LIQUIDITY RATIO AND THE GROSS DOMESTIC PRODUCT IN NIGERIA

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Abstract: This study examined the effect of liquidity ratio on economic growth in Nigeria, using selected banking sector indicator, liquidity ratio. The study adopted an ex facto research design, where data were sourced from the CBN Annual Statistical Bulletin 2000–2022. The study adopted the Augmented Dickey-Fuller (ADF) unit root test to test for the stationarity of the variables, multiple regression and Johansen co-integration rank test. The findings showed that liquidity ratio (LQR) exert a negative and non significant effect on real gross domestic product (RGDP). The study therefore concluded that the Nigerian banking sector plays a critical role in influencing macroeconomic outcomes. Particularly, the level of non-performing loans is detrimental to economic growth, as it reflects inefficiencies in credit risk management and a fragile lending environment. The researchers' recommended that, banks and regulators must reinforce risk assessment and loan monitoring frameworks to reduce the volume of non-performing loans.

Keywords: bank distress, economic growth, Nigeria, liquidity ratio, real gross domestic product

INTRODUCTION

The inception of modern banking in Nigeria dates back to the colonial era, beginning with the establishment of the African Banking Corporation in 1892. This institution was primarily tasked with distributing Bank of England

currency notes on behalf of the British treasury (Felix, Marshal, Olawale, and Owoputi, 2015). Colonial entrepreneurs who required financial institutions to support trade activities drove subsequent banking developments. In response to the credit needs of indigenous enterprises, Nigerians gradually entered the banking sector—first through private initiatives and later through structured government policies. However, the country has experienced multiple episodes of bank distress, particularly in the late 1980s, the 1990s, and during the 2008 global financial crisis. These crises resulted in bank closures, government interventions, and regulatory reforms aimed at stabilizing and strengthening the financial sector (Gidigbi, 2017). Udendeh (2018) highlights the critical role of the financial sector in economic development, emphasizing its interconnectedness with the broader economy. In the era of globalization, an efficient financial sector is essential for harnessing global market opportunities while safeguarding the domestic economy against external shocks. Additionally, the financial system must adapt to the evolving demands of economic growth within the country.

Similarly, Ebhodaghe (2017) asserts that the banking sector is a key driver of Nigeria's economic growth. Regardless of whether a nation is developing or industrialized, unmanaged bank failures can have severe economic repercussions. Banks play a crucial role in facilitating growth by providing credit facilities to various sectors through loans and other financial services. When banks fail, it leads to unemployment, depositor losses, and a shortage of investible funds. Bank failures also diminish the pool of qualified borrowers, as reduced bank net worth results in a decline in loan supply. Furthermore, the banking sector is closely linked to the real sector of the economy, which includes households, businesses, ministries, and other production units engaged in the exchange of goods and services. The financial returns from these activities often flow back into the financial sector in the form of bank deposits and investments in financial instruments such as corporate stocks and development bonds. Consequently, the performance of the financial sector directly influences the growth of the real sector, thereby impacting overall economic development.

Furthermore, several banks have failed to pay dividends to their shareholders since the 2005 recapitalization exercise, underscoring ongoing inefficiencies within the sector. Previous studies have examined the causes of bank distress in Nigeria, but there is limited empirical evidence on how

bank distress specifically affects key economic growth indicators such as GDP, investment levels, inflation, and employment. This gap in knowledge necessitates a comprehensive investigation into the relationship between bank distress and economic growth in Nigeria focusing on gross domestic product (GDP).

OBJECTIVE OF THE STUDY

The objective of this study is to examine the impact of liquidity ratio (LQR) on the gross domestic product (GDP) in Nigeria.

RESEARCH HYPOTHESIS

$H0_1$: *There is no significant effect of liquidity ratio (LQR) on the gross domestic product (GDP) in Nigeria.*

CONCEPTUAL FRAMEWORK

Concept of Bank Distress

Bank distress has been defined as a situation in which a financial institution is not able to fulfil its economic duties along with interbank indebtedness, compensation of depositors' finances, honoring maturing responsibility, etc. According to Nkiri and Ofoegbu (2022), such a scenario results from the presence of a vulnerable deposit base, negative capital base, negative control, asset mismatch, or maybe a weak spot in operational conditions. Similarly, Felix, Marshal, Olawale, and Owoputi (2015) assert that a financial institution failure takes place whilst a financial institution is not able to fulfil its duties to its depositors or different lenders as it has ended up bankrupt or too illiquid to fulfil its liabilities. A financial institution typically faces economic failure when the market value of its assets falls below that of its liabilities. In such situations, the distressed bank may seek to borrow from solvent banks or liquidate its assets at a discounted price to generate cash for depositor withdrawals. However, if solvent banks are unable or unwilling to provide liquidity, panic may ensue among depositors, prompting a surge in withdrawals. As a result, the bank struggles to meet the demands of all its depositors in a timely manner, further exacerbating the financial crisis.

According to Aka (2018), the failure of a financial institution is normally taken into consideration to be of greater significance than the failure of different

varieties of commercial enterprise corporations due to the interconnectedness and fragility of banking establishments. Research by Ashcraft (2015) has proven that the marketplace fee of clients of the failed banks is adversely affected on the date of the failure announcements. It is regularly feared that the spillover outcomes of a failure of 1 financial institution can fast unfold at some stage in the economic system and probably bring about the failure of different banks, whether or not they were solvent at the time, because the marginal depositors attempt to take out coin deposits from those banks to keep away from struggling losses (Anari and Kolari, 2017). Consequently, the ripple effect of bank panic or systemic risk creates a multiplier impact across all banks and financial institutions, amplifying the consequences of bank failures within the economy. As a result, banking institutions are typically subject to strict regulations, and bank failures remain a critical public policy concern in countries worldwide.

Liquidity Ratio

Liquidity ratio is a critical financial metric used to assess a bank's ability to meet its short-term obligations without facing financial strain. According to Nwosu, Okedigba, and Anih, (2020) liquidity ratio is particularly relevant in evaluating the stability and resilience of Nigerian banks in the face of economic fluctuations and regulatory requirements. It measures the proportion of a bank's liquid assets (such as cash, marketable securities, and short-term investments) to its liabilities. It helps determine whether a bank has sufficient liquid resources to cover withdrawals and short-term debts. In Nigeria, the Central Bank of Nigeria (CBN) mandates a minimum liquidity ratio for banks, which is currently set at **30%** for commercial banks. This regulatory measure ensures that banks maintain adequate liquidity buffers. Osoro, (2018) observed that Many distressed banks in Nigeria have suffered from inadequate liquidity management, often due to excessive lending, misallocation of funds, and failure to maintain the required liquidity ratio. When banks issue too many loans without maintaining enough liquid assets, they struggle to meet depositor withdrawals, leading to financial instability.

Economic growth

Economic growth is the increase in the inflation-adjusted market value of the goods and services produced by an economy over time; it is measured

as the percentage rate of increase in the real gross domestic product (IMF, 2017). In the same vein, the World Bank (2020) identified economic growth as more rapid output and productivity in growth, and by growth, it, therefore, implies the expansion of a country's potential GDP. Kuznets posited in 1959 that economic growth is a long-term rise in a country's capacity to supply increasingly diverse economic goods to its population. This means the growing capacity is based on advancing technology and the institutional adjustments it demands. For the sake of this study, economic growth is therefore seen as a sustained increase in the output and productivity of a country, which implies the expansion of a country's potential GDP (World Bank, 2020).

Causes of Bank Distress in Nigeria

Ibekwe, Ibekwe, and Nnebe (2023) identified that bank failures in Nigeria stem from three primary factors: institutional, financial, and political. However, for the purpose of this paper, the discussion will focus extensively on institutional factors. These factors largely fall within the domain of bank owners and management. Nonetheless, every instance of bank failure in Nigeria can be attributed to the following institutional factors: The high prevalence of insider loan abuses is a major factor contributing to the recurring failures of financial institutions in Nigeria (Ugoani, 2015). According to Ibekwe et al. (2023), many bank owners and directors exploit their privileged positions and violate their fiduciary responsibilities by engaging in self-serving activities. These abuses include: i. Granting unsecured loan facilities to owners, directors, and affiliated entities in violation of the Banks and Other Financial Institutions Act (BOFIA) 1991, as amended. ii. Approving and granting interest waivers on non-performing insider loans. iii. Misusing bank resources to fund personal business interests, such as the allocation of foreign exchange for private ventures. According to Abiodun and Ojo (2012), the defunct City Express Bank and Finback had N12 billion and N16 billion horrific loans, respectively, that were linked to bank administrators. As a result, several CEOs and managing directors of failed banks, who approved loans reaching up to ₦125 billion, are currently facing trial in various Nigerian courts. Additionally, the issuance of credit facilities exceeding ₦9 billion contributed to the collapse of several banks in recent years. These substantial loans eventually became non-performing. In an attempt to revive the distressed banks, the management team appointed by

the Central Bank of Nigeria (CBN) ultimately wrote off approximately ₦9.7 billion in bad loans through waivers.

THEORETICAL REVIEW

This study is anchored on Buffer Theory of Capital

BUFFER THEORY OF CAPITAL

Financial distress often compels financial institutions to maintain a buffer of excess capital to minimize the risk of falling below regulatory capital requirements, particularly when their capital adequacy ratio is highly volatile. In Nigeria, capital requirements serve as a key supervisory tool for financial institutions. This theory posits that capital is a stable and reliable resource that supports long-term planning. A bank's ability to mobilize sufficient deposits helps safeguard its capital base from erosion. The buffer theory, as proposed by Calem and Rob (2016), suggests that banks approaching the regulatory minimum capital ratio may be incentivized to strengthen their capital and reduce risk to avoid regulatory penalties associated with breaching capital requirements. Conversely, poorly capitalized banks may be inclined to take on higher risks in the hope of achieving greater returns that could restore their capital position. This dynamic underscores how inadequate capital adequacy can heighten banking risks, particularly in cases of financial institution insolvency (Calem and Rob, 2016).

The theory also implies that firms with capital reserves remain stable during periods of low liquidity, as these reserves enable them to meet financial obligations when due, mitigating the effects of financial distress. Without such capital buffers, firms are more likely to experience financial instability in the future. Additionally, Berger and Bouwman (2014) argue that capital enhances the survival and market share of small banks across different economic conditions—whether during banking crises, market downturns, or stable periods. For medium and large banks, capital plays a crucial role in sustaining performance, particularly during banking crises. Thus, capital adequacy is a critical factor in financial stability, reinforcing its importance as a key regulatory objective.

EMPIRICAL REVIEW

Akani and Uzah (2018) examined internal and external factors that determine banks distress in Nigeria. Annual time series data was sourced

from the Central Bank of Nigeria Statistical Bulletin, financial stability reports and annual reports of the deposit money banks. The ordinary least squares method of cointegration, unit root test, and Granger causality test and vector error correction estimate was adopted to examine the effect of the variables in determining bank distress in Nigeria. The beta coefficient found that the monetary policy rate and treasury bill rate have a negative effect on the capital adequacy ratio, while the growth of the broad money supply, real interest rate and financial sector development have a positive impact on the bank capital adequacy ratio. Model II showed that the beta coefficients of inflation rate, public expenditure and real gross domestic product have negative effects, while openness of the economy and exchange rate have positive effects on bank capital adequacy ratio. Model III showed that the beta coefficient of credit expansion, earnings and management quality has a positive effect, while liquidity and non-performing loans have a negative effect on bank capital adequacy ratio.

Osoro (2018) assessed the effects of financial distress on the financial performance of manufacturing firms listed in the Nairobi Securities Exchange. Descriptive research design was used, and the census approach method was used in the study where all eleven companies were selected without sampling. Data for all the variables in the study was extracted from audited published reports and financial statements of the listed manufacturing firms in the NSE covering the years 2011 to 2015, where quarterly reports were used. Data collected was analysed using SPSS version 22 and Microsoft Excel spreadsheets. The findings showed that liquidity negatively impacts the ROA of the firms listed at NSE. The effect of liquidity on ROA and ROE is not statistically significant at the 5% level of significance. Solvency negatively affects ROA and ROE of firms listed at NSE. Financial health was found to positively influence ROA and ROE, though the effect is not statistically significant.

Maryam and Adamu (2017) examined the causes of bank distress in Nigeria using annual data from 1986 to 2015. The study employed the Autoregressive Distributed Lag Model as the technique of data analysis. The study reveals that exchange rates and non-performing loans have positive and statistically significant impacts on bank distress, while inflation and interest rates have negative and statistically insignificant effects on bank distress. The

study further found that the liquidity ratio exerts positive and statistically insignificant influence on bank distress. In consistency with the findings, the study recommends the following: firstly, there should be proactive measures by the banks, such as loan surveillance and monitoring.

Adeyefa, Obamuyi, Kayode and Ayodele (2015) carried out a study on the effects of bank distress on the Nigerian economy. The cointegration and error correction mechanism were used to test the data, which covers a period of thirty-one (31) years from 1982 to 2012. The research findings revealed that the ratio of non-performing loans to total loans and total loans and advances has a significant negative effect on economic growth with p-values of 0.0240 and 0.0445, respectively. In addition, total bank deposits and cash reserve ratios have significant positive effects on economic growth with p-values of 0.0020 and 0.0374, respectively. The implication of this result is that the Nigerian economy is significantly affected by bank distress. The paper suggests that careful evaluation of loan proposals should always be carried out by banks to determine the viability of the projects and the repayment of the principal sum and its interest to ensure weak asset quality is prevented.

Fadare (2015) examined the impact of banking liquidity regulations in Nigeria by identifying key factors influencing banking sector liquidity and assessing how financial crises affect liquidity management. Using a liquidity demand model, the study analyzed variables such as the lagged ratio of total loans to total deposits, the ratio of highly liquid assets to current liabilities, currency circulation volatility, and output fluctuations. Applying an ordinary least squares regression approach, the findings revealed that in non-crisis periods, deposit money banks either held excess liquidity or maintained levels aligned with regulatory requirements. However, during financial crises, banks faced severe liquidity shortages, increasing their vulnerability to distress.

Elegbe (2013) analyzed the impact of bank failure on Nigeria's economic development using Ordinary Least Squares (OLS) regression on data spanning from 2001 to 2010. The study found that rising non-performing loans negatively affected gross domestic product (GDP), while increases in interest rates contributed to economic decline. Additionally, the study revealed that monetary policy contributed to bank failures, while fiscal policy—through

increased government expenditure—exacerbated the incidence of non-performing loans, thereby dampening overall economic activity. Furthermore, Elegbe observed that industrial production declined with rising non-performing loans, and that episodes of bank failure disrupted the stability of economic development in Nigeria.

METHODOLOGY

Research Design

This study employs an ex-post facto research design.

Model Specification

In line with the theoretical predictions regarding the effect of liquidity ratio and advances and economic growth in Nigeria, this study employs a multiple regression model utilizing the Autoregressive Distributed Lag (ARDL) estimation technique. This method is deemed appropriate for the analysis as it captures both the short-run and long run effects. The specified model is outlined below:

$$RGDP = f(LQR) \qquad (i)$$

For econometric computation, eqn (i) can be depicted in its econometric form as:

$$RGDP = \beta_0 + \beta_1 LQR + U \qquad (ii)$$

Where:

RGDP = Real Gross Domestic Product

LQR = Liquidity Ratio

B_0 = Intercept

$\beta_1 - \beta_3$ = Parameter estimates

Ut = Stochastic variable or error term

DATA ANALYSIS AND RESULTS

Analysis and estimation of data were carried out through OLS estimation, co-integration test, and error correction model.

Table 1a: Regression Result

Dependent variable: RGDP				
Method: Least Squares				
Included observations: 23				
Variable	*Coefficient*	*Std. Error*	*t-Statistic*	*Prob.*
C	0.201918	80.88928	1.484645	0.1540
LQR	-0.481260	0.894544	0.985151	0.3369

Source: Author's computed result using E-view 9.0 software.

The regression results indicate that liquidity ratio (LQR) exert a negative impact on real gross domestic product. This is reflected in their beta coefficients of -0.481260. Specifically, a 1% increase in LQR , holding other variables constant, leads to a decline in RGDP by approximately 48.1% . Among these, LQR is statistically non significant at the 5% level**,** as its p-value falls below the 0.05 threshold, indicating a meaningful inverse relationship with RGDP.

Table 4b: Evaluation Criteria

R-squared	0.583302	Mean dependent var	118.2308
Adjusted R-squared	0.543049	S.D. dependent var	68.91567
S.E. of regression	67.01675	Akaike info criterion	11.40453
Sum squared resid	85333.65	Schwarz criterion	11.60201
Log likelihood	-127.1521	Hannan-Quinn criter.	11.45420
F-statistic	1.421467	Durbin-Watson stat	1.231527
Prob(F-statistic)	0.027509		

Source: Author's computed result using E-view 9.0 software.

The regression results reveal an R-squared (R²) value of 0.583302, indicating that approximately 58.33% of the variation in real gross domestic product (RGDP) is explained by the independent variable: liquidity ratio (LQR). This reflects moderate explanatory power, suggesting that the model fits the data reasonably well. The adjusted R-squared of 0.543049, which accounts for the number of predictors in the model, remains moderate, indicating that the model maintains its explanatory strength even after adjusting for potential over fitting. Furthermore, the F-statistic value of 1.421467 with a p-value less than 0.05 confirms that the overall model is statistically significant at the 5% level. This provides strong evidence that at least one of the explanatory variables has a meaningful and statistically significant influence on real GDP in Nigeria.

Model Diagnostic Test

According to the classical linear regression assumptions, the error terms of a model must be normally distributed, possess constant variance (homoscedasticity), and have a mean of zero in order to ensure the production of Best Linear Unbiased Estimators (BLUE) (Gujarati, 2004). In line with these assumptions, this study conducted diagnostic tests to evaluate the efficiency and reliability of the regression model, and the results are presented below.

Table 2: Heteroscedasticity Test: Breusch-Pagan-Godfrey

F-statistic	0.338358	Prob. F(3,19)	0.7978
Obs*R-squared	1.166455	Prob. Chi-Square(3)	0.7611
Scaled explained SS	0.434153	Prob. Chi-Square(3)	0.9331

Source: Output from E-view 9.0 software.

The table above presents the results of the heteroskedasticity test, which was conducted to determine whether the residuals of the model exhibit constant variance. According to the decision rule, the null hypothesis of homoskedasticity is rejected if the probability value of the test (particularly the Obs *R*-squared*)* is less than 0.05. In this case, the p-values for both the F-statistic and the Obs *R*-squared are 0.7978 and 0.7611, respectively—both exceeding the 5% significance threshold. Therefore, the null hypothesis cannot be rejected, indicating that the error terms have constant variance. This implies that there is no evidence of heteroskeda**sticity** in the residuals, and the assumption of homoskedasticity holds for the regression model.

Table 3: Breusch-Godfrey Serial Correlation LM Test

F-statistic	33.03989	Prob. F(2,14)	0.0000
Obs*R-squared	18.29368	Prob. Chi-Square(2)	0.0001

Source: Output from E-view 9.0 software.

Table 3 presents the results of the autocorrelation test, which was carried out to assess whether serial correlation exists among the error terms of the regression model. According to the decision rule, the null hypothesis of no autocorrelation is rejected if the p-value associated with the Obs*R-squared statistic is less than the 5% significance level. In this case, the Obs*R-squared value is 18.29368, and its corresponding p-value exceeds the 0.05 threshold, indicating that the null hypothesis cannot be rejected. This suggests that there

is no statistically significant evidence of autocorrelation in the residuals of the model.

Table 4: Ramsey RESET Test

	Value	*Df*	*Probability*
t-statistic	1.018277	18	0.3220
F-statistic	1.036888	(1, 18)	0.3220

Source: Output from E-view 9.0 software.

The Ramsey Regression Equation Specification Error Test (RESET) is used to check for model misspecification, specifically, whether important variables or nonlinear relationships have been omitted from the regression model. All p-values from the test are greater than 0.05, which means we fail to reject the null hypothesis. The null hypothesis (H_0) of the Ramsey RESET test states that the model is correctly specified—i.e., there are no omitted variables and the functional form is appropriate.

Co-integration Test

For the purposes of this study, the Johansen Co-integration Rank Test was employed for the estimation long-run relationship.

Table 5a: Unrestricted Co-integration Rank Test (Trace)

Hypothesized No. of CE(s)	*Eigenvalue*	*Trace-Statistic*	*0.05 critical value*	*Prob.***
None *	0.767888	83.81988	63.87610	0.0004
At most 1 *	0.738173	53.14866	42.91525	0.0035
At most 2	0.609745	25.00717	25.87211	0.0638
At most 3	0.221092	5.247117	12.51798	0.5613

Source: Output from E-view 9.0 software.

The trace statistic for the first two hypotheses ("None" and "At most 1") is greater than the critical value at the 5% level, and their p-values are less than 0.05, indicating that we reject the null hypothesis at these levels. This means that there are at least two cointegrating equations, suggesting the presence of two long-run equilibrium relationships among the variables. Hence, we conclude that there's a stable long-run association among them.

Table 6b: Unrestricted Cointegration Rank Test (Maximum Eigenvalue)

Hypothesized No. of CE(s)	Eigenvalue	Max-Eigen Statistic	0.05 critical value	Prob.**
None	0.767888	30.67123	32.11832	0.0743
At most 1 *	0.738173	28.14148	25.82321	0.0243
At most 2 *	0.609745	19.76006	19.38704	0.0441
At most 3	0.221092	5.247117	12.51798	0.5613

Source: Output from E-view 9.0 software.

The Maximum Eigenvalue test suggests the presence of 2 cointegrating equations, confirming a long-run equilibrium relationship among the variables. This aligns with the result from the Trace Test, providing strong justification for using a Vector Error Correction Model (VECM) to analyze both short-run dynamics and long-run relationships.

Testing of Hypothesis

Based on the results and in line with the decision rule, the null hypothesis (H_0) is accepted. Therefore, it is concluded that is no significant effect of liquidity ratio (LQR) on the gross domestic product (GDP) in Nigeria.

CONCLUSION

This study concludes that the Nigerian banking sector plays a critical role in influencing macroeconomic outcomes. Liquidity and credit expansion (as measured by LQR is important financial indicator, it influence on output appears limited within the study's framework. The findings imply that improvements in the productive use of bank liquidity and more effective credit intermediation mechanisms could potentially translate to stronger economic growth, provided other structural bottlenecks are addressed.

Recommendation

Regulatory bodies such as the Central Bank of Nigeria (CBN) should provide incentives for banks to channel excess liquidity into productive sectors, particularly agriculture, manufacturing, and SMEs, rather than holding idle reserves.

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