Accounting and Auditing

The Global Financial Crisis and the Performance of Capital Markets of Developing Economies: Lessons from Nigeria

Edirin Jeroh[1]

Abstract: In recent times, economies worldwide are believed to be interrelated. This led to the interdependence of financial institutions such that developments in any part of the world, affects other parts as well. Thus, this study examines the extent to which the recent global financial crisis influenced the performance of capital markets in developing economies, with emphasis on the Nigerian Capital Market. The cointegration technique with its implied Error Correction Model was adopted. The results of the parsimonious ECM revealed amongst others that the recent global financial crisis does not have a severe negative impact on the performance of the Nigerian capital market. Based on the above, it was recommended amongst others that efforts must be made by the CBN and other regulatory bodies to ensure that reforms are made to reduce the over dependence on foreign borrowing by financial institutions in Nigeria as this will help to cushion the effect of credit crunch in advanced countries on the Nigerian economy.

Keywords: economic meltdown; stock market; all share index; credit crunch; market capitalization

JEL Classification: G01

1. Introduction

A capital market, according to Ologunde, Elumilade and Asaolu (2006), is a collection of financial institutions set up for the granting of medium and long term loans. It is a market, as Olugunde et al. (2006) further noted "for government securities, corporate bonds, and the mobilization as well as the utilization of long term funds for development – the long term end of the financial system". In line with the above assertion, Murinde (2006), opine that capital markets are markets for trading long term financial securities, including ordinary shares, long term debt securities such as debentures, unsecured loan stock and convertible bonds. More specifically, one must note that the capital market in any economy provides the mechanism through which investors interact directly or indirectly (through

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financial intermediaries) with borrowers, by making available, their surplus funds to those who intend to borrow them for use in their respective businesses.

As a market that synchronizes the different portfolio preferences of investors and financial intermediaries, the capital market is paramount to the acceleration of the economic development of economies across the globe (Oladipupo, 2010; Okafor & Arowoshegbe, 2011; Idolor & Erah, 2011; Ogege & Ezike, 2012 and Otto, Ekine & Ukpere, 2012). This is why most governments pay reasonable attention to the activities of the market since it is not only crucial, but also central to the entire capital mobilization process (Ologunde et al., 2006) which gives room for the creation of goods and services meant for the satisfaction and well being of the citizenry of any country.

Jeroh (2010) believes that the global financial system has in the last ten years witnessed rapid growth and substantial structural change, leading to globalization of financial markets in the world over. This has however resulted in an interrelatedness of world economies owing to the fact that the world is becoming a global village and there seem to be an integration of financial markets (Ajakaiye & Fakiyesi, 2009) which has spearheaded a form of rapid flow of capital across the globe. This interrelatedness of world economies in addition to the integration or connectivity of financial markets (Sanusi, 2011) is believed to have magnified the contagious effects of the recent global financial crisis or meltdown with implications for the transmission of financial policies on economies globally simply because any development in any part of the world affects other parts as well.

Over the years however, the Nigerian Capital Market is believed to have experienced series of shocks, and in recent times, a downturn in economic activities believed to have been induced by significant divestment by foreign investors as a result of the *ill wind* of financial recession that blew financial markets all round the globe (Jeroh, 2012). It is on this background that this study is designed to take a second look at the impact of the recent global financial crises on capital markets, with specific reference to the Nigerian capital market.

In view of the above, the following research question and hypothesis have been developed for this study.

Research Question

How severe was the impact of the recent global financial meltdown on the performance of the Nigerian Capital Market?

Hypothesis Of The Study

In order to achieve the objective of this study and to find answers to the research question stated above, the following research hypothesis was formulated and tested:

H_O: The recent global financial meltdown does not have a severe negative impact on the performance of the Nigerian capital market

H_A: The recent global financial meltdown has a severe negative impact on the performance of the Nigerian capital market

2. Review of Related Literature

Meaning of the Global Financial Crises

Global financial crisis otherwise known as global economic meltdown, or financial meltdown or economic crisis refers to a situation where financial institutions begin to loose substantial amount or parts of their value. The term has been referred to as "*a financial turmoil*" (Igbatayo, 2011), and "*a tsunami*" (Chossudovsky, 2009). According to Nwokah, Anyanwu and Momodu (2009:60) "*global financial meltdown* is a recognition of the globalized economy as we have today". This is because in about twenty five years before now, it is believed that an economy can easily be singled out or isolated from any identified problem(s) associated with the world economy, since as at then, financial markets were not as integrated as we find them today (Jeroh, 2010). This global financial crisis has caused considerable slowdown in most economies of the world today (te Velde, 2008; and Ujunwa, Salami and Umar, 2011). Despite government initiatives to contain the effect of this global financial crisis on their countries, many still believe that the worst is yet to come (Enebeli-Uzor, 2008; and te Velde, 2008). No doubt however, significant challenges have been posed on economies globally, since the crisis has exposed weaknesses in the functioning of the global economy (Ashamu & Abiola, 2012), thereby leading to a call for a reform in the international financial structure.

Origin and Cause of the Crisis

Jeroh (2010) asserts that opinions vary regarding the origin of the recent global financial meltdown **(2007 -2009)**. The frequently canvassed opinion is that the crisis started in the United States of America (USA), caused in part by mortgage crises resulting from failure on the part of households to make higher payments on mortgages in 2007 (Avgouleas, 2008; Aluko, 2008; Enebeli-Uzor, 2008; Soludo, 2009; Sanusi, 2011; Jeroh, 2010; Igbatayo, 2011; Ajao and Festus, 2011 and Ashamu and Abiola, 2012) causing the global credit market to come to a standstill in July, 2007 (Avgouleas, 2008). Igbatayo, (2011), strongly believes that what began as a meltdown of the United States sub – prime mortgage market in 2007, had grown steadily into a full blown economic crisis by 2008, wiping out trillions of dollars of financial wealth, undermining global trade and investment and putting the real economy on a course of protracted recession around the world.

The recent global financial crisis as noted by Ashamu and Abiola (2012) has some important common elements with previous financial crisis in Asia, Mexico and

Russia in terms of causes and consequences. Accordingly, varying weights have been placed on certain complex factors identified by experts and commentators to be the cause of the global financial crisis. Some of these causes in the views of Adamu, (2009) include the inability of homeowner to make their mortgage payments, poor judgment by the borrower and/or lender, speculation and overbuilding during the boom period, risky mortgage products, high personal and corporate debt levels, financial innovation that distributed and concealed default risks, central bank policies, and regulation. Hence, Kalu (2009) believes that the crisis resulted from laxities in the US financial and regulatory system. This is because the dramatic increase in the expansion of credit to a sub-sector (sub – prime mortgage) was not properly checked, until 2006, when according to Igbatayo (2011) it unraveled.

Prior to the period of the global financial meltdown, there was a period of strong global growth, growing capital flows, and prolonged stability. A period where market participants sought higher yields without an adequate appreciation of associated risks, and failed to exercise proper due diligence. In addition to this fact, it was very obvious that policy makers and other stakeholders failed to appreciate and address the risks that were building up in financial markets.

In line with the above, Avgouleas (2008) enumerated the causes of the crisis as: breakdown in underwriting standards for subprime mortgages; flaws in credit rating agencies' assessments of subprime Residential Mortgage Backed Securities (RMBS) and other complex structured credit products especially Collaterized Debt Obligations (CDOs) and other Asset-Backed Securities (ABS); risk management weaknesses at some large at US and European financial institutions; and regulatory policies, including capital and disclosure requirements that failed to mitigate risk management weaknesses.

The Global Financial Crisis and the Nigerian Capital Market

Generally speaking, the recent global economic meltdown had implications on emerging and developing economies with specific reference to Africa. In fact, the crisis is believed to have occurred at a period when the continent as noted by ECA and APF (2008) had attained an average growth rate of real output above 6.2% with a decline in inflation rate to single digits.

The debate on whether the global financial crisis will affect, or had affected Nigeria, attracted a lot of opinions. At the onset, some authors argued that with the developments in the banking sector, the crisis will have little or no impact on the Nigerian Capital Market. Others argue that the Nigerian Capital Market was yet to be fully integrated into the international financial architecture, as such, what is affecting the US and other Markets in Europe had nothing to do with the Nigerian Market. In line with this argument, Ibegbu (2009) pointed that Nigeria is not as inter – dependent on the global capital systems as other nations on the continent to the extent that it should be adversely affected by the global crisis. At this juncture, one must note however that although the Nigerian economy, prior to the crisis in 2007, performed below projection, with an estimated GDP growth of 6.2% which was below the set target of 10% (Ajakaiye & Fakiyesi, 2009), but by the year 2007, market capitalization was said to have grown by 74.7% which however fell in 2008, by 45.8% (Okereke-Onyiuke, 2009). In view of this development, Oladipupo (2010), opine that Nigeria's capital market before the recent financial crisis happened to be one of the most profitable investment havens. In his view, the global economic meltdown had over the years, eroded market capitalization and has also reduced the level of the All Share Index in the market, leading to the opening of what he described as "a can of worms and black boxes" which made eight bank Chief Executive Officers (CEOs) and their Directors to loose their jobs. It is in view of the above that the researcher seeks to determine the extent to which the Nigerian Capital Market was adversely affected by the recent financial crisis and to ascertain whether the negative trends in the market if any, could solely be attributable to the recent global financial crisis.

Research Methodology

Unlike most works in the area of global financial crisis and the Nigerian economy/capital markets to date, this paper utilized secondary data. The Vector Error Correction Model (VECM) was employed in analyzing the data obtained for the study. This is aimed at knowing the extent to which the recent global financial crisis had impacted on the performance of capital markets of developing economies, using the Nigerian Capital Market as a case study.

Statistical Procedure

As noted earlier, the Vector Error Correction Model (VECM) was used to analyse the data obtained for this study. This is because the model restricts the long run behaviour of the endogenous variables from converging to their cointegrating relationships, while allowing for a short run adjustment (Gujarati, 2003). The VECM is of the form stated below:

$$\Delta y_t = \alpha\, \beta' y_{t-1} + \sum_{i=1}^{j=1} \Gamma_j\, \Delta y_{t-1} + \pi + \varsigma_t,\ t = 1, \ldots, T$$

Where Y_t is a vector of the endogenous variables which include market capitalization, value of equity, liquidity ratio, prime lending rate and a dummy variable. The α parameter measures the speed of adjustment through which the variables adjust to their long run values and the β' vectors are estimates of the long run cointegrating relationships among variables in the model. The π is the drift parameter and is the matrix of the parameters associated with the exogenous variables. The stochastic error term is also included in the specification. The model to be estimated is thus stated below:

$MCAP = b_0 + b_1PLR + b_2LR + b_3VEQ + b_4FCDUM + U_t$

Where:

PLR = Prime Lending Rate

LR = Liquidity Ratio

VEQ = Value of Equity

FCDUM = Dummy variable capturing the global financial crises. It assumes the value of 1 prior to the period of the global financial crisis and 0 during the period of the global financial crisis.

L = Natural Logarithm.

The first stage of the test is a test of whether the variables are stationary or not.

Results and Discussion

Unit Root Test

The Augmented Dickey Fuller (ADF) unit root test was used to test whether the variables are stationary or not as well as their order of integration. The summary of the ADF unit root test is shown in Table 1 below:

Table 1. Summary of ADF Unit Root Test Result

Variables	Level Data	1^{st} Diff	1% CV	5% CV	10% CV	Order of Integration
PLR	-2.08	-4.94*	-3.69	-2.97	-2.62	I (1)
MCAP	-1.15	-4.41*	-3.69	-2.97	-2.62	I (1)
LR	-2.18	-4.86*	-3.69	-2.97	-2.62	I (1)
VEQ	-2.61	-5.82*	-3.69	-2.97	-2.62	I (1)

NB: * denotes statistically significant at the level of 1 percent.

The ADF unit root test result shown in Table 1 above indicates that none of the variable was stationary. However, after taking the first difference, they became stationary. This however permits us to go to the next stage which is the co-integration test.

Co-integration Test

In order to test for the long run relationship among the variables, we adopted the cointegration test. The Johansen Cointegration test was used for this purpose. This test is preferable to the Engel granger test because it permits more than one cointegration equation. The result of the Johansen Cointegration test is as shown in Table 2 below:

Table 2. Summary of The Johansen Cointegration Test Result

Hypothesized No. of CE(s)	Eigenvalue	Trace Statistic	5 Percent Critical Value	1 Percent Critical Value
None*	0.594963	49.24292	47.21	54.46
At most 1	0.499813	23.93720	29.68	35.65
At most 2	0.121162	4.539533	15.41	20.04
At most 3	0.032434	0.923198	3.76	6.65

Hypothesized No. of CE(s)	Eigenvalue	Max-Eigen Statistic	5 Percent Critical Value	1 Percent Critical Value
None	0.594963	28.30572	27.07	32.24
At most 1	0.499813	19.39767	20.97	25.52
At most 2	0.121162	3.616335	14.07	18.63
At most 3	0.032434	0.923198	3.76	6.65

Both the trace statistics and the max-eigen statistic indicate 1 cointegrating equation. The existence of at least 1 cointegrating equation permits us to estimate the over parameterize and the parsimonious ECM model.

Over parameterize and Parsimonious ECM Result

The results of the over parameterize Error Correction Mechanism (ECM) is shown in Table 3 below:

Table 3. Summary of Overparameterize ECM modeling: DLMCAP

Variable	Coefficient	Std. Error	t-Statistic	Prob.
DLPLR	0.124842	0.348785	0.357935	0.7251
DLPLR(-1)	-0.315315	0.389721	-0.809080	0.4303
DLPLR(-2)	0.525107	0.155080	3.386038	0.0025
DLLR	-0.269845	0.412400	-0.654327	0.5222
DLLR(-1)	0.714930	0.087195	8.199218	0.0000
DLLR(-2)	0.249174	0.354412	0.703063	0.4921
DLVEQ	0.407183	0.059263	6.870795	0.0000
DLVEQ(-1)	-0.004988	0.052609	-0.094807	0.9256
DLVEQ(-2)	-0.024420	0.044826	-0.544774	0.5934
FCDUM	0.040153	0.202416	0.198369	0.8453
ECM(-1)	-0.173256	0.056385	-3.072751	0.0044
C	0.274675	0.087468	3.140286	0.0063

R^2 = 0.67, AIC = 0.99. SIC = 1.56, Fstatistic = 30.79, DW = 1.85.

The parsimonious ECM model was gotten by deleting insignificant variables from the over parameterize ECM model.

The result of the parsimonious ECM model is shown in Table 4 below:

Table 4. Summary of Parsimonous ECM Result Modeling: DLMCAP

Variable	Coefficient	Std. Error	t-Statistic	Prob.
DLPLR(-2)	0.889766	0.181262	4.908717	0.0000
DLLR(-1)	0.685214	0.077328	8.861098	0.0000
DLVEQ	0.466654	0.111772	4.175055	0.0003
ECM(-1)	-0.844961	0.300682	-2.810148	0.0000
C	0.245646	0.058154	4.224065	0.0003

R^2 = 0.74, AIC = -0.62, SIC = -0.86, FStatistic = 40.96, DW = 2.04.

The dummy variable for global financial crisis was not significant and was thus deleted from the parsimonious ECM model. The result shows that the liquidity ratio lagged by 1 period has significant influence on the level of market capitalization. The prime lending rate also had a significant and positive impact on the level of market capitalization in Nigeria. The elasticity which is almost unity is an indication of the importance of the prime lending rate in influencing the level of market capitalization in Nigeria. The value of equities with relatively lower elasticity has a statistically significant and positive impact on the level of market capitalization in Nigeria. The statistical significance of the ECM which is also negatively signed indicates a satisfactory speed of adjustment. This suggests that about 84 percent of the errors were corrected in each period.

Vector Error Correction

The result of the Vector Error Correction is shown in Table 5 below:

Table 5. Summary of VEC Result

Cointegrating Eq:	ConitEq1
MCAP(-1)	1.000000
PLR(-1)	-168.7620 (70.8319) [-2.38257]
LR(-1)	-130.6703 (47.6401) [-2.74286]
VEQ(-1)	0.151723 (0.04334) [3.50081]
C	-19781.11

Error Correction:

D(MCAP)

D(PLR) D(LR)

D(VEQ)

ConitEq1 -0.053965 0.0013110.001595 20.14470

(0.02591) (0.00052) (0.00109) (6.04138)

[-2.08258]

[2.50550]

[1.46421]

[3.33445]

The result of the VEC indicates that the market capitalization equation represents the true co integrating equation. The other variables are statistically flawed. They either have the wrong sign or are not statistically significant.

Diagnostic Test Checks

The diagnostic test is used to test the null hypothesis and to know whether errors are normally distributed, whether they are homoskedastic and whether such errors are serially correlated. The summary of the diagnostic test result is shown in Table 6 below:

Table 6. Diagnostic Checks

Jarque – Bera			
Jarque – Bera	0.87	Probability	0.66
Breusch Godfrey Serial Correlation LM Test			
F Statistic	0.196	Probability	0.823
White Heteroskedasticity			
F Statistic	2.26	Probability	0.06

The result in Table 6 indicates an acceptance of the null hypothesis. This means that errors are normally distributed and that there is no serial correlation in the error term. The result also shows that the errors are homoskedastic (that is, they have constant variance). The result of the stability test is shown in Fig. 1 below:

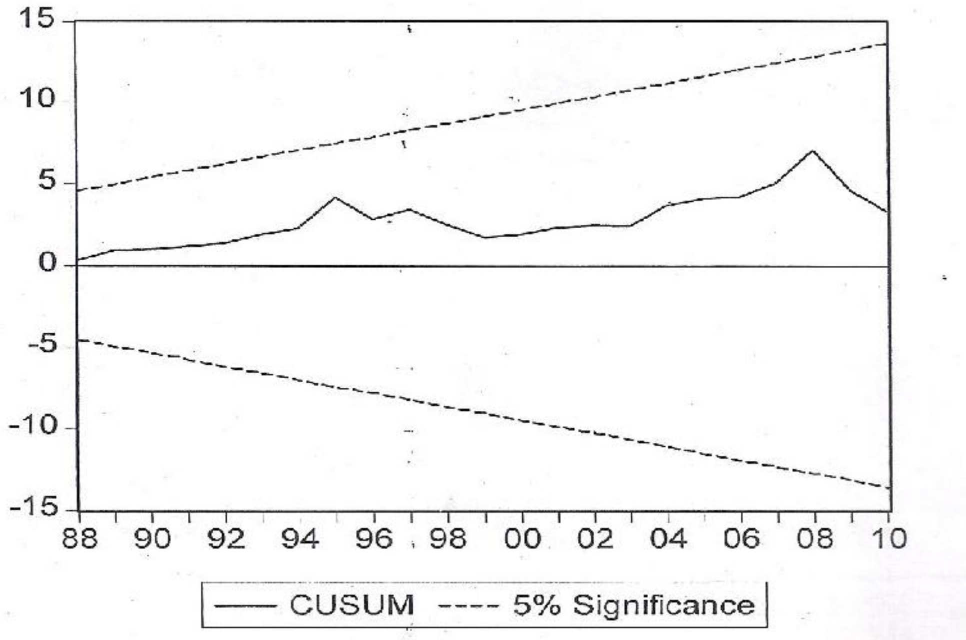

Figure 1. CUSUM Stability Test

The Cummulative Sum Squares (CUSUM) stability test shows that the model is stable because the CUSUM straight line is in between the two 5 percent lines.

3. Conclusion

The results from this study have some important implications regarding the impact of the recent global financial crisis on the performance of the Nigerian capital Market. The dummy variable for global financial crisis was not statistically significant. This is an indication that the global financial crisis did not have a severe negative impact on the Nigerian Capital Market. This result suggests a validation of the null hypothesis that the recent global financial crisis does not have a severe negative impact on the performance of the Nigerian Capital market. Several factors accounts for this development. First, Nigeria is a mono-economy with crude oil as a major source of earnings. The global financial crisis adversely affected mostly industrialized and emerging economies with diverse production base whose capital markets were globally integrated. Another plausible reason for this could be the strategic decisions taken by the Central Bank of Nigeria which includes the injection of liquidity into the capital market by the Central Bank of Nigeria (CBN) during the early period of the crisis.

Recommendations

The findings of this study should not be a cause for celebration for the relevant authorities in Nigeria; rather, it constitutes a source for worry for a country like Nigeria. This is because there is a potential danger of relying on only one major source of foreign exchange for a country. In short, the Nigerian budget is usually tied to a particular price of crude oil and when the prices of crude fell in the global market due to the economic meltdown, the budget was systematically reduced. This trend, if allowed to persist, will have a significant adverse effect on the entire economy. This therefore calls for the need of the Federal Government to be more committed to infrastructural development especially in the Manufacturing and Power sectors respectively as this will help to cushion the effect of shocks or breakdowns in one sector on the entire economy.

The recent reforms in the Nigerian banking sector could be seen as "*a stitch in time*". Probably, the current trends in the Nigerian capital markets simply could be "a tip of the iceberg" if not for the reforms which came at the time it was needed most in the country. Thus, much still need to be done. The recent losses recorded by the nationalized banks under the Sanusi regime (present CBN Governor) is an indication that all is yet to be well with the banking sector. We must not forget that most of the activities of the Nigerian Stock Exchange are directly and indirectly dominated by trends in the Nigerian banking sector.

At the international level, there is need for a reform in the financial structure of integrated markets such that lapses in any single market can easily be checkmated and if possible corrected to avoid the kind of chain reaction that was recently experienced resulting from the happenings in the US sub prime mortgage market.

Efforts must be made by the CBN and other regulatory bodies to ensure that reforms are in place to see that since our stock market is dominated by the activities of banks in Nigeria, the operations of Nigerian banks must not depend heavily on foreign borrowing. This will to some extent checkmate the effect of credit crunch in advanced countries on the Nigerian economy.

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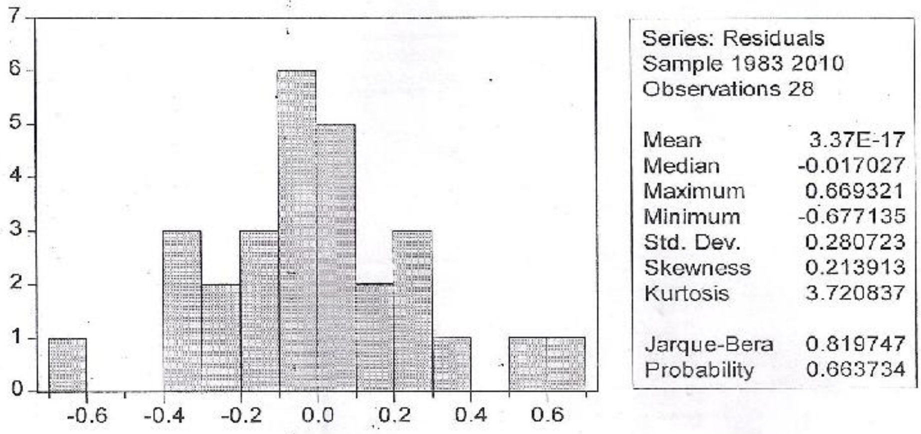
APPENDIX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Kurtosis 3.720837
Jarque-Bera 0.819747
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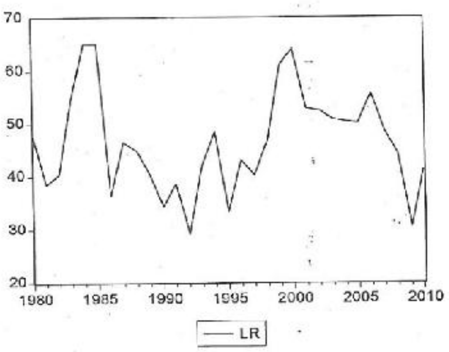
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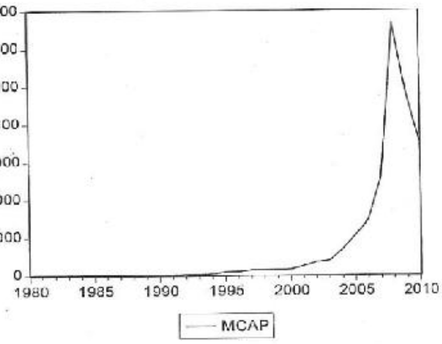
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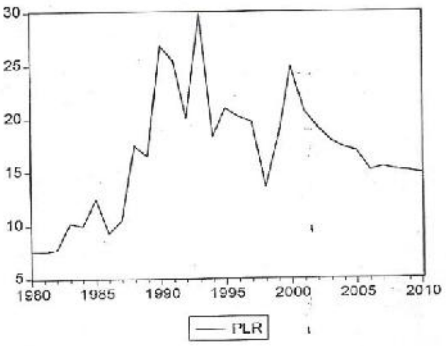
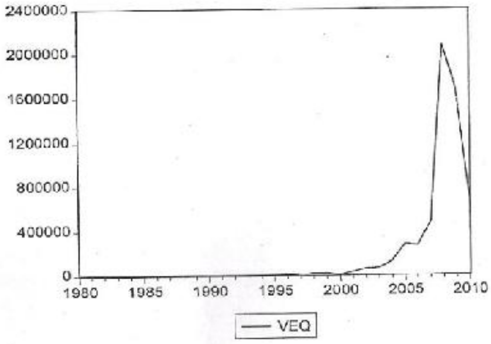

PLR


VEQ