

## MONETARY POLICY AND SMALL AND MEDIUM ENTERPRISES' PERFORMANCE IN NIGERIA 1970-2015

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### Abstract

*The study focused on the effect of monetary policy on the performance of Small and Medium Enterprises (SMEs) in Nigeria over the period of 1970 to 2015. Variables like credit to the private sector, interest rate, inflation rate and exchange rate were employed as explanatory variables, while SMEs output was employed as dependent variable. It was observed that credit to the private sector and inflation rate have negative effect on SMEs output, while exchange rate and interest rate have positive effect on SMEs output over the period. Consequently, it is concluded that monetary policy in Nigeria has not been favourable to the performance of the SMEs sector in Nigeria. It is therefore recommended that the central bank should ensure flexibility in its monetary policy regime and also pursue an expansionary policy that will stimulate the performance of SMEs in Nigeria.*

**KEYWORDS: Monetary Policy, SMEs Output, Private Sector, Nigeria.**

### 1. Introduction

The small and medium enterprises (SMEs) have a very crucial role to play in stimulating growth and development in every economy. The experience of Asian economies where small and medium enterprises are major contributors to economic growth is a good reference point (Selim, 2013). SMEs are often faced with myriads of challenges due to the nature and size of their businesses. Some of the challenges facing the SMEs sector stem from the fact that their output is somewhat smaller in most cases than those of the more established firms. Also, adequate financing of their activities is often a mirage as credit or financial institutions' requirement for granting loans are always not within the reach of the SMEs owing to the fact that they often lack the needed collateral securities and turnover that are favourable to being granted financial assistance. Conversely, however, they are also faced with several prospects and opportunities if well supported with appropriate economic policies and adequate financing (Ajagbe, 2012; Lawal, 2014). These opportunities stem from their ability to be able to service the domestic market and charge relatively low prices. Also, SMEs are able to reach out more to the vast majority of the masses in terms of providing them with goods in their required quantity, quality and specification. However, the problem of poor financing, unstable power supply and inappropriate policy instruments to enhance the productivity of the SMEs often hampered the extent to which they contribute to economic growth (Basil, 2005).

One of the means for stimulating the performance of the SMEs sector is through monetary policy. According to Mordi (2014), monetary policy is one of the macroeconomic management tools used to influence outcomes in the real economy to its desired direction. The basic goals of monetary policy are the promotion of stable prices, sustainable output and employment. In macroeconomic theory, monetary policy is expected to affect the real sector of the economy through interest rate movements that has effect in altering the cost of capital and investment in the productive sector. Similarly, monetary policy can influence economic output via several channels like interest rates, credit, asset prices through exchange rates, equity and housing prices (Mishkin, 1996 and 2007). Researches into the role of monetary policy on the productive sector of the economy is now gaining prominence owing to the channels through which shocks are transmitted in both the world and the domestic economy. This therefore has implications for macroeconomic management as monetary authorities then need to weigh the consequences of their actions on various sectors of the economy and consequently on how their actions affect the SMEs sectors. This becomes very important owing to the fact that the tightening of monetary policy, for instance, can be viewed as excessive for certain sectors of the economy. Thus, as identified by Alam and Waheed (2006), the need to understand those sectors that are adversely affected by monetary tightening, for instance, will help generate valuable policy information for the monetary authority.

The question that comes to mind is how effective are monetary policy instruments in stimulating the output of the small and medium enterprises in Nigeria? Several studies, like Udechukwu (2003), Basil (2005), and Ajagbe (2012), have been able to look into the relationship between the performance of the small and medium enterprises and economic growth while others have focused on monetary policy and economic growth. However, the dearth of studies on the link between monetary policy and SMEs performance necessitates this study. To this end, the study attempts to examine if long run relationship exists between the SMEs sector and the various monetary policy in Nigeria between 1970 and 2015. Moreover, it aims to determine the impact of interest rate on SMEs output in Nigeria. It evaluates the effect of inflation rate on the output of the SMEs sector and also assesses the impact of the available credit to the private sector on SMEs output in Nigeria. The rest of the study is organised into literature review in section 2, research methodology in section 3, presentation of results in section 4, while section 5 concludes the study.

## **2. Literature Review**

### **2.1 Conceptual Issues**

#### **2.1.1 The Role of SMEs in an economy**

The historical experience of economic development in the developed countries is replete with success stories of the role of SMEs in industrial development, technological innovation and export promotion. The Industrial Revolution (1760 to 1850) is a testimony of the innovative spirit of SMEs, which is increasingly challenged in the present century particularly after winds of economic change and industrial liberalization have swept various economies of the world (Udechukwu, 2003). Contrary to the general impression about SMEs, they are as much an important economic catalyst in industrialized countries as they are in the developing world. In many developed countries like Great Britain, more than 98% of all enterprises belong to the SME sector. Available evidence suggests that 80% of the total industrial labour force in Japan, 50% in Germany and 46% in USA are employed in smaller firms (Udechukwu, 2003). In USA, small business contributes nearly 39% to the national income. For instance, Basil (2005) and Lawal (2014) opined that the revival of interest in SMEs in the developed economies is due to technological as well as social reasons, namely, the growing importance of knowledge and skill-based industry as against material and energy-intensive industry (Udechukwu, 2003). This is also due to a paradigm shift to new processes of manufacturing based on flexible systems of production. Udechukwu (2003) further declared that the social reasons for promoting interest in SMEs in developed nations include the need for generation of more employment through self-employment ventures and decentralized work centres. Again, the developed countries' emphasis on SMEs promotion is through the provision of facilities and creation of supportive services rather than just protection and granting of subsidies. This is generally a hallmark of an effective strategy for promoting the SME sector. Asta and Zaneta (2010) argued that assistance provided by governments is making available commercial finance, venture capital, information, training and retraining, Research and Development support and infrastructure. The facilities are provided through local authorities and industry associations with increasing involvement of non-governmental organizations (Asta and Zaneta, 2010).

#### **2.1.2 Challenges facing the SMEs Sector in Nigeria**

Small domestic markets, inadequate infrastructure, high transport costs, shortage of capital and foreign exchange as well as surplus of low-quality labour are the general characteristics of developing countries. Basil (2005) claimed that the problems of SMEs in Nigeria include: Inadequate and inefficient infrastructural facilities which tend to escalate costs of operation, as SMEs are forced to resort to private provisioning of utilities such as road, water, electricity, etc. Inadequate access to credit, which can be traced to the

reluctance of banks to extend credit to those owing, among others, to poor documentation at project proposals as well as inadequate collateral by SME operators. In addition, bureaucratic bottlenecks and inefficiency in the administration of incentives which discourage rather than promote SME growth, weak demand for SMEs' products arising from low and dwindling consumer purchasing power, lack of patronage for locally produced goods in Nigeria, incidence of multiplicity of regulatory agencies and taxes which has always resulted in high cost of doing business, poor management practices and low entrepreneurial skill arising from inadequate educational and technical background of several SME operators. Others include uneven competition arising from import tariffs, which at times favour imported finished products, as well as unfair trade practices characterized by the dumping and importation of substandard goods by unscrupulous businessmen thereby making it difficult for SMEs to compete in the local market. Furthermore, Basil (2005) noted that weakness in organization, marketing, information processing and retrieval, personnel management, accounting records and processing etc. Others include high multiplicity of regulatory agencies, taxes and levies that result in high cost of doing business and discourage entrepreneurs. Ajagbe (2012) identified monetary policy inconsistency as well as the absence of long-term finance to fund capital assets and equipment as major problems facing the SMEs sector.

## **2.2 Empirical Review**

In this section, we present the review of the relevant literature that are germane to the subject matter in order to appreciate the flow of discussions on the link between monetary policy and SMEs performance. The apex bank's quest to strengthen the financial sector to enhance the performance of the SMEs in order to reduce poverty and promote growth cannot be over-emphasised, especially, for developing countries. Financial assistance and support to strengthen these small informal and formal businesses can help to stimulate higher profits, generate higher wages and enhance the level of employment thereby reducing the poverty gap (Bawuah, *et al*, 2014). To corroborate this, Sievers and Vandenberg (2007) researched into the development of micro financing and SMEs. The study opined that the formalization of informal business activities contributes to increasing tax revenue for the government and provide impetus for government to invest in health and education. It also helps to strengthen and expand existing SMEs and promote growth and development. Kapila and Mead (2002) suggested that in order to strengthen this position of SMEs, access to financial and non-financial services should be made available and interest rates should be kept reasonably low in order to boost SMEs performance. Bawuah, *et al* (2014) confirmed that there are enough and available financial opportunities for small businesses to access in Ghana, however, Leippoid, *et al* (2006) had earlier found a contrary opinion that financial institutions in Ghana were rather

cautious with lending to SMEs owing to high rates of default and risks. Kwaku (2014) extended the study by looking at the effect micro and small credit schemes have on the performance of the SMEs in Ghana. The study is of the opinion that although micro credit plays a very crucial role in advancing the course of the SMEs in Ghana, the unnecessarily high rate of interest and the rigidity involved in assessing the loans retard the performance of the sector. Selim (2013) looked at monetary policy and bank credit for SMEs in the manufacturing sector in Turkey. It was observed that money supply has a strong impact on the volume of credit in the manufacturing sector and that increase in the credit volume of large enterprises did not have any effect on the credit volume for SMEs. It also found a reverse causality between credit volume of SMEs and credit volume of large enterprises.

For studies focusing on the Nigerian economy, Ajagbe (2012) researched into the effect of inflation on the growth of SMEs in Nigeria taking a case study of Ogbomosho. It was observed that inflation rate has positive effect on SMEs output as well as capacity utilisation. Lawal (2014) focused on the relationship between banking sector and the development of SMEs in Osun state Nigeria. The study which conducted a survey analysis aimed at determining how the SMEs sector can be enhanced through banking sector intervention. Results showed that a positive relationship exists between bank loans and SMEs performance. It then called on flexibility of financial institutions' requirements for loans and less strict monetary policy by the central bank to enable the SMEs sector flourish. Akinlo and Odusola (2003) assessed the effect of exchange rate depreciation on output and inflation in Nigeria. The study found that exchange rate depreciation contracts output and is therefore of the opinion that Nigeria should encourage real appreciation in order to quickly deflate and boost real output generally and that of the SMEs sector in particular. Mordi (2014) employed the structural vector autoregressive framework to investigate the effect of monetary policy on real output in Nigeria. Several macroeconomic and non-macroeconomic policy variables based on quarterly data spanning the period 1993 quarter 1 and 2012 quarter 4 were used in the study. It was observed through the impulse response analysis that sectoral output responded heterogeneously following contractionary monetary policy shocks, with services and wholesale/retail sectors responding negatively to monetary policy, while manufacturing, building and construction, and agriculture displayed lagged negative responses also. The study therefore recommends that the monetary authority should provide some measure of support for specific sectors adversely affected by unanticipated monetary policy shocks.

### **3. Methodology**

As identified in Selim (2013) and Mordi (2014), there is a strong link between monetary policy instruments and the performance of the Small and Medium

Enterprises (SMEs). Akinlo and Odusola (2003), Lawal (2014) and Kwaku (2014) have also modelled the relationship between SMEs output and monetary policy variables such as exchange rate and interest rate for both the Nigerian and Ghanaian economies. To this end, this present study follows the aforementioned plethora of studies in specifying a functional relationship for monetary policy and performance of the SMEs sector in Nigeria as follows:

$$SME = f(EXR, INF, INT, CPS, SME_{-1})$$

(1)

Where SME represents the output of the Small and Medium Enterprises, while EXR, INF, INT and CPS are the monetary policy instruments employed in the study as explanatory variables while  $SME_{-1}$  is the lagged value of the output of the Small and Medium Enterprises. They represent exchange rate, inflation rate, interest rate and credit to the private sector respectively. Also, the credit to the private sector is expressed as a percentage of the gross domestic product (GDP) while SMEs' output is also expressed as a percentage of GDP because the variable is taken as the contribution of the SMEs sector to the real GDP in Nigeria.

For the purpose of regression analysis, equation (1) is explicitly stated as:

$$SME = \beta_0 + \beta_1 EXR + \beta_2 INF + \beta_3 INT + \beta_4 CPS + SME_{-1} + \varepsilon$$

(2)

In equation 2,  $\beta_0, \beta_1, \beta_2, \beta_3, \beta_4$  are the slope parameters of the model while  $\varepsilon$  is the white noise error term. The apriori expectation is that  $\beta_4$  should be positive since more credit to the private sector should stimulate more activities for the SMEs sector too, while  $\beta_3$  is expected to have a negative sign since higher rate of interest is expected to negatively impact the output of SMEs. However,  $\beta_1$  and  $\beta_2$  can show either positive or negative sign depending on the nature of economic activities. Moreover, in the study, equation (2) is estimated by employing the autoregressive lag model. Data for the study are mainly secondary and they are sourced from the Central Bank Statistical Bulletin (2016). Such data include SMEs output as a percentage of GDP, credit to the private sector as a percentage of GDP, inflation rate, interest rate and exchange rate over the period of 1970 to 2015. Pre-estimation tests such as unit root and cointegration tests were conducted on all the variables in order to ascertain their stationarity status and to examine if long run relationship exists between monetary policy and SMEs performance in Nigeria. The study also conducted post-estimation tests of normality and heteroscedasticity to determine the robustness of the autoregressive model estimated.

#### 4. Data Analysis and Discussion of Findings

This section of the study presents the empirical results based on autoregressive (AR) model where the lag of output of the SMEs is brought into the model as an explanatory variable owing to the fact that the current

value of SMEs output depends to an extent on its previous value. Therefore, the results of the output of SMEs, interest rate, inflation rate, credit to the private sector and lag of SMEs output for the considered period of 1970-2015 in Nigeria are presented and discussed.

**Table 1: ADF Unit Root Test Results**

Variable	ADF Tau Statistics		Order of Integration
	5% Significant	1% Significant	
<i>SME</i>	-10.28823 (0) [-2.929734]	-10.28823 (0) [-3.588509]	1
<i>INT</i>	-6.948692 (0) [-2.931404]	-6.948692 (0) [-3.592462]	1
<i>INF</i>	-6.833940 (0) [-2.931404]	-6.833940 (0) [-3.592462]	1
<i>CPS</i>	-6.682703 (0) [-2.931404]	-6.682703 (0) [-3.592462]	1
<i>EXC</i>	-5.814294 (0) [-2.929734]	-5.814294 (0) [-3.588509]	1

*Note: Mackinnon critical values are shown in parenthesis. The lagged lengths shown in brackets are selected using the minimum Schwarz Information criteria.*

**Source: Authors' Computation, 2016.**

In table 1, the test result indicated that the time series variables, small and medium enterprises' output, inflation rate, interest rate, exchange rate and credit to private sector were found to be non-stationary at levels. However, after first differencing the series, table 1 indicates that all the variables employed in the study are stationary at first difference at both 5% and 1% level of significance. We can therefore conclude that all the variables are stationary at first difference; hence, we reject the null hypothesis “*no stationarity*” at first difference. This indicates that those incorporated series in the regression model have no unit-root and that the series in their first difference are mean reverting and converge towards their long-run equilibrium.

**Table 2 – Restricted Cointegration Rank Test (Trace)**

Hypothesized No. of CE(s)	Eigenvalue	Trace Statistic	0.05 Critical Value	Prob.**
None *	0.631015	89.66414	69.81889	0.0006
At most 1	0.404630	45.79621	47.85613	0.0771
At most 2	0.278629	22.97907	29.79707	0.2471
At most 3	0.133980	8.608614	15.49471	0.4028
At most 4	0.050484	2.279331	3.841466	0.1311

The trace statistic indicates that there is 1 co-integrating equation at 5% significance level. Hence, a long-run equilibrium relationship exists between the variables and that there exists one co-integrating vector.

**Table 3. – Restricted Cointegration Rank Test (Maximum Eigenvalue)**

Hypothesized No. of CE(s)	Eigenvalue	Max-Eigen Statistic	0.05 Critical Value	Prob.**
None *	0.631015	43.86793	33.87687	0.0023
At most 1	0.404630	22.81714	27.58434	0.1814
At most 2	0.278629	14.37046	21.13162	0.3354
At most 3	0.133980	6.329284	14.26460	0.5713
At most 4	0.050484	2.279331	3.841466	0.1311

Both trace statistic and Maximum-eigenvalue statistic indicate that there is 1 co-integrating equation at 5% significance level. Hence, a long-run equilibrium relationship exists between the variables and that there exists one co-integrating vector. Since there is long run relationship among the variables employed in the study, we can now proceed to estimating the long run autoregressive model.

**Table 4. Result of the Long Run Model***Dependent Variable: SME**Included observations: 45 after adjustments*

Variable	Coefficient	Std. Error	t-Statistic	Prob.
<i>C</i>	3.012425	1.031087	2.921602	0.0058
<i>EXC</i>	0.028078	0.009271	3.028621	0.0488
<i>INF</i>	-0.007969	0.003241	-2.458809	0.0001
<i>INT</i>	0.027837	0.027019	1.030283	0.3092
<i>CPS</i>	-0.024923	0.013228	-1.884042	0.0670
<i>SME(-1)</i>	0.700842	0.101203	6.925106	0.0000
<i>R-squared</i>	0.762462	<b>F-statistic</b>	25.03690	
<i>Adjusted R-squared</i>	0.732009	<b>Prob(F-statistic)</b>	0.000000	
<i>Log likelihood</i>	-8.639900	<b>Durbin-Watson stat</b>	2.015353	

**Source: Authors' Computation (2016)**

The result of the autoregressive model presented in table 4 reveals that when all the explanatory variables are kept constant, the output of the SMEs sector in Nigeria is 3.012. Also, a cursory look at the result shows that exchange rate positively and significantly impacts SMEs output in Nigeria. Its value of 0.028 implies that while keeping constant inflation rate, interest rate, credit to the private sector and the previous value of SMEs output itself, a percentage increase in the naira relative to the US dollar (currency depreciation) brought about 2.8% increase in the output of SMEs in Nigeria. The reason for this is not far-fetched as most of the small and medium enterprises in Nigeria depend less directly on exchange rate in terms of input and raw material sourcing. In fact, there is more local content in producing output of the SMEs in Nigeria because the sector is mostly rudimentary and unorganised. They often engage in petty trading, art and craft and low-level production just to be able to keep body and soul together. Similarly, currency depreciation means that Nigerian goods become cheaper relative to foreign goods and so, Nigerians shift emphasis away from depending on imported goods and concentrate more on



buying Nigeria-made goods; this fuels the patronage of SMEs products and boosts their output.

The coefficient of inflation conforms to theory as it shows that inflation rate in Nigeria negatively and significantly impacts on the output of the SMEs sector. A percentage increase in inflation rate causes SMEs output to fall by almost 0.7% while keeping other explanatory variables constant. This is what is being witnessed currently in Nigeria and that is the channel through which exchange rate depreciation can negatively impact the SMEs sector. The reason is that currency depreciation is often associated with fuelling inflation in the domestic economy and persistent increases in the general price level shifts aggregate demand inward thereby negatively affecting consumption, investment and even output of the SMEs and the economy at large. Interest rate however positively but insignificantly impacts SMEs output as a percentage increase in interest rate causes SMEs output to rise by about 2.7% while other variables are kept constant. This is borne out of the fact that the SMEs sector does not often obtain long term loans directly from commercial banks while only the organised private sector does. Thus, increase in interest rates means that more people are encouraged to save either in commercial or micro finance banks thereby making some cheap funds available for the SMEs which boost their output; it is not significant because SMEs source more of their funding from friends, cooperative societies and others than they source from micro finance or commercial banks.

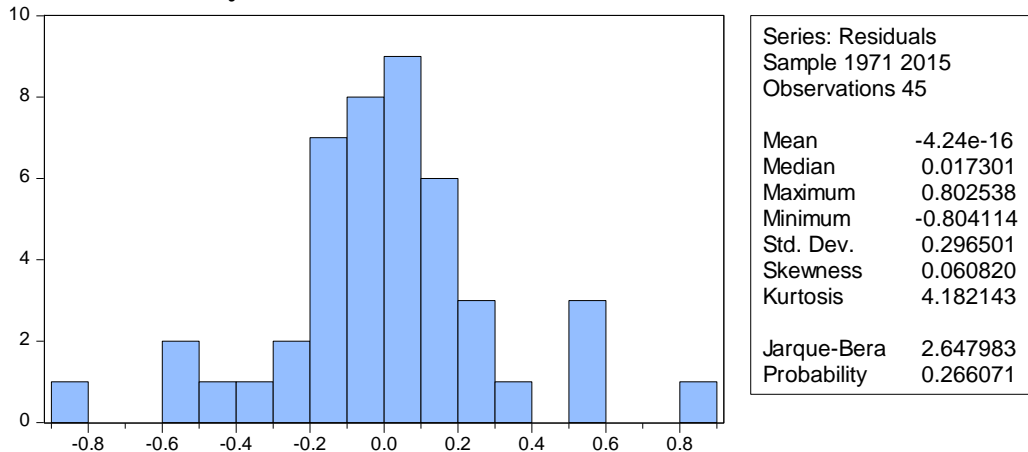
Credit to the private sector (CPS) negatively impacts the output of SMEs as a percentage increase in CPS leads to 2.5% decrease in the output of SMEs while holding other variables constant. The intuition behind this is that the increase of credits to the organised private sector crowds out the funds available for the SMEs thereby negatively affecting their output also. The most striking result reported in table 3 is that of the lag of SMEs output which is positive and significant in boosting the current value of SMEs output in the model. It thus follows that SMEs should look inward in their quest to expand production by ploughing back from their previous year's output. Whatever they have produced previously can be effectively managed to stimulate the next year's output rather than depending on the banks for succour. With regard to the aforementioned interpretations, over the period considered, we can conclude that exchange rate has positive and significant effect on the output of the SMEs sector in Nigeria. The R-squared value of 0.762462 implies that the model is a good fit as over 76% variation in SMEs output is explained by the explanatory variables in the model. Even after removing the effect of insignificant estimators, the adjusted R-squared value of 0.732009 implies that the model is still very good as about 73% variation in SMEs output is still explained in the model. The probability value of F statistic shows that the explanatory variables linearly explain changes in the dependent variable and thus the model is well specified. Also, the Durbin-

Watson (DW) value of 2.015353 suggests that the model is free of serial correlation and therefore, there is no autocorrelation in the model.

### 4.2 Residual Diagnostics Test

These tests are conducted to determine the efficiency of the estimated model.

#### 4.2.1 Normality Test



H<sub>0</sub>: Residual is multivariate normal

H<sub>1</sub>: Residual is not multivariate normal

Having considered the Jacque-Bera statistic with value 2.647983 and Probability value of 0.266071(i.e. 26.6%) which is greater than 0.05 (5%) significance level. We therefore accept the null hypothesis that the residual is multivariate normal and conclude that the residual of the model is normally distributed.

#### 4.2.2 Heteroscedasticity Test

According to Gujarati and Porter (2009), Autoregressive Conditional Heteroskedasticity (ARCH) may have an autoregressive structure, in that heteroskedasticity may be observed over different periods, hence it is needful to conduct the test for this study.

H<sub>0</sub>: There is no ARCH effect

H<sub>1</sub>: There is ARCH effect

Observation included: 43	Dependent Variable: RESID^2		H <sub>0</sub> : No ARCH effect
F-statistic	5.329446	Prob. F(5,39)	0.2008
Obs* R-squared	18.26620	Prob. Chi-Squared (5)	0.1626
Scaled explained SS	21.82941	Prob. Chi-Squared (5)	0.1506

**Source: Authors' Computation (2016)**

From the table above, both the Probability Chi-Squared values of observed R-squared (0.1626) and that of explained sum of squares (0.1506) which are

greater than 0.05 levels mean that they are insignificant. Hence, we can accept the null hypothesis that there is no ARCH effect. This is desirable for the study because it signifies that there is no heteroscedasticity problem in the model and that the variance of the residual term is homoscedastic.

## **5. Conclusion**

In this study, which covered the period of 1970 to 2015, it has been observed that exchange rate and interest rate have positive effect on SMEs output in Nigeria, which is consistent with result in Ghana (Isola, 2016), while Inflation rate and credit to the private sector have negative effect on the output of the SMEs sector. We therefore conclude that monetary policy has a very important role to play in determining the performance of the Small and Medium Enterprises in Nigeria. Hence, the central bank of Nigeria needs to come up with several policies that can enhance the performance of SMEs in Nigeria. First, the central bank can set aside a proportion of foreign exchange for the sector to enable it source some of its inputs at reasonable cost or the government should encourage the manufacturing sector to produce the desired inputs locally to lower the pressure on foreign exchange. Secondly, the micro finance banks should be made to solely concentrate on financing the operations of the SMEs through the provision of short and medium- term loans to them. This will make the high interest rate that encourages more savings to translate to more output for the SMEs sector. Moreover, with the high rate of inflation currently ravaging the Nigerian economy, the central bank needs to come up with an inflation benchmark that does not hinder the development of SMEs operators in Nigeria. More so, since empirical studies, like Selim (2013), have confirmed that the increase of credits to the organised private sector crowds out the funds available for SMEs thereby negatively affecting their output, policies should be targeted towards making sufficient funds available for small scale entrepreneurs in Nigeria. Finally, the central bank of Nigeria should ensure flexibility in its monetary policy regime and also pursue an expansionary policy that will stimulate the performance of SMEs in Nigeria.

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