

MONETARY POLICY AND STOCK MARKET PERFORMANCE IN NIGERIA- EVIDENCE FROM MARKET CAPITALIZATION

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Abstract

This study investigated the relationship between monetary policy and stock market performance in Nigeria, with market capitalization serving as the primary measure of market performance. Using a time-series research design, data spanning from 1981–2023 were analyzed, incorporating interest rate, inflation rate, and money supply as explanatory variables. Analytical methods include unit root tests, vector autoregressive (VAR) estimation, impulse response analysis, and Johansen co-integration tests. Results revealed that market capitalization exhibits strong sensitivity to its own innovations, with inflation shocks eliciting immediate but benign effects on market stability. Interest rate shocks showed a slight upward influence on market capitalization, suggesting no detrimental impact. Conversely, shocks to the money supply exert significant negative implications on market capitalization, as investors pivot to higher-yielding monetary assets, thereby reducing capital market participation. The Johansen co-integration test confirms long-term relationships between monetary policy variables and market capitalization. Regression diagnostics validate the model's robustness, free from issues like serial correlation or heteroscedasticity, while stability tests affirm the consistency of model parameters. The study underscores the pivotal role of monetary policy in shaping stock market outcomes. Recommendations include reducing borrowing costs to stimulate market activity, stabilizing the money supply to align with economic demands, and mitigating exchange rate volatility to bolster investor confidence. These measures are critical in navigating Nigeria's economic challenges, especially in the post-COVID era, where monetary interventions must be precisely calibrated to ensure sustainable market growth and resilience.

Keywords: Market capitalization, monetary policy, interest rate, inflation rate, money supply.

1. Introduction

Globally, stock markets are indispensable pillars of economic development, acting as conduits for channelling savings into productive investments and fostering sustainable growth (Federal Reserve, 2024). These financial hubs not only facilitate the efficient allocation of capital but also serve as mechanisms for risk management, innovation stimulation, and liquidity provision, making them integral to national economic systems. Stock markets play a vital role in economic

progress by stabilizing and driving economies forward (Federal Reserve, 2024). Beyond their financial functions, they influence macroeconomic stability, particularly through their interaction with monetary policy, a central bank tool for guiding economic outcomes. In developing economies like Nigeria, where financial markets are vulnerable to shocks, the relationship between monetary policy and stock market performance significantly impacts economic progress (Federal Reserve, 2024).

Monetary policy is a strategy by central banks to manage money supply, credit, and interest rates to achieve goals like price stability, employment, and growth. The Federal Reserve's 2024 report highlights that monetary policy adjusts financial conditions based on indicators like inflation and GDP to stabilize economies (Federal Reserve, 2024). The International Monetary Fund (IMF) also underscores its role in addressing inflation and post-pandemic recovery challenges (IMF, 2023). Chowdhury et al. (2003) define it as managing credit flow to ensure stable prices and progress. Monetary authorities implement policies through various mechanisms, including direct methods like selective credit control and administered interest rates or indirect tools like open market operations, rediscount rates, and reserve requirements Chowdhury et al., (2003)

Monetary policies often target inflation via consumer or producer price indices, while the credit transmission channel focuses on credit availability through debt or stock markets, enhancing the interest rate channel (Bernanke & Gertler, 2005). These policies aim to drive growth by empowering innovative entrepreneurs. However, the 2008–2009 global financial crisis significantly impacted the Nigerian stock market, reducing share volumes and transactions, and worsening economic challenges. Factors like profitability, political issues, interest rates, inflation, GDP, and exchange rates negatively influenced stock prices (Omodero, 2020). Despite Nigerian Stock Exchange reforms to boost investor participation, high interest rates, currency volatility, and inflation continue to hinder investment and market activities (Omodero, 2020).

The COVID-19 pandemic further disrupted the market, causing economic downturns, supply chain disruptions, and reduced consumer spending, which worsened stock market performance. Initial sharp declines in market capitalization highlighted vulnerabilities such as Nigeria's reliance on oil revenue, which suffered severe price shocks (Pitigala, 2022). Monetary responses, including interest rate cuts and liquidity injections by the

Central Bank of Nigeria, offered limited relief. Remote trading mechanisms helped mitigate operational disruptions, showing technological progress in the market (Pitigala, 2022).

Despite these efforts, recovery remains slow, with inflation rising and low foreign investor confidence due to exchange rate volatility and policy uncertainties. This raises concerns about the effectiveness of monetary policies in addressing stock market challenges in developing economies like Nigeria. This study aims to close the gap by examining monetary policy and Stock Market Performance in Nigeria as evidenced from market capitalization.

Objectives of the Study

The specific objectives of the study are to:

1. Examine the effect of money supply on stock market performance.
2. Investigate the impact of interest rate on stock market performance.
3. Determine the influence of inflation rate on stock market performance..

2. Literature Review

Market capitalization can be seen as the total value of a company's shares that are outstanding, and it is calculated by multiplying the current prices of shares by the number of shares outstanding (Fitrah et al., 2022). Market capitalization is the most important way of gauging the health position of any nation's capital market. It is often called 'market value', and it is used to assess the developmental nature of a country's capital market in relation to the growth of an economy (Ogieva & Igbiosa, 2023). Monetary policy is a critical instrument used by central banks to regulate economic activity and achieve key objectives such as price stability, economic growth, and employment. By influencing variables like the money supply, interest rates, and inflation, monetary policy ensures economic balance. Two primary approaches are employed: expansionary policy, which stimulates economic growth by increasing liquidity, and contractionary policy, which combats inflation by restricting money flow. These strategies address both short-term cyclical fluctuations and long-term structural challenges. The money supply, comprising all liquid assets in an economy, serves as a fundamental tool of monetary policy. Central banks control it through mechanisms such as open market operations, reserve requirements, and quantitative easing (Rana & Al-Mamun, 2024). During economic downturns, an increase in the money supply boosts activity, while tightening it helps stabilize prices during inflationary periods. Studies have emphasized the money supply's crucial role in stabilizing economies and influencing GDP growth (Rana & Al-Mamun, 2024).

Interest rates are another essential monetary policy instrument, affecting borrowing, saving, and investment decisions. Lower interest rates encourage borrowing and spending, spurring economic growth, while higher rates reduce consumption and curb inflation. Empirical evidence supports the effectiveness of rate adjustments in aligning short-term economic fluctuations with long-term stability (Vinayagathan, 2013).

Inflation management remains a key goal of monetary policy, with central banks aiming to maintain inflation within a target range for price stability and economic predictability. The COVID-19 pandemic

highlighted the importance of timely policy responses, as delays in interest rate adjustments exacerbated inflation in some cases. For example, Federal Reserve policies prioritizing employment during the pandemic inadvertently heightened inflation risks (Eggertsson & Kohn, 2023). Nevertheless, proactive strategies can mitigate inflation surges, safeguarding overall economic stability.

Several authors have delved into the relationship between the monetary policy and stock market performance in both developing and developed countries. Rifat (2015) investigated the relationship between monetary policy instruments and the Bangladesh stock market index using various econometric models. The findings revealed a weak connection between stock prices and monetary policy. In contrast, Atgur & Yigit (2017) studied the impact of monetary policies on Turkey's Borsa Istanbul stock market from 2006 to 2016. Employing Johansen Co-integration and Granger Causality tests, they found a significant long-term relationship between monetary policy tools, such as the money supply (M2) and deposit interest rates (DIR), and stock market indices, confirming a substantial influence of monetary policy on Turkey's stock market.

Lütkepohl & Netšunajev, (2018)) analyzed the European stock market using a co-integrated structural vector autoregressive model. Their study showed that contractionary monetary policies caused a long-term decline in stock values. Similarly, Chukwuemeka (2018) examined the Nigerian capital market using OLS and related econometric models. The results indicated significant positive associations between market turnover and variables like the monetary policy rate, monetary aggregate, and exchange rate, whereas the Treasury bill rate negatively impacted both market capitalization and turnover.

Anale & Umeora (2019) applied the ARDL model to assess the link between monetary policy instruments and the Nigerian capital market. They found that the monetary policy rate, cash reserve ratio, and loan-to-deposit ratio negatively affected market productivity, while the liquidity ratio showed a positive influence. John and Ezebasili (2020) extended this inquiry to Nigeria, South Africa, and Ghana, analysing the relationship between money supply and stock market performance. Their study established a long-term relationship and revealed a unidirectional causality where stock market performance influenced money supply rather than the reverse.

In a related study, Ojiako (2021) explored the dynamic relationship between monetary policy tools and the Nigerian stock market using time series data from 1981 to 2023. The findings revealed an inverse relationship between stock performance and private sector credit and lending rates, while money supply positively influenced stock performance. The error correction model confirmed convergence and statistical significance. Lastly, Lenyie (2023) examined monetary policy transmission channels and their effects on Nigerian stock market liquidity. Using OLS, the study attributed over half of the variations in stock market liquidity to monetary policy channels, with the credit channel showing a negative effect, highlighting a moderate overall influence.

In other study, Gabriel (2025) examined monetary policy in relation to market capitalization in Nigeria between

1986-2023, using ARDL as a method of technique. The results showed that, changes in monetary policy do not bring about significant impact on market capitalization. Determinants of market capitalization with a major focus on an emerging countries was carried out by Nguyen & Minh (2025), employing a data sets of 7,608 observations from 687 Vietnamese firms that are quoted. Regression analysis was adopted, and the finding revealed that, market capitalization is affected by both internal and external factors. Lyndon et al. (2019) empirically looked at macroeconomic determinants of market capitalization in Nigeria, and the researchers used multiple regression analysis with the help of E-view 10. The finding shows that GDP influences market capitalization significantly.

In light of the above, the study's hypothesis is as follows: H01: Monetary policy has no significant effect on the performance of the Nigerian stock market.

Theoretical Framework

The study is anchored on Fama's Efficient Market Hypothesis (EMH) (1970). The EMH is a theory that asserts that asset prices accurately represent all available information. The result is that the costs of equities reflect the entire economic environment in which they exist, including monetary policy announcements demonstrating the diversity in monetary policy tools. Fama (1970) divided the empirical efficiency test into three categories: weak-form, semi-strong-form, and strong-form. The weak form contains only past prices, but the semi-strong form has both historical prices and publicly accessible data, which invariably includes the influence of monetary policy pronouncements. However, Fama's Efficient Market Hypothesis (EMH) (1970) is relevant to this study as it explains how information, including monetary policy changes, is quickly reflected in stock prices in an efficient market. By analyzing the Nigerian stock market's response to monetary policy through market capitalization and other variables like money supply, the study can assess the market's efficiency and identify potential structural inefficiencies or behavioral deviations.

3. Methodology

This study employed a time-series research design, relying on secondary data sourced from the Central Bank of Nigeria (CBN) statistical bulletins (1981–2023). Data analysis involved econometric techniques common in contemporary time-series studies. The Dickey-Fuller (DF) and Augmented Dickey-Fuller (ADF) tests were used to assess data stationarity. Subsequently, VAR estimation was conducted, followed by impulse response and variance decomposition analyses.

Model Specification

Since the 1980s, VAR models have been the preferred tool for macroeconomic policy analysis, outperforming complex structural econometric models in predicting economic relationships (Urhoghide, & Ndubuisi, 2014). The Vector Autoregressive Model can be expressed as,

$$A_0 y_t = a_0 \sum_{i=1}^p A_i y_{t-i} + e_t \dots\dots\dots (1)$$

Accordingly the baseline VAR model with p lags VAR(P) is specified in its reduced form as:

$$k^t = \alpha^0 + \alpha^1(t) + \alpha^2 k^{t-1} + \alpha^3 k^{t-2} + \dots + \alpha^p k^{t-p} + e^t \dots\dots\dots (2)$$

Where α_0 is the $(k \times 1)$ vector of constants; $\alpha_1(t)$ is a $(k \times 1)$ vector of linear time trend;

$t=1, \dots, T$; A_i are $(k \times k)$ coefficient matrices, K being the number of endogenous variables in the system and $Y_t = (MS, INTR, INFR, e)$ is the vector of endogenous variables. The $K \times 1$ vector $e_t = (e_t^{MS}, e_t^{INTR}, e_t^{INFR},)$ consists of reduced form residuals ordered with their corresponding observed endogenous variables in vector Y_t . Furthermore, each residual is a mean zero white noise process that is serially uncorrelated, i.e., $e_t \sim N(0, \Sigma_e)$. In order to get the reduced form of our structural model (2) we multiply both sides with A_0^{-1} such as that:

$$y_t = a_0 \sum_{i=1}^p B_i y_{t-i} + e_t \dots\dots\dots (3)$$

where, $a_0 = A_0^{-1}c_0$, $B_i = A_0^{-1}A_i$, and $e_t = A_0^{-1}e_t$, i.e. $e_t = A_0 e_t$. The reduced form errors e_t are linear combinations of the structural errors ϵ_t , with a covariance matrix of the form $E[e_t, e_t'] = A_0^{-1} \Sigma_e A_0^{-1}$.

The structural disturbances can be derived by imposing suitable restrictions on A_0 . The short-run restrictions that are applied in this model as the following:

$$\begin{bmatrix} e_t^{MS} \\ e_t^{INTR} \\ e_t^{INFR} \end{bmatrix} \begin{bmatrix} \alpha_{11} & 0 & 0 & 0 \\ \alpha_{21} & \alpha_{22} & 0 & 0 \\ \alpha_{31} & \alpha_{32} & \alpha_{33} & 0 \end{bmatrix} \begin{bmatrix} e_t^{MS} \\ e_t^{INTR} \\ e_t^{INFR} \end{bmatrix} = X$$

Where; $(e_t^{MS}, e_t^{INTR}, e_t^{INFR})$ denote the shocks in money supply, interest rate and inflation rates respectively. The restrictions and identification of the VAR model is based on the recursive approach using Cholesky decomposition that decomposes a given positive definite matrix. Impulse response functions and Historical decomposition derived from vector autoregression (VARs) approach are also used.

4. Analysis and Discussion of Results

4.1 Unit root test

Table 1 shows the ADF test results at levels, indicating that all variables, except INTR, have ADF values below the 95% critical value of 2.96. However, after taking the first differences and reapplying the test, the ADF values in absolute terms exceed the critical value, confirming the stationarity of the variables.

Table 1. Unit root test Results

Unit root test at levels			
Variable	ADF-Test Statistic	95% Critical ADF Value	Remark
MKTCAP	-0.6238	-2.96	Non-stationary
INFR	-2.106	-2.96	..
INTR	-3.092	-2.96	Stationary
MS	-1.728	-2.96	Non-stationary
Unit root test at 1 st difference			
Variable	ADF-Test Statistic	95% Critical ADF Value	Remark
MKTCAP	-4.419	-2.96	Stationary
INFR	-20.408	-2.96	..
INTR	-5.918	-2.96	..
MS	-6.664	-2.96	..

Source: Source: Researchers' Compilation (2026)

4.2 Lag length Selection

Selecting the appropriate lag length is crucial for establishing the VAR model. Based on Table 2, a lag length of 3 was chosen as optimal, having the highest likelihood ratio (LR) and lowest information criteria (IC).

Table 2: Lag length selection

Lag Order Selection Criteria							
Lag	LogL	LR	FPE	AIC	SC	HQ	
1	-14.0464	NA	0.000209	2.861559	3.657385	3.034273	
2	3.91929	22.24319	0.0002	2.674353	4.266007	3.019783	
3	36.94798	28.31030*	6.29e-05*	1.052574*	3.440053*	1.570718*	

Source: Researchers' Compilation (2026)

* indicates lag order selected by the criterion
 LR: sequential modified LR test statistic (each test at 5% level) FPE: Final prediction error AIC: Akaike information criterion, SC: Schwarz information criterion, HQ: Hannan-Quinn information criterion.

4.3 Co-integration Test

The unit root test results show that the time series variables are integrated of order one I(1), making the co-integration test applicable (Ramirez, 2010). The Johansen approach was used to determine the number of co-integrated vectors among the stationary variables. This test examines the co-integrated relationship between market capitalization and monetary policy variables. The results in Table 3a and 3b reject the null hypothesis of no co-integrated vector, indicating that the variables are co-integrated.

Table 3a. Johansen co-integration Results (Market Capitalization)

Hypothesized		Trace	5% Critical Value	
No. of CE(s)	Eigenvalue	Statistic		Prob
$r=0^*$	0.29666	16.91462	15.49471	0.0304*
$r\leq 1^*$	0.111248	4.245734	3.841466	0.0393*
$r\leq 2^*$	0.479121	5.11039	4.038291	0.0361*

Source: Researchers Compilation (2024) using Eviews 10.

Table 3b. Johansen co-integration Results (Monetary Policy variables)

Hypothesized		Trace	5% Critical Value	
No. of CE(s)	Eigenvalue	Statistic		Prob
$r=0^*$	0.2392	17.29787	15.4947	0.0265*
$r\leq 1^*$	0.1871	7.45863	3.84146	0.0063*
$r\leq 2^*$	0.36711	14.38711	3.91628	0.0071*

Source: Researchers' Compilation (2026) using Eviews 10.

4.4 Impulse Response Functions

The impulse responses show the path of Market capitalization when there are innovations in market risk measured in this study using interest rate, inflation rate and money supply rate. The figures below show three panels of impulse response graphs indicating the innovations over a period of 12 quarters.

Figure 1 show that market capitalization responds strongly to its own shocks, suggesting reinforcing effects. Inflation shocks cause an immediate reaction in market capitalization without delay, displacing it from stability. Though the impact of inflation is mild, it persists throughout the period, indicating asymptotic disequilibrium. Innovations in money supply rate have a significant negative effect on market capitalization. Positive shocks to the money supply rate may lead investors to adjust portfolios and increase cash holdings in the banking system, as returns on money supply

investments might surpass those from the capital market. This effect persists until the end of the period, potentially reducing market capitalization.

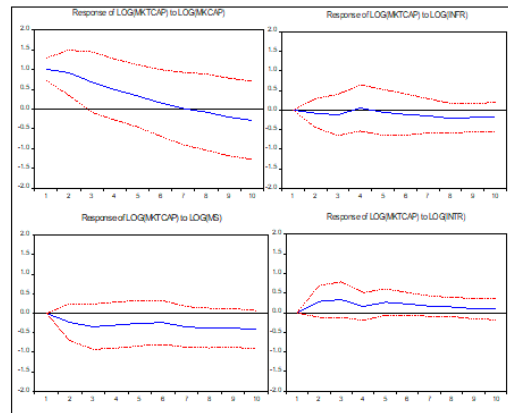


Fig. 1: Impulse-response Functions

Source: Author's Compilation (2026)

However, Interest rate shocks is seen to also drive Market capitalization slightly upward away from initial steady state and this suggest innovations to interest rate may not produce harmful effects on movements in Market capitalization process. Overall, when considering market risks, the money supply rate has the most significant impact on market capitalization. While inflation rate risks also cause some displacement, their effect is relatively mild, similar to the impact of interest rates. The findings of the study are in tandem with Zare, Azali and Habibullah (2013) though not totally in agreement with Hojat (2015). The finding is also consistent with the works of Sharma, et al., (2021); Uribe (2021); Atgur and Yigit (2017), Vladimir (2017), Pierre and Danillo (2017) though slightly in contrast with Aleksei (2018).

Table 4: Regression Diagnostics

B-G LM test for serial Corr	
F-statistic	0.6242
Obs*R-squared	1.5578
Prob.	0.5435
Prob. Chi-Square	0.4589
Heteroskedasticity Test: White	
F-statistic	0.36912
Prob (F)	0.57821
Scaled explained SS	12.337
Prob. Chi-Square	0.5239
Ramsey Reset Test	
t-statistic	0.9269
F-statistic	0.9269
Likelihood	0.9172

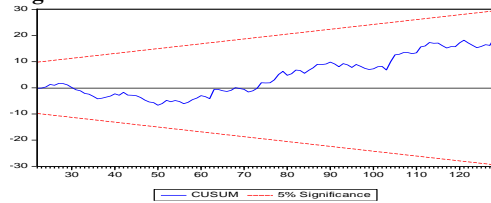
Source: Authors' Compilation (2026)

The regression diagnostics are shown in Table 4, including the Breusch-Godfrey LM test for serial correlation, which checks for stochastic dependence between errors over time. The F-stat probability value of 0.5435 indicates that the null hypothesis of no serial correlation in the residuals is accepted at the 5% level. The heteroskedasticity test reveals that the F-stat value of 0.369 and the p-value of 0.578 confirm the acceptance of the null hypothesis of homoscedastic errors at the 5% level. Finally, the Ramsey specification test validates the appropriateness of the model's functional specification.

Model Stability test

To assess the stability of our model, we perform the CUSUM test (Brown, Durbin, and Evans, 1975), which is based on the cumulative sum of the recursive residuals, as shown below:

Fig. 2: CUSUM



Source: Authors' Compilation (2026)

A visual inspection of the recursive parameter estimates helps evaluate the model's stability. Parameter instability is detected if the cumulative sum moves outside the area between the two critical lines. As seen in the figure, the cumulative sum lines remain within the 5% critical boundaries, indicating that the model's parameters are stable.

5. Conclusion

This study examines the relationship between monetary policy and stock market performance measured with Market capitalization in the Nigerian Stock Exchange. The result showed that market capitalization in Nigeria exhibits sensitivity to monetary policy variables. While inflation shocks create immediate yet benign effects, interest rate shocks slightly elevate market capitalization, indicating a non-harmful influence. However, money supply rate changes have the most critical impact, often causing a decline in market capitalization as investors shift portfolios to more lucrative monetary instruments. Above all, Stability tests (CUSUM) indicate consistent parameters over time, validating the reliability of the results. The basic limitation for this study is limited stock market performance measurement. The study proxy stock market performance by using market capitalization. Further research on the above topic should focus on other macroeconomic factors as a measure of monetary policy, and stock market return and all share index to proxy stock market performance.

6. Recommendations

Based on the findings of this study, the following recommendations are proposed: In Nigeria's post-COVID economy, it is essential to strike a balance between managing inflation and promoting economic growth. The Central Bank of Nigeria (CBN) should cautiously monitor money supply to avoid adverse impacts on market capitalization while incentivizing productive investments. Secondly, to reduce overreliance on monetary-driven shocks, diversification of the capital market through innovative instruments (e.g., green bonds) is vital. This could attract broader investor participation and stabilize the market. Thirdly, interest rate policies should aim at fostering stability without stifling market performance. Targeted interventions, such as subsidized lending rates for specific sectors, could enhance economic activity and mitigate risks associated with abrupt rate changes.

In addition, COVID-19 accelerated digital adoption globally. Nigeria should leverage fintech innovations to increase stock market accessibility, efficiency, and

resilience against global shocks. Furthermore, given the global emphasis on green energy and sustainability, aligning monetary and fiscal policies to attract ESG (Environmental, Social, and Governance) investments is crucial. Policies that foster stability in exchange rates and enhance export competitiveness can buffer the market against external shocks. Lastly, government should ensure collaborative fiscal policies focusing on infrastructure development and SME support can amplify the positive impacts of stable monetary policies, fostering economic growth and improving market capitalization.

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