

FINANCIAL INTEGRATION AND MACROECONOMIC PERFORMANCE

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A Presentation at CEPDeR Scholar Seminar

JUNE, 2025

Introduction

- ▶ An efficient financial system is paramount in achieving a market based system that will be responsible for allocation of resources (Oladele and Makwe, 2018). According to the financial integration hypothesis, a globally interconnected financial system will improve economic growth by enhancing output and specialisation, capital allocation, and risk distribution among economies (Gehringer, 2015).
- ▶ The phrase "financial integration" is used to define the global connection created by the movement of cross-border financial flows. Phutkaradze, Tsintsadze and Phutkaradze, 2019 define financial integration as the movement of direct investments, foreign capital and profitable transactions between a domestic economy's financial market and foreign capital markets.
- ▶ Economies can financially integrate through their financial institutions and capital markets, investors can buy and sell in capital markets, firms can also raise funds in the international capital markets, information regarding policies, strategies for growth and risk minimization can be shared among international financial institutions.

Introduction Contd.

- ▶ The deregulation of the Nigerian financial market was embarked upon in 1986 when the Structural Adjustment Programme (SAP) was introduced. The financial market was deregulated in order to improve macroeconomic performance, allow efficient allocation of economic resources, and attract foreign investors to invest in the country's capital market and also to reduce capital flight.
- ▶ It's been over 3 decades since Nigeria deregulated its financial market and allowed for cross-border flow of capital and the economy is yet to experience the changes one will benefit from a financially integrated economy.
- ▶ Some Authors have argued that Nigeria's capital market liberalisation has led to capital flight, and macroeconomic instability. Some authors like (Mougani, 2012) have argued that financial integration has no positive impact on developing economies, especially those with weak and unstable financial systems while others argue that financial integration in itself will bring about an improvement in a country's financial institutions through import of best practices from countries with developed financial institutions leading to financial development.

Objectives, Hypotheses and Research Questions

▶ **Research Questions**

The study sought to answer two main questions;

- ▶ Does financial integration lead to financial deepening?
- ▶ what is the effect of financial integration on macroeconomic performance of Nigeria?

▶ **Objectives**

- ▶ To determine the direction of causality between financial integration and financial deepening
- ▶ To examine the effect of financial integration on key macroeconomic variables (economic growth, inflation, balance of payment and unemployment rate) in Nigeria from 1981-2020

▶ **Hypothesis**

- ▶ H_0 : There is no significant relationship between financial integration and key macroeconomic variables (economic growth, inflation, balance of payment and unemployment rate) in Nigeria
- ▶ H_1 : There is no significant relationship between financial integration and key macroeconomic variables (economic growth, inflation, balance of payment and unemployment rate) in Nigeria

Literature Review

▶ **Theoretical Literature**

- ▶ The Mckinnon (1973) and Shaw (1973) Theory of Financial Liberalization was employed by the study. Mckinnon (1973), in his book “Money and Capital in Economic Development”, stated that national authorities of developing economies would have to make right policy decisions in order to achieve successful development. One of the policy choices mentioned by Mckinnon is the liberalization of the domestic financial markets in order to allow for foreign participation and also for domestic investors to be able to participate in the financial markets of other countries.

▶ **Empirical Literature**

- ▶ Some empirical studies (Adedokun & Osode, 2020; Nwodo & Ukwueze 2019; Olaniyi,2013) examined the effect of financial integration on economic growth of different countries and their studies revealed both positive and negative effects of financial integration on economic growth and other macroeconomic variables.

Gaps in Empirical Literature

- ▶ Majority of the studies reviewed employed cross-country analysis.
- ▶ The studies also used only economic growth as a proxy for macroeconomic performance failing to recognize other proxy of macroeconomic performance (unemployment, inflation and balance of payment).
- ▶ This study filled this gap by including other macroeconomic performance indicators in one study and conducting a specific country analysis.
- ▶ Olaniyi (2013) who examined the effect of financial integration on economic growth in Nigeria used capital inflows and FDI to proxy financial integration.
- ▶ This study checked the effect of financial market development on macroeconomic performance using the ratio of broad money supply (M2) to GDP as a proxy for financial deepening.
- ▶ This study used a robust number of variables to capture financial integration (Financial openness, international investment position and net capital flows).

Data and Sources

- ▶ The study employed annual time series data for analysis. Adopting four dependent variables;
- ▶ Real GDP to capture economic growth as it accounts for inflation
- ▶ Inflation to capture price stability
- ▶ Unemployment to capture the level of unemployment in the country
- ▶ Current account balance to proxy balance of Payment.
- ▶ **Independent Variables**
- ▶ Financial openness which is a de jure measure of financial integration is based on the configurations by Chinn and Ito (2008, 2010).
- ▶ Financial deepening measured by the ratio of broad money supply to GDP
- ▶ International investment position introduced by Lane and Milesi-Ferretti (2017) is a quantity based measure of financial integration.
- ▶ Net capital flows in this study is captured using foreign direct investment outflows + portfolio outflows - foreign direct investment inflows and portfolio inflows (capital inflows – capital out flows). The result is taken as a percentage of GDP. This measure was adopted by Kraay (1998) and Lane and Milesi-Ferretti (2002) to measure capital account openness.
- ▶ **Data Sources:** Central Bank of Nigeria (CBN) Statistical Bulletin, World Development Indicators (WDI) and International Monetary Fund (IMF) Financial Statistics Database.

Models and Methodology

- ▶ $RGDP = f(FOP, FID, NCF, IIP)$ (1)
- ▶ $INF = f(FOP, FID, NCF, IIP)$ (2)
- ▶ $BOP = f(FOP, FID, NCF, IIP)$ (3)
- ▶ $UNP = f(FOP, FID, NCF, IIP)$ (4)

▶ The ADF unit root tests revealed that the variables were of different order of integration $I(0)$ and $I(1)$. The study employed the ARDL bound test for co-integration in the RGDP model while the INF, BOP and UNP models that had uniformity in variable integration $I(1)$ were analysed using the Johansen co-integration test and the ECM for model estimation.

▶ The Granger Causality test was used to test for the direction of causality between financial integration variables and financial deepening.

Results

- ▶ financial openness (FOP) in the short and long run, had a positive effect on RGDP but was only significant in the long run.
- ▶ Net capital flows (NCF) is seen to have a positive and not significant effect on economic growth.
- ▶ (IIP) has a positive and significant effect on economic growth in the long run.
- ▶ FOP, NCF and IIP caused inflationary pressure during the study period but only FOP was significant at 5%.
- ▶ FOP, NCF and IIP brought about a balance in the current account but the coefficient of FOP was not significant.
- ▶ FOP and NCF caused a reduction in unemployment rate but only FOP was significant.
- ▶ IIP had a positive and significant effect on unemployment rate.
- ▶ FID had a significant effect on economic growth and current account balance of payment and there was no direction of causality between FID and financial integration.

Conclusion and Recommendations

- ▶ The study concludes that financial integration has a positive effect on economic growth but can also lead to an increase in inflationary pressure when not properly managed.
- ▶ Cross-border flow of capital can increase employment through an increase in capital investment and cause a balance in the current account balance.
- ▶ A country can benefit from financial integration when its financial systems are well developed
- ▶ **Policy Recommendations**
- ▶ The study based on the findings therefore recommends cross-border flow of capital but appropriate policies that will help in improving the efficiency and competitiveness of domestic markets should be put in place to increase production capacity.
- ▶ Capital inflows should be invested in infrastructures like transportation and logistics in order to improve supply chains.