The Effects of Trade Openness and Exchange Rate on Stock Market Capitalization Growth in Nigeria

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ABSTRACT

This study examines the linkage among trade openness, exchange rate on stock market capitalization growth in Nigeria, using annual data from 1981 to 2017. In conducting the analysis, this study utilized Vector Error Correction model and Granger Causality tests. Trade openness, foreign direct investment, exchange rate, balance of payment and stock market capitalization growth were captured in the model. The results show that trade openness, and balance of payment have positive and statistically significant impact on stock market capitalization growth in Nigeria, while foreign direct investment and exchange rate have negative and statistically significant influence on stock market capitalization growth over the study period which validates the unfavorable side of demand and supply theory. Granger causality results indicated that there is unidirectional causality running from trade openness, foreign direct investment, exchange rate and balance of payment to stock market capitalization growth. This study recommends the following: a need for policymakers to ensure effective implementation of existing monetary policy instruments and device strong way of harmonizing monetary and fiscal policies in order to maintain stable exchange rate and avoid structural break that affect the whole system including the stock market capitalization growth. There is the need for government to intensify its efforts in diversifying the economy that will help to have more active economic sectors that can contribute positively in reducing the existing foreign direct investment, exchange rate, crises and even boost the investment in the stock market capitalization growth.

1. Introduction

Efficient trade openness, Exchange rate stability and stock market capitalization growth are the three economic objectives that every country needs to achieve, this is because the financial position of every economy be it developed or developing can be accessed from its

exchange rate stability (Bala and Hassan, 2018). Trade openness in the developing countries became a household terminology in the 1990s, which in term of definition, is, external opening of the economy and increase role of markets domestically (that is the market economy) to developing world, modern way of running an economy (Loto, 2010). The essence of trade openness mainly is as a basis for moving the economy towards external liberation, focusing on market oriented system of government. Since the late 1980s, the pace of trade openness has rapidly quickened with the world trade rising nearly as fast as world Gross Domestic Product. This has been characterized by the trade openness; Exchange rate stability and stock market capitalization growth are accelerated by private capital flows (Adam, 2003). The recent growth of stock exchange market, through increase in cross-border capital movement has been attributed to the removal of statutory restriction on the capital account transactions and economy liberalization. (International Monetary Fund, 2003) attributed another impact of growth of stock market globally on macro-economic stabilization policy reforms in the developing countries which is privatization, liberalization of trade and growth of stock. Stock exchange is a medium to encourage savings, help channel savings into productive investments. The emphasis on the growth of stock market for domestic resource mobilization has also been strengthened by the need to attract foreign capital (Idele, 1999).

According to (Hassan, Abubakar, and Dantama, 2017) a very strong exchange rate is a signal that shows strong and viable stock market capitalization growth. While on the other hand a very weak currency is a reflection of a very vulnerable and weak stock market capitalization growth. Exchange rate instability has real stock market capitalization growth shocks because it negatively affects prices level, firms' profits and even the entire activity in an economy. Similarly, stock market plays crucial role in economic development of every nation, stock market serves as a transmission mechanism upon which savings are mobilized and adequately distributed across the economic sectors with the view to realize inclusive growth. Exchange rate and stock market price are interconnected directly or indirectly, because today, world is turning into a global village due to trade liberalization and globalization. For instance, foreign investors are busy investing their capital in the world stock markets. In this process international investment is booming rapidly and capital is moving across the world (Bala and Hassan, 2018). The benefits of these investors are being determined by foreign exchange rate. Moreover, instability in the exchange rate may bring

about uncertainty or otherwise in these investors. Thus, exchange rate is the important determinant of stock market fluctuations (Khan and Ali, 2015). In Nigeria, the value of naira experienced high degree of volatility recently, for example, statistical records have shown that from 2006 to 2008 the value of naira to US$ was 125, which further depreciated from 150.3 in 2010 to average of 153.90, 156.81, 305.25 and 306.45 per US$ dollar in 2011, 2013, 2017 and 2018 respectively. In the same vain the stock market moves so strong in the same direction with the currency exchange rate, statistically, stock market collapsed by about 70% between 2008-2009. In addition, the All Share Index (ASI) as measure of stock market performance has persistently declined from 65,652.38 in 2008 to less than 30,000.00 points in 2012. It however, increases from 31,853.19 to 41,210.10 points between 2013 and 2014, after which in continuously declined to less than 31,853.19 points from 2015 to date (Central Bank of Nigeria, 2018).

A liquid stock market development offers the potential for investors to quickly and cheaply alter their portfolios thereby reducing the riskiness of their investment, thus, facilitating investments in projects that are more profitable (Ezeabisili and Alajekwe, 2012). Without a liquid stock market, many profitable long-term investments would not be undertaken because savers would be reluctant to tie up their investments for long periods of time (Okonkwo, Ogwuru and Ajudua, 2014). A well-functioning stock market fosters growth and profit incentives and also helps in risk management (Beck and Levine 2012). It has also been observed that more developed market may provide liquidity that lowers the cost of the foreign capital essential for development, especially in low income countries that cannot generate sufficient domestic savings. However, the concern about the stock market growth in Nigeria is the impact of globalization on the market. It has not been clearly ascertained whether globalization especially through increased Foreign Direct Investment (FDI) generate positive impact or otherwise on the stock exchange market. Though the effect of globalization has not been undoubtedly looked at by many, trade openness has impacted on most factors identified in the literature to be determinants of stock exchange market growth (Obstfied, 2002). Specifically, the role of stock market in economic development cannot be overemphasized; the liquidity of stock (capital investment) has been noted. Many profitable investments require a long-term commitment of capital but investors might not want to tie up their savings for such long periods. Until recently, Nigerian stock markets have not performed impressively when compared to those in other regions of the world. However,

Nigerian stock exchange has experienced significant gains in the entry of the new millennium: market capitalization and new listing no doubt have increased. These changes have taken place within the context of globalization and internationalization policies that reflect the effort of the government to use stock markets as a means of privatization and engine growth of the economy. Against this background, this study is designed to under-study the effect of trade openness and exchange rate on stock market capitalization growth in Nigeria.

The objective of this study is to examine the effects of trade openness and exchange rate on stock market capitalization growth in Nigeria. To achieve the objective, this study is structured into five sections including this introduction. Section two and three contains review of related literature and methodology. While section four and five comprises findings of this study and conclusion and recommendations correspondingly.

2. Review of Related Literature

Theoretical Literature

Demand- Supply Theory

It is also referred to as theory of exchange rate. The theory stresses that the rate exchange basically relates to the position of balance of payments of the country concerned. A favourable balance of payments leads to an appreciation in the external value of the currency of the country. Unfavorable balance of payments causes a depreciation of the external value. The exchange rate holds that the price of foreign money in terms of domestic money is determined by the free forces of demand and supply in the foreign exchange market. It follows that the external value of a country's currency will depend upon the demand for and supply of the currency.

The theory states that the forces of demand and supply are determined by various items in the balance of payments of a country. According to the theory, a deficit in the balance of payments leads of a fall or depreciation in the rate of exchange, while a surplus in the balance of payments strengthens the exchange reserves, causing an appreciation in the price of home currency in terms of foreign currency. A deficit balance of payments of a country implies that demand for foreign exchange exceeds its supply. As a result, the price of foreign money in terms of domestic currency must rise, i.e., the exchange rate of domestic currency

must fall.

On the other hand, a surplus in the balance of payments of a country implies a greater demand for home currency in a foreign country than the available supply. As a result, the price of home currency in terms of foreign money rises, i.e., the rate of exchange improves. In short, the balance of payments theory simply holds that the exchange rates are determined by the balance of payments, connoting demand and supply positions of foreign exchange in the country concerned. As such, this theory is also designated as "Theory of exchange rate," the theory asserts that the rate of exchange is the function of the supply of and demand for foreign money and not exclusively the function of prices obtaining between two countries as asserted by the Purchasing Power Parity Theory which does not take into account invisible items. According to the demand and supply theory, the demand for foreign exchange arises from the "debit" items in the balance of payments, whereas the supply of foreign exchange arises from the "credit" items. Since the theory assumes that the demand for and supply of foreign currency are determined by the position of the balance of payments, it implies that supply and demand are determined mainly by factors that are independent of variations in the rate of exchange or the monetary policy.Demand-Supply Theoryshould be adopted because it portrays the framework of trade openness and exchange rate on stock market capitalization growth which the model will adopt.

Empirical Literature Review

Many studies have covered globalization and stock market growth from different perspectives, and examined focused variables and their relationship differently. Most relevant and useful studies for this study are included.

Torre and Schmuker, (2007), found out that stock market development is positively related to globalization in Nigeria through the use of single regression. This work shows that reform and globalization of capital market increases domestic market capitalization, trading and capital raising, increases in the chain of activity in international equity markets can contribute to the spread at least practices in corporate governance, accounting rules and legal traditions. Internationalization is a reality and no country of the world is immune to its impacts.

Maduka, Madichie, and Eze, (2017) examine the impact of globalization on economic growth

in Nigeria. The study uses the contemporary econometric techniques of co-integration and error correction mechanism within the framework of the Pesaran, Shin and Smith. (2001) ARDL model Using annualized secondary time series data from 1970 to 2015, the study reveals that trade openness; financial integration and foreign direct investment have significant positive impact on economic growth in Nigeria. Thus, adequate mechanism should be put in place to ensure that globalization brings about the desired pace of economic growth.

Araoye, Ajayi, and Aruwaji, (2018) study examined the impact of the Nigerian Stock market development on the nation's economic growth from 1985 to 2014. The economic growth was proxy by the GDP while the stock market variables considered included; market capitalization and market turnover ratio as proxy for stock market development in terms of size and liquidity. The study utilizes the Johansson's co integration long run relationship test does existing between establish stock market development and economic growth in Nigeria. The empirical results suggest that the stock market is significant in determining economic growth in Nigeria using the error correlation model and it was found that the stock market has impacted insignificantly on the economic growth.

Bala and Hassan, (2018) study examines the linkage between exchange rates and stock market in Nigeria using annual data from 1985 to 2015. In conducting the analysis, this study utilized Autoregressive Distributed Lag (ARDL) model and Granger Causality tests. Exchange rate, economic growth, money supply and stock market (i.e., all share indexes) were captured in the model. The results show that exchange rate and economic growth have positive and statistically significant impact on stock market in Nigeria, while money supply has negative and statistically significant influence on stock market over the study period.

Onwuka and Eguavoen (2007), studied globalization and its implications for the growth process of the Nigeria economy for the period 1985–2001. Using descriptive method of analysis, the study revealed that Nigeria has not benefited from globalization due to mono-cultural export, inability to attract increased foreign investment and huge indebtedness.

Omolade, Morakinyo and Ifeacho (2013), investigated the nexus between globalization and economic development of Nigeria over the period 1980–2011. The study employed Johansen co-integration and Granger causality tests and revealed that trade openness relates negatively with economic development in Nigeria. The study further revealed that a unidirectional causality flows from economic development to globalization without such in

reversed order and that trade partners appear to be gaining more than the country especially the developed trade partners.

Sede and Izilein (2013) examined the causal relationship between economic growth and globalization in Nigeria. In carrying out the study, Johansen co-integration, Granger causality and variance decomposition tests were employed. The study found that globalization does not Granger-cause economic growth in Nigeria.

Nwakanma and Ibe (2014) examined the causal relationship between globalization and economic growth in Nigeria from 1981 to 2012. In carrying out the study, Johansen co-integration and Granger causality tests were employed. The results show that there is a positive and insignificant relationship between financial integration, human resource development and trade openness, while gross fixed capital formation was negative and insignificant. The results further revealed that a unidirectional causality runs from financial integration to gross fixed capital formation.

Okpokpo, Ifelunini and Osuyali (2014), through their study interrogated globalization as a potent driver of economic growth in Nigeria using the non-oil (agricultural and manufacturing) export as reference point from 1970–2011. The study employed the ADF unit root test and OLS technique and found that globalization has no significant impact on non-oil export and that globalization has not been a potent driver of growth of the non-oil export in Nigeria.

Shuaib, Ekeria and Ogedengbe (2015), examined the impact of globalization on the growth of the Nigerian economy over the period 1960 –2010. The study employed the Johansen co-integration and error correction model and found that growth of external debt ratio was inversely related to economic growth in Nigeria.

Adesoye, Ajike and Maku (2015), examined the impact of economic globalization on output growth of the Nigerian economy over the period 1970 –2013. The study employed Engle-Granger co-integration and error correction model and found that a higher exchange rate and inflation rate, an increase in foreign direct investment, growth in trade and openness and a lesser interest rate enhance the growth rate of output in Nigeria.

3. Methodology

To examine the relationship among the variables, this study applied Augmented Dickey-Fuller (ADF) statistics where used to test the stationarity or non-stationarity of the variables

and their order of integration. The Johansen co-integration technique would be used to test for long run relationship between the variables. The VECM would be applied to estimate the speed of adjustment and causality test to examine the long run causal relationship between variables.This study also used annual data spanning from 1981 to 2017. This is the period for which all the data of the variables under assessment are available. The data is sourced from statistical Bulletin a publication of Central Bank of Nigeria, World Development Indicators, a publication of World Bank, and Nigerian Bureau of Statistics. The variables captured in the equation are Stock market capitalization growth (SMCG) as the explained variable, and Trade openness (TO), foreign direct investment (FDI), exchange rate (EXR) and balance of payment (BOP) as explanatory variables.

Model specification

This study analyze the effects of trade openness and exchange rate on stock market capitalization growth in Nigeria, which would be based on The model coined from the publication of Ajayi, Araoye and Aruwaji(2018),which have investigated the linkage between stock market and economic growth, but with slight modifications.To explain the relationship between Stock market capitalization growth and other economic variables in Nigeria economy, the model is specified below:

Stock market capitalization growth (SMCG) = f (Trade openness (TO), Foreign direct investment (FDI), Exchange Rate (EXR), Balance of payment (BOP)…… (3:1)

Let derive equation (3:2) from equation (3:1)

SMCG = f (TO, FDI, EXR, BOP)…… (3:2)

Let converted equation (3:2) into econometric model for Objective (1)

$SMCG_t = b_0 + b_1TO_t + b_2FDI_t + b_3EXR_t + b_3BOP_t + U_{1t}$…… (3:3)

Where:

Stock market capitalization growth = $SMCG_t$

Trade openness (TO) = TO_t

Foreign direct investment = FDI_t

Exchange Rate = EXR_t

Balance of payment = BOP_t

b_0 = Intercept of the relationship

b_1, b_2, b_3 = Measure of the slope

U = Error term.

4. Discussion of Findings

When dealing with time series data, it is important to test the series' behavior so as to know the stationary levels. Economic theory requires that variables be stationary before application of standard econometric techniques, this is to avoid misleading results. This has been carried out through the use of most frequently used testing techniques of Augmented Dickey Fuller.

Variables	ADF statistics			ADF statistics		
	Level	Critical values		1st difference	Critical values	
SMCG	0.569014	1%	-3.626784	-5.859350	1%	-3.632900
		5%	-2.945842		5%	-2.948404
		10%	-2.611531		10%	-2.612874
TO	-0.989652	1%	-3.626784	-6.439743	1%	-3.632900
		5%	-2.945842		5%	-2.948404
		10%	-2.611531		10%	-2.612874
FDI	-1.368560	1%	-3.626784	-8.325831	1%	-3.632900
		5%	-2.945842		5%	-2.948404
		10%	-2.611531		10%	-2.612874
EXR	-0.411637	1%	-3.626784	-3.769794	1%	-3.632900
		5%	-2.945842		5%	-2.948404
		10%	-2.611531		10%	-2.612874
BOP	-5.087645	1%	-3.626784	-9.612322	1%	-3.632900
		5%	-2.945842		5%	-2.948404
		10%	-2.611531		10%	-2.612874

Source: Author`s Compilation

The ADF results show that Stock market capitalization growth, Trade openness, Foreign direct investment, Exchange Rate are non-stationary in level, but stationary in difference. While Balance of payment is stationary both in level and 1st difference indicating that the variables are of different order of integration.

Co-integration Test Result

Having confirmed the stationary nature of the variables a necessary but not sufficient condition for co-integrating test is that each of the variables as different integrated order. The Johansen co-integration test uses two statistics test namely; the trace test and the likelihood Eigen-value test. The results obtained from the likelihood Eigen-value testis summarized in table below.

Hypothesized No. of CE(s)	Eigen-value	Max-Eigen Statistic	Critical Value 0.05	Prob.**
None *	0.691196	41.12672	33.87687	0.0057
At most 1 *	0.624325	34.26609	27.58434	0.0060
At most 2	0.226095	8.970734	21.13162	0.8348
At most 3	0.164041	6.271130	14.26460	0.5787
At most 4 *	0.127562	4.776216	3.841466	0.0288

Source: Author`s Compilation

Max-eigenvalue test indicates 2 cointegratingeqn(s) at the 0.05 level

Denotes rejection of the hypothesis at the 0.05 level

Max-Eigen statistics indicates the presence of two co-integrating equation at 5% significance level which implies that Stock market capitalization growth, Trade openness, Foreign direct investment, Exchange Rate, Balance of payment are co-integrated. This shows that there is a long-run relationship among Stock Market Capitalization Growth, Trade Openness, ForeignDirect Investment, Exchange Rate, and Balanceof Payment in Nigeria.

Vector Error Correction Model (VECM) Result

Since there is co-integration, the vector error correction model is estimated, TOanswer$H0_1$: There are no significant effects of trade openness, exchange rate on stock market capitalization growth in Nigeria.

Variable	α's	ECM
SMCG(-1)	1.000000	0.254556
		(0.09328)
		[2.72882]
TO(-1)	405285.2	
	(120887.)	
	[3.35259]	

FDI(-1)	-0.016014	
	(0.00187)	
	[-8.56286]	
EXR(-1)	-61956.62	
	(14095.7)	
	[-4.39543]	
BOP(-1)	10.92668	
	(2.30818)	
	[4.73390]	
C	4459143.	

R-squared= 0.321034

Note: The t-statistics [] are inParentheses

Source: Author`s Compilation

Interpretation of VECM Results

ECT_{t-1}=1.0000$SMCG_{t-1}$+405285.2To_{t-1}-0.016014FDI_{t-1} - 61956.62EXR_{t-1} + 10.92668$BOPt_{-1}$ + 4459143

The coefficient of TO is 405285.2 with a t-value of 3.35259. Since the t-value is greater than 2 in absolute sense, we reject the null hypothesis at 5% level of significance using the 2-t rule of thumb. This means that trade opening is statistically significant and affects Stock market capitalization growth in Nigeria. Specifically a unit increase in trade openness will on average increase Stock market capitalization growth by 405285.2 ceteris paribus. The positive sign of trade opening is unrealistic in Nigeria, in the sense that both foreign direct investment and exchange rate is negative, it will be actualize if only the government can control the domestic productive system, and be at advantage side of globalization.

The coefficient of FDI is -0.016014 with a t-value of -8.56286. Since the t-value is greater than 2 in absolute sense, we reject the hull hypothesis at 5% level of significance using the 2-t rule of thumb. This means that foreign direct investment statistically significantly affects Stock market capitalization growth in Nigeria. Specifically a unit increase in foreign direct investment will on average decrease Stock market capitalization growth by -0.016014% ceteris paribus. The negative sign of foreign direct investment validates the unfavorable side of **"**Demand- Supply Theory**",** in the sense that multinational company import their advance technology and labour (semi-skilled) from their country and utilize the domestic materials,

their profits are transferred back to their country which results to capital flight in the economy.

The coefficient of EXR is -61956.62 with a t-value of -4.39543. Since the t-value is greater than 2 in absolute sense, we reject the hull hypothesis at 5% level of significance using the 2-t rule of thumb. This means that exchange rate statistically significantly affects Stock market capitalization growth in Nigeria. Specifically a unit increase in exchange rate will on average decrease Stock market capitalization growth by -61956.62 ceteris paribus. The negative sign of exchange rate validates the unfavorable side of **"**Demand- Supply Theory**",** this effect can only be correct by checkmating all the variables that are affected domestically.

The coefficient of BOP is 10.92668 with a t-value of 4.73390. Since the t-value is greater than 2 in absolute sense, we reject the hull hypothesis at 5% level of significance using the 2-t rule of thumb. This means that balance of payment statistically significantly affects Stock market capitalization growth in Nigeria. Specifically a unit increase in exchange rate will on average increase Stock market capitalization growth by 10.92668 ceteris paribus. The positive sign of the balance of payment is unrealistic in Nigeria, in the sense that both foreign direct investment and exchange rate is negative, it will be actualize if only the government can diversify the production system, in a way that export will exceed import.

R-Squared measures the percentage of the total variation in the dependent variable that is explained by the explanatory variables. In the model, the total variation in SMCG jointly explained by the variations in TO, FDI, EXR and BOP is 32.11%. This means that the explanatory variables are able to explain close to optimum total variations in the dependent variable. Adjusted R-squared penalizes the model for introducing unimportant variables. From the model above, the R^2 adjusted penalizes the model by decreasing from 32.11% to 17.55%.

Interpretation of Vector error correction term:

$$SCMGt = 0.254556ECT_{t-1} - 0.307988\ SCMG_{t-1} - 186483.0\ TO_{t-1} + 0.002058\ FDI_{t-1} + 37955.04\ EXR_{t-1} - 3.256091\ BOP_{t-1} + 703392.8$$

The coefficient of the ECT_{t-1} indicates that 57.1% of the disequilibrium in the model will be corrected annually. In other words, 26% of disequilibrium in the short run will be corrected in the long run. The speed of adjustment indicates that the model will converge completely to its equilibrium system in 2.73 years. The significance result of ECM indicates that speed of adjustment will be very fast. This result is shown in the appendix index.

The optimum lag length of 11 was selected based on AIC and SBC information criteria for all ECM estimate above. This means that the convergence between the variables is not instantaneous.

Granger Causality Test

Granger Causality test shows that, there is unidirectional causality running from Trade openness, Foreign Direct Investment, Exchange Rate and Balance of Payment to Stock Market Capitalization Growth as a result of the one way significant p-value of F-statistic (0.0786, 0.0005), (0.7237,0.0013),(0.3197, 0.0274) and (0.0020,0.6379). Therefore, we accept alternative-hypothesis and conclude that Trade openness, Foreign Direct Investment, Exchange Rate and Balance of Payment have significant effect on Stock Market Capitalization Growth.

5. Summary, Conclusion and Recommendations

Nigeria has over the years experienced numerous challenges such as exchange rate fluctuations, collapse in the stock market price among others. It is on this basis that this study analyzed the effect of trade openness and exchange rate on stock market capitalization growth in Nigeria from 1981 to 2017. Following an extensive review of theoretical and empirical literatures, the study estimated a vector error correction model with stock market capitalization growth as the dependent variable and trade openness, foreign direct investment, exchange rate and balance of payment as the independent variables. Also co-integration was used to examine the long-run effect and Granger Causality Test to examine the exact causal relationship.

The findings of the study capturing both the short-run and long-run are hereby stated for better policy guidance. Trade openness was observed to be significant to stock market capitalization growth in Nigeria, in developed countries, resources from trade openness such as export and import are used to develop sectors simultaneously but in less developed country like Nigeria; the one case is different because the dependency on import rather than export will affect the growth of the other sectors and have negative effect on stock market capitalization growth. Foreign direct investment was observed to be significant to growth. Foreign direct investment has a negative impact on stock market capitalization growth in Nigeria, this shows that there is a negative relationship between net flows of foreign direct investment and stock market capitalization growth. Exchange Rate was observed to have a negative impact on stock market capitalization growth and it is a statistically significant

variable affecting the growth rate of stock market capitalization growth meaning that a negative relationship exists between Exchange Rate and stock market capitalization growth. Balance of Payment has a positive impact on stock market capitalization growth and it is statistically significant, meaning that in Nigeria, a positive relationship exists between Balance of Payment and stock market capitalization growth.

The result above validates the unfavorable side of "Demand-Supply Theory" which assert that, favorable balance of payments leads to an appreciation and Unfavorable balance of payments causes depreciation in the external value of the currency of the country. Also, the exchange rate holds that the price of foreign money in terms of domestic money is determined by the free forces of demand and supply in the foreign exchange market. It follows that the external value of a country's currency will depend upon the demand for and supply of the currency. Also the result shows that, both foreign direct investment and exchange rate are unfavorable in relation to stock market capitalization growth, which means, for Nigeria to experience the actual positive effect or favorable as shows by both trade openness and balance of payment, government need to developed all the domestic economic sectors in a way that, their output export will exceed import and augment stock market capitalization growth in Nigeria

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