

## **A CAUSALITY INVESTIGATION OF FINANCIAL LIBERALIZATION AND THE PERFORMANCE OF NIGERIAN ECONOMY (1990-2018)**

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### **ABSTRACT**

*The study investigated the causal relationship between financial liberalization and performance of the Nigerian economy; for the period (1990-2018). Variables used for this study are stated as Gross Domestic Product employed as the dependent variable of the study. Financial liberalization variables (explanatory variables) include: Credit to the Private Sector, Total Bank Deposits and Market Capitalization. The secondary data were used and collected from the Central Bank of Nigeria Statistical Bulletin. Hypotheses were formulated and tested using time series econometrics models. The study revealed that the variables do not have unit roots. There was also long-run equilibrium relationship between financial liberalization and performance of the Nigerian economy. The Vector Error Correction Model (VECM) result confirmed that about 87% short-run adjustment speed from long-run disequilibrium. The coefficient of determination indicated that about 68% of the variations in performance of the Nigerian economy can be explained by changes in financial liberalization variables. The study had a causality between financial liberalization and performance of the Nigerian economy. The study recommended that strong macroeconomic policies such as (monetary and fiscal) should be adopted to maintain and stabilize the economy. CBN should lay down strict prudential rules and regulations to stabilize and strengthen the banking industry. The Government and monetary authority should implement policies that will increase the flow of investable funds and improves the capacity of banks to extend credit to the economy.*

**Keywords:** Causality Investigation, Financial liberalization, Performance and Nigerian Economy.

### **Introduction**

The importance of financial development and growth relationship had occupied central position in the financial economics literature in recent decades for both develop and developing economies. Financial liberalization and performance of the Nigerian economy nexus had been identified as one of the areas in the financial economics literature that can quicken the pace of growth and development in an economy such as Nigeria. The effects of this strategy need to be determined and examined from time to time especially for

developing economies like Nigeria. Thus, the advent of financial liberalization policy in 1986 has drastically reduced financial repression in the Nigerian financial system. This is consistent with the financial liberalization theory by McKinnon (1973) and Shaw (1973), which addresses the problems caused by the repressive financial policies in most developing economies such as Nigeria. This corroborates the work of Okpalami and Ofoluewa (2018), which shows a positive significant relationship between financial liberalization and real sector growth in Nigeria. The study concludes that provisions of financial services stimulate the productive sectors such as: manufacturing, oil and gas, agriculture, construction, communication, solid minerals, real estate, trade, utilities etc.

Financial liberalization is the removal of all restrictions, controls, regulations and distortions imposed by the government on financial assets and its prices. Financial liberalization had created an opportunity for increasing global financial services and also posed a serious challenge to the developing countries due to their fragile financial systems; which makes them vulnerable to external financial shocks (Sulaiman, Oke&Azeez, 2012). Okpara (2010) observed that financial liberalization grants market forces a dominant role in setting financial asset prices and returns, allocating credit, and developing a wider array of financial instruments and intermediaries. He also noted that, the wave of liberalization in many developing countries in the 1980s was characterized by more attentions given to market forces in allocating credit through freely determined interest rates.

Financial liberalization policy would increase savings which consequently spurs investment and induce economic growth and development. They also argued that higher interest rates brought about liberalization that will lead to a more efficient allocation of resources, higher level of investment, economic growth and development. The focus of liberalization has been to replace the severely constrained command and control system with a relatively liberalized regime with prices reflecting economic costs (Ogwumike&Ikenna, 2012). Financial liberalization has become an important economic policy package in both advanced and advancing countries, for more than a decade now (Nzotta&Okereke, 2009). Financial liberalization in developing countries has been cited as a necessary and significant part of an economic policy package and promoted by what used to be called the Washington consensus (Bakare, 2011).

The developing countries, in order to revamp their economy, decided to implement the economy recovery programme famously called Structural Adjustment Programme introduced by the Bretton Woods institutions (World Bank and International Monetary Fund) aimed at liberalizing prices in distress and melt-down economies (Okpara, 2010). The adoption of this programme signals the phasing out of financial repressive policy in the economy. Thus, financial liberalization serves as a panacea to financial constraints in a financial repressed economy and under the financial repression regime. The monetary authorities imposed high reserve requirements, bank-specific credit ceilings, selective credit allocation, mandatory holding of treasury bills, bonds issued by the government, and finally, a non-competitive and segmented financial system (Omoke, 2010).

Various studies have been conducted in Nigeria by Okpara (2010); Bakare (2011); Ogwumike and Ikenna (2012) and Obamuyi (2012) on financial liberalization and performance of the Nigerian economy. The study shows a positive significant relationship between financial liberalization and performance of the Nigerian economy. While some other studies witnessed in South Africa by Kabango and Paloni (2011); Tswamuno et al (2013) and Bashar and Khan (2013) of Bangladesh and Khazri and Djelassi (2011) of Pakistan reveal a negative significant relationship between financial liberalization and economic growth in their various countries with similar time series data. Hence, Babajide (2010) in their study concluded that financial liberalization and economic growth have no consistent relationship in Nigeria. While Nzotta and Okereke (2009) also stated that the financial system had not sustained an effective intermediation, especially credit allocation and a high level of monetization

### **Theoretical Framework**

The theoretical framework underlining this study is the financial liberalization theory by McKinnon (1973) and Shaw (1973) and the theory advocated that financial liberalization is necessary to address the problems caused by the repressive financial policies of developing economies. McKinnon (1973) emphasized a fundamental way on the financial savings that guarantees growth and its further emphasize that governments must remove all barriers faced by financial intermediaries. According to Shaw (1973), financial liberalization is characterized by easing the functioning of the financial market by removing all obstacles as described by McKinnon (1973). And this goal is achieved primarily through a policy of financial liberalization in the context of perfect financial markets, which replaces the policy of financial repression as adopted by several developing economies. According to Qazi and Shahida (2013), during the years that followed the publication of the work of the pioneers of the school of financial repression by McKinnon (1973) and Shaw (1973), financial liberalization has been exploited as a step through to end the regime of financial repression and a starting point for the development and sustained growth of the economy. In addition, the liberalization of financial markets also contributes to the development of financial markets by financing sound investments.

They also contended that controlled lending and deposit rates would lead to non-price rationing of credit, which could result into repressed financial system and slow growth of the economy. However, financial liberalization would not only propel financial allocation efficiency of credit from the productive sectors to the unproductive sectors, but would also deepen the financial sector savings (deposits liabilities) role through a positive real interest rate (Nzotta, 2014). This is a complementary hypothesis between real money balance and investment and under this hypothesis, liberalization reforms will cause interest rate to be positive, which in turn increases savings liabilities, and credit allocation efficiency that eventually transform to real investments and increase output and economic growth. Financial liberalization in so many parts of the globe (especially the emerging economies) had led banking sectors to a remarkable number of problems some of which erupted in full-fledged systemic crises as documented in the extensive studies of Kammoun and Mamoghli (2011).

According to the financial liberalization theory, financial repression through interest rate ceilings keeps interest rates low and this discourages savings with the consequence that the quantity of investment is stifled. The quality of investment is also low because the projects that will be undertaken under a regime of repression will have a low rate of return. With financial liberalization, the interest rate will rise, thereby increasing savings and also investment. The increased investment results in the rationing out of low-yielding projects and subsequently undertaking high-yielding projects. Consequently, the quality of investment rises and this will ultimately increase economic growth and development in the economy. McKinnon and Shaw (1973) therefore advocated the liberalization of such repressed financial systems so as to promote economic growth and development. Nzotta and Okereke (2009) earmarked that financial systems have long been recognized to play an important role in economic growth and development and the benefit derivable from a healthy and developed financial system relates to savings mobilisation and efficient financial intermediation roles in the economy.

### **Empirical Literature**

Okpara (2010) investigates the effect of financial liberalization in the form of an increase in real interest rates and financial deepening ( $M_2$ /GDP ratio) on the rate of economic growth in Nigeria using the endogenous growth model. The study uses time series annual data covering the period, 1970-2002. The Error Correction Model (ECM) was used to capture both the short and long-run impact of the variables in the model. The finding shows a low coefficient of the real deposit rate which implies that interest rate liberalization alone is unlikely to expedite economic growth. Sulaiman, Oke and Azeez (2012) examine the impact of financial liberalization on the conduct of banking business and its effect on the real sector growth in Nigeria. Quarterly data were used from 1987q<sub>1</sub> to 2011q<sub>3</sub> for the following variables: gross domestic product, commercial bank credit to the industrial sector, premium on official exchange rate, lending rate, and inflation rate were analyzed using the vector auto regressive (VAR) methodology. The study shows that financial liberalization has promoted efficiency gains in the banking industry and consequently, the increased growth of credit to the private sector.

Omoke (2010) analyzes the impact of financial liberalization on economic growth in Nigeria through Johansen co-integration test using time series data from (1965-2005). The financial liberalization index was represented by the financial restraints index which includes interest rate controls, reserve requirements and directed credit multiplied by one. The results suggest that financial liberalization has positive and statistically significant impact on economic growth measured by the gross domestic product in Nigeria.

Bashar and Khan (2013) evaluate the impact of liberalization on the country's economic growth by analyzing quarterly data from (1987Q<sub>1</sub>-2013Q<sub>2</sub>) using co-integration and error correction method. The variables used were per-capita, GDP and gross investment. 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 coefficient of the financial liberalization policy variable (real interest rate) is negative and significant, implying that financial liberalization has had negative effect on Bangladesh's economic

growth. The study discards the fact that financial liberalization foster economic growth as asserted by Mckinnon and Shaw (1973).

Khazri and Djelassi (2011) determine the relationship among capital account liberalization, economic performance and macroeconomic stability in Pakistan using the VAR methodology. Two models were constructed with a de-jure index of financial liberalization which includes GDP nominal, exchange rate, country risk and interest rate and another with a de-facto index of financial integration including GDP nominal exchange rate, inflation rate and interest rate. The study data spans from 1994Q<sub>2</sub>-2009Q<sub>4</sub>. Their results offer no evidence that financial liberalization has generated positive effects on inflation and economic growth.

Qazi and Shahida (2013) investigate the impact of financial liberalization on economic growth in 10 new European Union countries and Turkey between 1995 and 2007. They constructed different financial openness indicators using panel data for different types of financial flows such as foreign direct investment, other investments, portfolio investments, trade openness index as well as other control variables, employing the ordinary Least Square (OLS) method their static robust and dynamic panel data estimates indicates clear evidence between the long-run growth and a number of financial liberalization indicators which confirms the anticipations of the new growth theory. Their findings take cognizance of financial liberalization as a policy tool because of its possibility to promote economic growth.

Asamoah (2008) assesses financial liberalization and its impact on savings investment and the growth of GDP in Ghana. The data used included monthly savings and interest rates and also yearly and seasonal dummy variables instead of post and pre-liberalization as the dummies. The empirical estimation of 42 observations, January 2000 to June 2003 was evaluated using the ordinary Least Square (OLS) regression analysis, the results show that the rise in interest rate over the years after liberalization of the financial sector has led to a corresponding savings which has a positive impact on the growth of GDP. The findings showed that financial liberalization has increased the rate of capital accumulation and improved efficiency in capital utilization which is both essential for economic growth.

### **Methodology**

The study applied *ex-post-facto* research design to source requisite information. An *ex-post-facto* research design is a systematic empirical inquiry that requires the use of variables which the researcher does not have the capacity to change its state or direction in the course of the study (Kerlinger, 1973 & Onwumere, 2009). Variables used for this study are stated as follows: GDP, CPS, TBD, and MAC. Where: GDP = Gross Domestic Product used as the dependent variable of the study. Financial liberalization variables (explanatory variables) include: CPS= Credit to the Private Sector. TBD = Total Bank Deposits. MAC = Market Capitalization.

**Model Specification**

Model specification is the determination of the endogenous and exogenous variables to be included in the model as well as the a priori expectation about the sign and size of the parameters of the function (Ibenta, 2012). Multivariate linear regression model is used to test the null hypotheses proposed for the study. Based on that a model is adapted from the work of (Sulaiman; Oke & Azeez, 2016). The model is stated as:  $GDP = f(CPS, ABD)$

The above model is modified in this study by introducing market capitalization and was employed as the independent variable. Thus, the modified model is stated as:  $GDP = f(TBD, CPS, MAC) \dots \dots \dots (i)$ .

Where: Where: GDP = Gross Domestic Product used as the dependent variable of the study. CPS= Credit to the Private Sector. TBD = Total Bank Deposits. MAC = Market Capitalization. The econometric equation becomes:

$$GDP = \delta_0 + \delta_1TBD + \delta_2CPS_2 + \delta_3MAC + \mu_t \dots \dots \dots (ii)$$

Where: GDP = Gross Domestic Product proxy for performance of the Nigerian economy used as dependent variable. CPS = Credit to the Private Sector; TBD = Total Bank Deposits and MAC = Broad Money Supply were used as the explanatory variables for the study.  $\delta_0$  = intercept and  $\delta_1, \delta_2,$  and  $\delta_3$  are the coefficients of the regression equation.  $\mu$  is the stochastic or error term (Gujarati, 2004).

**Data Presentation and Discussion**

**Unit Root Tests**

The test for stationary of the variables was done using the Augmented Dicker Fuller (ADF) Unit Root Tests. The results on table 1 show that all the variables are integrated of order one i.e. 1(1) at the 5% level of significance.

**Table 1: Unit Root Tests Analysis**

The ADF Unit Root test for Stationarity						
Variables	(with constant, no trend)		With Constant and Trend		Order of Integration	Decision
	At Level	First Difference	At Level	First Difference		
GDP	-3.64757	** -12.37485	-4.846402	** -13.45640	1(1)	Stationary
TBD	-1.63854	** -4.896493	-2.852723	** -4.048460	1(1)	Stationary
CPS	-4.75648	** -4.074647	-1.934240	** -4.065040	1(1)	Stationary
MAC	-2.45345	** -4.208397	-1.046294	** -4.312462	1(1)	Stationary
Critical values	1%	-3.064468	-3.8464353	-4.050412	-4.640505	
	5%	-2.842472	-2.6587499	-3.898426	-3.732468	
	10%	-2.867518	-2.5868133	-3.847032	-3.033456	

**Source:** Researcher’s Estimation using E-views 9.1  
 Note: \* (\*\*) denotes rejection of hypothesis at 5% (1%) significance level.

**Test for Co-Integration**

Since all the variables are integrated and stationary, the next step is to perform Johansen co-integration procedure to ascertain whether GDP, credit to the private sector (CPS), total bank deposit (TBD) and market capitalization (MAC) are co-integrated. Thus, long run relationship exists among the variables as indicated by the likelihood ratio that is greater than the critical values both at 1 percent and 5 percent level of significance on table 2.

**Table 3:** Multivariate Johansen’s Co-Integration Test Result.

Null hypotheses	Alternative hypotheses	Eigen value	Likelihood ratio	Critical vales 5%	Critical value 1%	Hypothesized No. of CE(s)
r=0	r=1	0.86985	69.65747	57.05	48.02	None **
rd≤1	r=2	0.73967	63.64549	45.03	36.04	At most 1
rd≤2	r=3	0.68496	48.00533	37.83	28.06	At most 2
rd≤3	r=4	0.57986	36.04532	28.76	24.45	At most 3

**Source:** E-views Econometrics 9.1. Note\* (\*\*) denotes rejection of hypothesis at 5% (1%) significance level.

**Vector Error Correction Model**

The Error Correction coefficient contains information about whether the past values affect the current values of the variable under study and the significant coefficient implies that past equilibrium errors play a role in determining the current outcomes (Ibenta, 2012).

**Table 4: Vector Error Correction Estimates Results**

Dependent Variable: GDP  
 Method: Least Squares, Time: 06:45  
 Sample: 1990-2018  
 Included observations: 29

Date: 24/03/2019	Coefficient	Std. Error	t-Statistic	Prob.
(ECM)(-1)	-0.874650	5.000583	14.85769	-0.000011
D(GDP <sub>-1</sub> )	5.645382	2.846570	1.859644	0.000020
D(GDP <sub>-2</sub> )	7.037564	5.638693	2.857699	0.000012
C	4.746395	1.957030	3.004866	0.000035
Ln(MAC)	3.947364	0.385099	0.375975	0.000300
Ln(TBD)	6.003746	3.905766	2.658902	0.000073
Ln(CPS)	5.940785	0.328962	5.048668	0.000041
R-squared	0.680957	Mean dependent var.		35.94657
Adjusted R-squared	0.650846	S.D. dependent var.		3248384
S.E. of regression	23.00386	Akaike info criterion		24.00675
Sum squared resid	462.0010	Schwarz criterion		10.64894
Log likelihood	163.0003	F-statistic		7.839576
Durbin-Watson stat	1.947586	Prob(F-statistic)		0.000000

**Source:** Author’s computation with the use of E-view 9.1

The results on table 3 show that error-correction coefficient (-0.874650) is statistically significant and has a negative sign, which confirms a necessary condition for the variables to be co-integrated. This implies that the speed with which credit to the private sector, aggregate bank deposit and broad money supply, adjust from short-run disequilibrium to changes in performance of the Nigerian economy in order to attain long-run equilibrium is 87% within one year. Hence, the coefficient of determination ( $R^2=0.680957$ ), which

indicates that about 68% of the variations in performance of Nigerian economy is explained by the changes in financial liberalization variables (TBD, CPS, MAC) in Nigeria. This implies that a good portion of economic performance trends in Nigeria is explained by financial liberalization variables. The F-statistics of 7.839576 which is statistically significant confirms the relationship between financial liberalization and performance of the economy. Whereas, (F-probability = (0.000000) at 5% accept the influence of the explanatory variables on the dependent variable because is statistically significant and is zero.

### Causality Test

**Table 4:** Result of Pair-wise Granger-Causality Test (1990-2018) with 2-period Lag length

Null Hypotheses:	Obs	F-Statistic	Probability	Decision
TBD does not Granger Cause GDP	27	3.64861	0.00009	Causality
GDP does not Granger Cause TBD		0.65478	0.00035	Causality
CPS does not Granger Cause GDP	27	4.46794	0.00460	Causality
GDP does not Granger Cause CPS		0.74650	0.00024	Causality
MAC does not Granger Cause GDP	27	4.37586	0.00033	Causality
GDP does not Granger Cause MAC		6.73546	0.00062	Causality
CPS does not Granger Cause TBD	27	8.36478	0.00154	Causality
ABD does not Granger Cause CPS		3.63758	0.00052	Causality
MAC does not Granger Cause TBD	27	1.94852	0.00034	Causality
TBD does not Granger Cause MAC		0.64867	0.00043	Causality
MAC does not Granger Cause CPS	27	2.26453	0.00034	Causality
CPS does not Granger Cause MAC		3.95868	0.00028	Causality

**Note:** The decision rule of a causality test states that if the probability value of the estimate is higher than the 5 percent (or 0.05) level of significance, we accept the null hypothesis, and vice versa.

**Source:** E-views Econometrics 9.1

The results of the Granger causality test indicate that performance of the Nigerian economy (GDP) has a causality with TBD (total bank deposits), MAC (market capitalization) and CPS (credit to the private sector). This implies that there is a causality between financial liberalization variables and performance of the Nigerian economy. This means that direct causality exists between financial liberalization and performance of the Nigerian economy.

### Conclusion and Recommendations

The study concluded direct causality exists between financial liberalization and performance of the Nigerian economy. This corroborates the work of .The study recommends that strong macro-economic policies (monetary and fiscal) should be pursued to maintain and stabilize the economy. One way to achieve this is by laying down strict prudential rules and regulations to strengthen and stabilize the banking industry. The policy towards interest rate should be made such that savings would be stimulated thereby placing more funds in the hands of banks to intermediate to investors seeking funds. Also lending rate should be reasonable so as not to deter investors to borrow and embark on viable investment projects. Government should create conducive business environment to encourage both local and foreign participation in investment thereby engendering



economic growth and development. Proper integration of the financial sector should be ensured by the government so that financial units can be strategically positioned and capable to intermediate funds. CBN should implement policies that will increase the flow of investable funds that will improve the capacity of banks to extend credit to the economy. CBN should also promote healthy competition in the banking industry so as to improve the efficiency of banks in rendering financial services to the public.

### **Contribution to Knowledge**

The study was able to modify the model and expanded the existing literature, geographical spread and updated data that will enable researchers and scholars to use it for further studies. Hence, from the results this study has also contributed to knowledge by discovering that Nigerian economy has a direct causality with financial liberalization policy.

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**Appendix 1:**

**Financial Liberalization and Performance of the Nigerian Economy (1998-2018)**

YEAR	GDP at Current Market Price (₦'BILLION)	Credit to Private Sector (₦'BILLION)	Market Capitalisation (₦'BILLION)	Total Bank Deposits (₦'BILLION)
1998	3,989.45	351.96	16.3	76.13
1999	4,679.21	431.17	23.1	93.33
2000	6,713.57	530.37	31.2	115.35
2001	6,895.20	764.96	47.5	154.06
2002	7,795.76	930.49	66.3	161.93
2003	9,913.52	1,096.54	180.4	241.60
2004	11,411.07	1,421.66	285.8	343.17
2005	14,610.88	1,838.39	281.9	451.96
2006	18,564.59	2,290.62	262.6	556.01
2007	20,657.32	3,668.66	300.0	655.74
2008	24,296.33	6,920.50	472.3	797.52
2009	24,794.24	9,110.86	662.5	1,316.96
2010	54,204.80	10,157.02	764.9	1,739.64
2011	63,258.58	10,660.07	1,359.3	2,693.55
2012	71,186.53	14,649.28	2,112.5	4,118.17
2013	80,222.13	15,778.31	2,900.1	5,763.51
2014	83,193.463	18,134.13	5,120.9	5,954.26
2015	87,576.474	18,4315.9	13,181.7	6,531.91
2016	91,144.960	19,026.36	9,563.0	8,062.10
2017	96,144.499	19,923.92	7,030.8	8,943.30
2018	102,763.458	16,846.97	9,918.2	9,897.65

Source: **Central Bank of Nigeria Statistical Bulletin, 2018**