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Abstract

The anatomy of Nigerian financial system is composed of the money and capital markets. Monetary policy is a framework used by the apex bank to regulate the flow of loanable funds in the economy, though the pricing of equity used by private investors to raise capital from the economy is carried out at the capital market end of the system. As earlier empirical studies have shown the relationship between monetary policy and stock market, this study provide a precise insight in the mechanism of interaction that co-exist between monetary policy and share pricing in Nigeria. The study identified money supply and interest rate (credit creation) as the main channels through which monetary policy influence sharing pricing in an open economy like Nigeria.

Keywords: Monetary Policy, Share Pricing, Monetary instruments, Money supply, Equity/capital market, money market, financial system, IPO pricing, Nigeria

1. INTODUCTION

In every country there exists of financial system that is responsible for regulating the financial environment of the economy, determining the types and amounts of founds to be issued, cost of funds and the use of which these funds are to be put. The financial system is really made up of two major markets the money market and the capital market. The Money Market is the market for short-term funds and securities, including treasury bills, one-year treasury certificates, central Bank notes, negotiable certificates of deposit; commercial paper; commercial and merchant bank savings and investment notes and other funds of less than one-year duration.

The Capital Market, on the other hand, is the market for longer term funds and securities whose tonsure extends beyond one year. These include long-term loans, mortgage bounds, preferences stocks, ordinary shares, federal government bounds and industrial loans and debentures. According to Gaumnitz and Dougall (1980), the capital market is a complex of institutions and mechanisms through which intermediate funds and long-term funds are pooled and made available to business, government and individuals and instruments already outstanding are transferred. These institution which traditionally play one role or the other in the transfer of funds from saving deficit unites to surplus units within the financial system include stock exchange, stock registrars, issuing houses, stock brokers and under writers.

In the Nigerian financial system, the apex institutions that oversee the both ends of the market are the Central Bank of Nigeria (CBN) for the money market an the Securities and Exchange Commission (SEC) for the capital market. These apex authorities tend to use various measure and policies to regulate respective market activities and securities prices. From a global perspective, the sate of the money and capital markets give and idea of the state of health of the national economy. The markets also measure the stability of the economy with regards to the extent to which economic activities can rely on it. Essentially, the level of national economic development and the extent of which most economic activities can effectively rely on the safety of the capital and money markets are major indicators of a healthy balance between a sound financial system and macro-economic stability (NEEDS, 2003). In one to achieve desirable level of economic development and stability through either of the markets, the apex authorities often regulate the market activities with policy instruments at their disposal. Although the policy instrument of one market often affect the activities of the other market especially in terms of securities valuation and pricing. For example, the Central Bank of Nigeria (CBN) regulates the supply of money in circulation through the use of specific monetary policy instruments and this often affects the demand and supply of stocks at the capital market. This implies that there is mechanisms o9f interaction between the capital and money markets through monetary policy instrument.

2. MONETARY POLICY: DEFINITION, OBJECTIVES AND PHASES IN NIGERIA

Monetary policy is the process by which the central bank or monetary authority of a country controls the supply of money, availability of money, and cost of money or rate of interest to attain a set of objectives oriented towards the growth and stability of the economy (Wikipedia, 2010). Monetary policy on the other hand, refers to the specific actions taken by the Central Bank to regulate the value, supply and cost of money in the economy with a view to achieving Government’s macroeconomic objectives. For many countries, the objectives of monetary policy are explicitly stated in the laws establishing the central bank, while for others they are not (CBN, 2006). Monetary policy is usually used to attain a set of objectives oriented towards the growth and stability of the economy. The objectives of monetary policy may vary from country to country but there are two main views. The first view calls for monetary policy to achieve price stability, while the second view seeks to achieve price stability and other macroeconomic objectives. The macroeconomic objectives include full employment of scare resources, economic growth, and balance of payment equilibrium. The Central Bank of Nigeria, like other central banks in developing countries, achieves the monetary policy goal through the amount of money supplied.

Monetary policy focuses on the relationship between the rates of interest in an economy, that is the price at which money can be borrowed, and the total supply of money. Monetary policy uses a variety of instruments to control one or both of these, to influence outcomes like economic growth, inflation, exchange rates with other currencies and unemployment. Where currency is under a monopoly of issuance, or where there is a regulated system of issuing currency through banks which are tied to a central bank, the monetary authority has the ability to alter the money supply and thus influence the interest rate (to achieve policy goals). The beginning of monetary policy as such comes from the late 19th century, where it was used to maintain the gold standard. A policy is referred to as contractionary if it reduces the size of the money supply or raises the interest rate. An expansionary policy increases the size of the money supply, or decreases the interest rate. Furthermore, monetary policies are described as follows: accommodative, if the interest rate set by the central monetary authority is intended to create economic growth; neutral, if it is intended neither to create growth nor combat inflation; or tight if intended to reduce inflation.

In Nigeria, the need to regulate money supply is based on the knowledge that there is a stable relationship between the quantity of money supply and economic activity and that if its supply is not limited to what is required to support productive activities like investing in the stock market; it will result in undesirable effects such as high prices or inflation. The Central Bank of Nigeria (CBN) derives its mandate from the CBN Act of 1958 and its subsequent amendments. In specific terms, part one, section one of the CBN Decree No. 24 of 1991, stipulates that the principal objects of the Bank shall be to:- Issue legal tender currency in Nigeria; maintain external reserves to safeguard the international value of the legal tender currency; promote monetary stability and a sound financial system in Nigeria, and Act as banker and financial adviser to the Federal Government. Over the years, the CBN has conducted its monetary policy towards achieving these objectives. More recently, the Bank has refocused on achieving price stability, while at the same time balancing it with other macroeconomic objectives of the Government.

In summary, monetary policy in the Nigerian context refers to the actions of the Central Bank of Nigeria to regulate the money supply, so as to achieve the ultimate macroeconomic objectives of government. Several factors influence the money supply, some of which are within the control of the central bank, while others are outside its control. The specific objective and the focus of monetary policy may change from time to time, depending on the level of economic development and economic fortunes of the country. The choice of instrument to use to achieve what objective would depend on these and other circumstances. These are the issues confronting monetary policy makers.

Over the years, the objectives of monetary policy have remained the attainment of internal and external balance of payment. However, emphases on techniques/instruments to achieve those objectives have changed over the years. There have been two major phases in the pursuit of monetary policy in Nigeria since the inception of the Cental Bank of Nigeria, namely, before and after 1986 Structural Adjustment Programme (SAP). The first phase (1959-1986) placed emphasis on direct monetary controls, while the second phase (1986-date) relies on market mechanisms or market-based controls.

The era of direct controls was a remarkable period in monetary policy management in Nigeria, because it coincided with several structural changes in the economy; including the shift in the economic base from agriculture to petroleum, the execution of the civil war, the oil boom and crash of the 1970s and early 1980s respectively and the introduction of the Structural Adjustment Programme (Chuku, 2009). The economic environment that guided monetary policy before 1986 was characterized by the dominance of the oil sector, the expanding role of the public sector in the economy and over-dependence on the external sector. In order to maintain price stability and a healthy balance of payments position, monetary management depended on the use of direct monetary instruments such as credit ceilings, selective credit controls, administered interest and exchange rates, as well as the prescription of cash reserve requirements and special deposits. During this period CBN's monetary policies focused on fixing and controlling interest rates and exchange rates, selective sectoral credit allocation, manipulation of the discount rate and involving in moral suasion. Reviewing this period, Omotor (2007) 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. The CBN (2010) also posited that the use of market-based instruments was not feasible at that point because of the underdeveloped nature of the financial markets and the deliberate restraint on interest rates. The most popular instrument of monetary policy was the issuance of credit rationing guidelines, which primarily set the rates of change for the components and aggregate commercial bank loans and advances to the private sector.

The Structural Adjustment Programme (SAP) was adopted in July, 1986 ushered in a new era of monetary policy implementation with market-friendly techniques in Nigeria and against the crash in the international oil market and the resultant deteriorating economic conditions in the country. It was designed to achieve fiscal balance and balance of payments viability by altering and restructuring the production and consumption patterns of the economy, eliminating price distortions, reducing the heavy dependence on crude oil exports and consumer goods imports, enhancing the non-oil export base and achieving sustainable growth. The capacity of the CBN to carry out monetary policy using market friendly techniques was letter reinforced by the amendments made to the CBN Act in 1991 which specifically granted the CBN full instrument and goal autonomy. In line with the general philosophy of economic management under SAP, monetary policy was aimed at inducing the emergence of a market-oriented financial system for effective mobilization of financial savings and efficient resource allocation. The main instrument of the market-based framework is the open market operations. These operations are conducted wholly on Nigerian Treasury Bills (TBs) and Repurchase Agreements (REPOs), and are being complimented with the use of reserve requirements, the Cash Reserve Ratio (CRR) and the Liquidity Ratio (LR). These set of instruments are used to influence the quantity-based nominal anchor (monetary aggregates) used for monetary programming. On the other hand, the Minimum Rediscount Rate (MRR) is being used as the price-based nominal anchor to influence the direction of the cost of funds in the economy. This rate has generally been kept within the range of 26 and 8 percent since 1986. As a companion to the use of the MRR, the CBN latter introduced the Monetary Policy Rate (MPR) in 2006 which establishes an interest rate corridor of plus or minus two percentage points of the prevailing MPR. Since 2007, this rate has been held within the band of 10.25 and 6 percent.

3. THE NIGERIAN STOCK MARKET: A BRIEF HISTORY

Capital market is an important subset of a national economy that derives any country on its path to growth and development because it is responsible for long-term growth capital formation. The money market only complements the capital market by providing the necessary working capital to support gross fixed capital formation.

The origins of the Nigerian capital market date back to colonial times when the British Government ruling Nigeria at the time sought founds for running the local administration. Most of these funds derived from agriculture, produce marketing and solid mineral mining. Discovering that these sources were inadequate to meet its growing financial obligations, the colonial administration decided to expand its revenue back by reforming the system of revenue mobilization, taxation and other payments. It also saw the need to raise funds from the public sector to cover temporary shortfalls in funds availability. Hence, it found it necessary to establish a financial system by setting up the basic infrastructure for its take off pending the development of an organized private sector. (Osaze, 2007:55).

In 1957, the Government and other securities (Local Trustee Power) Acts was enacted. This law specified the types of securities in which trust funds may be invested. It also clearly defined the power and responsibilities of trustees. In addition, the colonial government set up the Professor Barback committee to examine the ways and means of fostering a shares market in Nigeria. Part of the terms of reference of this committee included the possibility of establishing a capital market in Nigeria. The committee recommended, among others, the creation of facilities for dealing in shares, the establishment of rules regulating share transfer and measures for encouraging savings and issue of securities of the government and other organization. By the end of the year (1957), the colonial administration had promulgated the General Loan and Stock Act and the Local Loans (Registered Stock and Securities) Act on the recommendations of the Barback Committee.

In 1958, the Central Bank of Nigeria was established through the Central bank of Nigeria Act of 1958. The purpose of these various legislations was to establish the legal and infrastructural framework for the take off of a visible securities/capital market in Nigeria. As a follow-up to ₦2million Federal of Nigeria Development Loan Stock in May 1959. On September 15, 1960, the Lagos Stock Exchange was incorporated as a private limited liability company, limited by guarantee under the provisions of the Lagos Stock Exchange Act of 1960. The Lagos Stock Exchange Act 1960 conferred monopoly powers on its members to deal in securities granted quotation on the Exchange. It also allowed the Central Bank to deal directly in securities. On June 5, 1961, the Lagos Stock

Exchange opened for business with 19 listed securities made up 3 equities, 6 Federal Government Bonds and 10 industrial loans.

In 1962, the Exchange Control Act and the Trustees Investment Act were enacted. The Capital Issues Committee was also constituted to examine and recommend the establishment of an apex monitoring institution for the growing Nigeria capital market. In 1966, the Borrowing by Public Bodies Act was enacted. This was followed in 1968 by the Companies Decree and the Banking Decree in 1969. In 1972, the Nigerian Enterprises Promotion Decree was promulgated which was followed in 1993 by the Capital Issue Commission Decree. The Capital Issue Commission thus became the apex regulatory body for the Nigerian capital market. By this decree, it was empowered to determine the price and timing of new issues of securities through offer for sale or for subscription.

In 1977, the name of the Lagos Stock Exchange was changed to the Nigerian Stock Exchange by the Indigenization Decree of 1977 following the recommendations of the industrial Enterprises Panel (Adeosun Panel) of 1975 that Branch exchange should be established. On April 1, 1978, the securities and Exchange Decree was promulgated to replace the Capital Issue Commission and expand the scope of its activities following the recommendations of the Financial System Review Committee (Okigbo committee) of 1976. This committee also recommended the establishment of multiple exchange and approval of share allotments by the Securities and Exchange Commission. In 1978, the first state government revenue bond was floated by the defunct Bendel State of Nigeria. The ₦20million 1% first Bendel State Loan was floated to finance the state's housing development programme. On April 5, 1985, the Second-tier Securities Market (SSM) of the Nigeria Stock Exchange was established to cater for the capital requirements of small and medium scale enterprises.

In 1988, the functions of the Securities and Exchange Commission were further expanded by Decree 29 of 1988 to include the review and approval of al mergers, acquisitions and combinations between or among companies. In 1988 also, the Privatization and commercialization decree 25 was promulgated. This Decree provided for the privatization of some enterprises in which the Federal Government of Nigeria has equity interest and the commercialization of some Federal Government wholly-owned enterprises. The exercise that ensued from this Decree brought more companies to the Nigeria Stock Exchange whose shares were thus listed.

In 1992, the Chartered Institute of Stockbrokers Decree was promulgated which granted the institute of stockbrokers power to charter stockbrokers and dealers, conduct examination of brokers and generally oversee the conduct of its members in the interest of the orderly development of the capital market. On July 29, 1992, The Central Securities clearing system was incorporated as the official central clearing and depository of the Nigeria Stock Exchange. The CSCS was incorporated to implement a computerized Stock Exchange Management System (SEMS) which emphasizes the immobilization of share certificated in a Central Depository. In 1993, the Federal government, through its budget presentation, formally deregulated the capital market, thus ending the official pricing, tinning and allotment of security issue. These functions were passed on to the issuing houses to perform.

On December 19, 2002, the Nigerian Instrument also securities Tribunal was inaugurated by the Minister of finance, in accordance with section 224 of the Investment of Securities Act of 1999; with the objective of ensuring transparency, effective, speedy and flexible resolution of disputes among capital market participants. On July 25, 2006, the Abuja securities and commodity Exchange Plc formally began trading operation with spot market transactions in agricultural commodities.

4. MONETAY POLICY AND SHARE PRICING

The Central Bank of Nigeria Decree of 1991 was promulgated to expand the functions of the Central Bank granting it greater autonomy in monetary policy and repealed the Central Bank of Nigeria Act of 1958. The use of the monetary policy instruments by the Central Bank in regulating the supply of investment funds often affects the activities of the Nigerian Capital market. The control of money in circulation influence investors supply and demand of shares at both ends of the capital market-Primary and Secondary market and this consequently affect the share pricing which is dependent on market forces.

Profitable investment is a question of knowing what investment opportunities are available in the market, their value/worth and the returns that the investor expects to earn on such investments. But the first step is to be conscious of the process of the investments in the market in order to determine if they are worth the value attributed to them (Osaze, 2007:319). However, in discussing the pricing of shares in the capital market, it is important to recall that the capital market is made up of two parts- the primary market and the secondary market.

4.1. SHARE PRICING IN THE PRIMARY MARKET

The Primary Market is the new issues market where newly issued securities being offered for the very first time to the investing public are valued, priced and approved for sale or for subscription. It is the price that a security takes to the market for the very first time that serves as a benchmark for what happens to its value subsequently in the secondary market. The three major securities traded in the market are Bonds, Preference Share and Ordinary Share. Although, this chapter is to discuss ordinary shares pricing.

Common stock is the most difficult security to value either in the primary or secondary market because of some factors inherent and fundamental to the stock; factors that are outside the control of the issuing company and other economic, business political and psychological factors all of which must be considered in the pricing process. Common stock pricing in the primary market is the joint responsibility of the Nigeria Securities and Exchange Commission, the issuing house to the stock issue, brokers to the issue and the issuing company itself. In the process of pricing, the issuing house, representing the company is expected to be accompanied by the senior management staff of the company to the meeting of the SEC to provide further information about the prospects and operation of the company and the basis of the pricing. According to Osaze (2007:321), any company that is desirous of having its shares priced for public subscription or for sale and quotation on the Nigeria Stock Exchange (NSE) must provide the following documents to SEC:

(i) a five-year audited annual account for the period immediately preceding the applications;

(ii) details of all financial statements for the same period as in (i)

(iii) history of the issuing company, including its business, date of incorporation and capitalization;

(iv) nature of the staff and management of the issuing company;

(v) details of any pending or potential litigations involving the company;

(vi) the Memorandum and Articles of association; and

(vii) all other information as may be required by the SEC, NSE, the issuing house and the stock brokers to the issue.

Before the actual pricing is done using one of the three methods of pricing that is applicable:-

1. the Maintable Average Annual Profit (MAAP) method;
2. the Weighted Average Annual Profit (WAAP) method; and
3. the Net Asset method

The following fictitious assets are excluded from the financial statements of the company whose stock is being valued:

(a) Goodwill;

(b) Formation expenses not yet written off;

(c) Adverse balance on profit and loss account not yet written off; and

(d) Advertising and publicity expenses not yet written off.

4.2 SHARE PRICING IN THE SECONDARY MARKET

The secondary market is the market for securities already bought and owned by investors, but that are changing hands and traded among investors. When a security reaches the markets, it obviously has had a history behind it, a history of profit, divided and interest income, and a history of the performance of the company that issued it. It is this history that makes its pricing rather different from that done fro primary issues. The valuation and pricing of secondary market securities are done by investors rather than pricing bodies and market operators.

The price of a share of common stock that is traded in the secondary market or stock exchange is really a function of the force of supply and demand for that share. Supply and demand are in turn a function of the attractiveness of the share in terms of the returns that its offers investors and the risks associated with earning those returns. However, certain salient factors tend to influence share prices in the market which is discussed in the next sub-section. Although some of the factors that influences share prices in the capital market include:

(i) Investors' attitudes and responses to developments affecting the fortunes of the issuing company;

(ii) Investors' attitudes and responses to bullish and bearish markets;

(iii) The level of interest rates within the economy as regulated by the monetary policy authority;

(iv) Speculative activities of investors and stockbrokers can aggravate share price movements either northwards or southwards.

(v) Performance results of the companies issuing traded stocks are usually the main factors that influence share prices.

Although, it is pertinent to note that the stock market is highly unpredictable at times because the share prices of traded stocks often tends volatile as a result of continuous information asymmetry and investors changing moods, emotions and speculations.

5. DETERMINANTS OF SHARE PRICES

In spite of the volatility of stock prices and theoretical constructs of share pricing in the literature, two major views hold about the determinants of share prices and their behaviour in the capital market as explored by Osaze (2007) and Maku and Atanda (2009). These are the fundamental and technical views. The fundamentalist posited that stock prices are determined by fundamental factors inherent in the company's structure. While, the technicalist views that company's stock prices are mainly influenced by force of demand and supply.

5.1 THE FUNDAMENTAL FACTORS

The fundamental factors that influence stock prices, their behaviour and movements in the market are explained as follows:

1. Firm Specific Factors:

These are factors that are inherent in the operational performance of a firm that issue trade able stock which influence the behaviour of the prices of these stocks. These include earnings stability, earnings growth rate, dividends stability, dividend growth rate, the growth potential of the company, innovations and technological breakthroughs and the quality of the firm's management.

2. Industry Specific Factors:

Similarly, there are factors within the industry to which a company belongs that can influence its business, its performance, future prospects and consequently the price of its stocks in the market. These include the demand and supply situation for the industry's goods and service, raw materials costs and the regularity of supply for the industry; effects of government policies; bank credit availability to the industry; and the impact of inflation on the industry.

3. Economic Specific Factors:

The economic situation and level of development at large can also influence the fortunes and performance of industries and companies operating there in and consequently the prices of stocks in the market. These include the general economic outlook and investment conditions; interest rate, inflation rates and changes in money supply; economic stability; balance of trade and payment performance; levels of investment and consumption; and the strength of the domestic currency.

4. Political Factors:

The political climate of the country in which industries and companies operate, as well as the effects of government policy directions on corporate performance also affect stock price. The major political factors which play key roles here include:

(a) political stability and the possibility of loss of investment and drop in business activities as a result of outbreak of hostilities.

(b) change of government and possibilities of new government policies that might affect business activities.

5. Monetary Rules and Policy

There tends to be close relationship between money supply and stock prices as observed by Maku and Atanda (2009). Since, the total money in circulation is controlled by the Central Bank through the use of monetary policy instruments; therefore the direction of the policy from time to time determines the movement of share prices. Also, interest rate on loanable funds for credit creation is not channel through which monetary policy influence equity pricing (Maku and Atanda, 2010). The mechanism of interaction is depicted in the figure 1 below.

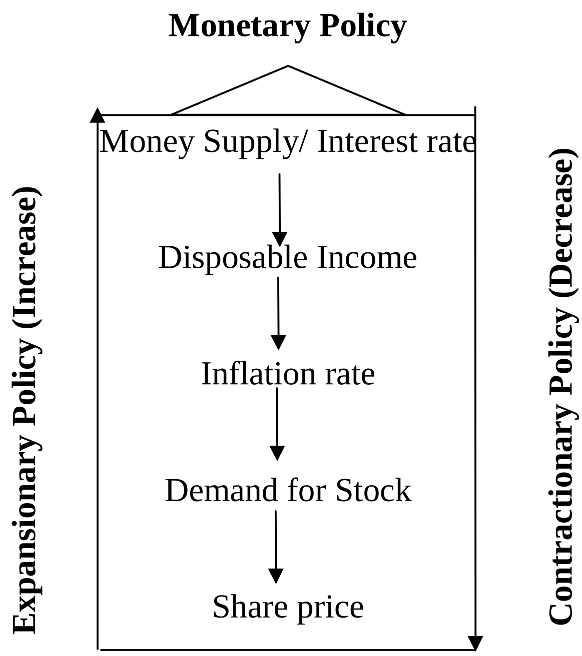

Figure 1: Monetary Policy and Sharing Paring Transmission Mechanism

The figure 1 shows that an expansionary monetary policy will increase money supply or reduces interest rate, disposal income of investors and lead to increase in inflation rate. Consequently, the demand for stock will increase and lead to increase in share price because demand will exceed supply of stocks at the market.

5.2 TECHNICAL FACTORS

The proponents of the technical factors posited that factors that determined stock price movement in the capital market are reflect in the price behaviour of stocks in the market. They argue that psychological and other factors like investors' emotions epitomized in the sometimes irrational behaviour of investors are also important in determining the behaviour prices in the market. Thus, it is possible to predict the future price of a stock by a diligent and painstaking study of the historical price movement of the stock in the market using techniques of technical analysis like moving average, confidence index, relative strength analysis, Fibonacci analysis, pivot point analysis, Bollinger-band analysis and other trend analysis techniques.

Hence, technical analysis is based on the assumption that stock prices are determined by demand and supply for these securities in the market, mainly as a result, not only of investors' perception of the intrinsic value of a stock, but also the tangible market sentiment and emotions which cannot be quantified. Technical analysis is thus the plotting of historical financial data on charts and graphs and estimating the next price movement or change based on the last price change. It involves studying these historical graphs in an attempt to discover meaningful trends and patterns to be used in prediction future prices.

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