

## Interest Rate and the Growth of Capital Market: Imperatives for Economic Development in Nigeria

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**Abstract:** The importance of the capital market to any nation's economic growth cannot be overemphasized. Nations have embraced stock trading in order to raise and distribute capital resources for the development of their economy, and Nigeria not being an exception have faced numerous challenges associated with growing economies. The nature and trend of interest rate have been found to exert a lot of influence on the growth of the capital market even in the developed countries. This is why this paper took a mindful look at the impact of interest rate on capital market growth in Nigeria. The paper explored the history of the Nigerian capital market, highlighted the challenges to the growth of the Nigerian capital market and examined the relationship between interest rate and investment in relation to their impact on the Nigerian capital market growth. It is discovered that the higher the interest paid on deposits by banks, the more investors patronize the banks, consequently pulling their resources from the capital markets leaving the market in a stunted nature. It is the paper's position that the fluctuation of interest rate constitutes a major impact on the growth of the Nigerian capital market.

**Keywords:** economic growth, markets, development, capital resources

### INTRODUCTION

The continuous growth and survival of every business entity is dependent upon the ability of such enterprise to access and continuously increase capital [1]. This is because for the business to run smooth and easy there is the need to employ more competent staff, upgrade to modern technology and source for quality raw materials etc. It is in the bid to meet this business need that the capital market exists. Capital market according to Owolabi and Adegbite [2] are markets where long term financial securities such as ordinary shares, debt securities like debentures, unsecured loan stock and convertible bonds are traded.

The capital market has been seen to be so significant for the growth of economies worldwide through its aid to business capital formation [3, 4] and this has been made possible through stock exchange. According to Chris and Roland [5] in consonance with Levine [6], the stock market makes room for liquidity and provides aid to capital formation. It also reduces risk on investment which it does by opening opportunities for portfolio diversification. Levine [6] argued the value of stock market in the sense that its liquidity role allows investors the confidence to make long term investments.

Ologunde *et al* [7] argued that for any investment to contribute to economic growth and development it must be by long term funding and such long period of investment is what most savers are not willing to allow their fund. In line with this, Akingunola *et al* [8] argued that for economic growth and development to be sustainable, there is the need for mobilization and allocation of funds which will aid business to harness human and material resources that will make the growth possible.

In view of the above significant role of the capital market to economic growth, the Nigeria capital market was created, and like other capital markets around the world, it aims at providing long term capital to aid development. The role of the Nigeria capital market in providing ready capital for business entities and investment opportunities for investors have raised the opportunity for Foreign Direct Investment (FDI) with its attendant benefit to economic growth. Yet a closer look at the Nigerian economy reveals that along with monetary aggregates, the interest rate has become the rallying point for economic policies in Nigeria [9]. This is so because as argued by Akingunola *et al* [4] when the banks increase the interest rate on deposits, investments tilts towards bank deposit which will invariably decrease investment on capital. This makes the economy suffer since nation's output is to a large

extent determined by how capital resources are allocated.

It is in line with the above understanding that this study seeks to review literature on interest rate and capital market growth in Nigeria. It shall specifically take an overview of the history of the Nigerian capital market; investigate challenges to the growth of the Nigerian capital market; and review the relationship between interest rate, investment and capital market growth in Nigeria.

### **THE NIGERIA CAPITAL MARKET IN PERSPECTIVE**

According to Esosa [10] the history of the Nigeria capital market can be traced to the colonial periods when the colonial government sought for funds to run the day to day administration of the nation and therefore resulted to sourcing funds from the public sector. Nyong [11] argued that they started with the enactment of the 1946 Ordinance for the floatation of the first N300, 000 Government stock 1956/61.

In 1957 further moves were made through the enactment of the Government and Other Securities Acts, which described the types of securities for the investment of trust funds. The same year register the promulgation of the General Loan and Stock Act and the Local Loan Act. To lay a good foundation for the off-take of the Capital market, the Central Bank of Nigeria was formed in 1958 to consolidate on the previous policies.

This continued through the Federation of Nigeria Loan Stock of 1959; Statutory Corporations Act 1959; the first Nigerian Treasury Bills by Central Bank in 1960; the Lagos Stock Exchange in 1960 by the Lagos Stock Exchange Act 1960; in 1961 the LSEA had 19 listed securities of 3 equities. 1966 marked the enactment of the Borrowings by Public Bodies Act which paved way for the 1968 Companies Decree.

The 1972 and 1973 Nigerian Enterprises Promotion Decree and Capital Issues Commission Decree respectively are very significant to the history of Nigeria capital market. This is because the Capital Issue committee got the official role of regulating the Nigeria Capital Market. Then the Lagos Stock Exchange was nationalized in 1977 and the name was changed to the Nigerian Stock Exchange by the Indigenization Decree of 1977.

The Second tier Securities Market opened in 1985 to take care of the SMEs. The Companies and Allied Matters Act was enacted in 1989; the Chartered Institute of Stockbrokers Decree was enacted in 1992 and in same year, the Central Securities Clearing

System was incorporated. The capital market was deregulated in 1993 and in 1995 the Nigeria Investment Promotion Act was enacted. The Odife Panel was commissioned in 1996 by the Federal Government of Nigeria to review the Nigerian Capital Market and their recommendations resulted in the promulgation of the Investment and Securities Act of 1999.

The Automatic Trading System came into operation in the Nigeria Capital Market in 1999 and it replaced the Open Outcry method. 2002 marked the inauguration of the Nigeria Investment and Securities Tribunal. In 2005 the 19<sup>th</sup> floor of the Nigeria Stock Exchange was opened and e-IPOs and e-Pos were introduced into the Nigerian Capital Market which has been electronic till date [10-13].

### **IMPEDIMENTS TO THE GROWTH OF THE NIGERIAN CAPITAL MARKET**

Though this study's variables are the interest rate and capital market, it became unavoidable to take another variable in discussing the challenges to the growth of the Nigerian capital market, and this variable is the exchange rate. Exchange rate like the interest rate is one of the major factors that affect the behavior of the capital market worldwide. In Nigeria the exchange rate fluctuation has been a cause for concern to financial policy makers.

The capital market is what determines the financial situation of any economy [2], and this is dependent upon how volatile the exchange rate of that nation is. Yet research reports like that of Shigeru and Evan [14] have been led by the recent exchange rate crisis to argue that exchange rate volatility is necessary to tackle the capital market volatility. And Owolabi and Adegbite [2] agree that the fluctuations in exchange rate determine to a large extent the trend of any nation's financial system via the capital market.

Akingunola *et al* [4] identified the all share index as the major factor that determines the general performance of the capital market, and therefore extends the logic, that the size and growth of the all share index influences the economic development of any nation. Nevertheless, it is also argued that monetary policies in Nigeria revolve around interest rate and that an increase in the interest on deposit results to an increase in bank deposits and decrease of investment in the capital market. This has led to slow growth of the capital market since the banks are always trying to out-compete their counterparts by raising their interest on deposits. This has led to fluctuations on interest rate as they often don't maintain the increase.

Ujunwa *et al* [15] have argued that political and administrative inefficiency has also affected the

Nigerian capital market. According to them, one cannot say that the financial crisis is the cause of lag in the growth of the Nigerian capital market because, while the developed economies were busy injecting liquidity into their capital market to help their market survive the crisis, the then Central Bank of Nigeria governor was busy deceiving investors by asking them not to worry [16]. Yet the Nigerian financial system was seriously hit, a situation that led to many investors pulling out of the Nigeria stock market.

Inflation is another factor which affects the growth of the Nigerian capital market. According to Gerolamo [17], interest rate stands between inflation and the capital market; which is to say that inflation impact on the interest rate and the interest rate transfers the impact on the capital market. In agreement, Daferighe and Aje [18] who studied the impact of Real Gross Domestic Product, Inflation and Interest rate on stock prices of quoted companies, reports a negative correlation between inflation, interest rate and stock prices.

#### **INTEREST RATE, INVESTMENT AND CAPITAL MARKET GROWTH IN NIGERIA: A NEXUS**

Interest rate is an important variable in the discourse of international finance and a very significant factor to consider in the planning of any nation's economic development. And to discuss its relationship with the capital market, it will be easily understood if discussed together with investment. This is so as has been argued by some researchers, that "high cost of credit hampers investment [19, 20]. But whether one agrees with that or not, the major issue here is that there exist a relationship between interest rate and investments which this study sets to review in this section with the aim of finding out the effect of their relationship on the Nigeria capital market.

Interest rate according to Obansa *et al* [21] is the reward of accumulating financial assets at the expense of current consumption. And Soludo [16] defined it as the cost of capital that influences how borrowers demand for loan-able funds. Then Onwumere *et al* [22] see interest rate as the rental payments for the use of credit by borrowers. In all the above definitions, one can derive that interest refers what one expects to get in return for giving out one's credit in cash or otherwise.

Research findings have reported in different ways, the relationship between interest rate and investment particularly, and interest rate and economic development generally. Engle and Rangel [23] compared the developments in the industry and capital markets of three countries namely Brazil, Mexico and the US between 1830 and 1930 in order to understand

the relationship between interest rate and economic development. The result from that research was that capital market developments affect industrial composition and the nation's economic output. Many other research findings reports that interest rate have positive effects on economic development, but most of this reports never said how this happens [21, 24-26].

Jhingan [27] argues that when interest rate is high, it reduces the level of investment and when interest rate is low, investment will rise. This goes to say that to encourage investment, there is the need for an interest rate regime that protects the interest of investors by ensuring less cost of spending on investment, which will boost economic development. Nevertheless, Vaish [28] opined that demand for capital is made for the purpose of production and consumption. According to their opinion, it is the benefit of capital that makes investors demand for it.

But Owolabi and Adegbite [2] argued that "the productivity of capital is subject to the law of variable proportions". Jhingan [29] further argues that capital supply is determined by savings and not the will or power to save. Many people will always save in spite of the rate of interest, while some follows the trend of interest rate in saving. This goes to say that if for instance banks increase the rate of interest on deposits, they will record increase in savings which according to Akingunola [8] will affect capital supply via the capital markets.

In line with the Keynesian and Neoclassical theories, Odhiambo [30] argues that low interest rate encourages investment and economic growth both in developing and developed countries; which agrees with Chete [24] who concluded that interest rate is a significant factor in Nigeria's economic growth. But Chete [24] emphasized the effect of deregulating interest rate which according to the report does not encourage investment until the other factors of investment is well taken care of.

Obadeyi *et al* [31] opined that when the interest rate is low it lowers borrowing cost for investors and consequently increases the tendency to invest since the cost of capital is low. In a related report Nwachukwu and Odigie used the error-correction model to examine the determinants of deposit in Nigeria between 1970 and 2007. They found that deposits increase as much as real interest rate on bank deposits increase. This goes to say that resources for capital mobilization is channeled to the banks as savings when interest rate on deposit is increased thereby affecting capital supply and consequently the economic growth of the nation.

## POLICY SUGGESTIONS FOR CAPITAL MARKET GROWTH IN NIGERIA

From the fore going, it would be enough to suggest as follows:

- That if the Nigerian Capital Market would grow to achieve the objective of its establishment, the government in collaboration with other stakeholders should create incentives and make necessary policies that will keep lending rate low and steady. This will motivate investment into the capital market as investors can confidently borrow from the banks.
- Sagacious and all-encompassing economic policies should be made in order to explore all the benefits of the Nigerian capital market.
- An amendment of the legislation on the appointment of the Central Bank of Nigerian governor. This is necessary in order to make that appointment free from the control of political parties in order to allow transparency in the selection of one who is qualified and vested with the knowledge of both local and international economic dynamics. It is only when this is done that the nation will be able to avert such incident that occurred in Nigeria during the Global Economic Crisis which made the Nigeria Stock Market lose many investors.
- When the above is done, then the government can apply the use of incentives to regulate the rate of fluctuations of the interest and exchange rate. This will help to stabilize the occasional increase in banks' interest on deposit which pulls resources from the capital market into banks' savings. Such incentives can also be made to affect the lending rate in order to encourage borrowing from banks and investing in the capital market.
- The regulating authorities should as well look into the regulation of interest rates on savings in the banks. If interest on deposits is fixed and lending interest is reduced, this will cause investors to borrow from banks instead of saving. And such credit will be reinvested in the capital markets.

## CONCLUSIONS

The fact that no business entity can continue to survive in the contemporary economic world without a continuous supply of capital have made the capital market an attractive one in the global business stage. And any country that can make her capital market juicy and attractive is on her way to rapid economic development. This study has discovered that as much important as the capital market is to the economy, the Nigerian capital market is still facing some major challenges. The challenges faced by the Nigerian capital market include interest and exchange rate fluctuations, political and administrative inefficiencies, and the global economic crisis. These challenges have so far

reduced the growth rate of the Nigerian capital market, and consequently have not allowed it to fully achieve its founding objectives. And it is discovered also that interest rate affect investment and inversely impacts on the growth of the Nigerian capital market.

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