



## DETERMINANTS OF FINANCIAL DEVELOPMENT IN NIGERIA: A BOUND TESTING APPROACH

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**Abstract:** *This research work is set out to examine the determinants of financial development in Nigeria over the period of 1981 to 2016. Autoregressive Distributive Lag (ARDL) model was employed to estimate the influences of institutions, inflation, interest rate, debt service, foreign direct investment, economic growth, quality of life, government expenditure, trade openness, and quality of human capital on financial development based on the theoretical underpinnings and related empirical literature on financial development. The result revealed that there is an evidence of cointegration among the variables under investigation. However, the results revealed that quality of life, foreign direct investment, and debt service had positive impact on financial development while inflation, economic growth, government expenditure, and trade openness have negative impact on financial development throughout the study period. More so, the nature of relationship between financial development and institutions is found to be statistically insignificant. The study concluded that the most important determinants of financial development in Nigeria over the study period are quality of life and debt services.*

**Keywords:** *financial development, quality of life, trade openness, debt service, foreign direct investment, economic growth, ARDL, bound test*

JEL Classification: *E6, E31, H5, & P36*

### 1. INTRODUCTION

Over the past three decades, it has been undeniably observed that the financial sector of many successfully developed countries have always played a crucial role in economic growth because the financial sector is able to contribute to economic development through accumulating capital and redirecting aggregate savings into financing productive investments (Ramez and Lean, 2017). Financial markets and institutions perform an important function in the economic development process, particularly through their role in allocating finance to productive activities. For a fundamental building block for a healthy and well-diversified economy a financial system has to be considered. The failure of any of the components such as markets, banks

and other financial institutions can surge over the whole sector and vice the economy. Weaknesses in the financial system are an example of the Asian crises of 1997-1998 and the global financial crises. The Asian crises was related mostly to real estate, stock price and currency inflations while that of global financial crisis is related to high risk mortgages i.e. institutions lending to those with poor credit (Jayesh, 2016). In addition, a victorious, productive, competent, advanced and well-managed financial sector will be a great national increase. This definitely will make the country to change into twenty-first-century ranking out among its peers. Many countries have made an effort to develop their financial sector and yet remained financially under-developed. An interesting question remains why? In general why do some countries have growth enhancing

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financial system while others do not? Exploring determinants of financial development across the globe answers the question. For countries that aim to achieve high and sustainable economic growth exploring financial sector development determinants is inevitable. Policy measures such as financial trade liberalization have officially been declared as determinants of financial development by many developing countries following the directives of “Bretton Woods or “Washington Consensus” (Anthony *et al.*, 2015). Financial liberalization means removal of controls and restriction placed on financial sector by a governing authority. It gained attention in the early 1970’s due to work of McKinnon and Shaw (1973) where they argued that liberalization of financial sector will lead to increase in savings, encourage investment and induce economic growth. The liberalization process reduces inefficiency, improves transparency and fosters a competitive environment which; is conducive for the economy as a whole (Seetanah, Padachi, Hosany, and Seetanah, 2011). Financial market liberalization in Nigeria began in 1987 with the support of International Monetary Fund (IMF) and World Bank through an economic policy prescription by developing a programme called “Structural Adjustment Programme (SAP)” aimed at liberalizing distressed economies. Nigeria, prior to liberalization of the financial sector, had an oppressed financial sector in which the government and the Central Bank of Nigeria (CBN) restricted and controlled the activities of the financial sector. The programme set prices right, initiated structural reforms, including fiscal and monetary operations, and privatizations including banks (Bawumia, 2010).

Given this background, the determinants of financial development in Nigeria need to be examined carefully, since financial markets are found to have played an important role in promoting economic growth. Thus, the purpose of this study is to investigate the determinants of financial development in the theme of Nigeria.

## 2. LITERATURE REVIEW

This section reviews related literature on financial development both within Nigeria and outside. Therefore, the following serves as the foundation of this study as discoveries in relation to the topic are reviewed.

In Mauritius study, Seetanah, *et al.* (2011) examines the determinants of financial development using time series data for the period 1970-2008 which was supplemented with primary data. The secondary data was sourced from the website of the Central Statistics Office, the IMF’s International Financial Statistics (IFS), The World Development Indicators of the World Bank and The United Nation Statistics Division. With regard to their technique of analysis, Autoregressive Distributed Lag (ARDL) approach was employed by using two proxies for financial development. Their results revealed that trade openness and trade liberalization are leading determinants of financial development, and also revealed investment rate, per capita and literacy rate as determinants of financial development, while inflation has the negative impact on financial development. Results of their survey-based approach strengthen the findings from secondary data and further show that policy measures such as capital account liberalization, inflation rate, and monetary policy efficiency and factor endowment were the major determinants of financial development. The institutional quality plays an important role in determining financial development while religious or cultural forces play an insignificant role in stimulating financial development in a multi-cultural and relatively educated society like Mauritius. Battagi *et al.* (2007) investigate the effects of openness and economic institutions on financial development across countries and over time. Dynamic panel GMM estimator was employed to estimate the models. The results indicate that openness and economic institutions are potent determinants of the variation in financial development across countries and over time since the 1980s. Moreover, trade openness was found to be the principal determining mechanism of financial development financial openness. The results obtained



using four different datasets were robust in measuring financial development and financial openness. The authors, therefore, suggested that trade and financial openness are substituted mechanisms of financial development but do not complement each other. They further suggested that the necessary conditions for promoting financial development are trade and capital account openness. Herger *et al.* (2007) empirically study the cultural values, a dysfunctional institution on impediments to trade as determining mechanisms of variation in financial development across countries with the inclusion of Nigeria, Mauritius, Niger, and Ghana. With regard to their method of analysis, OLS regression and 2SLS regression techniques were used to estimate the joint effect of trade openness, culture and institutional quality on financial development. The results obtained by using parsimonious models show a strong and theoretical underpinned correlation between institutional quality and trade. Moreover, they also find that trade openness and institutions constraining the political elite from expropriating financiers exhibit a strong positive effect on the size of the capital market. Thus financial development seems not to be stimulated by cultural beliefs and the cost of enforcing financial contracts.

Hauner (2006) examines the effects of public sector debt from the domestic banking system on financial development in middle-income countries with the inclusion of Mauritius and Ghana, using OLS and Multivariate regressions to estimate the variables. With regard to their results, large government borrowing from the domestic banking sector was reported to have a negative impact on financial depth and quality, and also weak financial development has a negative boomerang effect on fiscal policy. Therefore, financial liberalization and improvements to the institutional environment for financial development are insufficient to improve credit access for the private sector if the government absorbs a large part of the credit in many developing countries. Huang and Temple (2005) investigate the link between external trade and financial development in lower-

income countries and higher-income countries as well using cross-section analysis to examine the long-run relationship and also using panel data analysis to examine Granger-causality. The OLS and GMM were used in estimating the variables. Their results from the cross-section method revealed that trade openness has a stronger association with bank-based finance than stock market development (equity-based finance). Therefore in the long-run openness strongly promotes bank-based financial development in higher-income countries, but not in the lower-income countries. Their results from panel data estimation revealed that trade openness has strong positive on financial development for lower-income countries but not for higher-income countries in the short-run, therefore, increases in openness automatically lead to subsequent increases in financial depth.

Furthermore, Koubi (2008) examines the cross-country differences in financial development and stock return using financial markets and stock returns in a group of 49 countries including Nigeria over the period 1980-1999. Transaction cost was used as a proxy for general economic efficiency. His results revealed that financial market depth and stability of rate of returns on financial assets are negatively associated with the quality of government as reflected in country's respect to rule of law, quality of bureaucracy as well as infrastructure. Moreover, high transactions and legal uncertainty negatively affect stock market stability and exchange rate, while general economic fluctuation destabilizes stock market returns, therefore neither capital control nor the degree of openness matters. Therefore, government quality strongly determines the quality of the banking system and the liquidity of the stock market. Claessens and Laeven (2003) assessed the relationship between financial development, property right, and growth using data on the sectoral value generated from a large number of countries including Nigeria by employing OLS regression and instrumental variable analysis. The authors used the ratio of private credit to GDP as a proxy of financial development three broad indices of property



rights and two indices of intellectual property rights as well as a specific index of patent rights (i.e. economic freedom) as proxies for the level of property rights protection. They found that the weak property rights hinder efficient allocation of resources and growth of firms, therefore, the strength of country's property rights determine the level of firm's optimal allocation of resources which in turn stimulate firm's growth. That is, a functioning legal system determines the degree of financial sector development through protecting the returns to assets. Therefore, better property rights lead to higher growth through efficient asset allocation and this growth effect is economically important as that of improved access to finance due to greater financial development. Therefore, greater financial system development increases the availability of external resources for firm investment. Likewise well property rights settings determine efficient *asset* allocation that stimulates growth. Moreover, their results also revealed less growth in countries with less secure property rights as a result of the inefficiency of firm's *asset* allocation and also less growth in countries with lower financial development due to lack of firms' access to finance, therefore firms underinvest.

Moreover, Honoham (2004) examines the relationship between financial development, growth, and poverty using cross-country regressions. The author finds that financial development strongly contributes to sustainable economic growth and it is also negatively correlated with headcount poverty rates, even after taking account of mean income and inequality. Therefore, finance-intensive growth is seen as pro-poor. Moreover, finance-intensive growth as measured by banking depth is associated with a lower poverty ratio even though financial depth is not a sufficient measure of financial development. FitzGerald (2006) investigates the impact of financial development on economic growth. The author found that financial development leads to economic growth while in turn depends on the level of institutional quality. Conventional measures of financial depth (in terms of private assets) and financial

development (as moving from banks towards capital markets) are not associated with higher rates of economic growth. Moreover, financial liberalization leads to more efficient and liquid financial intermediation but does not raise the rates of aggregate domestic savings and investment. The efficiency gains from financial liberalization in terms of investment allocation and corporate governance induce economic instability due to short-term foreign capital flows.

### 3. Methodology EST

#### 3.1 Sources of Data and Variables Measurement

The study intends to examine the influence of investment rate, foreign direct investment, institutions, inflation, interest rate, debt services, economic growth, Quality of Life, government expenditure, trade openness, and quality of human capital on financial development, whether the aforesaid variables determine financial development in Nigeria over the period of the study. The datasets are obtained from Central Bank of Nigeria databank and World Bank database. Thus, the variables are selected based on the existing relevant literature on the topic under study and availability of data. However, to measure financial development we use the monetary aggregates, which capture the value of credits issued by the financial intermediaries to the private sector of the economy divided by Gross Domestic Product. Moreover, the essence of using this measure is that the bulk of credits issued by the central bank are eliminated, following the work of Seetanah, *et al.* (2010). On the other hand, Quality of Life (GDPPK) is measured as GDP per capita. Trade openness (TOPEN) is measured as the total of export and import divided by the Gross Domestic Product of the country. More so, investment rate (INVESTM) is measured as Gross Domestic Fixed Capital Formation divided by GDP of the country. To measure inflation, we use the percent change in Consumer Price Index (CPI), which captures the average price of consumer goods and services bought by households. For quality of human capital (QHUMANK), we use primary school enrolment.



### 3.2 Technique of Data Analysis

This paper uses Autoregressive Distributed Lag (ARDL) model of Pesaran, Shin and Smith (2001) in estimating the influences of investment rate, institutions, inflation, interest rate, debt service, foreign direct investment, economic growth, Quality of Life government expenditure, trade openness, and quality of human capital on financial development. The data covers thirty five years i.e. from 1981 to 2016. The data is sourced from a publication of the World Bank, World Bank Database. The period was justifiably selected based on the availability of data in Nigeria. The study will test for stationarity using Augmented Dickey-Fuller (ADF) and Phillips-Perron (PP) unit root tests. However, following the work of Pesaran et al, (2001), Autoregressive Distributed Lag (ARDL) model is specified as follows:

$$\Delta \text{FINDEV}_{t-1} = \beta_0 + \sum_{i=1}^m \beta_1 \text{INVESTM}_{t-1} + \sum_{i=1}^m \beta_2 \text{FDIGDP}_{t-1} + \sum_{i=1}^m \beta_3 \text{INST}_{t-1} + \sum_{i=1}^m \beta_4 \text{INFL}_{t-1} + \sum_{i=1}^m \beta_5 \text{RINTR}_{t-1} + \sum_{i=1}^m \beta_6 \text{DEBTS}_{t-1} + \sum_{i=1}^m \beta_7 \text{GDPG}_{t-1} + \sum_{i=1}^m \beta_8 \text{GDPPK}_{t-1} + \sum_{i=1}^m \beta_9 \text{TGOVEX}_{t-1} + \sum_{i=1}^m \beta_{10} \text{TOPEN}_{t-1} + \sum_{i=1}^m \beta_{11} \text{QHUMANK}_{t-1} + \alpha_1 \text{INVESTM}_{t-1} + \alpha_2 \text{FDIGDP}_{t-1} + \alpha_3 \text{INST}_{t-1} + \alpha_4 \text{INFL}_{t-1} + \alpha_5 \text{RINTR}_{t-1} + \alpha_6 \text{DEBTS}_{t-1} + \alpha_7 \text{GDPG}_{t-1} + \alpha_8 \text{GDPPK}_{t-1} + \alpha_9 \text{TGOVEX}_{t-1} + \alpha_{10} \text{TOPEN}_{t-1} + \alpha_{11} \text{QHUMANK}_{t-1} + \mu_t$$

Where:

$\beta_0$  = Constant parameter

$\beta_1 - \beta_{11}$  = Coefficient of independent variables

FINDEV = Financial Development

INVESTM = Investment Rate

FDIGDP = Foreign Direct Investment

INST = Institutions

INFL = Inflation rate

RINTR = Real Interest rate

DEBTS = Debt Services

GDPG = Economic Growth

GDPPK = Quality of Life

TGOVEXP = Government Expenditure

TOPEN = Trade Openness

QHUMANK = Quality of Human Capital

$t-1$  = Lag Value

Autoregressive Distributed Lag (ARDL) model is made up of two parts, the first part of the equations with  $\beta_1$  to  $\beta_{11}$  stand for the short-run relationship among the variables, while the coefficients  $\alpha_1$  to  $\alpha_{11}$  represents the long-run relationship among the variables. Therefore, the null hypothesis of ARDL model is defined as  $H_0: \alpha_1 = \alpha_2 = \alpha_3 = \alpha_4 = \alpha_5 = \alpha_6 = \alpha_7 = \alpha_8 = \alpha_9 = \alpha_{10} = \alpha_{11} = \alpha_3 = 0$  indicating that there is no evidence of long run relationship among the variables (Pesaran *et al.* 2001).

Thus, ARDL model is usually begun by conducting cointegration test in order to determine the co-movements among the variables under investigation. To achieve that, the calculated F-statistics is compared with the Critical Value as tabulated by Pesaran *et al.* (2001). If F-statistics exceeds or supersedes the upper bounds (critical values), then the decision rule is to reject the null hypothesis of existence of no cointegration (no long-run relationship) among the variables under study irrespective of whether the variables are stationary at level or first differenced (underlying order of integration of the variables is zero or one) i.e. I(0) or I(1), whereas if F-statistics falls below lower bounds (critical values), then the null hypothesis cannot be rejected and if F-statistics falls within these two critical bounds, hence the result is bound to be inconclusive (Pesaran *et al.*, 2001). Consequently, the Error Correction Model (ECM) of the ARDL approach is specified as follows:

$$\Delta \text{FINDEV}_{t-1} = \beta_0 + \sum_{i=1}^m \beta_1 \text{INVESTM}_{t-1} + \sum_{i=1}^m \beta_2 \text{FDIGDP}_{t-1} + \sum_{i=1}^m \beta_3 \text{INST}_{t-1} + \sum_{i=1}^m \beta_4 \text{INFL}_{t-1} + \sum_{i=1}^m \beta_5 \text{RINTR}_{t-1} + \sum_{i=1}^m \beta_6 \text{DEBTS}_{t-1} + \sum_{i=1}^m \beta_7 \text{GDPG}_{t-1} + \sum_{i=1}^m \beta_8 \text{GDPPK}_{t-1} + \sum_{i=1}^m \beta_9 \text{TGOVEX}_{t-1} + \sum_{i=1}^m \beta_{10} \text{TOPEN}_{t-1} + \sum_{i=1}^m \beta_{11} \text{QHUMANK}_{t-1} + \beta_{12} \text{ECM}_{t-1} + \mu_t$$

Where ECM is the Error Correction Model

representation of equation (i) is to capture the short-run relationship among the variables under investigation. However, before estimating equation (i), there is need to conduct unit root tests using popular stationarity tests; Augmented Dickey-Fuller (ADF) and Phillips-Perron tests.



#### 4. DATA PRESENTATION, ANALYSIS AND INTERPRETATIONS

This section presents the results of Unit Root tests of Augmented Dickey Fuller (ADF) and Phillips-Perron, Autoregressive Distributed Lag (ARDL) model as well as Error Correction Model.

Even though Autoregressive Distributed Lag (ARDL) model does not require a stationarity test due to its peculiarity and capacity to handle variables with different levels of stationarity, but this study decides to determine the stationarity level of the variables under investigation before running the ARDL bound testing approach. This is because ARDL bound testing approach is not capable of handling any series that goes beyond

first differenced i.e. integration of order one I (1). Thus, Table 1, indicates the results of the Augmented Dickey Fuller (ADF) and Phillips-Perron unit root tests and none of the series goes beyond integration of order one I(1) i.e. first differenced. Based on the Augmented Dickey Fuller (ADF) test, the results show that only government expenditure is stationary at level while financial development, institutions, inflation, interest rate, debt services, foreign direct investment, Quality of Life, economic growth, and quality of human capital are stationary at first difference. In addition, the results from the Phillips-Perron test show that trade openness is stationary at first difference.

**Table 1: Unit Root test (ADF and Phillips-Perron)**

Variables	ADF		PP	
	Level	First Diff.	Level	First Diff.
Financial Development		-5.4174***		
Foreign Direct Investment		-4.1967***		
Institutions		-7.6888***		
Inflation rate		-5.4163***		
Interest rate		-3.5308**		
Debt Services		-4.1140***		
Economic Growth		-3.2393**		
Quality of Life		4.8255***		
Government Expenditure	-6.3413***			
Trade Openness				-8.8087***
Quality of Human Capital		-4.8849***		

Note: \*\*\*, \*\*, and \* indicating significant at 1%, 5% and 10% respectively.

Source: Authors computation using Eviews Version 9.

However, after the unit root test, there is a need to know the value of F-statistics in order to determine the presence or existence of cointegration or otherwise among the variables under estimation. This has been carried out using Autoregressive Distributed Lag (ARDL) bounds testing approach and the result reveals the evidence of cointegration among the variables under study. From Table 2, the result indicates that F-statistics is **14.3232**. This shows that the null hypothesis of no

cointegration among the variables can be rejected at not only five per cent significance level but also one per cent level of significance as depicted in the table. This is because the value of F-statistics is greater than the both values in upper bound critical value as well as the lower bound critical value, **6.58** and **6.44**, respectively. Since there is cointegration among the variables, we should go further to estimate the long-run relationship among the



variables under investigation using Autoregressive Distributed Lag (ARDL) model.

Table 2: ARDL Bounds Test for Cointegration

F-statistics value = 14.3232		
Critical Value of Bounds		
Significance	I(0) Bound	I(1) Bound
1%	6.44	6.58
5%	4.6	5.39
10%	3.8	4.6

Source: Authors Computation Using Eviews Version 9.

However, the ARDL long-run coefficients are presented in Table 3. The results indicate that there is a statistically significant relationship between financial development, quality of life, economic growth, trade openness, foreign direct investment, government expenditure, inflation and debt service in Nigeria throughout the study period. However, the results reveal that quality of life, foreign direct investment, and debt service have positive impact on financial development while inflation, economic growth, government expenditure, and trade openness have negative impact on financial development over the study period. More so, the nature of relationship between financial development and institutions is found to be insignificant. Thus, this implies that an increase in quality of life, foreign direct investment, and debt service are associated with significant increase in financial development in Nigeria. A percentage increase (decrease) in quality of life, foreign direct investment, and debt service will lead to about 21.3%, 19.1%, and 36.4% increase (decrease), respectively in financial development. Meanwhile, a percentage increase (decrease) in inflation, economic growth, government expenditure, and trade openness will lead to about

19.9%, 52.9%, 87.5% and 31.8% decreases (increases), respectively in financial development.

However, the results further revealed that the variation in the dependent variable is explained by 98% changes in the independent variables as indicated by the value of the  $R^2$ . Therefore, the changes in financial development is associated with 98% changes in quality of life, inflation, debt service, foreign direct investment, economic growth, government expenditure and trade openness, while only 2% changes in financial development is explained by other variables not captured in the model. The results imply that there is no autocorrelation among the residuals of the variables under investigations going by the value of Durbin-Watson statistic. Having estimated the long-run relationship among the variables, then there is need to estimate the short-run relationship using Error Correction Model (ECM).

Table 3: Result of the Estimated Long-Run Coefficients of the ARDL		
Dependent Variable: Financial Development		
Variables	Coefficients	t-Statistics
Financial Development(-2)	0.0426	0.20473*
Quality of Life	0.2130	0.2041*
Institutions	-0.1320	-0.1750
Inflation	-0.1990	-0.23293**
Debt Service	0.3640	0.3079**
Foreign Direct Investment	0.1907	0.2823**
Economic Growth	-0.5290	-0.3405***
Government Expenditure	-0.8750	-0.1849*
Trade Openness	-0.3176	-0.2179*
$R^2 = 0.9820$ , Adj. $R^2 = 0.9650$ , AIC = -45.7879, SIC = -45.0247, HQC = -45.5276, DW = 2.5379		

Note: \*\*\*, \*\*, and \* indicating level of significance at 1%, 5% and 10% respectively.

Source: Authors computation using Eviews Version 9.0

Furthermore, the moment variables under investigation are cointegrated. Then we should go further to conduct an error correction model (ECM) analysis to express the short-run relationship among the variables and the speed of adjustment from the short-run to the long-run. Thus,



this is because ECM expresses the speed of adjustment from the short-run to the long-run equilibrium in case of any distortion in Nigerian economy as the case may be. The results as presented in Table 4, show that the ECM coefficient is -0.2645 and statistically significant at 1% level going by its t-Statistic and p-value of -6.8226 and 0.0000, respectively. This shows a high speed of adjustment to equilibrium level after a shock or distortion. For the other explanatory variables, the short-run analysis reveals the existence of a statistically significant relationship with the dependent variable.

**Table 4: Error Correction Estimate of the ARDL Model (Short-Dynamics)**

Dependent Variable: Financial Development		
Variables	Coefficients	t-Statistics
Financial Development (-2)	0.0968	-0.8844
Quality of Life	-0.0010	2.7904**
Institutions	-0.0011	-2.7862**
Inflation	-0.0016	-1.3433
Debt Service	-0.0001	3.7601***
Foreign Direct Investment	0.7687	3.1120***
Economic Growth	-0.0002	-7.1263***
Government Expenditure	-0.0003	-0.8100*
Trade Openness	-0.1535	-2.3265**
ECM(-1)	-0.2645	-6.8226***

Note: \*\*\*, \*\*, and \* indicating level of significance at 1%, 5% and 10% respectively.

Source: Authors computation using Eviews Version 9.0

### 4.3 Discussion of Findings

This paper is set out to empirically examine the determinants of financial development in Nigeria. To accomplish the aforementioned objective, the authors applied Autoregressive Distributed Lag (ARDL) Model to estimate both the short-run and long-run relationship between the variables under investigation. However, the results from the aforesaid technique partially corroborate with the results of other related study on financial development and they are also consistent with the theoretical underpinning on financial development.

Our result also revealed that institutions and trade openness had negative and statistically significant influence on financial development which is in line with

a priori expectation and the findings of Seetenah *et al.* (2011) and Battaqi *et al.* (2007). The result discovered that inflation rate negatively influences financial development over the period of the study which corroborates the findings of Seetenah *et al.* (2011). The results of the study showed that debt services and quality of life positively affect financial development which is consistent with the findings of Hauner (2006). It also showed that economic growth had negative and statistically significant impact on financial development which corroborates the findings of Honoham (2004) and Seetanah *et al.* (2011), respectively. The results revealed that foreign direct investment yields a positive impact on financial development and statistically significant. This is in line with the findings of Seetanah, *et al.* (2011) for Mauritius.

### 5.0 Conclusions

On the basis of the findings of this study, the following conclusions are drawn: the study found that quality of life, foreign direct investment, debt service, inflation, economic growth, government expenditure, and trade openness are factors that determine financial development in Nigeria over the period of the study. The study revealed the relative importance of the determinants of financial development and the magnitudes of their impact on financial development matters a lot. For instance, the leading determinant among the factors that influence financial development is debt services followed by quality of life.

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