EXCHANGE RATE AND STOCK MARKET PERFORMANCE IN NIGERIA

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Abstract

The study investigated the effect of exchange rate on the performance of the stock market in Nigeria. The study made use of annual data spanning a period of 1986 and 2016.The data were analysed using multiple regression analysis, augumented dickey fuller of unit root test, cointegration test and error correction model. The study revealed that exchange rate has a positive and significant effect on the performance of the stock market. It was recommended that government should fashion out ways of holding the movement of exchange rate such that it does not spiral into threshold of which it starts to undermine stock market investments in Nigeria.

Keywords: Exchange rate, All share index, foreign direct investment.

Introduction

Capital inflow is the movement of capital resources in to a country for the purpose of investment, trade or business production. Global flows to Africa have increased rapidly since 1990s for all types of private investment and capital. Financial liberalization whose key factor is free movement of capital has been experienced in the last decade. In following years there has been a growing interest among researchers in the examination of effect of foreign investor transactions on emerging stock markets. Reason behind that interest could be the view which associates foreign investor transactions and financial crises for emerging markets. According to proponents of this view, foreign investor transactions lead emerging markets to become destabilized and expose them to financial crises.

Thus, many African countries are trying to attract private capital flows. With regards to the economic weight of African countries, net private capital flows remain high. Contrary to popular beliefs, bilateral donors and international institutions are no longer the main source of funding

(capitals flows and transfer included) of investment and growth (Sayeh, 2011). With the increase of private investment on equity returns and economic growth many African countries are hosting major stock markets.

Foreign investment flows are important to nations that are recipients of these flows as they have an opportunity to benefit from less expensive modes of financing. Nevertheless, they intensify a country's susceptibility to global economic meltdown which occurs during spontaneous reversals in foreign investment flows. The economic crisis of the 1980s, Latin American and the association of South East Asian Nations in the 1990s and Argentina in 2001-02, are examples of the adverse effects result in from uncertainties in foreign portfolio flows (Chen and Quang, 2012). Although the economic turmoil in the united states of America (U.S.A) and some parts of the group of European nations in 2008-2009 may have been agitated ny many issues such as bank failures, property bubbles and government fiscal deficit, the crises were transmitted to other nations through financial intermediaries. The meltdown in these advanced economies that were believed to be resilient exposed the vulnerability of developing countries that depended on foreign inflows and the global financial system as a whole.

Foreign capital brings credit, knowledge, and discipline to the host countries, which are thought to be essential for economic growth. In addition, access to foreign funds can enhance capital allocation efficiency and productivity, and thus growth in recipient countries (Ahmed and Zlate, 2014). Yet, a number of recent studies argue against such and the other positive benefits of capital inflows. For example, capital inflows can cause a transfer of economic resources from tradable to non-tradable sectors, which are often subject to slow productivity growth (Benigno and Fornaro, 2014; Reis2013). In addition, episodes of large capital inflows increase the possibility of a sudden stop which hurt economic performance (Calvo and Reinhart, 2000) and

may trigger a shift of capital and labour out of the manufacturing sector to non-manufacturing sectors (Beningo converse and Fornaro, 2015). All in all, the jury is still out on whether capital inflows are associated with better economic growth performance.

A close survey of the Nigeria economy indicates that Nigeria has recorded the trade imbalances in most fiscal years, indicating that total payments surpassed total receipts in relation to total imports and total exports. Overall balance of payments became worse in 1999, 2002 and 2008 mostly because of increased outflow from capital accounts (CBN, 2009). Most of the capital outflow must be attributed to increased importation, declining exports mainly non-oil subsector and particular due to external debt servicing required in meeting up with resource gaps. Essien and Onvioduokit (1999) and Ariyo (1999) described debt servicing and reserve creation as fluctuating variables that create dependence on foreign capital the flows into Nigeria through foreign investor's transactions. Investments inflows are a broad term which foreign direct investment (FDI) and foreign portfolio investment (FPI).

Portfolio investment is a recent phenomenon in Nigeria. Up to the mid-1980s, Nigeria did not record any figure on portfolio investment (inflow or outflow)in her balance of payment account. The nil return on the inflow column on the account is attributable to absence of foreign portfolio investors in the Nigerian economy. This is largely because of non-internalization of the country's money and capital market as well as nondisclosure of information on the portfolio investments in foreign capital /money markets. Following a careful review of consequences of the Exchange Control Act of 1962 on the economy, after some 33years of its operation; Nigerian authorities came to the conclusion that the Act had not brought the economy any substantial benefits. The Act was judged inimical to a market driven economy. While equity trickled into Nigerians a result of the Exchange Control Act of 1962, portfolio investments dried up, because portfolio

investment required an investment climate, which guarantees speedy free entry and free exit of investment funds into and out of the country in a flash. The investment climate in Nigeria engineered by the Exchange control Act of 1962 did not guarantee the speedy mobility of funds across borders. It took the authorities more than three decades to realize that protection of the economy in a world striving to dismantle economic frontiers had not paid off., and that the capital market being the major player in the mobilization of funds for investment has to be liberalized and modernized to enable it capture enough resources for the economy from within and from outside. The Exchange control Act of 1962 was identified as a major constraint on the growth of the Nigeria capital market. Accordingly, the Act was blown away with gale force in 1995,by the strong wind of deregulation which swept across the Nigerian macroeconomic arena from the beginning of the last quarter of 1986 (Onoh, 2002). The deregulations of the securities pricing by SEC in 1993, the abolition in 1995 and the reorganization of the Nigerian stock Exchange to make more dynamic and mobile in the provision of adequate liquidity of investment bring up the operation of the Exchange to international standard and attract foreign portfolio investors. Accordingly, FGN in March 1996 set up a panel on the Nigeria stock Exchange and the panels term of reference include the reorganization of the Nigerian stock Exchange to make it more dynamic.; to recommend ways for modernizing the Exchange to bring it to international standard and to make other recommendations, which in the view of the panel, would strengthen the operation of the Exchange, and position it to deal with the domestic and international capital market challenges to the coming millennium(Onoh,2002).

Every investor wants to get better returns from investment .there are many investment opportunities around the globe, investment in stock market is one of them. The return on investment in stock market depends on various factors, the precise number of those factors is not

known yet. All share index is mostly used to determine the growth of the market as it captures the overall performance of the market. NSE all share index captures all the other performance measures such as market capitalisation, liquidity and turn over ratios.it the major determinants of market size of any stock exchange. The size of the all share index and its growth rate pose a major influence on the growth and Development of the economy.

Conceptual and Theoretical Framework

Foreign private investment is and investment made by a private individual or a private entity in a foreign country. This type of investment differs from other investments made by a foreign public or governmental entity in another country for the fact that it is made by an individual or a private entity. It can either be direct or indirect in nature, that is, foreign direct investment and foreign portfolio investment. Foreign direct investment (FDI) is a direct investment into production or business in a country by an individual or company by another country, either by buying a company in the target country or by expanding operations of an existing business in that country. Foreign direct investment is in contrast with portfolio investment which is a passive investment in the securities of another country such as stocks and bonds (Adeleke, Olowe, and Fasesin, 2014).

Foreign portfolio investment consists of securities and other fiscal resources inactively held by alien investors. Foreign portfolio investment does not provide the investor with direct ownership of financial assets, and thus no direct management of a company. This kind of investment is relatively liquid, depending on the volatility of the market invested in as is usually used by investors who do not want to manage a firm abroad. Foreign portfolio investment (FPI) is an important source of investment inflows to an economy. FPI investors usually make short term

investment in domestic security of foreign country with expectation of earning return on it after weighing the expected risk. Nigeria in the last few years had clamoured for foreign portfolio investment to the country as this is believed to be a facilitator of economic growth and development, which could lead to industrialization of the economy in the long run (Adeleke et al, 2004).

The stock market is common feature of a modern economy and it is reputed to perform functions that promote the growth and development of the economy. It is an institution that promotes efficiency in capital formation and allocation.

The capital market has been identified as an institution that contributes to the economic growth and development of emerging and developed economies. The stock market, through the provision of long term funds, enhances capital accumulation that is seen as significant tool in the process of economic growth and development. The stock market has basically been viewed as a predictor of the direction of national economy. It is a fact that if significant occurs in the share (stock) price, they are reflective of an impending recession while if significant increase occurs in the share (stock) price they are suggestive of a future economic boom (Uremadu, 2008).

Capital market is defined as the market where medium and long term finance can be raised (Akugbohungbe, 1996). It offers a variety of financial instruments that enable economics agents to pool liquidity and risk characteristics, as well as encourage savings in financial form. According to Al-Faki (2006), the capital market is a network of financial institutions, series of mechanisms, process and infrastructure, that in various ways facilitate the bringing together of suppliers and users of medium to long term capital for investment in economic development projects.

Capital Flow Liberalization Theory: Cited in Miguel and Paul (2006) argued that early and middle 1990s saw a rough consensus the openness to capital flows has salutary effects on economic growth. According to Miguel and Paul, (2009), subsequence to the Asian crisis of 1997 and the Russian crisis of 1998, the consensus unravelled. Strong and opposing views are feasible because hypothesized relationship between financial openness and future growth do not assert themselves strongly in statistics. They stated that at this point, it is not clear whether or not (and under what conditions) capital account openness and/or liberalization lead to economic growth. Also, that openness is a continuous economic concept that has most often been measured with discrete or categorical policy variables with attendant loss of statistic power. Furthermore, the argued that early studies of this issue access financial openness using single indicator variable summarizing government policies. More so, the cited Bekaert, et al (2002) which adopted measures of openness that consider richer information, such as political environment and information in stock market time series. These measures retained the featurethat openness is non-decreasing over time within most of the samples that have been studied. According to Bekaert et al (2002),the assessment of liberalization focus on time of a breakout in capital flows in an upward direction in determining liberalization occurs. Baier et al. (2004) studied investment and productivity before and after the establishment of a stock exchange. Taylor (2006) showed that policy openness is only one aspect of actual openness. These finding suggested that a more flexible measure might be useful. Data in cross-border investment flows are one possibility. Though henry (2000) showed that net investment flows are strongest on average immediately after liberalizations, there is considerable variation in the cross-section. Also, gross invested flows (i.e. inflows and outflows together) also exhibited substantial variation across countries but, on average; tend to grow slowly following liberalization. Finally, gross flows are

much larger than net flows, so outflows of funds are significant consequences of openness. Defenders of capital flow liberalization argue that foreign portfolio investment tends to increase the liquidity and the efficiency to local markets. They claim that the long-run, the expected return decreases as a result of market integration. Henry (2000) and Bekaert and Harvery (2000) address this issue and the abnormal after market liberalization. These studies argue that, with more foreign investor, start-up companies as well as existing companies are raised capital easier. The entrance of foreign investors also increases the liquidity of local market, and makes the base of investors broader, increasing the risk sharing.

Empirical Review

Exchange is the price of a unit of a given currency in relation to other currencies. The performance and profitability of industries and companies that are major importers or heavy users of imports are considerably affected by the exchange rate of the Naira against major currencies of the world (Osamwonyi 2003). Exchange rate is a product of a country's external trade and directly related to the balance of payments. Balance of payments deficit and the level of external reserve usually influence exchange rate. There is paucity of literature on the effect of exchange rate on stock price behavior. The theoretical postulation states that there is a positive relationship between exchange rate and stock returns. Maku and Atanda (2010) shows that stock returns and depreciating Naira rate are positively related.

Model Specification:

Multiple Regression Model

Functionally, $ASI=f(FDI,FPI,EXR)$,

Mathematically, $ASI=B_0+B_1FDI+B_2FPI+B_3EXR+e$

Converting the above equation into log-linear form, we have:

$LogASI=B_0+B_1logFDI_t+B_2logFPI_t+B_3logEXR_t+e_t$

The a-priori expectation of the slope coefficient is:

$B_o>0$; $B_1>0$; $B_2>0$ and $B_3>0$.

Error Correction Model

$dASI=B_0+B_1dFDI_{t-1}+B_2\ dFPI_{t-1}+B_3\ dEXR_{t-1}+ECM+e_t$

Augmented Dickey Fuller Model

$dY_t=a_0+a_1Y_{t-1}+\ b_1dY_{t-1}+e_t$

where,

ASI=All-share index proxy for stock exchange performance

FDI=foreign direct investment

EXR=exchange rate

B_i=coefficient parameters of the variable or a_i

e=stochastic error term

d=change

ECM=error correction model

The result of the dependent variable ASI indicates that its mean value during the period under study is 15623.95, maximum value 57990.20 and minimum 163.800. On the other hand, EXR shows an average of 90.31806 during the period under study with the maximum and minimum of 305.000 and 1.75000 respectively.

In order to have an first insight into the order of integration of the individual variables ,Augumented Dickey Fuller unit root test was conducted for this study and the result presented below:

Table 2: Unit Root Test

VARIABLE	ADF at level	ADF at first difference	Order of integration
ASI	-2,631672	-3.803834***	1(1)
FDI	-2.385838	-8.802471***	1(1)
FPI	0.050594	-6.026549***	1(1)
EXR	-2.518820	-5.527176***	1(1)

Source: E View Version 8

Note: Test critical value at i% =-3.67, 5%=-2.96, and at 10%=-2.62.

Asterisks *,**,and *** represents 10%,5%, and 1%.

The ADF unit root test result above showed that all the variables were not stationary at level as their values in absolute terms are less than their critical value at 5% level of significance. However, all the variables became stationary after the first difference.

Result and discussions

In order to have a first insight into the nature and trend of the individual variables, descriptive analysis was conducted for this study and the result presented below:

Table 1: Descriptive statistic result

Variables	observations	Mean	Maximum	Minimum
ASI	31	15623.95	57990.2	163.8000
FDI31		404861.4	1360308	735.8000
EFI31		299735.8	2687233	151.6000
EXR31		90.31806	305.0000	1.75OO

SOURCE: E VIEW VERSION 8

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Asterisks *,**,and *** represents 10%,5%, and 1%.

Johansen cointegration test

Table 3: Panel A: Trace statistic

Hypothesized No. of CE	Eigen value	Trace statistic	.05 critical value	Prob.**
None*	0.569316	59.52236	47.85613	0.0028

At most 1*	0.544593	35.09333	29.79707	0.0112
At most 2	0.251711	12.2830015.49471	0.1439	
At most 3*	0.125048	3.8739963.641466	0.0490	

Source: E View Version 8

Table 3: Panel B: Max-eigen statistic

Hypothesized No. of CE	Eigen value	Max-eigen statistic	.05 critical value	Prob.**
None*	0.569316	24.42903	27.58434	0.1204
At most 1*	0.544593	22.81033	21.13162	0.0288
At most 2	0.251711	8.409003	14.264600.3386	
At most 3*	0.125048	*3.8739963*.841466	0.0490	

Source: E View Version 8

Note: Max-Eigen value tests indicate 2 cointegrating equation at the 0.05 level of significance

Denotes rejection of the hypothesis at the 0.05 level

Table 5: Pasimonious Result for the study

Dependent variable: D(LogASI)

Method: Least squares

Date:10/11/2018< Time:9:30amSample(adjusted): 1987-2016

Included observations: 30 after adjustments

Variable	Coefficient	Standard error	t-statistic	Prob.
C	1.376784	0.407807	3.376066	0.0024
LOGFDI(-1)	-0.145135	0.069501	-2.088236	0.0471
LOGFPI(-1)	-0.037256	0.027100	-1.374368	0.1814
LOGEXR(-1)	0.222378	0.104130	2.135585	0.0427
ECM(-1)	-0.355236	0.117651	-3.019413	0.0058
R squared		0.464488	Mean dependent variable	0.170010

Adjusted R squared	0.378806	S.D.dependent Variable	0.309931
S.E. of Regression	0.244275	Akaike Information criterion	0.169967
Sum squared residual	1.491757	Schwarz criterion	0.403500
Log Likelihood	2.450489	Hannan-Quinn criterion	0.244677
T-statistic	5.42068	Durbin-watson criterion	1.707625
Prob.(t-statistic)	0.002770		

Source: E View Version 8

$ASI=B_0+B_1FDI+ B_2FPI+B_3EXR+e$

ASI=1.38-0.15FDI -0.04FPI+ 0.22EXR+e

The above table showed that there exists a positive and significant relationship between one-year lagged EXR and stock market performance, proxies in ASI in Nigeria. This means that 1% increase in EXR leads to 22% increase in stock market performance. The probability value of EXR (0.042) is less than the test significant level (0.05).With this, we conclude that EXR has significant effect on stock market performance in Nigeria in the short run. This collaborates with the study of Koskei (2017), who found out that FPI has no effect on stock returns of listed institutions in Kenya.

Furthermore, an important feature to notice is the coefficient of error correction term. This carries the correct sign and it is statistically significant at 5% level with the speed of adjustment to equilibrium of 36%. This implies that in the short run, the economy adjusts by 36%of the past years deviation from equilibrium. This indicates that the speed of adjustment to equilibrium is relatively low. This is essential for maintaining long run equilibrium to reduce the existing disequilibrium over time. This result justifies the use of an ECM specification of the model in the study.

The coefficient of determination measured by adjusted $R^{2,}$ showed that 46% of the variations in stock market performance, proxies by Log ASI are explained by changes in independent variables (FPI,EXR). Hence, the remaining 54% of the variations are due to other factors (which may be qualitative), not included in the model.

Finally, the Durbin-Watson statistic (1.70) which is approximately 2, showed that there is no presence of autocorrelation being that 2<=DW>=4. Most interestingly, the Durbin Watson statistic exceeds the R-squared value ($DW>R^2$) which indicates that the regression result is not spurious.

Conclusion and recommendation

The study also found out that exchange rate has a positive and significant effect in stock market performance in Nigeria exchange rate was introduced as an explanatory variable while all share index of the Nigeria stock exchange served as the proxy for stock market performance. The study made use of annual data spanning 1986 to 2016. Findings showed that foreign direct investment has a negative and significant effect on stock market performance. In conclusion, the study argued that foreign investment inflows have significant effect on stock market performance in Nigeria.

The study recommends that the government should fashion out ways of holding the movement of the exchange rate such that it does not spiral into thresholds in which it would start to undermine stock market investment in Nigeria.

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