

## **EFFECT OF FINANCIAL DEREGULATION ON MANUFACTURING SECTOR IN NIGERIA 1986-2015**

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### **Abstract**

*The Study investigates the effect of Financial Deregulation on the performance of manufacturing sector in Nigeria. The empirical investigation was done using, Augmented Dickey Fuller (ADF) test also known as unit root, auto Regressive Distribution Lag (ARDL) co-integration test and Error correction Mechanism (ECM). The results obtained from unit root showed that not all the variables were stationery at level, therefore, ARDL was used. The study employed index of industrial production (IIP) as the dependent variable and the following financial deregulation variables; Interest rate (INTR), Exchange rate (EXCHR), Inflation (INFR) and Financial Deepening variables; the ratio of money supply to gross domestic product (M2/GDP) and ratio of credit to private sector to gross domestic product (CPS/GDP) as the independent variables. The ARDL bound Co-integration test revealed the existence of a long-run equilibrium relationships among the variables and co-integrating equation at 5% significance level. It also showed that the F-statistic value at 6.08 higher than both the upper and the lower bound at 5% significant level. Also, the error correction mechanism (ECM) showed a negative and significance at 5%. The study recommended that, the monetary should keep pace with market driven interest rate in demand and supply mechanism and should further encourage private sector participant in the economy of the*

country. Moreover, the domestic production should be encouraged in order to stabilize the fluctuations of the exchange rate and the government should intensify efforts towards maintaining a single digit inflation rate.

*Keywords: Financial Deregulation, Manufacturing Sector, Financial Market, Financial Deepening, ARDL, Index of Industrial Production (IIP)*

## **INTRODUCTION**

The Nigerian economy has at different times witnessed enormous financial regulated patterns (Exchange rate control ordinance, exchange control Act 1962 and Interest rate ceiling) in different sectors of the economy under the regulated regime by the Central Bank of Nigeria (CBN). The preferential financial regulations which were largely on Interest rate and exchange rate were based on the premise that the financial market, if freely applied would exclude some priority sectors, such as: Agricultural sector, Manufacturing sector, Education, etc.

The past three decades have been characterized by extensive structural change in the Nigerian financial system. The reduction and removal of controls over the Nigerian financial system have turned it from “one of the most controlled banking systems in the world to one of the least controlled” (Perkins, 1989) In particular, the banking industry, which is the focus of this paper, has seen significant growth in assets and volume of activity, as well as increased competition and changes in market structure and market share.

The generally accepted perception of the deregulation of the financial sector is that bank efficiency and competitiveness have improved resulting in greater benefits to bank customers and the economy in general. These conclusions are often based on anecdotal evidence and when data analysis is undertaken to support the conclusions they are usually derived from very broad Reserve Bank data, which consists of large financial account aggregates. Any analysis of the effects of deregulation is inherently difficult because changes were implemented over a prolonged period, concurrent with numerous other changes, some completely unrelated to the process of deregulation itself. In most cases, it is difficult to produce reliable quantitative assessment of the separate impact of deregulation. Quantitative assessments of the consequences of deregulation have to be further qualified due to the lack of reliable and conclusive data in many areas.

There are several preferred sectors in the economy in which the government of every nation believed to be among the sectors that will contribute to the growth and economic development of the country. Among these preferred sectors is the manufacturing sector which is

the main focus of this research. The manufacturing sector is one of the main stay of the economy and it also forms the part of the variables that determine the directions at which the economy of a nation moves.

It has been discovered that the manufacturing sector has not been contributing meaningfully to the Nigerian Gross Domestic Product (GDP) compared to the other preferred sector of the economy like Agriculture which has been contributing significantly to the GDP (Sangosanya and Onayemi, 2004). In 2014, manufacturing sector contributed merely 5% to the GDP, while the Agricultural sector contributed about 23.5% and in the year 2015, though, there was a slight increase in the Manufacturing sector, but it was marginal. It contributed 9.93%, Agriculture 19.77% and Trade contributed 21.55%. Having discovered that the Manufacturing sector has not really grown with the deregulation of interest rate in the financial industry and it has been discovered that among other things (Epileptic power, Lack of good infrastructural facilities and Insecurity) that contributed to the small contribution of manufacturing sector to the GDP is inadequate access to finance.

Financial market deregulation enabled the government to pursue positive real interest rates, as a means of inducing local savings and attracting foreign funds from abroad (Ikhide and Alawode, 2002, Obokoh, 2009). On the other hand, the devaluation of the Naira was aimed at discouraging the import of finished goods. While the deregulation of the foreign exchange market, allowed the Naira to float against other major currencies. It was envisaged that this would facilitate easy access to foreign exchange for the importation of needed raw material and intermediate goods.

Despite the perceived advantages of these actions, the outcome created obstacles to the competitive performance of the manufacturing sector in Nigeria. These policies have put the manufacturing sector in a position where they have to struggle for survival, just as what is being witnessed in the country as a result of the continuous increase in the foreign exchange rate, which have even led to the failure of some domestic industries against the expectation of exporting their finished products and make more income, as was promised by the deregulation policy.

In this regard, the crux of this study is to establish the effect of financial deregulation on manufacturing sector performance in Nigerian.

This paper is organized into five sections. Chapter one is introduction, chapter two literature review, while chapter three, four and five are methodology, results discussion and conclusion respectively.

## **LITERATURE REVIEW**

### **The Financial Market**

The financial market is defined as a couple of institutional arrangement which brings together the buyer (borrower) and the seller (lender) of financial instrument. The market embraces both the money and capital markets (Adeusi, 2005).

The financial market has become an essential market playing a vital role in economic prosperity by fostering capital formation and sustaining economic growth. The market is more than a place to trade securities; they operate as a facilitator between savers and users of capital by means of pooling of funds, sharing risk, and transferring wealth. It is essential for economic growth as they ensure the flow of resources to the most productive investment opportunities. Soyode (1990).The market therefore embraces both Money and Capital markets.

### **The Role of the Financial Market in the Economy**

Financial markets help to efficiently direct the flow of savings and investment in the economy in ways that facilitate the accumulation of capital and the production of goods and services. It also ensures markets (such as those that trade stocks or bonds), instruments (from bank certificate of deposits), and institutions (from banks to insurance companies to mutual funds and pension funds) provide opportunities for investors to specialize in particular markets or services, diversify risks, or both. In addition, financial markets with lots of trading activity provide more liquidity for market participants than thinner markets with few available securities and participants and thus limited trading opportunities.

### **Financial Deregulation**

Reforming the regulation of financial institutions and markets is critically important and should provide large benefits to society (Douglas,Suzanne and André 2012)

Deregulation of the economy comes in as a result of depression. Depression is said to be a period when there is rigorous and prolonged down turn in the economy, prices fall, reducing purchasing power (Adekanye, 2002). It also resulted into high unemployment, lower productivity, shrinking wages and general economic pessimism. According to Adekanye (2002), the deregulation policy was adopted in 1987 against a crash in the international oil market and the reactant deteriorating economic condition in the country due to stringent policies in the financial sector. The policy was adopted to achieve fiscal balance and balance of payment availability as well as liberation of the financial system by altering and restructuring the production and consumption pattern of the economy, eliminating price distortions, reducing the

heavy dependency on crude oil export and consumer goods importation, enhancing the non-exports base and achieving sustainable growth.

### **Theory of Market Efficiency**

This theory was propounded by (Fama, 1965) Titled "The Theory of Efficient Market" who said that in an efficient market, on the average, competition will cause the full effects of new information on intrinsic values to be reflected "instantaneously" in actual prices. This theory was a significant contributor to the crisis being faced in the financial sector then as it helped to justify financial deregulation process. Base on this assumption, Financial Deregulation could be traced to this theory because if competitions are allowed in the financial industries, there will be efficiency in the financial market which will ultimately lead to productivity. Therefore, on the bases of competitions, financial sector was deregulated to allow the forces of demand and supply to dictate the market.

### **Theory of Bank Deregulation (Doctrine of laissez faire)**

This theory was propounded by Smith in (1776) and was later developed by (Jhinghan, 2005).He regarded every person as the best judge of his own interest who should be left to pursue it to his own advantage. Since every individual if left free, will maximized his own wealth, therefore all individuals if left free, maximized aggregate wealth. Smith was naturally opposed to any government intervention in industry and commerce. He believed in the doctrine of laissez faire (no government). He noted that bankers are entrepreneurs, who when freed from constraints of regulations, will readily pursue new opportunities for better services, stronger growth and improved earnings whenever these opportunities appear. Too much regulation, especially the inflexible and dogmatic ones deny banks of their innovation and incentive to take risk and invest in business enterprise. It could also result in problems such as loss of competitiveness and inefficiency, resource misallocation, etc among banks, thereby hindering the growth of the nation's economy.

### **Empirical Review**

A number of studies have been reviewed on this study. According to Tamim (1992), he evaluated Financial Deregulation and Household savings in UK. The study used overlapping generation model and found out that deregulation will produce an exogenous short run fall in savings, though, some of which will be recoup overtime, while increasing the sensitivity of saving to wealth, current income, real interest rate and demographic factor. He recommended that deregulation will bring forth result in the long run.

Sveta (2006) evaluated the Impact of Financial Deregulation on Australian financial institutions. The study made use of Panel data analysis. The result shows that banking sector continues to grow and expand into new areas (insurance and superannuation) and as financial markets become even further integrated, The sector will need to become increasingly more competitive and efficient to survive. It recommended that banks should allow the market to determine market outcomes without jeopardizing stability.

Subal, Ana and Knox (1999), examined the effects of Deregulation on the performance of financial institutions in Spain. The study made use of Panel data for the period of 1986-1995 and flexible variable profit function that incorporate time varying technical efficiency. The results show that declining levels of output technical efficiency along with significant high rate of technical progress. Despite, they found evidence of an increasing trend in productivity of the financial institutions.

Udom (2013) investigated “An empirical analysis of the impact of deposit money bank on the manufacturing sector in Nigeria” (1980-2011). The result showed that the lag of exchange and commercial bank credit have a significant and positive impact on the manufacturing sector in Nigeria within the period under review. He recommended that the monetary and the capital market in Nigeria should be further strengthened to meet the standard and provided necessary capital for the manufacturing sector. More so, the Nigeria government should as a matter of urgency see to the strengthening of the exchange rate.

Bashar and Khan (2007) in their econometric study of Bangladesh evaluated the impact of liberalization on the country's economic growth by analyzing quarterly data from 1974Q1 – 2002Q2 using Co-integration and Error Correction Method. The variables used was per capital GDP, gross investment as a share of GDP, Labour force as a share of population, secondary enrolment ration, trade openness indicator, real rate of interest and net capital inflows. The empirical results show that the coefficient of the financial liberalization policy variable (real interest rate) is negative and significant, implying that financial liberalization has had negative effect of Bangladesh's economic growth.

According to Beck and Levine (2002), using panel method, greater financial development would disproportionately benefit the firms in the sectors that are more external finance dependent. The explanation is that, since financial repression tends to restrict access to bank credit and, therefore, firms more dependent on external finance face a financial constraint that is especially severe compared to firms that are less external finance dependent, the former type of firms would gain much more than the latter from financial development and greater access to credit. Hence, industrial sectors in which firms are more external finance dependent

will grow faster in countries with greater financial development. According to these studies, therefore, financial development reduces the cost of external finance for firms.

Ochei, Areghan and Tochuchwu (2016) evaluated the deregulation of foreign exchange market and its effect on Industrial Produce in Nigeria. They used Ordinary Least Square method to measure their variables (Industrial produce, Exchange rate, Inflation rate, labour force per time, capital stock and Political Instability). Their result shows that while both labour and capital are positively significant in explaining industrial output, Inflation was negatively significant. They now recommended that, long term fund should be provided for the growth of manufacturing sector by the financial institutions.

Onuoha and Nnachi (2014), the study was undertaken basically to evaluate the financial performance on banks in the deregulated environment using ordinary least square( OLS) method of regression analysis. The study showed that the nominal lending rate has a positive effect on the manufacturing companies while the exchange rate has a negative impact. The study recommended that greater policy sensitivity towards the creation of credits and regulation of exchange rate volatility is urgently needed so that enough funds will be made available for potential investors. Felicia (2011) used regression analysis to investigate the determinants of commercial banks lending behaviour in Nigeria. The study discovered that commercial bank deposit have the greatest impact on their lending behaviour. The study then suggests that commercial banks should focus on mobilizing more deposits as this will enhance their lending performance and should formulate critical, realistic and comprehensive strategic and financial plans.

Aiyetan and Aremo (2015), the study evaluate Effect of Financial Sector Development on Manufacturing Output in Nigeria (1986-2012). The study used Vector Autoregression (VAR) analysis with special attention on financial sector variables such as interest rate, exchange rate. The Study believes that financial sector Variables stimulate the Industrial Growth and recommended that, relaxing financial development constraints and deepening the financial sector are crucial to boosting the manufacturing output growth in Nigeria.

## METHODOLOGY

### Research Design & Model Specification

The design of this research is the “ex-post facto research design”. The model specification was built on on the modification of the models in Udom (2013), Berger and Mester (1999)

$$GDPOUT = f (EXR , INT , INF ) \dots\dots\dots(i)$$

$$\log GDPOUT = f ( \log EXT , \text{LogINT} , \log INF ) \dots\dots\dots(ii)$$

The model is modified as follows:

$$IIP = f (INTR, EXCR, CPS/GDP, M2/GDP, INFR) \dots \dots \dots (iii)$$

Where:

- IIP = Index of Industrial Production
- INTR = Interest Rate
- EXCR = Exchange Rate
- CPS/GDP = Ratio of Credit to private Sector to GDP
- M2/GDP = Ratio Money Supply to GDP
- INFR = Inflation Rate.
- $f$  = Functional Notation
- $\mu$  = Error Term
- $\delta, \beta_1, \beta_2, \beta_3, \beta_4$   
and  $\beta_5$  = Coefficients of Estimates parameter

The techniques used are, the Augmented Dickey Fuller (Unit Root), Auto-regressive Distribution Lag (ARDL) Test and Error Correction Model

**Sources of Data**

The model is estimated using time series annual data for the period 1986 – 2015. This is because the Nigerian government simultaneously pursued microeconomic stabilization and adjustment policies during the period understudy through the introduction of Structural Adjustment programme (SAP) that started in (1986) and other subsequent deregulation policies afterwards. The data needed for the study are secondary in nature; implying data will be obtained from published sources.

Sources of these data include:

- a) Central Bank of Nigeria Statistical Bulletin
- b) National Bureau of Statistics.

**Apriori Expectation**

It is expected *apriori* that

$$\frac{dIIP}{dINTR} > 0, \frac{dIIP}{dEXCR} < 0, \frac{dIIP}{dINF} < 0, \frac{dIIP}{dCPS/GDP} > 0 \text{ and } \frac{dIIP}{dM2/GDP} > 0$$



## ANALYSIS AND RESULTS

Table 1. The Unit Root Test

Variable	ADF statistical level	1% Critical Level	5% Critical Level	10% Critical Level	Order of co-Integration
IIP	-3.570127	-3.679322	-2.967767	-2.622989	<b>1(1)</b>
CPS/GDP	-1.764890	-3.679322	-2.967767	-2.622989	<b>1(0)</b>
EXCHR	0.389027	-3.679322	-2.967767	-2.622989	<b>1(0)</b>
INFR	-3.522956	-3.769597	-3.004861	-2.642242	<b>1(1)</b>
INTR	-4.644209	-3.679322	-2.967767	-2.622989	<b>1(1)</b>
M2/GDP	-1.909737	-3.679322	-2.967767	-2.622989	<b>1(0)</b>

Source: Author's Estimation Using E-View 8, (2017).

The results shows some variables IIP, INFR, and INTR are integration of order one that is 1(1) while CPS/GDP, EXCHR and M2/GDP which is stationary at level, that is 1(0). The implication is that since not all the variables are 1(1) then, Johansen co-integration cannot be applied hence, Autoregressive distributed lag ARDL bound test is used.

### Test for Co-integration

Table 2. Unrestricted ARDL Model

Variables	Co-efficient	Std. Error	T-statistics	Prob.
C	78.16253	27.96615	2.794898	0.0136
D(IIP(-1))	-0.142014	0.207451	-0.684566	0.5041
D(EXCHR)	-0.189431	0.161645	-1.171895	0.2595
D(CPS_GDP)	-1.231012	1.250771	-0.984202	0.3406
D(INFR)	-0.094912	0.159029	-0.596823	0.5595
D(INTR)	1.387595	0.604761	2.294452	0.0366
D(M2_GDP)	0.519285	1.491644	0.348129	0.7326
IIP(-1)	-0.712238	0.242938	-2.931764	0.0103
EXCHR(-1)	0.033308	0.052024	0.640244	0.5317
CPS_GDP(-1)	-1.159391	0.955267	-1.213683	0.2436
INFR(-1)	-0.269634	0.178379	-1.511578	0.1514
INTR(-1)	2.162144	1.053309	2.052716	0.0580
M2_GDP(-1)	0.078608	0.988587	0.079516	0.9377

The results showed that there is a significant positive short-run relationship between INTR and IIP at 5% level. While M2/GDP is not statistically significant but has a positive relationship with IIP in the short run. Also, INFR, EXCHR and CPS/GDP are not statistically significant and also inversely related to IIP. This implies that, if not well manage and control, INFR, EXCHR and CPS\_GDP tend to reduce the productivity of the manufacturing sector. Since INTR and M2/GDP exhibit a positive relationship with IIP in the short run, it implies that both INTR and M2/GDP tend to increase the productivity of the manufacturing sector.

Table 3. Co-integration Bound Test

Test Statistics	Value	K
F-statistics	6.084642	5

Table 4. Critical Value Bound

Significance	I0 Bound	I1 Bound
10%	2.26	3.35
5%	2.62	3.79
2.5%	3.96	4.18
1%	3.41	4.68

The results showed that IIP estimated model passed the bound test. This is because the F-statistics value is greater than all the critical value at both the lower and upper bounds. Consequently, it shows that IIP, which is dependent variable exhibit a long run relationship with other independent variables.

Table 5. Error Correction Mechanism (ECM)

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	1.421890	2.266733	0.627286	0.5379
D(IIP(-1))	0.306786	0.221490	1.385100	0.1821
D(EXCHR)	-0.168822	0.168295	-1.003133	0.3284
D(CPS_GDP)	-1.811750	1.110344	-1.631701	0.1192
D(INFR)	-0.151048	0.144670	-1.044089	0.3095
D(INTR)	0.856906	0.427986	2.002182	0.0597
D(M2_GDP)	1.095979	1.184003	0.925655	0.3662
ECM(-1)	-1.051859	0.438589	-2.398277	0.0269

The Table presented explained the relationship between IIP and other independent variables. Firstly, the error correction mechanism in the estimate is (-1.051). ECM is the dynamic adjustment to the equilibrium in the short run. The most importance is the coefficient of ECM. From the results, the ECM term is well defined, that is negative and significant at 5% level. The coefficient is -1.051 which indicates approximately 1.051% of the past year's disequilibrium in IIP. This also shows the speed at which the model converges to equilibrium. The magnitude of this coefficient implies that nearly 1.051% of any disequilibrium in IIP is corrected by the independent variables within one period (a year)

Table 6. ARDL Test for Serial Correlation

Lags	LM-Stat	Prob
1	1.461879	0.2266
2	2.265754	0.1323
3	1.771442	0.1832
4	0.179997	0.6714
5	0.014785	0.9032
6	0.177193	0.6738
7	0.221670	0.6378
8	0.043303	0.8352
9	0.562899	0.4531

A key assumption in the ARDL/Bond Testing methodology is that the errors of the equation must be serially independent. LM was used to test for this hypothesis. The LM test of serial correlation in Table 4.5 conducted on ARDL showed no traces of serial correlation at one lag at 1% and 5% level of significance. Therefore, to avoid multi-collinearity, a maximum of one lag is selected.

### SUMMARY OF FINDINGS AND IMPLICATIONS

The results from this study have shown that the incidence of exchange rate in Nigerian at present is relatively high especially in the recent time. The summary of statistics which explain the phenomena came up with an inverse relationship to index of industrial production. This could be attributed to the shortage of foreign exchange in the recent time which has brought a lot of difficulties to the manufacturing sector in securing raw materials to aid their productions. As a result of this, the issue has caught the attention of CBN as several policies have failed to yield any reasonable result to stop the economy from bleeding and run into depression. In the

past, deregulation of exchange rate has made Nigeria to compete effectively in the international market, but recently, it has really gone unmanageable. Also from the findings, INTR and its lagged value have a direct relationship with IIP. This implies that the deregulation of interest (lending rate) has been beneficial to the prospective investors and the economy at large. The movements in lending rate did not deter investors to seek funds from financial institutions for their various investment projects and through these investment projects, manufacturing sector is boosted. Similarly, Inflation rate, as expected and in conformity with the *apriori* expectation returned with a negative relationship with Index of industrial production. Inflation rate causes prices of every product to move up unabatedly. Producers can no longer invest as a result of increase in the price of raw materials, consumptions has reduced drastically as a result of increase in price of goods and services and consequently affected the manufacturing sector of the economy. The ratio of credit to private sector to GDP does not conform with the *apriori* expectation of significant positive relationship but can be explained partly by diversion of credit away from real sector operations to areas that could return quick profit to compensate for the prevailing high rate of interest.

## CONCLUSION

It can be concluded from the autoregressive distributed lag (ARDL) analysis of the study that CPS/GDP and INTR are significant in the short run, though; CPS/GDP is negative but significant in the short run. This implies that, certain funds that were channeled to the manufacturing sector were not put into their proper use, that is, they were put into a quick profitable business other than the manufacturing sector. On the other hand, INTR have the same implication both on short and long run period. The results show that on both short and long run, interest rate has a positive and significant relationship with IIP. This implies that, the lower the INTR the higher the investment which will ultimately increase the productivity of the manufacturing sector.

As a result of this, the study affirms that interest rate has a positive and significant effect on the manufacturing sector both on the long and short run. This means the monetary authority should target a lower interest rate for the manufacturing sector which will help the infant industries to grow and reduce the influx of the international companies that normally crippled the growth of the domestic companies. The lower the interest rate (Lending rate), the better the manufacturing sector and the better the whole economy at large.

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