater risk taking has resulted in insolvency and failure of a large number of the banks [9].

The continuing deterioration in the financial health of the banks and increasing incidence of bank failure since deregulation have raised question about the nature and state of the Nigerian banking sector.

1. Statement of the Problem

It is a known fact that banks play several vital roles in any economy. And these roles are aimed at ensuring sound financial system and economic stability. It is incontrovertible that the banking system is the engine of growth in any economy, given its function of financial intermediation. Through this function, banks facilitate capital formation, lubricate the production engine turbines and promote economic growth. However, banks' ability to engender economic growth and development depends on the health, soundness and stability of the banking system itself. The need for a strong, reliable and viable banking system is underscored by the fact that the industry is one of the few sectors in which the shareholders' fund is only a small proportion of the liabilities of the enterprise. It is, therefore, not surprising that the banking industry is one of the most regulated sectors in any economy.

Yet it has been argued in the public domain that the commercial banks have not been performing the desired roles in improving capital formation and promoting economic growth in the country.

Capital formation refers to the net addition to the capital stock after of any nation after depreciation. It is defined as an addition to stock of capital assets set aside for future productive endeavours in real sector which will lead to more growth in physical capital assets of the country. Capital formation captures all the real-value-added to the economy in real-asset-terms which will lead to further enhancement of savings, investment and generation of more wealth in future. Capital formation derives from savings accumulation. It has a positive impact on private savings accumulation in the sense that increase in capital formation will lead to more savings. When savings accumulate it will lead to an increase in gross domestic investment (GDI) and income generated as a result of the investment projects made will, in turn, lead to GDP growth [7, 356-367].

Now, the supposed relationship between banking, capital formation and economic growth is that banking through its activities such as savings and deposit mobilization, credit creation, etc increases the accumulation of capital formation which in turn is expected to enhance economic of the country. So, whether or not this relationship holds in Nigeria is also the essence of this study.

2. Objectives of the Study

The central objective of the study is to empirically investigate the role of Nigerian banks in Capital Formation and economic growth. The specific objectives are as follows:

i. To analyze the impact of banks' deposit mobilization on capital formation and economic growth in Nigeria.

ii. To investigate the impact of other banks' performance indicators such as credits to the economy and banks investment on Nigeria's economic growth.

iii. To determine the association existing between capital formation and economic growth in Nigeria.