

Foreign Exchange Management and Economic Development in Nigeria

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Abstract

The choice and management of an exchange rate regime is a critical aspect of economic management to safeguard competitiveness, macroeconomic stability, and sustainable development. But rather, the country has continued to be at a disadvantage in terms of macroeconomic performances as the different regimes have been accompanied by instability and uncertainties, hence the need for the present study to examine the relationship between exchange rate regimes and output growth in Nigeria in different periods from 1970 to 2021. The study employs the Ordinary Least Square (OLS) to estimate economic growth equation as a result of endogeneity problem, Engle-Granger Residual Root Test of cointegration to estimate the long term relationships of the variables and Granger Causality test for study the direction of the variables. In contrast with previous findings, our study strongly suggests that exchange rate regimes indeed matter in terms of real economic performance in Nigeria as the results reveal that deregulated exchange rate regimes spur economic growth in Nigeria as against the whole period and fixed exchange rate regime. All in all, the findings suggest that fixed exchange rates constrain the performance of the Nigerian economy as the real exchange rate depicts an inverse relationship with economic growth during the whole period and period of the fixed exchange regime. It is against this background, that we recommend the sustainability of the regime of exchange rate liberalization that has been in operation from 1986.

Keys Words: Foreign Exchange, Management, Economic development, Exchange rate regimes

Introduction

The Nigerian economy aspires to become one of the 20 largest economies in the world by 2020 and 12 largest by 2050 (CBN, 2009). One of the surest ways to achieve the aforementioned goals is to seek strong, rapid and sustainable economic growth and development through well-managed exchange rate policies. Recognizing this role, Rodrick (2007) argues that poorly managed exchange rates can be disastrous for economic growth. Thus, exchange rates act as international prices that determine the competitiveness of a country. Similarly, Takaendesa (2006) explains that exchange rates play a decisive role in guiding the broad distribution of production and spending between foreign economy. Exchange rates are one of the most important prices in an open economy. It affects the flow of goods, services and capital in a country and exerts strong pressure on the balance of payments, inflation and other macroeconomic variables. The choice and management of the exchange rate regime is an important aspect of economic management to protect competitiveness, macroeconomic stability and

growth. Therefore, it could be said that the impact of exchange rate regimes on economic performance is one of the most controversial issues in macroeconomic policy, and empirical studies provide mixed results. One line of literature provides evidence that floating regimes are associated with higher growth (eg, Odusola and Akinlo 2001; Eichengreen and Leblang 2003; Levy-Yeyati and Sturzenegger 2003; "Reinhart and Rogoff 2004; Miles 2006). ; and Rano- Aliu 2009).

Among all the macroeconomic variables, the effect of changes in nominal and real exchange rates on macroeconomic conditions is gaining in importance due to the consolidation of financial markets and the acceleration of capital flows. Over time, after the closure of the Bretton Woods system, a floating exchange rate system was adopted in the major industrial economies and other emerging countries. Since then, the issue of the impact of exchange rate fluctuations on prices

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and aggregate output has received much attention. Economists have developed various explanations for the prominent factors in exchange rate fluctuations that have impeded the possible positive outcomes of effective macroeconomic management strategies as one of the main determinants of aggregate supply and demand. Empirical studies explaining the causes of these fluctuations have generally focused on two main approaches. The first suggests that changes in real exchange rates arise from nominal shocks that refer to changes in the relative prices of goods traded between countries (Dornbusch, 1976; Krugman, 1990, 1993; Engel, 1993; Eichenbaum & Evans, 1993; Bayoumi & Eichengreen, 1994). ; Engel, 1999; Roger, 1999). In this context, Clarida and Gali (1994) obtained similar results that monetary policy authorities influence the real exchange rate by modifying the price level and the nominal exchange rate through policy measures. A second perspective of empirical studies emphasizes that real shocks, or surges motivated by productivity, explain changes in real or nominal exchange rates (Balassa, 1964; Samuelson, 1964; Lastrapes, 1992; Inoue and Hamori, 2009).

Since exchange rate fluctuations partially reflect deviations from the basis on which exchange rates are determined, the possible causes of exchange rate fluctuations led to a review of the rationale for determining exchange rates. One of the theories that explains the determination of the real exchange rate is the Purchasing Power Parity (PPP) theory, which is based on the assumption that a good should be sold at the same price in several countries, excluding transaction costs. , when measured in a current currency. One of the main considerations that explains the deviation from the PPP condition is the Balassa-Samuelson effect. According to this effect, the price of a commodity is affected by the relative cost of production, which is determined by the relative productivity of the sectors that produce tradable and non-tradable goods. The impact of the trading sector on real exchange rates shows that increased productivity and competitiveness of the trading sector with foreign countries puts downward pressure on real exchange rates (Ricci and MacDonald, 2005). Therefore, it is very likely that the production process plays an important role in exchange rate fluctuations. Another idea that explains the deviation from PPP is the monetary approach developed by Mussa (1986), Frenkel (1976), and Bilson (1978, 1979), in which prices

are fixed in the short term, but exchange rates return to their equilibrium values. . In the long term, the PPP is maintained as the price adjusts.

According to Reinhart and Rogoff (2004), countries with intermediate regimes grow faster, and Levy-Yeyati and Sturzenegger (2003) found that in developing countries, less flexible exchange rate regimes resulted in slower growth, as well as an increased output volatility and Industrial Miles (2006)) argues that the impact of pegged exchange rates on growth in emerging markets is not direct, but depends on the existence of macroeconomic imbalances and other distortions. Rano-Aliyu (2009), a national economist, found in a study in Nigeria that an increase in the exchange rate had a positive effect on real economic growth in Nigeria and in Odusola and Akinlo (2001) Impact of currency depreciation on Nigerian output. On the other hand, Bailiu; France; And Perrault (2003) found that fixed rates were associated with higher growth rates. Several studies report marginal growth effects of exchange rate regimes (Ghosh; Gulde; Ostry; and Wolf 1997; Edwards and Magendzo 2006; De Grauwe and Schnabl 2008; Klein and Shambaugh 2010).

Since Nigeria's exchange rate policy has basically oscillated between the fixed exchange rate system since 1960, just after independence, and the fixed exchange rate system since 1986, when the fixed exchange rate system was introduced in the context of the restructuring program (SAP), the goods and services under the floating exchange rate system and the fixed exchange rate system. The various regimes were accompanied by instability and uncertainty. Exchange rate uncertainty due to macroeconomic reform can be divided into two types. The former reflects the systematic movement of exchange rates and the latter reflects exchange rate volatility. Exchange rate volatility affects economic performance through a variety of channels, including savings, lending rates, and inflation. However, Nigeria continues to face a series of economic problems due to exchange rate reforms. Among these problems are low levels of savings and investment, high inflation, and high levels of unemployment and poverty. Although the economic literature seems to make a stronger case for the idea that fixed exchange rates can lead to higher growth rates, the question of whether there is a link between regimes and growth can ultimately be addressed in the same way. Following way. It is an

empirical problem. Therefore, the purpose of this paper is to address this issue by examining the relationship between the exchange rate regime and output growth in Nigeria from 1970 to 2021.

Literature review

Conceptual Review

Exchange Rate: refers to the price of one currency relative to another. An exchange rate is the relationship between a unit of one currency and the amount of another currency for which that unit can be exchanged at a specific time (Ngerebo-a and Ibe, 2013). In other words, an exchange rate is the price of one currency relative to another and is the number of currency units required to buy another currency (Mordi, 2006). The exchange rate of a currency is the link between the internal and external prices of goods and services. Exchange rates can also go up or down. Exchange rate depreciation occurs when the unit of the domestic currency is less than that of the foreign currency.

Devaluation: is used interchangeably with depreciation. Devaluation refers to a decrease in the value of money converted to a specific unit of gold, while depreciation refers to a decrease in the value of money in a specific foreign currency. Since the IMF stopped measuring currency in gold in 1984, the terms are generally used interchangeably.

Economic history has shown that there are two general concepts of exchange rates: nominal and real exchange rates. The nominal exchange rate (NER) is a currency concept that measures the quantity or relative price of the currencies of two countries. However, as its name indicates, the real exchange rate (RER) is a real concept that measures the relative price of two goods-tradable goods (exports and imports) with respect to non-tradable goods (goods and services produced and consumed locally) (Obadan, 2006). Likewise, the nominal exchange rate is the number of units of national currency that must be yielded to obtain a unit of foreign currency. In other words, the nominal exchange rate is the price of the domestic currency converted into foreign currency. marked with e The real exchange rate is the relative price of foreign goods to domestic goods. That is, the price-adjusted exchange rate.

More complex measures of exchange rates go beyond bilateral comparisons to include

multilateral comparisons, and a good example of this is the real effective exchange rate. The real effective exchange rate is the weighted average of the real exchange rates between the two countries taking into account the trade share of each in the total trade of a country. Exchange rate issues should also be taken into account. The convertibility of a currency means that it can be easily converted from one currency to another without government restrictions.

Foreign Exchange Rate Management in Nigeria

Nigeria's foreign exchange policy has undergone many changes. It evolved from a fixed peg when it was pegged only to the British pound sterling in 1960. After the devaluation of the pound sterling until 1967, the US dollar was included in the exchange rate peg. Peg swaps with the British pound were discontinued in 1972 as a result of the strengthening of the US dollar.

In 1973, Nigeria returned to the pound sterling and to a peg due to the devaluation of the US dollar. In 1974, the Nigerian currency was pegged to the pound and the dollar to minimize the effects of the devaluation of a single individual currency. During most of the 1970s, rising oil prices on international markets continued to push up the Naira's nominal exchange rate. This increase in the nominal exchange rate led to an excessive dependence on imports, accompanied by capital flight, which reduced non-oil exports and ultimately caused balance of payments problems and depletion of foreign reserves. The increase in the marginal propensity to rent has disturbed the agricultural sector in Nigeria, Osaka, Mash and Adamgbe (2003). In 1978, the naira was linked to a basket of 12 currencies made up of Nigeria's major trading partners. However, the 1978 policy was removed in 1985, resulting in a bid for the Naira against the dollar. Prior to 1986, the prevailing exchange rate policy encouraged an overestimation of the Naira. To address issues related to overvaluation, the Naira was deregulated in September 1986 under a package of restructuring programs. The Secondary Foreign Exchange Market (SFEM) was introduced to strengthen the implementation of the restructuring program. SFEM was expected to introduce exchange rate determination and allocation mechanisms to ensure short-term stability and long-term balance of payments.

As stated by Mordi (2006), the intrinsic purpose of

SFEM is to achieve realistic Naira exchange rates through the market forces of supply and demand, a more efficient allocation of resources, the stimulation of non-oil efforts, containment of currency inflows and outflows, informal parallel currency trade Eliminate markets to prevent money traffic and improve the balance of payments. To achieve the objectives of SFEM, several modifications were made from the Foreign Exchange Market (FEM) to the Autonomous Foreign Exchange Market (AFEM), the Dutch Stock System and the Dutch Wholesale Auction System. FEM was introduced in July 1987 due to problems with first and second market interest rates. The bureau de change was introduced in 1989 to broaden the reach of FEM. In 1994, the fixed exchange rate system was reintroduced. In 1995 there was a deregulation reversal policy called the Autonomous Exchange Market (AFEM). In 1999, the Interbank Foreign Exchange Market (IFEM) was reintroduced. As a result, the official exchange rate system was abolished on January 1, 1999, and the dual exchange rate system was integrated. The continuation of the depletion of the foreign exchange market and of the country's foreign reserves. Finally, it was an attempt to further liberalize the market by introducing a wholesale DAS in 2006 to develop a realistic exchange rate for Naira.

Theoretical Literature

While the impact of exchange rate fluctuations on outputs has long been recognized in the literature, but there is no consensus on the direction of the effect, traditionalists believe that a fall in the exchange rate boosts the balance of trade, alleviates balance of payments difficulties, and thus expands the economy. Production and employment if the Marshall-Lerner condition is met (the Marshall-Lerner condition is that the sum of the price elasticity of export demand and the price elasticity of import demand is unity). According to Taye (1999), the mechanism behind these positive effects is that devaluation raises the relative price of imports and makes exporting industries more competitive in international markets, shifting the demand for imports towards domestically produced products. Encourages goods and industries to use more domestic inputs. Monetaryists, on the other hand, argued that changes in exchange rates did not affect real variables in the long run. The monetary view is that devaluation of exchange rates affects real size mainly through real equilibrium effects in the

short run, but leaves all real variables unchanged in the long run (Domac 1977). This approach is based on the assumption that purchasing power parity (PPP) is maintained. In the short term, it is predicted that a rise in the exchange rate will increase production and lead to an improvement in the balance of payments, but in the long run, the monetary result of the devaluation will guarantee an increase in production and an improvement in the economy. BOP is neutralized by rising prices.

Empirical Reviews

From an empirical point of view, the controversy over the impact of exchange rate fluctuations has not been resolved. For example, many researchers, such as Diaz-Alejandro (1963), Pierrer-Richard (1991) and Kandil (2004), Yaqub (2010), Bakare (2011), Adelowokan, Adesoye and Balogun, 2015, have studied the contractile effects of depreciation. Although we found evidence, we also found evidence for an expansive effect of currency depreciation in many studies, such as Fry (1976), Edwards (1992), Lyons (1992), Adewuyi (2005), and Bahmani-Oskooee & Kandil (2007). Opaluwa & Ame (2010), Omen Ehin & Oladipo (2012).

Does it float or not float in a study by Miles (2006)? Monetary regimes and growth argue that the impact of fixed exchange rates on growth in emerging markets is not direct, but rather depends on the presence of macroeconomic imbalances and other distortions in the domestic economy. For him, these results seem to fit better with exchange rate theory, which assumes mostly positive channels and few negative channels for fixed currencies to influence long-term growth.

Fapetu and Oloyede (2014) investigated foreign exchange management and economic growth in Nigeria from 1970 to 2012 using ordinary least squares estimation techniques within the framework of an error correction model (ECM). Research shows that an economy's exchange rate management influences several economic variables that affect economic growth.

Eze and Okpala (2014) performed a quantitative analysis of the impact of exchange rate policies on Nigerian economic growth. production of

goods and services. According to their research, in addition to government spending (GEX), both the exchange rate (EXR) and the money supply (M2) are very important in determining the performance of Nigeria's economic growth. In addition, the Chow test performed showed no significant structural change in the relationship between Nigeria's exchange rate and economic growth. This means that management efficiency is key, whether the exchange rate regime is fixed or flexible. Nigeria can significantly improve economic growth through improved overall management of its exchange rate policy.

Adelowokan, Adesoye, and Balogun ("2015) found that exchange rate volatility has a negative effect on investment and growth in their analysis of the impact of exchange rate volatility on investment and growth in Nigeria using vector error correction methods. Investments, growth and exchange rate volatility have a positive impact. Nigeria's relationship with inflation and interest rates. Apart from the debate surrounding the impact of exchange rate fluctuations on output that exists in the theoretical and empirical literature, it should be noted that much research has been done on the impact of exchange rates on economic growth in Nigeria and abroad. However, the authors are unaware of studies examining the link between exchange rate regimes and economic growth in Nigeria over different time periods and taking into account the general classification problem of exchange rate regimes and the endogeneity of exchange rate regimes. This study finds it convenient to fill this gap in the literature.

Analytical Framework

Theoretical Framework, Model Specification and Method of Study

In the literature, the theoretical link between exchange rates and output is the standard IS-LM model. To motivate empirical research, we use the implications of the theoretical model of Kandil and Mirzaie (2002). This model was developed assuming fixed wages and money prices, which means a perfectly elastic aggregate supply curve in which output is determined according to the position of the aggregate demand curve. The main advantage of this model over some other models is that it contains consumption, investment, government spending, taxes, exports, imports, interest rates,

exchange rates, current account balances, capital and national production in a single framework. . In this model, exchange rates do not directly affect production, but indirectly through import and export and money supply channels. Theoretically, the devaluation is expected to have a positive effect on exports because it makes domestic goods cheaper for foreign consumers.

Depreciation is expected to reduce income due to an increase in the relative price of imported goods. So, if the Marshall-Lerner condition is met, depreciation increases net exports and income. When this condition is met, domestic income (output) increases with depreciation through the commodity market. Exchange rates also affect the domestic money supply and can thus affect domestic income. In theory, a devaluation would be expected to be accompanied by an increase in the national currency, which is an increase in the money supply. Accordingly, interest rate cuts and investment expansion are expected. An increase in investment will lead to an increase in national income and output, given the equality of national income. The interest rate effect of exchange rate changes can also act through the capital flows in the BP equation. The domestic interest rate is lower than the international interest rate due to a drop in the interest rate due to the devaluation and the consequent expansion of the money supply. This is expected to lead to capital flight and reduced domestic income and production. Therefore, in this model, the effect of exchange rates on output cannot be determined on a priori ground. Theoretically, the combination of supply and demand channels indicates that real output depends on unexpected movements in exchange rates, money supply and government spending. Moreover, the supply-side channel confirms that the output varies depending on the expected exchange rate change. Given a channel on the demand side, aggregate demand increases with an increase in government spending or money supply, increasing output and price in the short run.

In light of theoretical predictions, we study the impact of exchange rate regimes on Nigeria's economic growth using an empirical model that replicates the reduced form solution of Kandil and Mirzaie (2002) theoretical model as follows. The

method of regression analysis using the Ordinary Least Square (OLS) method was used to estimate the parameters. E-view 9 software was used to analyze the data. An estimated regression model was fitted. Out of the three (3), independent variables only one was found insignificant. The Apriori expectation of the model is specified below:

$$y = \beta_0 + \beta_1x_1 + \beta_2x_2 + \beta_3x_3 + \mu_t \dots \dots \dots (1)$$

$$GDP = \beta_0 + \beta_1EXCHRATE + \beta_2INFRATE + \beta_3INTRATE + \mu_t \dots \dots \dots (2)$$

Where

GDP = Gross Domestic Product

EXCHRATE = Exchange Rate

INFRATE = Inflation Rate

INTRATE = Interest Rate

μ_t = stochastic term

$\beta_0, \beta_1, \beta_2$ and β_3 are the parameters of the model.

However, the explanatory variable may be endogenous, either individually or jointly with the dependent variable real gross domestic product. Therefore, bias due to simultaneous or inverse causality must be controlled. An inverse causal relationship may occur. The empirical section begins by analyzing summary statistics and the correlation matrices of all variables to determine their correlations. Summary statistics and correlation matrices are presented below.

Table 1: Summary Statistics Results Descriptive Statistics

	GDP	Exchang Rate	Inflation Rate	Interest Rate
Mean	8.68E+11	86.02634	18.14615	15.24031
Median	20765562	21.90000	12.94500	16.75750
Maximum	4.51E+13	409.7300	72.84000	31.65000
Minimum	13779255	0.500000	3.460000	6.000000
Std. Dev.	6.26E+12	108.6788	15.32897	6.063498
Skewness	7.001398	1.312259	1.997594	0.151863
Kurtosis	50.01959	3.999042	6.238744	2.501597
JarqueBera	5214.994	17.08673	57.31049	0.738088
Probability	0.000000	0.000195	0.000000	0.691395
Sum	4.51E+13	4473.370	943.6000	792.4960
Sum Sq. Dev	2.00E+27	602365.4	11983.84	1875.066
Observation	52	52	52	52

Source: Author's Computation

The table presents the summary of descriptive statistics. The findings indicate that all the variables passed the Jarque-Bera (JB) test except the interest rate. Meaning all the variables met the normality test except the interest rate. The skewness of all the variables is greater than 1 except interest rate. As shown in the table, over the period considered, Nigerian real level of economic activities averaged about N8.68 Trillion with actual values ranging from N13.8 Billion to about N4.51 Trillion. It also cost about N86.0 to purchase a unit of dollar on average within the periods. While the rate ranged from about N0.50 to N409.7.

The inflation rate on average was also double-digit being about 18% within the timeframe considered. The highest recorded within the period was about 72% while the least recorded was approximately 3%. The interest rate on average was also 15% on the average within the period of carrying out this study. The highest rate was recorded within the period was about 31% while the least recorded was 6%.

Table 2: Test For Unit Root Using Augmented Dickey-Fuller Test.

S/N	Variable	t-Statistic	Critical values			Prob*	Level
			1%	5%	10%		
1	GDP	-4.091748	-3.577723	-2.925169	-2.600658	0.0024	I(0)
2	Exchange Rate	-4.919120	-3.568308	-2.921175	-2.598551	0.0002	I(1)
3	Inflation Rate	-7.344188	-3.571310	-2.922449	-2.599224	0.0000	I(1)
4	Interest Rate	-7.774922	-3.568308	-2.921175	-2.598551	0.0000	I(1)

Source: Authors' Computation

Table 2 shows the Augmented Dickey-Fuller test of a unit root. GDP is significant at 1%, 5% and 10% levels which shows there is no unit root and the data is stationary at level. Also, the Exchange rate is significant at 1%, 5% and 10% levels which shows that there is no unit root and the exchange rate is stationary at first difference. While inflation rate is significant at 1%, 5% and 10% levels which revealed that the inflation rate has no unit root and it is stationary at first difference. It is evident also that the Interest rate is significant at 1%, 5% and 10% level which shows that there is a characteristic of stationarity in the series.

Table 3: Angel Granger Residual Unit Root Test of Co-integration

Variable	t-Statistic	Critical values			Prob*	Level
		1%	5%	10%		
ESN	-3.825334	-3.565430	-2.919952	-2.597905	0.0049	I(0)

Source: Author's Computation

Table 3 shows the co-integration test using Angel Grangel residual test. At level, it is stationary which means there is a co-integration between GDP and the independent variables (Exchange rate, Inflation rate and Interest rate).

The Augmented Dickey-Fuller test is significant at 1%, 5% and 10%. We reject the null hypothesis that the error term has a unit root at 1%, 5% and 10% and accept the alternative hypothesis that the error term has no unit root. This also means that the linear combination of this variable when GDP in the dependent variable is stationary. The variables are co-integrated. We can now go ahead and

interpret. Since we have confirmed that there is a co-integrated between these variables.

Discussion of Result

The regression result shown above revealed that two of the independent variables are statistically significant since their P-values are less than 0.005, Based on apriori expectation, the coefficient of all the independent variables that is the value of Exchange Rate (EXCHRATE), Inflation Rate (INFRATE) and Interest Rate (INTRATE) are positively signed except the Interest Rate. The Exchange Rate (EXCHRATE) is statistically significant since the P-value of 0.0004 is less than 0.05 which conformed to the apriori expectation. This implies that a unit change in Exchange Rate (EXCHRATE) will lead to 3.04E+10 increases in Gross Domestic Product (GDP) while other variables are holding constant. It was found that the Inflation Rate (INTRATE) is statistically insignificant since the calculated P-value of 0.1870 is greater than 0.05. A unit change in Inflation Rate (INFRATE) will lead to 7.71E+10 increases in Gross Domestic Product (GDP) while other variables are held constant. It was also found that Interest Rate (INTRATE) is statistically insignificant since the calculated P-value of 0.0633 is greater than 0.05. A unit change in Interest Rate (INTRATE) will lead to 2.76E+11 decreases in Gross Domestic Product (GDP) while other variables are holding constant.

The coefficient of determination R^2 shows that 24.1% of the total variation of the dependent variable (GDP) is explained by the independent variables EXCHRATE, INFRATE and INTRATE. It dropped to 19.4% after being adjusted. DW (Durbin Watson) = 1.309475 shows that there is an element of positive autocorrelation, meaning that there is a linear relationship among the independent variables. The F-Statistic, $F(13, 49) = 5.083$ shows that the model is not sufficient for predictions. In other words, the prediction power is very low.

Conclusion

This study performed a comparative analysis to investigate the relationship between Nigeria's exchange rate regime and production growth over various periods from 1970 to 2021. This study divided the data into three time periods. In other words, as for Nigeria's foreign exchange policy, the entire period (1970-2021), the exchange rate regulation system (1970-1985), and the

deregulation system (1985-2021) have undergone many changes, but there are two. The main regimes, namely fixed and floating exchange rate regimes. Ordinary least squares (OLS) were used to estimate economic growth equations as a result of the endogenous problem, the Angel Granger residual cointegration test, and the Granger causality test using 1970-2021 data obtained from the CBN Statistical Bulletin Board. Contrary to the findings of previous studies, our study shows that the unregulated exchange rate regime promotes economic growth in Nigeria over the whole period and relative to the fixed exchange rate, strongly suggesting that the exchange rate regime is indeed important in terms of Nigeria's actual economic performance. do. rate plan. Overall, the findings suggest that the peg exchange rate limits the performance of the Nigerian economy as the real exchange rate shows an inverse relationship with economic growth over the period and across the peg regime. In this context, the sustainability of the foreign exchange liberalization system, which has been in effect since July 1986, is recommended.

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