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MONETARY POLICY AND STOCK MARKET PERFORMANCE IN NIGERIA

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ABSTRACT

The study examined the effect of monetary policy on stock market performance in Nigeria. It employed intermediate monetary policy targets as proxies for monetary policies of the Central Bank of Nigeria and All Share Index as proxy for stock market performance. Monetary policy variables include money supply, interest rate and exchange rate all of which were obtained from the CBN statistical bulletin. The time frame covered 1986 to 2015. Statistical analysis employed was OLS regression technique. The results showed that money supply and exchange rate fluctuation have significant positive effect on stock market price movement, while Interest rate has insignificant negative effect on stock market price movement. On the overall, the results show that monetary policy variables significantly determines 94% of the stock market performance movements in Nigeria. The study posits that monetary policy has a very high determining influence on stock market performance which implies that monetary policy can be used to control stock market activities in Nigeria. It thus recommends, among others that the monetary authorities should make information relevant for securities available to the stock market participants and also make sure the transparency and accountability of audit reports.

KEY WORDS: *Monetary Policy, Stock Market, Broad Money Supply, Interest Rates, Exchange Rate*

INTRODUCTION

A good number of developing economies have joined the developed world in recognising the usefulness and importance of stock market in improving the quality and efficiency of domestic financial system. With the exposure of local markets to the international community, the global capital market has become inevitable. Thus economies crave for development stock so as to enhance its growth. This attracted the attention of many researchers to investigate the variables affecting stock markets (Aliyu, 2009). Monetary policy is one of the economic tools used mostly by central banks to

influence economic variables such as GDP, industrial production index, consumer price index, exchange rate or the inflation rate. One of the most popular monetary tools applied by central bank is to alter the short term interest rate to achieve the macroeconomic goals of government.

Fama's (1981) Efficient Market Hypothesis (EMH), states that investors should know, all the necessary or relevant information regarding their investment and also about profit maximizing and the macroeconomic variables which might lead to a supernatural earning. This clearly indicates that stock price actually reflects the shocks from

macroeconomic variable. In case of the existence of EMH in capital market, markets become efficient. Therefore we can say that stock market plays the vital role to transfer of funds from capital borrowers to capital investors which is very essential for economic growth. Therefore, in order to understand how monetary policy changes transmit to the economy and how the market responds to the changes is important for both policy makers and investors.

Stock market, especially in small economies, plays a very vital role in mobilizing economic resources within and from outside the economy to achieve greater and better economic potentials. The market, therefore, serves as an important conduit through which funds flow from individuals and corporate bodies across the globe to investors residing in a particular economy. According to Karolyi (2001) cited in Aliyu (2010) strong asymmetric relationship exists between stock returns and stock returns volatility, and stock price volatility is higher when stock price decreases than when price increases.

The three most noted monetary policy targets are interest rates, monetary aggregates, and exchange rates. These targets are usually intermediate targets that can be quickly achieved and easily measured, but then move the economy towards the ultimate macroeconomic goals of full employment, stability, and economic growth. (http://www.amosweb.com/cgi-bin/awb_nav.pl?s=wpd&c=dsp&k=monetary%20policy%20targets). However, Omotor (2011) observes that monetary policy was ineffective particularly because the CBN lacked instrument autonomy and goal determination, being heavily influenced by the political considerations conveyed through the Ministry of Finance. It thus becomes pertinent to examine the extent to which these monetary policy targets influence stock market performance in Nigeria.

A review of recent empirical studies showed that monetary policies have significant effect on stock market performance (Ajie & Nenbee, 2010; Okpara, 2010; Aliyu, 2010; Nwakoby & Alajekwu, 2016; Onyeke, 2016; Adekunle, Alalade & Okulenu, 2016; and Nkoro & Uko, 2016) and elsewhere (Barakat, Elgazzar & Hanafy, 2016; Bissoon, Seetana, Bhattu-Babajee, Gopy-Ramdhany & Seetah, 2016). Critical review showed that none of the studies employed all the three intermediate monetary policy targets of money supply, interest rate and exchange rate in one model, rather a mixture of monetary policy targets and price-based tools abound. This study thus intends to fill this technical gap in the study of monetary policy – stock market nexus, especially in Nigeria.

Furthermore, theoretically, the efficiency market hypotheses expects that prices of stock will reflect all macroeconomic information including the changes in monetary policy instruments and targets. However, the theoretical alignment of present value of stock reflecting today's information as postulated in Efficient Market Hypothesis, and the anticipated

future returns affecting today's stock price as proposed by the discounted cash flow model, is at least, confusing.

The main objective of the study is to examine the effect of monetary policy on stock market performance in Nigeria. Specifically, the study aims:

1. To examine the effect of money supply on stock market performance.
2. To determine the effect of interest rate on stock market performance.
3. To find out the effect of exchange rate on stock market performance.

Hypotheses

Ho1: Money supply movements has no significant effect on stock market price movement.

Ho2: Interest rate movements has no significant effect on stock market price movement.

Ho3: Exchange rate fluctuations has no significant effect on stock market price movement.

LITERATURE REVIEW

Conceptual Framework

The concept of monetary policy is related to measures designed to influence the availability, volume and direction of money and credits to achieve the desired economic objectives. In the view of Folawewo and Osinubi (2006), it is a combination of measures designed to regulate the value, supply and cost of money in an economy, in consonance with the expected level of economic activity. It is also the discretion of the overseer of a country's money supply (usually a central bank) to regulate the amount of money in the economy in order to control aggregate demand (Mortimer, 2012). Specifically, monetary policy cuts across all the articulated strategies and efforts of the monetary authorities to control the money supply and credits conditions for the purpose of achieving diverse macroeconomic objectives.

In order to maintain monetary stability, the Central Bank uses the deposit money banks to implement policies that guarantee the orderly amount and development of the economy through appropriate changes in the level of money supply (Masha, Essien, Musa, Akpan & Abeng, 2004). The reserves of the banks are influenced by the Central Bank through its various instruments of monetary policy. These instruments include the cash reserve requirement, liquidity ratio, open market operations and primary operations to influence the movement of reserves. All these activities affect the banks in their credit operations and thus influence the cost and availability of loanable funds. Thus, the financial market provides a useful channel for the implementation of monetary policy.

The financial market comprising the money and capital market, is an organized institution that is meant for the sale and purchases of funds. Money market deals in short-term securities while capital markets specialize in the mobilization of long-term funds for the purpose of rapid economic growth and development (Ajie, 2006). The segment of the capital

market that deals in buying of new issues is the primary market while the second segment is the secondary markets that consists of exchanges and over-the-counter market where securities are bought and sold for their issuance in the primary market. The capital market generally defined as the market where medium to long-term finance can be raised (Akingbohunge, 1996), facilitates the buying and selling of securities such as shares and bonds (Pandey, 2002). The amount of funds available for mobilization and allocation in the financial market depends on a host of factors including disposable income, consumption pattern, price level, financial intermediation, market confidence and integrity.

Summarily, a robust capital market is only feasible through a well formulated and implemented macroeconomic policies (especially monetary policy) (Ajie & Nenbee, 2010). It is thus expected that there should be a linkage between monetary policy and stock market performance. Stock market all share index has been used by most authors as a means of measuring stock market trends and performance (Nwakoby & Alajekwu, 2016; Barakat, Elgazzar & Hanafy, 2016; Onyike, 2016; Adekunle, Alalade & Okulenu, 2016). The index is an indicator monitoring upswings and downswings in the stock market (SEC, 2006:15).

Theoretical Framework

The goal of every economy is to pursue basic economic goals such as full employment, price stability, and economic growth. Anyanwu (1993:147) in Ajie and Nenbee (2010) noted that the choice of a monetary policy target variable requires some theoretical hypothesis as to the interrelationship between the target variable and the ultimate goal variable.

This study is hinged on the discounted cash flow model which posit that stock prices are equal to the present value of expected future net cash flows. Thus monetary policy should then play an important role in determining equity returns either by altering the discount rate used by market participants or by influencing market participants' expectations of future economic activity. These channels of influences are interlinked since more restrictive monetary policy usually implies both higher discount rates and lower future cash flow (Thorbecke, 1997).

Monetary policies that reduces the monetary aggregates (contractionary monetary policy) should then be associated with lower stock prices because of the resultant higher discount rate for the expected stream of cash flows and/or lower future economic activity. On the other hand, an expansionary monetary policy should usually be seen as positive business period since it is associated with low interest rates, increases in economic activity and higher earnings for the firms in the economy. As a result, stock market participants give high interest in understanding business trends from the stand point of the monetary authority as inferred by changes in indicators of central bank policy. Finance analysts

have relied on the reactions to monetary policy shifts in interpreting asset price movements (Patelis, 1997). Changes in exchange rate, interest rate or money supply may affect stock market movement, thus this theoretical background have prompted the need to find out whether and to what extent does monetary policy influences stock market performance.

Empirical Review

Ajie and Nenbee (2010) investigated empirically the relationship between monetary policy and stock prices in the Nigerian stock exchange market. The data employed were money supply, interest rate and stock prices spanning 1986 to 2008 and were analysed using the co-integration and Error correction modelling (ECM). The findings indicated revealed that both money supply and interest rate had short run significant effect on stock prices.

Okpara (2010) employed the Two Stage Least Squared Method on a set of simultaneous equations to investigate the effect of monetary policy on the Nigerian stock market returns between 1985 and 2006. The all share index was dependent variable of the study while Treasury bill rate, interest rate and monetary policy rate were employed as the monetary policy tools. Data were analysed using the Augmented Dickey Fuller Unit Root Test and Cointegration Test, Vector Error Correction Model and the Forecast Error Decomposition Analysis. The study found that monetary policy is a significant determinant of long-run stock market returns in Nigeria.

Aliyu (2010) employed the generalized autoregressive conditional heteroskedasticity (GARCH) model to examine the impact of inflation on stock market returns and volatility using monthly time series nominal stock return and inflation rate data from Nigeria and Ghana covering 1998 to 2010. In addition, the impact of asymmetric shocks was investigated using the quadratic GARCH model developed by Sentana (1995), in both countries. Results for Nigeria show weak support for the hypothesis which states that bad news exert more adverse effect on stock market volatility than good news of the same magnitude; while a strong opposite case holds for Ghana. Furthermore, inflation rate and its three month average were found to have significant effect on stock market volatility in the two countries.

With the help of monthly data ranging from January, 2003 through December, 2013, Rifat (2015) investigated the extent to which monetary policy tools such as inflation, real output, money supply, exchange rate can explain stock market returns in Bangladesh. The study used Johansen Cointegration test, Vector Error Correction, and Vector Autoregressive Model. It was found that there is no significant relationship between monetary policy instruments and stock market in Bangladesh.

Nwakoby and Alajekwu (2016) used the price-based monetary policies to investigate the effect of monetary policies on stock market

performance in Nigeria within 1986 and 2013. All Share Index was used as the indicator of stock market performance while the explanatory variables included monetary policy rate, Treasury bill rate, lending interest rate, liquidity ratio and deposit rate. The co-integration result indicates that there is long run relationship between monetary policy and stock market performance in Nigeria. The method of data analyses used are the Johansen co-integration, OLS and granger causality tests. The findings show that monetary policy has the potential (53%) to influence the stock market, but the causality analyses showed that monetary policy cannot influence stock market performance but rather stock market performance has influenced the direction of monetary policy in Nigeria through lending and deposit rates.

With the help of monthly time series, Barakat1, Elgazzar and Hanafy (2016) examined the relationship between the stock market and macroeconomic factors in two emerging economies of Egypt and Tunisia for the period from January 1998 to January 2014. The macroeconomic factors considered are effect of Consumer Price Index, Interest on Deposit, National Currency exchange rate Per USD and broad money supply on the market Index. The econometric tools included ADF, Johansson co-integration, VAR and granger causality tests. Results indicated that there is a causal relationship in Egypt between market index and consumer price index (CPI), exchange rate, money supply, and interest rate. The same goes for Tunisia except for CPI, which had no causal relationship with the market index. Results also revealed that the four macroeconomic variables are co-integrated with the stock market in both countries.

Onyeke (2016) investigated the impact of monetary policy on stock returns in Nigeria over a monthly time period covering January 2003 to June 2014. The explanatory variables employed are consumer price index, inter-bank rate, open buy-back, Treasury bill rate, and exchange rate while the all share index is the dependent variable. The dynamic interactions among the variables are based on variance decompositions and impulse response functions generated from the VAR. The estimated results revealed that monetary policy variables did not have a significant impact on the prices of stock in Nigerian equity market.

Bissoon, Seetah, Bhattu-Babajee, Gopy-Ramdhany and Seetah (2016) employed a panel data from five open countries to investigate the impact of monetary policies on stock markets covering the period of 2004 to 2014. The explanatory variables of interest rate and money supply were regressed on stock returns from Mauritius, London, Trinidad, Australia and Japan. Using a random effect model for the panel regression coupled with a panel vector error correction model to study the short term and long term relationship between the variables, the findings reveal a negative relationship between interest rate and stock return and a direct link between money

supply and stock return. The results confirm that both in the short run and long run monetary variables explain changes in stock return.

Adekunle, Alalade, and Okulenu, (2016) examined the effect of macroeconomic pricing variables such as interest rate, inflation rate, and exchange rate on capital markets growth between 1985 and 2013. Both simple and multiple regression analysis of the ordinary least square was employed estimate the specified model equations. Findings of the study revealed that interest rates have an adverse effect on capital market growth as proxied by all share index. However, inflation rate and exchange rate are not significant, especially at the 5 percent level of significance. Further result revealed that the negative linkage between interest rate and All Share Index sufficiently proved when independently examined, multiple regression with variables such as inflation rate and exchange rate, shows dominance effect on the dependent variable.

Nkoro and Uko (2016) investigated the relationship between exchange rate and inflation volatility and stock prices volatility in Nigeria, using time series quarterly data from 1986Q1-2012Q4. The volatilities of exchange rate and inflation in this study were calculated using standard GARCH(1,1) models. The relationship between exchange rate, inflation volatility and stock prices volatility was examined using GARCH(1,1)-S models of an extended GARCH-X models. The findings of the study show that there is a negative relationship between stock market prices volatility and exchange rate and inflation volatility in Nigeria.

Summary of Literature

Most of the studies reviewed both in Nigeria (Ajie & Nenbee, 2010; Okpara, 2010; Aliyu, 2010; Nwakoby & Alajekwu, 2016; Onyeke, 2016; Adekunle, Alalade & Okulenu, 2016; and Nkoro & Uko, 2016) and elsewhere (Barakat, Elgazzar & Hanafy, 2016; Bissoon, Seetah, Bhattu-Babajee, Gopy-Ramdhany & Seetah, 2016) posited that monetary policy have significant effect on stock market performance, safe for the work of Rifat (2015) in Bangladesh which posited the otherwise. The findings are indicative that monetary policy can be used to control the activities on the stock market. Hence economies that want to boost economic growth through stock market development can explore monetary policies. However, all the studies employed either an incomplete monetary policy targets or in combination with the monetary policy instruments. The present study used only the three core intermediate monetary policy targets (interest rate, monetary aggregates and exchange rate) in examining the monetary policy – stock market performance nexus.

METHODOLOGY

The study adopted the *expost facto* research design that enable it to collect already existing secondary data from official publications of reputable organisations without the intention of manipulating or

altering the figures. The data for the study were obtained from the Central Bank of Nigeria (CBN) Statistical Bulletin, 2016 edition. The quarterly data covering 1986 to 2015 were collected to account for the use of monetary policies in the liberalised Nigerian economy only. The data collected included broad money supply (M2), Gross Domestic Product, real interest rate, real exchange rate of Nigerian Naira to US dollar, and the Nigerian Stock exchange All Share Index. The data on M2 was divided with GDP to obtain financial deepening which is used as proxy for depth of money supply in this study.

Model Specification

Theory has shown that the major desire for monetary policy are full employment, price stability, economic growth. These aims are achievable through the three major intermediation monetary policy targets which are interest rates, monetary aggregates, and exchange rates. The use of these three variables is a modification of the works of Ajie and Nenbee (2010) (money supply, interest rate), Rifat (2015) (inflation, real output, money supply, exchange rate), Barakat1, Elgazzar and Hanafy (2016) (Consumer Price Index, deposit rate, exchange rate & money supply), Bissoon, Seetannah, Bhattu-Babajee, Gopy-Ramdhany and Seetah (2016) (interest rate and money supply), and Adekunle, Alalade, and Okulenu, (2016) (interest rate, inflation rate, and exchange rate). These studies like the present study used only the monetary policy targets in the study of the effect of monetary policies on stock market performance.

The modified model is thus:

$$ASI = f(M2, INTR, EXCHR)$$

The equation form of the model is thus:

$$ASI = \alpha_0 + \beta_1 M2 + \beta_2 INTR + \beta_3 EXCHR + \mu$$

In line with Rifat (2015), all the variables were converted to natural logarithm in order to smoothen the stochastic effect of time series.

Thus the model employed for the study is:

$$\ln ASI = \alpha_0 + \beta_1 \ln M2 + \beta_2 \ln INTR + \beta_3 \ln EXCHR + \mu$$

Where:

ASI = All Share Index of the Nigerian Stock market as proxy for stock market performance. This is the dependent variable of the study.

M2 = money supply as proxy for monetary aggregates represented in this study by financial deepening measured by M2 divided by GDP.

INTR = Interest rate measured as maximum lending rate

EXCHR = exchange rate of Nigerian Naira to US dollar measured as Monthly Average Official Exchange Rate of the Naira (N/US\$1.00).

\ln = the natural log of the variables that is introduced to smoothen the stochastic effect of time series.

α_0 = constant

$\beta_{1,3}$ = the coefficients of the independent variables.

Method of Data Analyses

The Ordinary Least Square (OLS) technique was employed to analyse the multiple regression model developed for the study. The model was first tested for reliability using the Variance Inflation Factor (VIF) test for multicollinearity and Durbin-Watson statistics of autocorrelation.

The study relied on OLS because it has the criteria of being Best Linear Unbiased Estimator of linear relationship. The decision rule for test of hypotheses is to reject the null hypotheses for calculated significance value below 5% level of significance. The statistics of OLS used to address the objectives of the study are the coefficient of determination (R^2), the coefficient of regression, t-statistics and F-statistics. The Coefficient of Determination (R^2) measures the explanatory power of the independent variables on the variables in the dependent variable. Student T-Test measures the individual significance of the estimated independent variables; whereas the F-statistics measures the overall significance of the independent variables.

Multicollinearity is a condition that results to inflation of the results thereby making the OLS estimators imprecisely estimated (Ranjit, 2006). Ranjit(2006) posited that the decision rule for using the VIF for estimation of multicollinearity is thus: "if any of the VIFs exceeds 10 (or 5), it is an indication that the associated regression coefficients are poorly estimated because of multicollinearity"

However, the Durbin-Watson (DW) test for autocorrelation was used. This is used to check for the appropriateness of the models for analysis. Any equation with Durbin-Watson less than or greater than values not approximately 2, is not acceptable. Unacceptable Durbin-Watson suggests that the analysis cannot be relied on.

RESULTS AND INTERPRETATION

The model estimated result is presented on Table 1 below. The results of the Variance Inflation Factor (VIF) (for multicollinearity) and Durbin Watson statistics (for autocorrelation) were used to determine the reliability of the model used. The result of the OLS estimation is presented on Table 1 below. The Table shows the statistics for reliability test, and model estimation.

Model	Unstandardized Coefficients		Standardized Coefficients	T	Sig.	Collinearity Statistics	
	B	Std. Error	Beta			Tolerance	VIF
(Constant)	5.797	1.489		3.892	.001		
1 LnM2	.385	.130	.449	2.966	.006	1.101	4.937
LnINTR	-.851	.478	-.094	-1.779	.087	.831	1.203
LnEXCHR	.748	.211	.551	3.543	.002	1.095	0.472
Coefficient of Determination (R ²) = 0.94							
Adjusted R ² = 0.93							
Durbin-Watson = 1.631							
F-statistics = 135.751							
F-Probability = 0.000							

a. Dependent Variable: LnASI

Reliability of the Model

From Table 1, the VIF for each of the explanatory variables are 4.937 for LnM2, 1.203 for LnINTR and 0.472 for LnEXCHR. The VIF for all the variables are below the value of 5. This implies that there is no multicollinearity in the model. Again, the result of the Durbin Watson statistics is given as 1.63. The result is approximately equal to 2. This implies that there is no presence of autocorrelation in the model. Both results suggest that the result of the OLS regression model is reliable.

Model Estimation

The result of the coefficient of determination (R²) is 0.94 which indicate that about 94% of the changes in the dependent variable can be explained by the independent variables. This suggests that monetary policy variables (interest rate, money supply and exchange rate) explains 94% of the changes in all share index (ASI) in Nigerian stock market. However, the F-statistics is 135.751 with probability value of 0.000. Since the p.value is less than 0.05 level of significance, we reject the null hypotheses that monetary variables do not have effect on stock market performance. This implies that monetary policy variables significantly determines 94% of the stock market performance movements in Nigeria.

The coefficient of regression of the independent variables were used to address the specific objectives of the study.

Ho1: Money supply has no significant effect on stock market price movement.

The coefficient of LnM2 is 0.385. This indicate that the relationship between money supply and All share index is positive. This suggests that a unit increase in money supply will lead to 0.39 units of increase in all share index (ASI). The t-statistics is 2.966 with a p.value of 0.006. Since the p.value is less than 0.05 level of significance, we reject the null hypothesis and then conclude that money supply movements has significant effect on stock market price movement. This supports the work of Barakat, Elgazzar & Hanafy, (2016)

Ho2: Interest rate movements has no significant effect on stock market price movement.

The coefficient of regression for LnINTR is -0.851 indicating that interest rate has negative effect on all share index (ASI). This means that a unit increase in interest rate will lead to decrease in all share index by 0.85 units. The t-statistics is -1.779 with a p.value of .087. Since the p.value is greater than 0.05 level of significance, we do not reject the null hypothesis and then conclude that interest rate has no significant effect on stock market price movement. The findings here is in line with Nwakoby & Alajekwu, (2016).

Ho3: Exchange rate fluctuations has no significant effect on stock market price movement

The coefficient of LnEXCHR is 0.748. This indicate that the relationship between exchange rate and all share index (ASI) is positive. This suggests that a unit increase in exchange rate will lead to 0.748 units of increase in all share index (ASI). The t-statistics is 3.543 with a p.value of 0.006. Since the p.value is less than 0.05 level of significance, we reject the null hypothesis and then conclude that exchange rate fluctuation has significant effect on stock market price movement. The empirical study of Adekunle, Alalade, and Okulenu, (2016) supports the findings.

Summary and conclusion

The study examined the effect of monetary policy on stock market performance in Nigeria. It employed intermediate monetary policy targets as proxies for monetary policies of the Central Bank of Nigeria and All Share Index as proxy for stock market performance was the dependent variable. Monetary policy variables which include money supply, interest rate and exchange rate were the explanatory variables all of which were secondary data obtained from the CBN statistical bulletin. The time frame covered 1986 to 2015 and adopted the ex post facto research design. Statistical analysis employed was OLS regression technique.

On the overall, the findings show that monetary policy variables significantly determines

94% of the stock market performance movements in Nigeria. Specifically,

1. Money supply movements has a significant positive effect on stock market price movement in Nigeria.
2. Interest rate has insignificant negative effect on stock market price movement in Nigeria.
3. Exchange rate fluctuation has a significant positive effect on stock market price movement in Nigeria.

With the help of the major intermediate monetary policy targets, the study has investigated the effect of monetary policy on stock market performance in Nigeria. The results showed that monetary policy has a very high determining influence on stock market performance which implies that monetary policy can be used to control stock market activities in Nigeria. Thus monetary policy is the very tool for management of capital market in Nigeria. The influences are positive from money supply and exchange rate fluctuation. Efforts made to stabilise money supply and exchange rate is capable of enhancing market performance growth in Nigeria.

Further results showed that a high interest rate can attract more savings and discourages the flow of capital to the stock markets leading investors to demand for a higher risk premium which impedes investment and slows down stock market performance in Nigeria. On the contrary, a low interest rate can encourage higher capital flows to the stock market in expectation of a higher rate of return. This effect is not feasible since interest rate does not have significant effect in Nigeria.

5.3 Recommendations

The development of stock market in Nigeria requires trained professionals who understand the workings of monetary policy. Thus, the board of Nigerian stock exchange should be head, not just by a professional guru, but also a specialist in economics and finance.

Also, the monetary authorities should make information relevant for securities available to the stock market participants and also make sure the transparency and accountability of audit reports.

Furthermore, monetary authorities should exercise restraint in the use of policy instruments indiscriminately, because it is clearly evidenced that the use of monetary policy instruments affects the performance of the stock market to a very large extent.

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