International Journal of Innovative Research in Education, Technology & Social Strategies
p-ISSN: 2465-7298 | e-ISSN: 2467-8163
Volume 10, Number 2 November, 2023
IJIRETSS

Political Stability, Quality of Governance and Stock Market Performance in Nigeria: A VECM Approach

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Article DOI: 10.48028/iiprds/ijiretss.v10.i2.13

Abstract

Governance structure is riddled with rent-seeking behaviour by public agents, public institutions are not only ineffective and retroactive but there is also no regards to rule of law, no accountability and above policy inconsistencies which affects the economy including vibrant development of the stock market. This paper examined the impact of political stability and quality of governance market performance in Nigeria from 1986-2022. The variables of this study are credit to the private sector, gross domestic product, inflation, and investment (domestic), and broad money supply. The other variables are political stability, quality of governance government expenditure, unemployment and value of stocks traded. The data for these variables were sourced from the Central Bank of Nigeria Statistical Bulletin and the National Bureau of Statistics of various years. This paper was anchored on the efficient market hypothesis and the impulse response function and variance decomposition was used. The result suggested that market capitalization was strongly endogenous in the short-run predicting itself about 93 percent and 86 to 85 percent in the long-run while a one standard deviation of shock from gross domestic product to market capitalization continuously decreased from periods 1 to 10. The conclusion from the analysis of the findings is that political stability and quality of governance impacted on stock market performance. This paper recommended economy-wide reforms tom stem the impact of negative shock on the economy and stock market.

Keywords: *Nigeria, Political stability, Quality of governance, Stock market capitalization, and Value traded shares, Vector error correction model*

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Background to the Study

The maximization of the capital market development depends on the effectiveness of governance and institutional framework. In the economic literature, capital market development must be accompanied by structural and institutional transformation which will yield the desired growth and development of the whole economy (Todaro, 2002). The role of institutions is very crucial in the attainment of liberalized capital market in any economy especially in a resource –rich country that is not resilient to abuse of power, office and opportunities (Adewuyi & Adeleke, 2016).

Analysis of institutional framework in Nigeria suggests that the economy is characterized by dysfunctional institutional regime, rent-seeking behaviour and bureaucracy. The capital market in Nigeria lack depth and breadth and is constrained by lack of infrastructure which institutional framework must provide for the growth of the market (Dada, 2003). This situation raises the question of how political stability and quality of governance have influenced capital market development in Nigeria.

In the light of the above, this paper examined the impact of institutional framework on stock market capitalization in Nigeria. It also investigate the shock effect of political stability and quality of governance of stock market capitalization in Nigeria using the vector error correction model(VECM(impulse response function and forecast error variance decomposition) approaches from 1986 to 2022.Following this introductory section, section 2 provides the review of empirical literature, section 3 details the theoretical framework and methodology while section 4 presents and discusses the empirical results and section 5 rounds up this paper with conclusion and policy implications.

Empirical Literature Review

Empirical studies on the impact of institutional framework on stock market capitalization are scarce and the few existing studies have examined the subject differently. For instance, Ajide (2014) examined the impact of governance on stock market performance using quarterly data series spanning 1996Q1 to 2010Q4. An autoregressive distributed lag approach was used. The variables included in the model are all share index, market capitalization, and the value of total traded respectively. Findings show that macroeconomic and financial stability should be constantly maintained and promoted as it constitutes a drag on the stock performance.

Boadi and Amegbe (2017) investigated the link between quality of governance and stock market performance within the context of international market. The study used the fixed effect technique model using 23 countries with complete relevant data from the period spanning from 1996 to 2014. The study showed that quality of governance as captured by voice and accountability, political stability and absence of violence, government effectiveness, regulatory quality, rule of law and control of corruption significantly affect stock market performance.

Fagbemi, Adeniyi, and Kehinde (2021) examined stock market development and governance regulatory framework in Nigeria from 1996 to 2019 using the ARDL approach. The variables

used are stock market capitalization, governance effectiveness, value traded ratio and regulatory quality and significantly influences the performance of stock market , which strengthens the view that market –enhancing governance can engender an improvement inn stock market performance.

Iyoboyi (2021) explored the impact of institutions on stock market performance in Nigeria between 1996 and 2019 using the ordinary least square (OLS). The variables included in the model are all share index, market capitalization (equities only), market capitalization(total), number of deals(equities), number of deals(total) and value of stock traded were each regressed on institution, proxy by the World Governance Indicators including the control of corruption , government effectiveness , political stability, and absence of violence/terrorism, regulatory quality, rule of law and voice and accountability, while controlling for macroeconomic factors. The findings indicate that the control of corruption and government effectiveness have a direct impact on stock market performance.

Khan, Munir, Abbas and Umar (2022) examined the impact of governance on stock market performance in Pakistan using the ARDL approach between 1996 to 2018. The variables used are the quality of governance (voice and accountability, political stability, absence of violence, government effectiveness, regulatory quality, rule of law, and control of corruption which positively affect stock market performance. The findings show countries with better developed political system would favour stock markets with higher market capitalization, better turnover ratio, higher value in shares traded and a greater number of listed companies.

Mai, Saleem and Kamran (2023) investigated the relationship between political instability and stock market performance: An analysis of the MSCI index in the case of Pakistan between the period 1996 to 2021. Data collected from the Data stream data base MSCI indices are used as the proxy for the stock market performance of the selected country. World governance six indicators were used in the study as the explanatory variable concentrating on the political instability index as the main explanatory variable. Regression analysis was used but two-way robustness analysis was done for the accuracy of the findings through generalized method of moment methods and taking GDP as another endogenous variable. The findings show that political stability has significant positive impact on the stock market performance, while political instability has negative impact on stock market performance. These empirical studies present conflicting results following different analytical approaches and different measures of variables.

Theoretical Framework/Model

The efficient market hypothesis is in line with this paper based on the assumptions that the stock market prices and returns reflect fully all available information including macroeconomic policy announcement of monetary and fiscal policy at any given period of time. This is a concept that addressed the extent to which markets for equities reflect information (policy information) in their prices. It asserts that markets are informational efficient and as such, no one can consistently achieve returns that is in excess of the average market returns. Fama (1970) revealed that there are three versions of the hypothesis namely,

the weak, the semi-string, and the strong forms. The weak forms claims that prices are traded assets (e.g., stocks & bonds) already reflect all past publicly available information. The semi-strong-form claims, simultaneously, that prices reflect all publicly available information and that prices instantly change to reflect new public information. Lastly, the strong form additionally claims that prices instantly change to reflect new public information. The strong form additionally claims that prices instantly reflect even hidden or, insider information.

Empirical Model Specification

In attempting to investigate the relationship between institutional framework and capital market performance, this paper adopted with modification the work of Anyamaobi (2018). The author expressed the functional relationship as follows:

$$MCT = F(MPR, INTR, TBR, EXR, MOG) \quad (1)$$

Where MCT = Nigeria stock market capitalization; MPR = Monetary policy; TBR = Treasury bill rate; EXR = Naira exchange rate per US dollar; INTR = Interest rate and MOG = Monetary aggregates. From the model specified in (1), it would be concluded that the study focused on the association between monetary policy and market capitalization. Hence, modifying equation (1) to accommodate fiscal policy, the model of this study in theoretical and mathematical form will be specified as follows:

$$MCAP = F(CPS, INF, INV, M2, POLSTAB, QGOVT, GEXP, UNE, VTS) \quad (2)$$

Equation (2) is formulated to accommodate fiscal policy, the interaction of fiscal and monetary aggregate and institutional framework. This model is specified alongside the objectives of this study and the transmission channels through which monetary-fiscal policies impacts on the capital market performance. Equation (2) can be specified econometrically as follows:

$$MCAP = \beta_0 + \beta_1 CPS + \beta_2 INF + \beta_3 INV + \beta_4 M2 + \beta_5 POLSTAB + \beta_6 QGOVT + \beta 7 GEXP + \beta_8 UNE + \beta_9 VTS + \beta_{10} GDP + \mu \quad (3)$$

To enhance its elasticity, linearity and easy interpretation, the model is log-linearize except for variables with rates and percentages, in other words, nominal variables will be logged. Therefore, equation (3) becomes in log form:

$$LnMCAP = \beta_0 + \beta_1 LnCPS + \beta_2 INF + \beta 3 LnINV + \beta 4 LnM2 + + \beta 5 LnPOLSTAB + \beta_6 LnQGOVT + \beta_7 LnGEXP + \beta_8 UNE + \beta_9 LnVTS + \beta_{10} LnGDP + \mu \quad (4)$$

Where MCAP = Market capitalization; CPS = Credit to the private sector; INF =Inflation rate; INV = domestic Investment; M2 = Broad moneys s; POLSTAB = Political Stability; QGOVT =Quality of governance; GEXP= Government expenditure, UNE= Unemployment rate and VTS= Value of traded shares and GDP= Gross domestic product.

The dataset for this study is time-series data from 1986 to 2022 using the impulse response function and the forecast error variance decomposition.

Empirical Results and Analysis

This chapter presents the results of the estimated data, the interpretation, analysis and the evaluation of the research hypotheses and the implications of the empirical results. Table 1 presents the summary of the descriptive statistics.

Table 1: Summary of Descriptive Statistics

	CPS	EXP	INF	INV	M^2	MCAP	POLSTAB	QGOVT	GEXP	UNE	VTS
Mean	2961878	423816.0	20.25553	866397.1	2224389	2434040	-1.731038	-1.013826	3150805	10.50882	150864.7
Std. Dev.	5206478	244121.5	17.97888	1193196	3074387	3850581	0.373742	0.091035	4031366	7.556150	261840.7
Stewness	1.813211	0.941204	1.590195	1.269176	1.319200	1.506115	0.714889	-0.478355	0.9242	0.6936711	1.541672
Kurtosis	5.014713	2.534124	4.253475	3.147301	3.405606	3.972098	2.878109	1.871580	0.050920	2.194428	3.852199
Jarque-Bere	24.38085	5.327378	16.55528	9.158655	10.09470	14.19288	2.917091	3.100555	6.116652	3.646020	14.49711
Probability	0.000005	0.069691	0.000254	0.010262	0.006426	0.000828	0.232514	0.212189	0.046966	0.161539	0.000711

Note: CPS = Credit to the private sector; GDP = Gross domestic product; INF = Inflation rate; INV = Investment (GFCF); M2 = Broad money supply; POLSTAB = Political stability (proxy for institutional framework); QGOVT = Quality of Governance (proxy for institutional framework); GEXP= Government expenditure; UNE = Unemployment rate and VTS = Value of traded stocks.

Source: Researchers' computation using EView 10.

From the Table 1, the quality of governance and political stability represents the institutional variables of this paper. Of recent, important attention has been paid on institutional framework. Government is needed for effective implementation of economic policy, be it monetary, fiscal and financial policy measures. From the empirical results presented in Table 1, the mean/average values of these variables are mostly positive except the institutional variables (political stability and quality of governance), from the results, with the exception of quality of governance, the other included variables suggested a positive skewness value; this means that the distribution is positively skewed while a negative mean implies that the distribution is negatively skewed. The standard deviation measures the average distance between each quantity and mean. From the results presented in Table 1, CPS, GDP, INV M2, MCAP and GEXP, VTS have high standard deviations suggesting that these variables are more spread out than the others. It implies that the values are above the mean. However, POLSTAB, Qgovt and UNE have low standard deviation suggesting that the values are below the mean. In relation to this study, the standard deviation measures market volatilities measuring how widely stock performance are dispersed from the average price. The variables with high standard deviations suggested high volatility while the variables with low standard deviation suggested low volatility.

Table 2 Presented the correlation matrix. The result displays the correlation coefficients for the different variables used in this study. The matrix depicts the correlation between all the possible pairs of values.

Table 2: Correlation Matrix Results

Variables	MCAP	CPs	GDP	INF	INV	M^2	POLSTAB	QGOVT	GEXP	UNE	VTS
MCAP	1.000000	0.917112	0.933012	-0.313579							
CPS	0.917112	1.000000	0.924039	-0.261998							
GDP	0.933012	0.924039	1.000000	-0.320892							
INF	-0.313579	-0.2661998	0.320892	1.000000							
INV	0.956414	0.966997	0.981065	-0.31380	1.00000						
M^2	0.952039	0.966214	6.982175	0.323368	0.994999	1.000000					
POLSTAB	-0.591112	-0.557791	-0.736981	0.210709	-0.651727	-0.663190	1.00000				
QGOVT	-0.511095	-0.555840	-0.655031	0.19988	-0.607770	-0.618458	0.526966	1.000000			
GEXP	0.902536	0.838725	0.945500	-0.351882	0.940321	0.932751	-0.675218	-0.6264481	1.0000000		
UNE	0.810133	0.849404	0.882331	-0.449637	0.879732	0.886251	-0.697137	-0.665776	0.821213	1.00000	
VTS	0.784486	0.751743	0.842561	-0.292384	0.830597	0.827678	-0.602336	-0.616354	0.885567	0.724905	1.000000

Source: E-View 11 Version Computation

From the results presented in Table 2, the institutional variables (POLSTAB, QGOVT) were negatively correlated. The implications of these results follow thus: (a) institutional framework in Nigeria has not correlated positively with stock market development in Nigeria. The results of the institutional variables are in contrast with the submissions of Ahmed.

Poluk (2013) that argued that political stability is expected to promote growth of the economy including the capital market as it promotes infrastructure and services and ensures foreign investment. From the result, it was observed that the diagonal of the correlation matrix is equals 1, implying that the diagonal is a correlation of a random variable with itself. Each diagonal element is between -1 and +1 inclusive. The unit root test result is presented in Table.

Table 3: Unit Root Test Results

Variables	Level	$1^{st}/2^{nd}$ Difference	Order of Integration	Level	PP $1^{st}/2^{nd}$Difference	Order of Integration
MCAP	-6.007442	***	I(1)	-7.239457		I(1)
CPS	-4.507184	***	I(1)	-15.91110		I(1)
GDP	-5.319995	***	I(1)	-5.308887		I(1)
INF	-6.7571165	***	I(1)	-13.15958		I(1)
INV	-4.084679	***	I(1)	-4.789655		I(1)
M^2	-4.817589	***	I(1)	-4.5523211		I(1)
POLSTAB	-13.89320	***	I(1)	-25.89128		I(1)
QGOVT	-10.77729	***	I(1)	-40.02037		I(1)
GEXP	-10.27564	***	I(1)	-6.419481		I(1)
UNE	-6.128475	***	I(1)	-6.1141.21		I(1)
VTS	-5.225454	***	I(1)	-22.59904		I(1)

Note: *, **, *** denotes rejection of the null hypothesis at the 10%, 5% and 1% significance levels @ (-3.580, -2.930 & -2.600)
Source: EView Version 10

The unit root test results suggest that variables are integrated at order I(1) at the various levels of significance. Stationarity means that the statistical properties of a time series (or rather the process generating it) do not change over time. Stationarity is important because many useful analytical tools (co-integration and error-correction) model rely on it. From the result, it can be concluded that the null hypothesis of no stationarity was rejected. Table 4.4 present the Johansen co-integration test result. The results showed scenarios where two or more non-stationary time series are integrated together in a way that they cannot deviate from equilibrium in the long-term.

Table 4a: Johansen Co-integration Test (Unrestricted Co-integration Rank Test (Trace)

Hypothesized No of CE(s)	**Eigenvalues**	**Trace Statistics**	**0.05 Critical Values**	**Prob ****
None *	0.989232	513.2863	197.3709	0.0001
At most 1*	0.977087	359.2263	159.5297	0.0000
At most 2*	0.911835	230.8406	125.6154	0.0000
At most 3*	0.759070	148.2702	95.75366	0.0000
At most 4*	0.643272	99.87974	69.81889	0.0000
At most 5*	0.572886	64.83316	47.85613	0.0006
At most 6*	0.439082	35.90928	27.79707	0.0087
At most 7*	0.318536	16.25112	15.49471	0.0384
At most 8	0.090138	3.211721	3.84166	0.0731

Note: Trace test indicates 8 co-integrating equ(s) at the 0.05 level, * denotes rejection of the hypothesis at the 0.05 level and ** MacKinnon-Haug-Michelis (1999) P-values
Source:

Table 4a presents the Johansen Trace co-integrated test results. From the result, it was suggested that there were 8 co-integrating vectors using the trace statistics. This implies that there existed long run equilibrium association between capital market performance and institutional framework and institutional variables.

Table 4b: Johansen Co-integration Test (Unrestricted Co-integration Rank Test (Maximum Eigenvalue)

Hypothesized No of CE(s)	**Eigenvalues**	**Max-Eigen Statistic**	**0.05 Critical Values**	**Prob ****
None *	0.989232	154.0600	58.43354	0.0000
At most 1*	0.977087	128.3857	52.36261	0.0000
At most 2*	0.911835	82.57040	46.23142	0.0000
At most 3*	0.759070	48.39046	40.07757	0.0045
At most 4*	0.643272	35.04658	33.87687	0.0361
At most 5*	0.572886	28.92393	27.58434	0.0335
At most 6*	0.439082	19.65811	21.13162	0.0793
At most 7*	0.318536	13.0392	14.26460	0.0774
At most 8*	0.090138	3.2117	3.841466	0.0731

Note: Max-eigen value test indicates 6 co-integratingequ(s) at the 0.05 level of significance; * denotes rejection of the hypothesis at the 0.05 level; ** denotes MacKinnon-Haugh-Michelis (1999) P-value.
Source: Researchers' computation using EView 10.

Table 4b represents the maximum co-integration rank test, suggesting also a long-run co-integrating vector association between institutional framework and capital market performance in Nigeria within the reviewing period.

Table 5: VAR Lag Length Selection

Endogenous variables: GDP CPS INF M2 MCAP POLSTAB QGOVT GEXP UNE VTS Exogenous variables: C						
Lag	LogL	LR	FPE	AIC	SC	HQ
0	-4635.344	NA	4.44e+92	244.5444	245.0185	244.7131
1	-4387.958	338.5286	7.33e+99	237.8925	243.5810	239.9164
2	-3874.552	405.0839*	5.18e+81*	217.2554*	228.1582*	221.1345*
Note: * indicates lag order selected by the criterion; LP = Sequential modified LR test statistic (each test at 5% level) FPE = Final prediction error, AIC = Akaike information criterion SC = Schwarz information criterion HQ = Hannan-Quin information criterion						

Source: Researchers' computation using EView 10

Table 6a: Forecast Error Variance Decomposition

Variance Decomposition on MCAP					
Period	**S.E**	**MCAP**	**POLSTAB**	**QGOV**	**INF**
1	1079695	100.0000	0.00000	0.00000	0.00000
2	1119432	93.25596	1.383273	5.084079	0.276683
3	1305923	90.33652	5.119484	3.735722	0.808277
4	1335498	87.69359	4.928987	6.4836180	0.893800
5	1349067	86.04480	6.013239	6.549898	1.392061
6	1371389	86.16602	6.030647	6.4389591	1.364371
7	1376578	85.51768	6.010567	7.115031	1.356718
8	1378849	85.25802	6.042115	7.3472031	1.352661
9	1387297	85.21032	6.050598	7.399364	1.339719
10	1390450	84.99133	6.083792	7.5906961	1.334179

Table 7b: Variance Decomposition on POLSTAB

Variance Decomposition on CPS					
Period	**S.E**	**MCAP**	**POLSTAB**	**QGOV**	**INF**
1	474945.8	12.62233	87.37767	0.0000	0.00000
2	590399.6	31.77727	67.61702	0.545854	0.059855
3	894989.5	60.73294	37.79882	1.442140	0.026096
4	977022.7	60.35890	35.00537	4.552818	0.082917
5	1012372	60.42121	34.12912	5.252278	0.197396
6	1060726	61.77537	33.22032	4.8217920	0.283515
7	1089049	61.48298	33.69575	4.593492	0.227779
8	1100747	61.16548	34.04497	4.538321	0.251238
9	1115523	60.76919	34.23065	4.734506	0.265662
10	1125655	60.10388	34.52585	5.094331	0.275933

Table 8c: Variance Decomposition on QGOV

Variance Decomposition on GDP					
Period	**S.E**	**MCAP**	**POLSTAB**	**QGOV**	**INF**
1	14517.87	4.741005	3.684645	91.57435	0.000000
2	25991.14	9.739552	9.149762	79.80332	1.307363
3	35296.92	17.48068	6.446162	74.11943	1.953723
4	41786.51	18.45381	4.987939	74.53417	2.024084
5	46832.21	21.32651	4.001580	72.90722	1.764692
6	51676.04	26.15247	3.482784	68.90366	1.461091
7	55658.22	29.54682	3.462595	65.72588	1.264675
8	5883.918	32.51987	3.721201	62.616601	1.142328
9	61562.47	35.32521	4.324249	59.30094	1.049604
10	63667.78	37.35929	5.097286	56.56114	0.982281

Source: Researchers' computation using EView 10

Table 4.a-d presents the forecast error variance decomposition (FEVD). The FEVD demonstrates how important a shock is in explaining the variations of the variables in the model. The period 1-10 explains the short-run and long-run periods. 1-4 is the short-run, while 5-10 is the long-run. Table 4.8a showed the variance decomposition of MCAP. From the period, in the short-run (period 1), the main variable MCAP predict itself by 100 percent. In other words, MCAP was strongly endogenous in the short-run. MCAP predicted itself from 93 percent in period two to 88 percent in period 4. From period 5, the long-run period, the variable MCAP predicted itself from 86 percent to 85 percent. In general, in both the short-run and long-run, the variable MCAP predicted itself strongly endogenous.

Table 4.8b showed the variance decomposing of CPS on MCAP. The result suggested that in the short-run, POLSTAB predicted MCAP from 87 to 68 percent in periods one and two. The variable exhibited a least exogenous influence on MCAP. This implies a strong influence on MCAP. In the rest of the periods particularly in the long-run, POLSTAB predicted MCAP strongly exogenous. This implies a weak influence on MCAP. Table 4.8c showed that variance decomposition of QGOV on MCAP. From the results, the short-run period suggest a QGOV predicting MCAP least strongly.

Table 9: Autocorrelation Test

VAR Residual Serial Correlation LM Tests						
Lag	**LRE* Stat**	**df.**	**Prob.**	**Rao F-Stat**	**df**	**Prob.**
1	29.21756	16	0.0225	2.177109	(16,37.3)	0.0253
2	11.40815	16	0.7836	0.684729	(16,37.3)	0.7901
3	31.52469	16	0.0115	2.418192	(16,37.3)	0.0132

Source: Researchers' computation using EView 10

Table 9 presents the autocorrelation test. From the table, lag 1 and 3 are significant while lag 2 was insignificant. The significant values imply the rejection of the null hypothesis at the 5% significance level. Table 4.11 presents the normality test.

Table 10: Normality Test

Component	**Jarque-Bera**	**df.**	**Prob.**
1	26.94485	2	2.1346
2	12.68914	2	1.3456
3	13.61733	2	7.123
4	6.125055	2	5.2341
Joint	59.37637	8	

Source: Researchers' computation using EView 10

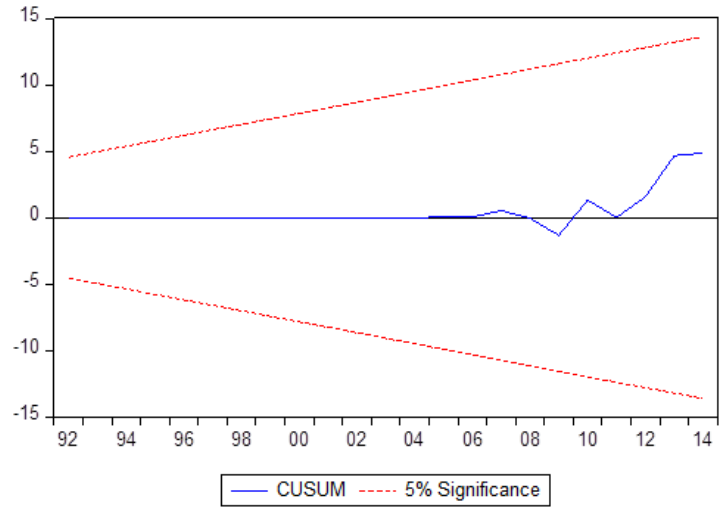
Table 10 showed the normality test. From the test, the prob (>0.05) implies that the variables are normally distributed and therefore, the rejection of the null hypothesis. Table 12 presents the residual heteroskedasticity test.

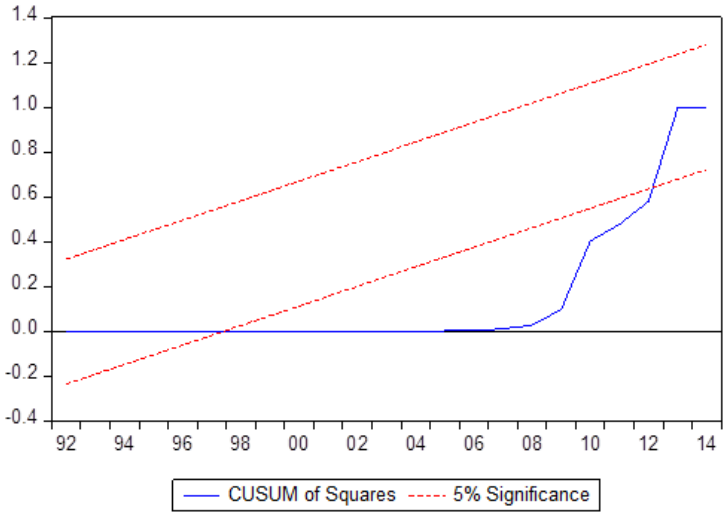
Table 11: Residual Heteroskedasticity Test

Joint test		
Chi-Sq	Df	Prob
269.0509	240	1.2345

Source: Researchers' computation using EView 10

Table 12 showed significant residual heteroskedasticity at the 10% significance level, this implies that the null hypothesis of no heteroskedasticity was rejected, and the alternative hypothesis accepted. This denoted that the model was homoscedastic. In summary, the results suggest that the model was normally distributed, homeskedastic and serially uncorrelated and the parameters appear to be reliable. Figure 3 and 4 showed the model stability results. The CUSUM test is presented in figure 3.





Source: Researchers' plot using EView 10

From the results, this study accepted the alternate hypothesis and rejected the null hypothesis that there is no dynamic impact of capital market performance to monetary, fiscal and institutional framework.

Conclusion and Policy Implications

The coefficient of POLSTAB in the current realization was negative and insignificant. This implied weak influence of institutional framework on capital market within the reviewing period. Similarly, the coefficient of quality of governance suggested a positive but insignificant relationship with market performance. From the variance decomposition and impulse response function, the results show that MCAP was strongly endogenous in the short-run predicting itself about 93 percent and 86 to 85 percent in the long-run. It further showed that one standard deviation of shock from POLSTAB to MCAP continuously decreased from periods 1 to 10 while the shock of INF to MCAP showed a steady state from period one to period 7, and a negative decline from 7 to 10. The results of the forecast error variance decomposition and impulse response function suggested the predictability of market performance on itself and monetary and fiscal policy on market performance.

Policy Implication

In the light of the empirical evidence and the policy implications of this study, the government needs to institute effective resilient mechanisms to absorb shocks both interna and external that could impact negatively on the stock market.

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