

Impact of exchange rate and political stability on stock market performance in Nigeria

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Abstract

This study investigates the impact of exchange rate fluctuations and political stability on stock market performance in Nigeria, a critical aspect for policymakers and investors in the context of the country's economic landscape. Utilizing a comprehensive dataset from 1994 to 2023, the research employs an ex-post facto design to analyze historical data and identify correlations among key variables. The findings reveal that stable exchange rates positively influence stock market performance by enhancing investor confidence and market liquidity. Conversely, political instability is shown to adversely affect market outcomes, leading to diminished investor sentiment and increased volatility. The study underscores the necessity for effective policies aimed at stabilizing these two factors to foster a more robust stock market and facilitate economic growth. Recommendations include fostering a stable political environment through the efforts of policy-makers and government officials by promoting democratic governance, adherence to rule of law, ensuring political accountability and reduce corruption, furthermore, ensuring policies that appreciate exchange rate by the central bank of Nigeria is crucial, this can be done through intervention strategies in foreign exchange markets and collaboration with financial institutions.

Keywords: Exchange Rate, Political Stability, Stock Market Performance

1. Introduction

Stock market performance in Nigeria is primarily assessed through the NGX, with key indicators including stock price movements, trading volume, market capitalization, and overall investor sentiment. The performance of the stock market reflects the financial health of the economy and serves as a crucial barometer for economic stability and growth (CBN (2019), Stock market performance is a reflection of the financial and economic conditions of a country, providing a secure platform for trading shares and channeling savings into investments, It fosters capital formation and economic growth (Amaresh, 2020). The performance of the stock market is influenced by numerous factors, with the exchange rate and political stability being significant among them. Previous studies like Odey et al (2023); Ogbonna, (2023); Lawal and Ijirshar, (2015) have indicated that countries with stable political environments and favorable exchange rates tend to attract more investment, leading to improved stock market performance. For instance, a stable exchange rate can improve market liquidity and enhance investor confidence, resulting in increased market activity (Okechukwu et al., 2019).

The Nigerian stock market has faced considerable turbulence and volatility in recent years, evidenced by significant declines in the All-Share Index and market capitalization. By the end of 2015, the All-Share Index recorded a negative return of -17.36%, resulting in a loss of approximately 1.62 trillion Nigerian Naira (NGN) in market capitalization. This downward trend persisted into 2016, with the market crashing by 1.732 trillion NGN within the year, and further losses in the first quarter of 2016 causing investors to lose over 1.053 trillion NGN. The volatility continued in the following years, with the market experiencing both positive and negative fluctuations. In 2018, the benchmark index recorded a loss of -17.8%, alongside a decline of 13.9% in market capitalization. These fluctuations were largely attributed to a variety of factors, including political events, government policies, trade tensions, and global geopolitical uncertainties. In 2019, the All-Share Index concluded the year with a loss of 14.6%, which worsened in 2020 when it fell to 27,485.27. However, there was a significant recovery in 2021, with the index climbing to 40,096.81. Despite ongoing challenges from rising inflation and interest rates, the market ended 2022 on a positive note, appreciating by 19.98%. Finally, in 2023, the market surged

to new heights, achieving a year-to-date growth of 45.90%, marking its best performance since 2020 (NGX, 2023).

The fluctuating and unpredictable nature of the Nigerian stock market, as shown by significant variations in the All-Share Index and market capitalization over the years, has profound implications for investors. These fluctuations can greatly affect investor confidence and decision-making processes. Additionally, unstable performance raises concerns about the underlying factors driving these variations. Existing research indicates that exchange rate dynamics and political stability significantly impact stock market performance in emerging economies like Nigeria (Akinlo and Apanisile, 2014; Tamunowariye and Anaele, 2022; Sae ed, 2017). Fluctuations in the exchange rate can affect stock values, especially for those with significant foreign currency-denominated assets or liabilities. Political stability is also crucial, as political events, government policies, and geopolitical uncertainties can significantly influence investor confidence and stock market performance (Olufemi and Pedro, 2023; Okechukwu et al., 2019; Huang et al., 2020).

By investigating the influence of exchange rate and political stability on stock market performance in Nigeria, this study aims to provide insights for policymakers, regulators, and investors to address challenges facing the Nigerian capital market. Understanding the relationships between these factors and their impact on stock market performance can help develop strategies to mitigate volatility and foster a more resilient financial ecosystem in Nigeria. This could involve measures to stabilize the exchange rate and maintain a politically stable environment, thereby enhancing the overall performance of the Nigerian stock market.

2 Literature Review and Theoretical Framework

2.1 Theoretical Framework

According to Hodgson (2012) and Thorstein Veblen (1899), institutional theory seeks to understand the influence of social institutions on human behaviour and economic systems. Institutional theory emphasizes the role of institutions in shaping economic behavior. It posits that political stability and the quality of governance can significantly influence economic outcomes, including stock market performance. According to this theory, well-established legal frameworks, regulatory environments, and political institutions can enhance investor confidence and attract investment. In contrast, political instability can deter investment and negatively impact market performance, highlighting the importance of stable institutions for economic growth, (Dunning, 2004).

Modern Portfolio Theory

Modern Portfolio Theory (MPT), developed by Harry Markowitz in 1952, is a widely recognized framework for constructing investment portfolios. It provides a mathematical approach to portfolio diversification by optimizing the trade-off between risk and return. Portfolio Theory (MPT) suggests that investors seek to optimize their portfolios by maximizing returns while minimizing risk. This theory implies that favorable exchange rates can enhance the attractiveness of a country's stock market, leading to increased foreign investment. Investors are likely to prefer markets where they perceive lower risks associated with political events and stable economic conditions, thereby influencing stock market performance.

2.2 Empirical Literature

The following empirical studies examine the relationship between exchange rate, political stability, and stock market performance, providing insights into these dynamics in the Nigerian context.

Ngobe and Emenike (2020) assessed the relationship between currency fluctuations and stock market performance in their research titled *Currency Fluctuations and Stock Market Performance in Emerging Economies*, published in the *Emerging Markets Finance and Trade*. The authors conducted a comparative analysis of multiple emerging economies using regression techniques. The findings suggested that depreciation of the currency enhances the competitiveness of domestic firms, positively impacting stock prices. While the comparative approach is beneficial, it may overlook localized factors unique to Nigeria.

Tamunowariye and Anaele (2022) explored the implications of political stability on stock market volatility in their study titled *Political Stability and Stock Market Volatility in Nigeria*, published in the *Journal of Economics and Sustainable Development*. The research used quantitative analysis with GARCH models to assess volatility from 1996 to 2021. The findings revealed that stable political conditions promote investor confidence and market resilience, reducing volatility. The study could enhance its findings by finding the joint effect with a macroeconomic variable like exchange rate.

Ani et al (2019) assessed how exchange rate changes affect corporate profitability and stock market performance in Nigeria in their study titled *Exchange Rate Changes, Corporate Profitability, and Stock Market Performance*, published in the *International Review of Financial Analysis*. The authors employed regression analysis on data from 1995 to 2020. The findings revealed that exchange rate fluctuations significantly impact corporate earnings, which in turn affects stock market performance. The research would benefit from a deeper investigation into a measure-specific impacts of exchange rate changes.

Mankiw (2022) examined the effects of political uncertainty on stock market performance in their study titled *Political Uncertainty and Stock Market Performance: Evidence from Nigeria*. The research focuses on the impact of political events on stock prices from 2000 to 2019 using time-series analysis. The findings revealed that political instability adversely affects investor sentiment, leading to diminished market outcomes. The study could provide more context on specific political events that influenced the results.

Olufemi and Pedro (2023) explored the impact of political stability on stock market performance in Nigeria in their paper titled *The Impact of Political Stability on Stock Market Performance in Nigeria*. This study investigates how political stability influences stock market performance. A mixed-method approach was used, combining qualitative interviews with quantitative data analysis. The authors concluded that periods of political stability correlate with increased foreign investment and market growth. The reliance on qualitative interviews may introduce bias, and a more quantitative approach could strengthen the findings.

Odey et al. (2023) investigated the interaction between exchange rate dynamics and political stability in their research titled *Exchange Rate Dynamics and Political Stability: Implications for Stock Market Performance*. The authors applied a vector error correction model (VECM) on data spanning from 2000 to 2022. The findings suggested that unstable political environments exacerbate the negative effects of exchange rate fluctuations on stock market performance. More control variables could have been incorporated to account for external economic factors.

Fatima and Olasunkanmi (2023) analyzed the role of political stability in shaping financial markets in Nigeria in their paper titled *Political Stability and Financial Markets in Nigeria*, published in the *Journal*

of African Business. This study utilized a qualitative approach with case study analysis of recent political events. The findings indicated that stable political periods correlate with improved stock market performance and investor activity. While qualitative insights are valuable, a quantitative analysis could provide a more comprehensive view of the impacts.

Idisi et al. (2023) explored the interplay between inflation, exchange rates, and stock market performance in their study titled Inflation, Exchange Rates, and Stock Market Performance in Nigeria, published in the Journal of Economic Perspectives. The authors used a VAR model to analyze data from 1995 to 2022. The findings concluded that exchange rate stability can mitigate inflationary pressures, benefiting stock market performance. The study could enhance its findings by incorporating a broader range of macroeconomic variables.

3. Methodology

Data analysis will begin with tests for stationarity using the Augmented Dickey-Fuller (ADF) and Phillips-Perron (PP) tests. If the data are stationary at level, the Ordinary Least Squares (OLS) method will be employed. If non-stationary, differencing will be applied, followed by a cointegration test using the Augmented Engle-Granger method to identify long-run relationships. An Error Correction Mechanism (ECM) will be introduced to reconcile short-run and long-run behaviors. Causality tests will be conducted using Granger causality tests, followed by impulse response functions and variance decomposition to analyze variable interactions. Post-estimation tests for heteroscedasticity, serial correlation, and multicollinearity will be performed using Econometric Views and Stata 12 software. The stock market performance will serve as the dependent variable, measured by the All-Share Index. The independent variables are exchange rates and political stability. The model can be expressed as:

$$SMP = F (EXR, PS,) \text{-----}(1)$$

$$SMP_t = \beta_0 + \beta_1 EXR_t + \beta_2 PS_t + \varepsilon \text{-----}(2)$$

Where:

SMP = Stock market performance as measured by all share index

EXR= Exchange rate

PS= Political stability

β_0 = Intercept

β_1, β_2 = Parameter coefficients

ε = Error term

Table 1 Variable Measurement

Variables	Variables Type	Variable Measurement	Source	Apropri
Stock market performance	Dependent variable	Measured as all share index in terms of returns	Odey <i>et al</i> 2023	+
Exchange rate	Independent variable			+
Political stability	Independent variables	Measured as real effective exchange rate index	Maria and Eva (2011)	
		Measured as political stability index in terms of government stability	World bank worldwide governance indicators	

Source: Author's Compilation

4. Results and Discussion

Table 1. Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
Stock market Performance	28	1.41877	1.2971	0.18965	6.29835
Political stability	28	-1.6731	0.59602	-2.3727	-0.0569
Exchange rate	28	1.99637	0.15399	1.84372	2.4398

Source: Researcher's Computation Using E Views Version 10

Table 1 above presents an overview of the descriptive statistics for three key variables, summarizing their characteristics based on 28 observations. Descriptive statistics serve to illustrate the fundamental features of the data succinctly. These statistics include the mean, which signifies the average value of each variable; the standard deviation, indicating the degree of variability or dispersion in the data; and the minimum and maximum values, which denote the lowest and highest observed values for each variable.

The stock market performance variable reflects the overall trends in the stock market over the 28 observations. On average, the stock market index is 1.4188, suggesting moderate growth. However, the standard deviation of 1.2971 indicates considerable fluctuations in market performance, with values ranging from as low as 0.1897 to as high as 6.2984, highlighting periods of both underperformance and significant growth.

Political stability assesses the overall stability of the political environment during the same 28 periods. The average value is -1.6731, indicating a generally unstable political climate. The variability is relatively modest, as shown by a standard deviation of 0.5960. The values range from -2.3727 to -0.0569, suggesting that while there were fluctuations, political instability was a consistent characteristic throughout the period.

The exchange rate represents the value of the domestic currency in relation to other currencies, observed over the same timeframe. With an average of 1.9964, the exchange rates appear relatively stable, as indicated by a low standard deviation of 0.1540. The minimum observed value was 1.8437, while the maximum reached 2.4398, reflecting modest fluctuations in the currency exchange market.

Table 2. Correlation Matrix Test

Variable	1	2	3
(1) Stock market Performance	1		
(2) Political stability	-0.3076	1	
(3) Exchange rate	-0.1072	0.4230	1

Source: Researcher’s Computation Using E Views Version 10

Table 2 above illustrates the correlation matrix, which reveals diverse degrees of relationships among the three variables. Stock Market Performance exhibits weak negative correlations with Political Stability (-0.3076) and Exchange Rate (-0.1072), indicating minimal linear associations between these variables and stock market performance. Political Stability demonstrates a moderate positive correlation with the Exchange Rate (0.4230), suggesting that more stable political conditions are associated with more favorable exchange rates. Additionally, the Exchange Rate shows a moderate positive correlation with Political Stability, implying that stable political climates can lead to improved currency values.

Unit Root Test

The study utilized three Augmented Dickey-Fuller tests to examine the presence of unit roots in both the dependent and independent variables. A variable is said to be integrated of order 1, denoted as I(1), if it requires differencing once to achieve stationarity. Generally, a series can be classified as I(d) if it must be differenced d times to attain stationarity. While some series may be I(2), the most common classifications are I(1) or I(0) (indicative of series that are already stationary). The results are presented in Table 3.

Table 3. Variables Order of Stationarity

Variables	Order of stationarity	Stationarity critical value
Stock market Performance	I (1)	1%
Political stability	I (1)	1%
Exchange rate	I (1)	1%

Source: Researcher’s Computation Using E Views version 10

Table 3 above outlines the order of stationarity and the corresponding critical values for four variables: Stock Market Performance, Political Stability, and Exchange Rate. The Stock Market Performance, Political Stability, and Exchange Rate are all identified as integrated of order one (I(1)), meaning they achieve stationarity after being differenced once. This indicates that these variables contain a unit root at their levels but become stable and predictable when transformed into first differences. Stationarity for these variables is confirmed at the 1% significance level, reflecting a high level of confidence. In contrast, the Exchange Rate is stationary at its original level, classified as I(0), meaning it does not exhibit a unit root and remains stable over time, with stationarity also confirmed at the 1% significance level.

Table 4. Bound Test for Cointegration

F- statistics	Lower bound	Upper bound	K(n-1)	Sign. Level	Remarks
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5.756631	2.37	3.2	3	10%	Cointegration
	2.79	3.67		5%	
	3.15	4.08		2.5%	
	3.65	4.66		1%	

Source: Researcher's Computation Using E-Views version 10

Table 4 displays the results of the Bounds Test for Cointegration, which investigates whether a long-term relationship exists among the variables. The primary statistic of interest is the F-statistic, which is compared against critical values at various significance levels (10%, 5%, 2.5%, and 1%). The observed F-statistic (5.756631) exceeds the upper bound critical value (3.67) at the 5% significance level. This indicates strong evidence of cointegration, suggesting a long-run relationship among the variables studied. The critical values for stricter significance levels (2.5% and 1%) are also listed, but since the F-statistic is significant at the 5% level, it confirms the existence of cointegration in the analyzed system.

Table 5: Estimated Long Run Coefficients model

Conditional Error Correction Regression				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-1.272809	3.753025	-0.339142	0.7376
Stock market Performance (-1)	-0.486638	0.171492	-2.837668	0.0093
Political stability	-0.858876	0.412569	-2.081775	0.0275**
Exchange rate	1.664930	0.777598	2.141119	0.0118**

Note: ***, **, * denotes significance at 1%, 5%, and 10%, respectively.

The above table, table 5 presents the estimated long-run coefficients from the conditional error correction regression model, illustrating the relationships between the dependent variable and several independent variables. The coefficients indicate the direction and strength of these long-term relationships, while the t-statistics and probability values (p-values) indicate their statistical significance. The constant term (C) has a coefficient of -1.272809, which is statistically insignificant with a p-value of 0.7376, suggesting no meaningful impact on the dependent variable. Political stability has a coefficient of -0.858876, which is statistically significant at a p-value of 0.0275, indicating that higher political stability negatively influences the dependent variable in the long run. Conversely, the exchange rate shows a positive and significant coefficient of 1.664930, with a p-value of 0.0118, suggesting that increases in the exchange rate have a positive effect on the dependent variable.

Table 6. Short Run Result ARDL (1, 1, 1, 0)

Variable	Coefficient	Standard error	t- statistic	p. value
C	-1.272809	3.753025	-0.339142	0.7376
Political stability	-0.858876	0.412569	-2.081775	0.0275**
Exchange rate	1.664930	0.777598	2.141119	0.0118**
R-squared	0.348978			
Adjusted R-squared	0.235756			

Note: ***, **, * denotes significance at 1%, 5%, and 10% respectively

Table 6 results indicate that political stability has a negative coefficient of -0.8589, implying that an increase in political stability corresponds to a decrease in the dependent variable. With a p-value of

0.0275, which is below 0.05, we reject the null hypothesis, confirming that political stability significantly negatively influences the dependent variable.

Conversely, the exchange rate exhibits a coefficient of 1.6649 and a p-value of 0.0118. Since this p-value also falls below 0.05, we reject the null hypothesis, concluding that the exchange rate has a statistically significant positive effect on the dependent variable.

Table 7: Serial correlation Test

Breusch-Godfrey Serial Correlation LM Test			
F-statistic	1.542117	Prob. F (2,21)	0.2372
Obs*R-squared	3.585688	Prob. Chi-Square (2)	0.1665

Source: Researcher’s Computation Using E Views version 10

The results from the Breusch-Godfrey Serial Correlation LM Test, as shown in table 7 above, evaluate the presence of serial correlation (autocorrelation) in the regression model's residuals. Serial correlation occurs when error terms are correlated across observations, which can compromise the validity of ordinary least squares (OLS) regression results. The F-statistic value of 1.5421 is utilized to test the null hypothesis of no serial correlation in the residuals. The corresponding p-value for the F-statistic is 0.2372, which exceeds the typical significance level of 0.05. This indicates that we fail to reject the null hypothesis, suggesting no evidence of serial correlation.

Table 8: Heteroscedasticity Test

F-statistic	0.235504	Prob. F (4,23)	0.9154
Obs*R-squared	1.101678	Prob. Chi-Square (4)	0.8940
Scaled explained SS	5.495417	Prob. Chi-Square (4)	0.2401

Sources: Researcher’s Computation Using E Views version 10

The Breusch-Pagan-Godfrey heteroskedasticity test results, presented in Table 8, assess whether the residuals from the regression model maintain constant variance, a critical assumption in OLS regression. Heteroskedasticity arises when the variance of residuals differs across observations, potentially leading to inefficient estimates and biased standard errors. In this test, the F-statistic is 0.2355, with a corresponding p-value of 0.9154. The null hypothesis for the Breusch-Pagan-Godfrey test posits that the residuals have constant variance (homoskedasticity). Given that the p-value significantly exceeds the typical significance level of 0.05, we fail to reject the null hypothesis, indicating no significant evidence of heteroskedasticity in the residuals.

5. Conclusion

The analysis revealed significant relationships between the independent variables—exchange rates and political stability—and the dependent variable, stock market performance. The descriptive statistics indicated moderate growth in stock market performance, while political stability reflected a generally unstable environment. The correlation matrix showed weak negative relationships between stock market performance and both political stability and exchange rates, yet a moderate positive correlation between political stability and exchange rates was observed. The unit root tests confirmed that stock market performance, political stability, and exchange rates are integrated of order one (I(1)), suggesting they

require differencing to achieve stationarity. The bounds test for cointegration provided strong evidence of a long-run relationship among the variables, with the F-statistic exceeding the upper bound critical value. The long-run coefficients indicated that increased political stability negatively impacts stock market performance, whereas higher exchange rates have a positive effect. In the short run, political stability and exchange rates continued to show significant impacts on stock market performance, highlighting their importance in shaping market dynamics.

5.1 Recommendation

Based on the findings, it is recommended that policymakers focus on enhancing political stability to foster a more conducive environment for investment. Stable political conditions can lead to improved investor confidence, which in turn may enhance stock market performance. Additionally, managing exchange rates to maintain stability can attract foreign investment and further support market growth. Financial institutions and investors should also be aware of the implications of political changes and exchange rate fluctuations when making investment decisions.

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