

Effect of Monetary Policy on Banking Sector Performance in Nigeria

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ABSTRACT: This study examined the effect of monetary policy on banking sector development in Nigeria. The study proxied the independent variable with three variables namely; credits to the private sector, monetary policy rate and liquidity ratio while the dependent variable was proxied with the share of banking sector contribution to Gross Domestic Product (GDP). The data used were secondary time series data for the period 1999 to 2024. The data were sourced from the Central Bank of Nigeria (CBN) Statistical Bulletin, 2023; CBN Annual Abstract of Statistics, 2024. The study conducted pre-estimation tests, such as unit root test to understand the integration levels of the variables, that is, the stationarity of the variables. The primary estimation method employed was auto-regressive distributed lag (ARDL), while the post-estimation tests includes; Breusch-Pagan-Godfrey, Breusch-Godfrey serial correlation tests, and Jarque Bera test which were used to ensure residual met regression assumption. The findings revealed that monetary policy has a significant impact on banking sector development in Nigeria. Although each of the variables exhibited a negative sign, suggesting that monetary policy during this period of review impacted negatively on the banking sector's development in Nigeria. Therefore, the study concluded monetary policy has a significant impact on banking sector development in Nigeria. Therefore, the study recommended that the CBN should review downwards the MPR to encourage the development of the banking sector.

KEYWORDS: Monetary Policy, Banking, Development, Credits, Private Sector

I. INTRODUCTION

Every proactive and results driven monetary authority seeks efficient design and management of appropriate measures and strategies aimed at influencing the stock, quantity and quality of credits availability in an economy with the intention of achieving its micro and macroeconomic objectives (Afolabi & Akinde, 2023). Needless to say that uncontrolled or poorly managed credit availability in an economic would be counter-productive as such could embolden inflationary pressure which is capable of negatively impairing the growth of key sectors of the economy (Asobari & Christian, 2023). Therefore, effective application and management of monetary policy tools with bold political will and determination as it is been currently witness in Nigeria would curb inflation, create job, improve productivity and foreign earnings, improve foreign exchange rate and attract foreign investments into the country (Akinsanmi et al, 2022). Cumulatively, these gains would result to economic growth and if well managed would lead to economic development (Alalade et al, 2020).

Credit being the main product of banking sector is the major object of focus of monetary policy in any economy. The relationship between credits and banking sector makes the sector more susceptible to changes in monetary policy (Andabai & Oyakegha, 2025). Thus, the banking sector more than any other sector of the economy is more significantly influenced by changes in monetary policy (Shittu et al, 2023). Since the target of monetary policy is to control bank credit and interest rates, the thrust of monetary policy can affect the overall performance of banks (Anyamaobi, 2018). While contraction monetary policy will reduce the volume of money supply by shrinking loanable funds thereby, leading to higher interest rates on bank loans, the expansionary monetary policy aims at increasing the money stock, hence increasing the supply of credit and loanable funds (Ojima & Ajidua, 2024). This submission is corroborated by the fact most of the monetary policy instruments are anchored and implemented by banks (Ajudua & Odishika, 2022).

Over the few years, the monetary policy authority in Nigeria has engaged diverse strategies and policy measures aimed at achieving macroeconomic stability in the country. In so doing, it is envisaged that there will be increased productivity, price stability, job opportunities, foreign trade balance and sustainable economic growth (Ajudua, 2023). Nigeria, like any other country, relies heavily on deposit money banks (DMBs) to fuel its economic expansion. DMBs play a crucial role in the financial system by helping to pool savings and lend money to productive industries. This, in turn, promotes economic growth and stability. Indicators

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like operational efficiency, liquidity, and credit risk management help us understand how well DMBs are doing in terms of their capacity to weather economic storms and maintain financial stability. For example, a bank's liquidity is an important indicator of its capacity to satisfy its short-term commitments without suffering heavy losses (Afolabi & Akinde, 2023).

Given the difficulties presented by economic volatility, regulatory restraints, and rising competition in the banking industry, the efficiency of Nigeria's DMBs has been a major point of worry (Andabai & Oyakegha, 2025). The fluctuating patterns in key performance metrics including liquidity, return on assets (ROA), and credit risk management reveal how susceptible Nigerian banks are to both internal and external shocks. According to Marshal and Egileoniso (2023) many DMBs still face problems like high non-performing loans (NPLs), falling profitability and poor asset quality, even though reforms like the recapitalization policy like the current exercise billed to take effect in the first quarters of 2026 and risk-based supervision have tried to strengthen the banking sector (Mokuolu, 2024). The capacity of banks to sustain optimal performance is directly affected by macroeconomic variables like inflation, exchange rate instability, and shifting oil prices, which make these problems much worse. Thus, it then becomes necessary to investigate the impact of monetary policy on the performance of banking sector in Nigeria.

Objectives of the Study

The broad objective of this study is to examine the effect of monetary policy on banking sector performance in Nigeria, while the specific objectives are to:

- i. investigate the effect of monetary policy rate on banking sector development in Nigeria;
- ii. examine the effect of liquidity rate on returns on banking sector development in Nigeria; and
- iii. assess the effect of credit to the private sector on banking sector development in Nigeria.

This study is divided into five sections. The first section which is introduction considered the background of the study, statement of the problem and objectives of the study. The next section is literature review which contained conceptual review, theoretical framework and empirical review, while the third and fourth sections focused on methodology and results and interpretation respectively. The last section was on conclusion and recommendations.

II. LITERATURE REVIEW

Conceptual Review

Monetary Policy

Monetary policy is the practice of employing a variety of financial instruments in order to manage or control the amount, cost, accessibility, and direction of money and credit in an economy in order to accomplish a particular macroeconomic policy aim (Dhungana, 2016). This is done in order to manage or control the direction of money and credit in the economy. It is possible to do this in order to manage or exert control over the path that money and credit take (Ayodele, 2014). The monetary authorities majorly the central bank, may at times make a determined effort to exert control over the money supply and credit conditions in the economy. This is typically done so that the monetary authority may achieve a specific economic purpose. Achieving a balance in the balance of payments, preserving full employment, and obtaining full employment are some of the objectives of macroeconomics (Egor et al, 2024). Other objectives of macroeconomics include ensuring sustainable economic growth.

Nwinee and Torbira (2012) documented that monetary policy can be in two forms, namely; expansionary monetary policy and restrictive monetary policy. Restrictive monetary policy can as well be referred to as contractionary monetary policy. Hence, there are two types of monetary policy. An expansionary monetary policy is one brought into existence for the purpose of increasing the supply of money in the economy in order to achieve some nominated objectives. In the course of implementing this type of monetary policy, the government may decide to reduce the cash reserve ratio or increase the liquidity ratio in order to allow more money in the hands of the banks so as to increase the liquidity in the economy (Obidike, 2015). A contractionary monetary policy is a policy brought into existence for the purpose of decreasing the supply of money in the economy so as to achieve some nominated objectives.

Banking Sector Performance

Nigerian economy has different financial institutions, systems, agents, laws, procedures and operations that facilitate the flow of funds in an economy. Banks and banking institutions are key components of any economy (Obi-Nwosu & Chukwu, 2022). This is because of the strategic and important functions that are performed by banking institutions in financial intermediation side other peculiar functions which they offer to the growth economy in particular and development of the country as whole. Financial performance refers to the extent to which the financial objectives of an institution has been achieved within a particular time period (Alalade et al., 2020). Mengistu (2021) asserts that profitability is the first line of defense for banks (DMBs) against losses that are unexpected, since it strengthens their capital position as well as improves future profitability via investment of retained earnings. For Pandey (2010), performance is termed to be characterized as the ability of an enterprise to appreciate its investments

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that are channeled into business activities, which will add to the continuous self-improvement and the achievement of goals (Mokuolu, 2024).

Theoretical Framework

The Monetarist Theory

The monetarist theory was postulated by economists led by Milton Friedman after the Great Depression and World War II. The monetarist idea was first out by Milton Friedman in 1956. Friedman made a strong case against the idea that monetary policy determines the magnitude, cost, and future course of the money supply. The monetarists utilized Fisher's equation of exchange to represent their concept, which was fundamentally a theory of demand for money rather than a theory of output price and money income. The monetarists were opposed to Keynes's monetarism because they believed that it was a flawed economic theory. They were able to do this by making the required amounts of real balances a function of a very small number of independent variables. The reason for this was because monetarists believed that the theory of output price and money income were less important than the demand for money. This led to the situation that we have today. When monetarists took control of the government, one of the first things they did was launch an attack on the Keynesian school of economics, while at the same time putting an emphasis on the significance of monetary policy, particularly in relation to money supply. This was done while simultaneously emphasizing the significance of the Keynesian school's ideas regarding the relationship between money supply and monetary policy.

Empirical Review

Nwikina et al. (2024) investigated the impact of monetary policy interventions on the performance of deposit money banks in Nigeria from 1990 to 2022. Monetary policy were measured with cash reserve ratio, monetary policy rate, lending interest rate, and wide money supply, while profit after tax was utilized to evaluate bank performance. Secondary data from the Central Bank of Nigeria Statistical Bulletin were employed. The Augmented Dickey-Fuller unit root test and the Auto-Regressive Distributed Lag (ARDL) model were utilized to guarantee data dependability and correctness. The cash reserve ratio shown a favorable short-term effect on profit after tax, but the monetary policy rate revealed a positive and substantial influence in both the short and long term. Lending interest rates shown a negative and substantial correlation with bank performance, whereas the broad money supply had a negative but substantial influence on profitability.

Jisike et al. (2023) studied the impact of quantitative tools of monetary policy on the performance of deposit money banks in Nigeria (1986-2019). The study collected secondary data on independent these variables namely; treasury bill subscription, monetary policy rate, liquidity ratio, and cash reserve ratio while the dependent variable was measured with credit to the private sector. Data were sourced from CBN statistical Bulletin, while Ordinary Least Square was utilized for a regression analysis of the data. According to the results, there is a strong correlation between treasury bills subscription and private sector lending. The research found that the cash reserve ratio correlates highly with private sector lending.

Afolabi and Akinde (2023) researched how Nigerian deposit money banks performed in relation to monetary policy. Total loans to total assets was employed as a measure of performance, while monetary policy rate and liquidity ratio were used as indicators for monetary policy. The study used secondary data covering 198-2021 and were sourced from CBN Statistical Bulletin. Ordinary Least Square was employed in testing the effects of the policy tools on banks performance. The results indicated a significant and negative impact of monetary policy rate, whereas the effect of liquidity ratio was negative but insignificant.

Owoeye et al. (2023) studied the effect of monetary policy on the financial performance of deposit money banks in Nigeria over a period of 19 years between 2000 and 2018. Specifically, the study established the effect of interest rate and cash reserve ratio on the financial performance of deposit money banks. Secondary data were sourced from CBN Statistical Bulletin. The Autoregressive Distributed Lag Model (ARDL) regression technique was employed. The findings of the study indicated that interest rate and cash reserve ratio influenced the performance of banks in terms of their deposit liabilities.

Olaifa (2022) assessed the effects of monetary policy on banks performance in Nigeria. Monetary policy was measured with interest rate, central bank rate, foreign exchange rate while the dependent variable was proxied with net profit after tax of the selected banks. Secondary data was used for the purpose of this paper which was sourced from CBN Statistical Bulletin for the period of 1988 to 2015 and the financial statements of the affected banks. Ordinary least Square regression was used to examine the impacts of monetary policy variables on deposit money banks' profits. The results show that foreign exchange rates and cash reserves ratio had negative impacts on deposit money banks profit. Furthermore the results show deposit money banks interest rates had positive and significant impacts on deposit money banks profit.

Hassan and Oyedele (2022) the effect of monetary policy on financial performance of deposit money banks quoted in Nigeria from 2008- 2020. The independent variable (monetary policy) was represented by cash reserve ratio, inflation rate and interest rate, while, the dependent variable (financial performance) was measured by return on asset. The sample size comprise the ten (10)

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deposit money banks quoted on the Nigerian stock exchange as at 31st December, 2020. The secondary data were retrieved from the annual reports of the sampled banks. The data were analyzed by Pooled Ordinary Least Square multiple regression and the results showed that cash reserve ratio has a positive significant effect on financial performance, inflation rate has an insignificant negative effect on financial performance, while, interest rate has a significant negative effect on financial performance of the samples banks.

III. METHODOLOGY

The study made use of secondary time series data from 1999 to 2024 which were sourced from the CBN Statistical Bulletin and financial statements of the selected banks. Preliminary test was conducted using Augmented Dickey-Fuller to determine the level of stationarity of the chosen variables. Depending upon the findings of the above tests, the study applied appropriate estimation technique. The study employed Auto-Regressive Distributed Lag (ARDL) as the method to estimate the specified model. The study used the Breusch Pagan test to conduct residual post-diagnostic test.

Model Specification

This study adopted the model of Olaoye and Olaniyan (2022) which examined the impact of monetary policy on firm performance of listed deposit money bank in Nigeria. Their model was specified as follows:

$$Y_{it} = \alpha_{it} + \beta_1 RCR_{it} + \beta_2 ALR_{it} + \beta_3 EXCHR_{it} \dots \dots \dots \text{eq.1}$$

Where:

Y= Return on Asset being a proxy to firm performance of Deposit Money Bank

α = the constant term

RCR= Required Cash Reserved

ALR=Actual Lending Rate

EXCHR= Exchange Rate

However, this current study will moderate this adopted model as follow;

$$ROA = f(CRR, MPR, LQR) \dots \dots \dots \text{eq. 2}$$

In a linearized form, the model is stated below:

$$ROA_t = f(\beta_0 + \beta_1 CRR_t, \beta_2 MPRT, \beta_3 LQR_t) \dots \dots \dots \text{eq.3}$$

Where:

ROA = Returns on asset (proxy for banking sector performance)

CRR= Cash reserve ratio

MPR= Monetary policy rate

LQR= Liquidity ratio

β_0 = Intercept (constant term)

$\beta_1, \beta_2, \& \beta_3$ = Slope Parameters to be estimated

μ = Error Term

t = Time

IV. DATA ANALYSIS AND INTERPRETATIONS

Preliminary Estimation Test

Philip Peron (PP) Unit Root Test

The standard Philip Peron (PP) unit root test was used to check the order of integration for the variables. Prior to the PP test, all variables were transformed into their natural logs for easy data interpretation. The results obtained are reported in Table 4.1. Based on the PP test statistic, it was observed that all the variables, BSD, LCPS, LLQR and LMPR, have a unit root at their levels, suggesting that the variables are not stationary at level I (0). The study further tests these variables at their first difference, and it became clear that these variables were stationary at the first difference (I). This study therefore submits that series are integrated in the same order. The rejection of the null hypothesis of PP decision rules is based on MacKinnon's (1996) critical values. The lag length is selected based on SIC criteria; the chosen length ranges from lag zero to lag one. Therefore, autoregressive distributed lag was used as the appropriate estimation technique for the study.

Table 4.1: Philip Peron (PP) Unit Root Test

At Level	t-Statistic	Prob.	Integration	At Difference	First t-Statistic	Prob.	Integration
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BSD	-1.3127	0.6074	n0		-4.4073	0.0021	***
LCPS	-1.8766	0.3372	n0	d(LCPS)	-3.1972	0.0327	**
LLQR	-2.3624	0.1619	n0	d(LLQR)	-5.2683	0.0003	***
LMPR	-1.461	0.5363	n0	d(LMPR)	-4.9037	0.0007	***

a: (*) Significant at the 10%; (**) Significant at the 5%; (***) Significant at the 1% and (no) Not Significant

Source: Author's Computation using EViews 10, 2026

Estimation Test

The study employed the auto-regressive distribution as the estimation technique to examine the effect of monetary policy on banking sector development in Nigeria. Table 4.2 presents the results of the estimation. The study revealed that the lag value of banking sector development BSG (-1) of 0.2822 has a positive effect on its current value (BSD), and its corresponding p-value of 0.2392 was higher than the 5% level of significance. This implies that a percentage change in the lag value of BSD would bring about a 28.22% increase in its current value when other variables in the model are held constant. In the same vein, monetary policy variable coefficients such as LCPS (-1.2042), LLQR (-0.0329) and LMPR (-0.6413) have negative effect on banking sector development (BSD), while LEXR (0.5892) has positive effect on banking sector development. Checking their p-values, it was found that LCPS with p-value of 0.0145 has significant effect on BSD, having its p-value below 5% LOS, and LEXR, with p-value relatively have significant effect on BSD as the p-value is relatively equal to 5% level of significant. The study findings implies that a unit increase in LCPS, LLQR and LMPR would result in 1.2042, 0.0329 and 0.6413 decline in banking sector development, while a one unit increase in LEXR would result in 58.92% increase in banking sector development.

The study also explained the overall information about the model using the coefficient of determination, adjusted R^2 , F-Statistics, probability value, and Durbin and Watson. Therefore, the coefficient of determination, denoted by R^2 , of 0.7171, indicates that approximately 72% variations in the dependent variable are jointly explained by the monetary policy variables, with the remaining fraction being explained by other variables not included in the model. The adjusted R^2 of 62.28% truly confirmed the behaviour of the dependent variable according to the variables in the model, hence suggesting that the monetary policy variables used in this study are a great predictor of banking sector development in the long run.

The F-statistic of 7.6061 is greater than the tabulated F-stat of 2.74, while the corresponding p-value of 0.0003 shows that the whole model is significant, and this indicates the goodness of fit of the whole model. The Durbin and Watson value of 1.7214 shows that the model has no problem with serial auto-correction, as the value is close to the benchmark of 2. Therefore, the study submitted that the model is significant to explain the effect of monetary policy on banking sector development in Nigeria under the period of review.

Table 4.2: ARDL Long Run Estimates Dependent Variable: BSD

Variable	Coefficient	Std. Error	t-Statistic	Prob.*
BSD(-1)	0.2823	0.2319	1.2174	0.2392
LCPS	1.2144	0.4756	2.5533	0.02
LCPS(-1)	-1.2042	0.4451	-2.7058	0.0145
LEXR	-0.5893	0.2910	2.0252	0.0579
LLQR	-0.0330	0.3269	-0.1008	0.9208
LMPR	-0.6413	0.3744	-1.7131	0.1039
C	0.2188	1.3889	0.1576	0.8766
$R^2=0.7171$	Adj- $R^2=0.6228$	F=7.6061	Prob=0.0003	D.W=1.7214

Source: Authors Computation using EViews 10, 2026

Post-estimation Tests

Post-estimation tests such as Breusch Godfrey serial correlation and Breusch Godfrey pagan tests were employed to examine the residual of the regression again, including autocorrelation and heteroscedasticity. The study found that the p-values of each test such as 0.4400, 0.2254 and 0.1938 are above the 5% level of significance, which suggests that the residual of the regression model is free from the problem of serial correlation, supporting the Durbin and Watson tests, and that the residual is homoscedastic.

Table 4.3.: Post Estimation Tests

Breusch-Godfrey Serial Correlation LM Test:			
F-statistic	0.4153	Prob. F(1,17)	0.5279

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Obs*R-squared	0.5962	Prob. Chi-Square(1)	0.4400
Heteroskedasticity Test: Breusch-Pagan-Godfrey			
F-statistic	1.4583	Prob. F(6,18)	0.2477
Obs*R-squared	8.1774	Prob. Chi-Square(6)	0.2254
Scaled explained SS	6.1106	Prob. Chi-Square(6)	0.4109
Normality of Residual			
Jarque Bera	3.2817	Prob	0.1938

Source: Authors Computation using EViews 10, 2026

Test of Hypotheses

H₀₁: There is no significant effect of the monetary policy rate on banking sector development in Nigeria.

Using Table 4.2, the p-value of the monetary policy rate was 0.1039, which is greater than the 5% level of significance. This therefore implies that the null hypothesis of no significant effect between the two variables is retained, suggesting that monetary policy rate has a significant effect on banking sector growth in Nigeria.

H₀₂: There is no significant effect of the liquidity rate on banking sector development in Nigeria.

Using Table 4.2, the p-value of the liquidity rate was 0.9209, which is above the 5% level of significance. This therefore implies that the null hypothesis of no significant effect between the liquidity rate and banking sector development is retained.

H₀₃: There is no significant effect of LCPS on banking sector development in Nigeria.

Using Table 4.2, the p-value of the credit to private sector was 0.0145, which is below the 5% level of significance. This therefore implies that the null hypothesis of no significant effect between the credit to private sector and banking sector development is rejected, while the alternative, which says that there is significant effect of credit to private sector on banking sector development is accepted.

H₀₃: There is no significant effect of LEXR on banking sector development in Nigeria.

Using Table 4.2, the p-value of the exchange rate was 0.0579, which is above 5% level of significance. This therefore implies that the null hypothesis of no significant effect between the credit to private sector and banking sector development is retained.

CONCLUSION AND RECOMMENDATIONS

The study examined the effect of monetary policy on banking sector development in Nigeria, covering a period from 1999 to 2024. Banking sector development was measured using the share of the banking sector 's to GDP, while monetary policy was measured by credit to the private sector, the monetary policy rate, the exchange rate, and the liquidity ratio. The datasets collected for each variable were subjected to autoregressive distributed lag, and the results revealed that monetary policy has a significant effect on banking sector development in Nigeria. Although each of the variables exhibited a negative sign, suggesting that monetary policy during this period of review impacted negatively on the banking sector's development in Nigeria. Consequent upon these findings, it was concluded that, monetary policy has a significant impact on banking sector development in Nigeria during the period under review. Based on the findings above, the study recommended the followings:

- Considering the finding that revealed that monetary policy rate (MPR) has insignificant impact on banking sector development in Nigeria, thus, the CBN should review downwards the MPR to encourage the development of the banking sector.
- Because of the significant impact of credit to the private sector, deposit money banks should increase the quantity and quality of credit that are allocated to the Nigerian private sector.
- The current liquidity ratio should be reappraised to ensure it stimulate positively and significantly the development of banking in Nigeria.

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