The Effect of Exchange Rate on Economic Growth of Nigeria

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Abstract: This research work explored the effect of Nigeria's exchange rate on the economic growth of Nigeria. It is focused on establishing the extent to which Naira rate have influenced economic growth from using data spanning between 1987 and 2018; and the extent to which the Naira rate has influenced inflation in Nigeria within the same time frame. This study however employed Ordinary Least Squares technique of analysis to construct a regression model to test stated hypotheses. Findings revealed that the Naira rate has no significant impact on economic growth in Nigeria and that the Naira rate has a significant influence on inflation rate in Naira. The study, therefore, recommends that the export base of Nigeria should be strengthened to ensure a sustainable impact and that local manufacturing should be fully encouraged.

Key words: Real GDP, Exchange Rate, Export, Import, Forex market.

SECTION ONE INTRODUCTION

1.1 Background to the Study

The depreciation of a country's currency should foster increased production output, the CBN will rather pump in billions of dollars into the FOREX market to leverage the value of Naira than pump in these money to productive activities which will in long run improve Naira, what an expression of good understanding of common economics? Does the CBN pursue a short-term appreciation of Naira or a long run? Won't it be economically wise to put in money to productive activities which will have multi-effect on the nation's economy than pursuing one economic-slump symptom –drop in currency value? If money pumped into the forex market from time to time could be pushed into productive activities, Nigeria's GDP will improve, employment rate will improve, inflation will drop significantly and even the lastborn(value of Naira) of Nigeria's economic indices that always seeks immediate attention will appreciate. It is traditional knowledge that when countries produce locally for exportation in larger quantities than they import, the value of their currency will appreciate against all odds. Pumping money to the forex market is the laziest solution any economy should adopt to cure progressive drop in currency value. Exchange rate is the price of one country's currency in relation to another country. It is the required amount of units of a currency that can buy another amount of units of another currency.

In Nigeria, the exchange rate policy has undergone significant transformation from the immediate post-independence period when the country maintained a fixed parity with the British pound, through the oil boom of the 1970s, to the floating of the currency in 1986, following the near collapse of the economy between 1982 and 1985 period. In each of these epochs, the economic and political considerations underpinning the exchange rate policy had important repercussions for the structural evolution of the economy, inflation, the balance of payments and real income. There could not be a better time to research into this line of interest as there has never been a time in the history of Nigeria that Naira fell to the tone of N358 to 1 dollar in the official market, hence, the focus of this research is to examine the effect of Naira value on economic growth in Nigeria. This study therefore seeks provide answers to questions: does the Naira rate have significant impact on economic growth in Nigeria? It also seeks to establish the extent to which Naira rate have influenced economic growth; and to examine the extent to which the Naira rate have influenced the inflation in Nigeria.

1.2 Statement of Problem

Promotion of economic growth is one of the major objectives of international trade, but in recent times, this has not been the case because the Nigerian economy is still experiencing some elements of economic instability such as price instability, high level of unemployment and adverse balance of payments. Furthermore, the benefits of international trade had not been noticed in the economic growth of Nigeria because some of the goods imported into the country were those that cause damages to local industries by rendering their products inferior and being neglected, thereby reducing the growth rate of output of such industries which later spread to the aggregate economy. Also the poor performance of international trade has been ostensibly blamed on factors such as different languages, difficulty in transportation, risk in transit, lack of information about foreign businessmen etc.

1.3 Objective of the Study

The main objective of this study is to examine the effect of foreign exchange rate on international trade on the Nigerian economy from 1987 to 2018.

Other specific objectives include;

1. To assess the effect of exchange rate on the Nigerian economic growth.
2. To ascertain the relationship between export and real GDP.
3. To determine the relationship import and economic growth

1.3 Research Questions

The following research questions have been constructed to guide and sharpen the study:

1. To what extent does exchange rate stimulates economic growth in Nigeria?
2. Does export have impact on real GDP in Nigeria?
3. What impact has import on economic growth?

1.4 Research Hypotheses

1. $H0_1$: There is no significant relationship between exchange rate and economics growth in Nigeria.
2. $H0_2$: Export in Nigeria has not impacted positively on Nigeria economic growth.
3. $H0_3$: Import in Nigeria does not have any significant effect on economic growth.

1.5 Justification of the Study

This study will bring out the effect of exchange rate and how Nigeria has modified its effects to increase her earnings. Therefore, it will crucially inform the reader as to the extent to which the unstable foreign exchange rate affects the level of economic growth in Nigeria.

SECTION TWO

2. **LITERATURE REVIEW**

Conceptually, an exchange rate implies the price of one currency in terms of another; in the Nigerian context, it is the units of naira needed to purchase one unit of another country's currency e.g the United States dollar (Campbell, 2010). The management of any country's foreign exchange market is carried out within the ambit of a foreign exchange policy, which according to Obaseki (2001) is the sum total of the institutional framework and measures put in place to gravitate the exchange rate fluctuations towards desired levels in order to stimulate the productive sectors, curtail inflation, ensure internal balance, improve the level of exports and attract direct foreign investment and other capital inflows. Exchange rate policy also determines the mechanism for channelling foreign exchange to end-users and therefore, reflects the institutional framework, system of exchange rate determination and allocation of foreign exchange rate fluctuations as well as the policy options for managing the exchange rate fluctuations. Economic growth is an increase in the capacity of the economy to produce goods and service compare to one period of time to another (Amadeo, 2018)

2.1 Theoretical Framework

Exchange rate is one of the basic economic tools that are used to correct a number of economic misalignments facing nations. It has been widely applied in most structural adjustment programmes across the world. It has been used as a strategic policy vehicle for directing the direction of flow of economic resources (skilled labour, Capital, managerial know-how, and foreign exchange) into import and export sectors. However, for this to result to sustainable economic growth and development stability must be maintained in exchange rate regime (Schaling, 2008). Theories of Foreign Exchange Rate, This study reviewed three main theories namely: The Mint Parity Theory, The Purchasing Power Parity Theory, and The Balance of Payment Theory

2.1.1 The Mint Parity Theory

This theory is associated with the working of the international gold standard. Under this system, the currency in use is made of gold or is convertible into gold at a fixed rate (Jhingan 2004). Here, the value of the currency unit was defined in terms of certain weight of gold and the Central Bank of the country concerned was always ready to buy and sell gold at the specified price. The rate at which the local currency could be converted into gold is called the mint price of gold.

2.1.2 The Purchasing Power Parity Theory

This Theory states that spot exchange rate between currencies will change to the differential in inflation rate between countries. The theory states that the equilibrium exchange rate between two inconvertible paper currencies is determined by the equality of their purchasing power. That is, the exchange rate between two countries is determined by their relative price levels (Obadan, 2006).

2.1.3 The Balance of Payment Theory

This theory stipulates that under free exchange rate, the exchange rate of the currency of a country depends upon its balance of payment. According to Jhingan (2004), a favourable balance of payments raises the exchange rate, while an unfavorable balance of payments reduces the exchange rate. Thus the theory implies that the exchange rate is determined by the demand for and supply of foreign exchange.

2.2.4 Neoclassical growth theories and the exogenous theory of Robert Solow

The first neoclassical growth theories emerged in 1950s –1960s, when attention to the problems of dynamic equilibrium weakened and to the fore came the problem of achieving potential growth not so much due to unused capacity, as through the introduction of new technology, improving productivity and improving the organization of production. The main representatives of this school are Alfred Marshall (1842-1924), Carl Menger (1840-1921), Friedrich von Wieser (1851-1926), Leon Walras (1834-1910), John Bates Clark (1847 –1938), William Stanley Jevons (1835-1882), Irving Fisher (1867-1947) and others.

The American economist, Robert Solow (1924-present) , together with other scholars opposed the state's intervention in the economy and were up for allowing large firms to achieve their growth potential in a competitive market, by using most of the resources available to them. The methodological basis of their theories was based on the classical theory of the factors of production, regarding labor, capital and land as independent factors of the formation of national product, as well as on the theory of marginal productivity, according to which, the income derived by owners of the factors of production are determined by the marginal products of these factors. Neoclassical theorists criticized the neo-Keynesian growth theory on three points (UN, 2011): **Firstly**, because they are focused on only one growth factor - capital accumulation, (i.e. investment growth), ignoring all other factors, and in particular those associated with technological progress: the growth of education, skills, improving the organization of production, etc; **Secondly**, because they originate from the immutability of the capitals share in income. Neoclassical model, taking into account capital and labor, and assuming their interchangeability, allow the possibility of change in the coefficient of capital. Hence, even in current technical equipment of production it is possible to achieve certain output volume just by applying different combinations of resources; **Thirdly**, because the Neo-Keynesians underestimated the ability of the market mechanism for automatic rebalancing. Neoclassical economists, on the other hand, believed that the only competitive market system is able to provide balanced economic growth. This condition also applies to stable monetary system. So they opposed inflationary government spending, considering state intervention to the economy as a factor of stability violations.

The Theory of Robert Solow Solow's theory was outlined for the first time in an article entitled "A Contribution to the Theory of Economic Growth" (1956), and then developed in the "Technical Change and Aggregate Production Function"(1957). In 1987, for its development, the author was awarded with the Nobel Prize in Economics. Solow proceeds from the assumption that a necessary condition for equilibrium of the economic system is the equality of aggregate demand and aggregate supply. In his theory, aggregate supply is determined on the basis of the production function of Cobb-Douglas, which expresses the functional dependence between production volumes on the one hand, and the factors used and their combinations, on the other. Solow's theory can reveal interconnections between three sources of economic growth investments, workforce and technological progress.

2.2.5 Theory of Endogenous Economic Growth

A new stage in the development of the theory of economic growth occurred in the 80-90s., which allowed to talk about the "new growth theory". It reflects the impact of imperfect competition and the role of possible changes in the profit rate. And most importantly -the scientific and technical progress has been considered as an endogenous, growth factor generated by internal causes. For the first time, in formal mathematical and economic models, the American economists Paul Romer(1955-till now) and Robert Lucas(1937-till now) hypothesized about the endogenous character of the most important technological innovations based on investment (contribution) in technological development and in human capital. Endogenous growth models look similar to the neo-classical ones, but they differ significantly in initial

assumptions and conclusions (UN, 2011). On the basis of the Solow model, the state with the help of economic policy instruments (such as changes in taxation, government spending) is not able to provide long-term impact on the growth rate. The impact of the state on economic growth is only possible through the impact on the savings rate. As noted by P. Romer: "In terms of advice to politicians, the growth theory had little to offer. In theory, with exogenous technological change and exogenous population growth did not matter what the government does" (Romer, 1989).

Endogenous growth theory overcomes this shortcoming of neoclassical theory. First of all, they reject the neoclassical premise of diminishing marginal productivity of capital, assume the possibility of production scale effect throughout the economy, and often focus on the impact of external effects on the profitability of investments. Positive externalities act as an important prerequisite. In the theories of endogenous growth, technological progress is not the only possible cause of economic growth in the long term. The value of intensive, high-quality determinants of economic growth (parameter A in neoclassical theory) is defined in the theories of endogenous growth with the following factors: -The quality of human capital, which depends on investment in human development (education, health); -Creation of the necessary conditions and prerequisites for the protection of intellectual property rights in the conditions of imperfect competition; -State support for the development of science and technology; -The role of government in creating a favorable investment climate and attracting new technologies. Therefore, the theories of endogenous growth in contrast to neoclassical ones are in favor of state's intervention in the development process. These theories can be divided into two groups.

The first group includes theories in which human capital emerges as an important determinant of

Economic Growth. These are the theories of P. Romer (1989b) and R. Lucas(1988). A key factor in the endogenous growth theory of Paul Romer is the variable called "knowledge" or "information". It assumes that the information contained in the inventions and discoveries are available to everyone and can be used at the same time. The Romer's theory assumes that the total amount of human capital remains constant during the considered time interval. It is only possible its redistribution between the sphere of production and R & D (research and development activities) in accordance with the function of consumer preferences. The basic idea of the theory of Romer is as follows: "there is an exchange between consumption today and knowledge that can be used for the expansion of consumption tomorrow." He formulates the idea as "research technology," which produces "knowledge" from the past consumption. Thus, the rate of economic growth is in theory of Romer directly dependent on the value of human capital, focused in obtaining new knowledge. In reality, this means that the sphere of research affects the economy not only directly through the application and development of new ideas. Its existence is a necessary (but not sufficient) condition for economic growth, because it provides human capital accumulation.

In the second group of theories, R&D is a key factor of growth. So, the theory of J.Grossman

(1953 –till now) and E.Helpman (1946 –till now) describes the effect of endogenous high-tech

innovations to economic growth rates (UN, 2011). On the example of two countries trading with each other, these authors, in particular, have shown that subsidies for R&D in a country that has a relatively scientific and technical excellence, there will be recorded an increase in the overall rate of economic growth. Protectionist trade policy can contribute to economic growth of countries with a lower level of R & D, however, has the opposite effect if it is carried out in the country with a high scientific and technical potential. The theory takes into account the possibility of inflow/outflow of capital for R & D funding and predicts under certain conditions, the formation of transnational corporations. This group also includes the theory of endogenous technological progress of P.Aghion (1956 –till now) and P.Howitt (1946 –till now).

According to this theory, economic growth is driven by technological progress, which in turn is ensured by competition between firms, generating and implementing long-term products and technological innovation. Each innovation brings to market new interim goods (product, technology), which can be used in a more effective production of goods than it was before. The main motivation for the firms within the research sector is the prospect of monopoly rents in the case of successful patenting of innovations. This rent covers costs associated with the development and implementation of innovations. Thus, a critical role in determining the rate of economic growth plays the arising endogenously flow of professionals between the sector of interim goods production and the R & D sector. Thus, endogenous growth theories allowed formalizing the relationship between the mechanisms of economic growth and the process of obtaining and accumulating new knowledge, which is materialized in technological innovations. These theories examine the reasons for the differences in growth rates of different countries, the effectiveness of various measures of the state's scientific, technical and industrial policies, as well as the impact of the processes of international integration and trade on economic growth.

2.3 Empirical Review

Similar research has been conducted in Nigeria and other countries. These researches all have come up with interesting findings using different methodologies. In this section, we will split our empirical literature based on studies carried out abroad and those carried out in Nigeria.

Daly, S. (2007) in his research titles "the choice of exchange rate regime in the MENA countries: a profit analysis. He employed a profit analysis to analyze the choice of exchange rate regimes of 17 countries in the MENA regions from 1990 to 2000. The result of the research showed that economic development and international reserves levels are major determinants of the exchange rate regime of a country. Sebastian, F. (2016) in his research on the impact of the choice f exchange rate regimes and its impact on economic growth between 1990-2014, conducted across different levels of country development, the result of this paper contrast the findings of many research papers. It employed a cross sectional analysis and found that the choice of exchange rate regime has no statistically significant impact on economic growth. Monetary policy targets and exchange rate regime according to their finding has not changed significantly.

Oladapo, F and Oloyede, J. (2014) examined the impact of exchange rate management on the level of economic growth in Nigeria from 1990-2012, the study employed the OLS (ordinary least squares) methodology and the ECM (error correction model), and they result demonstrate that exchange rate, import, export and money supply has a positive relationship with economic growth. Eze, C and Okpala, S. (2014) tested the impact of the two exchange rate policy (fixed and floating) practiced in Nigeria using annual data covering from 1980-2012. It was relive that exchange rate moves around the same direction with trade in the long run. The research split the period in two- before and after the introduction of the SAP. After conducting a chow test, they showed that there is no statistically significant impact of the exchange rate regime of economic growth. They suggested that what mattered was the management of such policy. Isola, L., Oluwafunke, A., Victor, A. and Asaleye, A. (2016) investigated the effect of exchange rate fluctuation on economic growth from 1990-2014. They employed the Autoregressive Distributed Lag model (ARDL), and based on their sample, they found no effect of exchange rate fluctuations on economic growth in the long run. However, in the short run an effect exists. A similar research aimed at ascertaining the impact of the various regimes on economic growth found that fixed exchange rate regime in Nigeria constrains growth (Obi, Oniore and Nnamdi, 2016).

Ferrando (2011) examined the relationship between exchange rate fluctuations and economic growth in China using the annual data between 1987 and 2008. Using the Generalized Method of Moment (GMM) technique, the study revealed that exchange rate and import have a negative effect on economic growth in China.

Akoku (2009), who analyzed the effect of money supply, exchange rate fluctuations on the Nigeria economic growth using the annual data between 1975 and 2008. Using Ordinary Least Square technique, the result revealed that money supply and exchange rate exerted positive impact on economic growth in Nigeria. In short the choice of exchange rate regime and economic growth is yet unresolved. There therefore the need for more empirical research on the subject matter. This is particularly important in the view of the nature choice of exchange rate regime in the developing countries like Nigeria.

SECTION THREE

3. METHODOLOGY

The data used for this study are basically annual time series data covering 1987 to 2018. The data used for both dependent (real gross domestic product) and independent (foreign exchange and Export and Import) variables were obtained from Central Bank of Nigeria Statistical Bulletin. This study adopts the statistical method of multiple linear regression approach using Ordinary Least Square (OLS) to examine the relationship between RGDP, EXTR, XE and IM.

3.1 Model Specification

The multiple regression equation is explicitly specified as follows:

The above model can be expressed in a linearized form as thus:

$$RGDP = f(EXTR, XE, IM) \quad (3.2)$$

The above model can be expressed in a linearized form as thus:

$$RGDP = \beta^0 + \beta_1 EXTR + \beta_2 XE + \beta_3 IM + U_t$$

Where:

RGDP = Real Gross Domestic Product,

EXTR = Exchange Rate,

XE= Export,

IM= Import

3.2 Method of Data Analysis

The statistical technique that will be used in this study is co-integration technique of analysis which is an improvement on the classical ordinary least square technique (OLS). This technique was chosen as it depicts the relationship of the variables. The following techniques of estimation will be employed in carrying out the co-integration analysis:

3.2.1   Unit Root Test (ADF Test)

This test is carried out using the Augmented Dickey-Fuller (ADF) test to determine the stationarity of our variable. This help to determine the order and level of difference stationary of the variables on the first order autoregressive process AR (1). The null hypothesis is that there is no unit root. The decision rule is that; if the ADF test statistic is greater than the 5 per cent critical value, we accept the null hypothesis i.e the variable is stationary, but if the ADF test statistic is less than 5 per cent critical value i.e the variable is non-stationary, then we reject the null hypothesis and go ahead to difference once; if the variable does not become stationary at first difference, we difference twice. However it is expected that the variable become stationary at first difference, Dickey and Fuller, (1979). The Augmented Dickey-fuller test (ADF) was used to handle the problem of data stationarity.

3.2.2 Co-integration test

After the test for the order of integration, the next step is to test for co-integration. This test is used to check if long run relationship exists among the variables in our models, Ogundipe and Alege, (2013).

SECTION FOUR

DATA ANALYSIS AND RESULTS

The unit root test adopted here is the Augmented Dickey Fuller (ADF) Unit Root Test and the results are shown below:

Table 1: The ADF unit Root Test for the series of RGDP, EXTR, XE and IM

Table 1: Unit Root Test Summary Statistics (ADF Unit Root Test Results)

Variable	ADF statistic	Critical Values	Sig%	Lagged diff	Order of Integration
RGDP	-5.764101	-3.679322	1%	I	I
EXTR	-3.956783	-3.670170	1%	I	I
XE	-5.750413	-3.679322	1%	I	I
IM	-4.660801	-3.679322	1%	I	I

From the table above the results of ADF unit root tests are presented in table above, suggests that the variables of the test indicate non-stationary at levels. However, these variables were stationary after first difference, which implies that they are integrated of order I(1) series. Given the unit root properties of the variables.

Table 2: Cointegration test

Unrestricted Cointegration Rank Test (Trace)				
Hypothesized		Trace	0.05	
No. of CE(s)	Eigenvalue	Statistic	Critical Value	Prob.**
None *	0.647365	48.20756	47.85613	0.0463
At most 1	0.260294	16.93789	29.79707	0.6446
At most 2	0.184448	7.892816	15.49471	0.4769
At most 3	0.057485	1.776100	3.841466	0.1826
Trace test indicates 1 cointegratingeqn(s) at the 0.05 level				
* denotes rejection of the hypothesis at the 0.05 level				
**MacKinnon-Haug-Michelis (1999) p-values				
Unrestricted Cointegration Rank Test (Maximum Eigenvalue)				
Hypothesized		Max-Eigen	0.05	
No. of CE(s)	Eigenvalue	Statistic	Critical Value	Prob.**
None *	0.647365	31.26967	27.58434	0.0160
At most 1	0.260294	9.045071	21.13162	0.8288
At most 2	0.184448	6.116716	14.26460	0.5983
At most 3	0.057485	1.776100	3.841466	0.1826

Max-eigenvalue test indicates 1 cointegratingeqn(s) at the 0.05 level					
* denotes rejection of the hypothesis at the 0.05 level					
**MacKinnon-Haug-Michelis (1999) p-values					

Source: Aurthors computation

The co-integration result above shows that there is one co-integrating equation at 5% level of significance. This implies that there is a long run relationship between the dependent variables (RGDP) and independent variables (EXTR, XE and IM)

Error Correction Model Results

The null hypothesis of the study is tested and analysed using error correction model (VECM). The hypothesis is rejected, if the p-value is less than 0.05 and accepts if revise is the case. The R-square of 0.728 explains that 27.94 percent of total variation in RGDP is caused by the explanatory variables. The ECM is rightly signed but not significant. The overall regression is significant.

Table 3

Dependent Variable: RGDP				
Method: Least Squares				
Date: 08/27/19 Time: 17:57				
Sample: 1987 2018				
Included observations: 32				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
EXTR	41.28655	16.26796	2.537906	0.0170
XE	0.226457	0.371155	0.610141	0.5467
IM	3.372676	0.548098	6.153412	0.0000
C	17977.77	1245.307	14.43641	0.0000
R2 = 96.4% Adjusted R = 96.1%, F-statistic 257.1640				
Prob(F-statistic) 0.000000 Durbin-Watson stat 0.846733				

From the above result, R^2 shows that all the explanatory variables in terms of foreign exchange rate (EXTR), Export (XE) and Import (IM) explained 96% variability in the gross domestic product (RGDP). This implies that the model explain 96% of the changes in RGDP and the remaining 4% is contributed by other variables outside the model or that are captured by the error term. Since R^2 measures the fit of the model so this model is highly fitted i.e. the data is fitted well. Considering the adjusted R^2 96.1% (which can be less than or equal to R^2) after considering the degrees of freedom, the 2 explained 96% variability in RGDP. Therefore, we can still conclude that the explanatory variables perfectly explained the behavior of the dependent variable. To check if the independent variables are jointly significant to explain the dependent variable or the overall significance of the model we use F-statistic. So given the F-statistic value to be 257.16 with the F-Prob value of 0.000 we can conclude that there is statistically significant relationship between the explanatory variables and the dependent variable. This is because the probability value of 0.000 is less than 0.05 i.e. at 5% level of significance which led to the rejection of the null hypothesis which states that there exist no significant relationship between the explanatory variables and the dependent variable; hence, the acceptance of alternative hypothesis which states otherwise. The coefficient of EXTR is positive and statistically significant. Foreign exchange plays a vital role in

Nigeria's level of trade and its movements affect the country's trading relationships with other countries. The higher the exchange rate the more expensive the exports and more cheaper the imports in foreign markets, and the lower the exchange rate the cheaper the exports and more expensive the imports in foreign markets, so the higher the exchange rate the lower the GDP while a lower exchange rate will increase the GDP. The coefficient of XE and IM showed positive and in line with the apriori expectation that there is positive relationship between Export/Import and RGDP.

SECTION FIVE

SUMMARY, CONCLUSIONS AND POLICY RECOMMENDATIONS

5.1 Summary

This paper has empirically examined the impact of foreign exchange on economic growth in Nigeria using real GDP as the dependent variable and degree of openness, foreign exchange, Export and Import independent variables from 1987-2018.

5.2 Conclusion

Data analysis revealed that relationship exists between international trade and economic growth, and that while some components of international trade exerted positive and significant effect on growth. The results of the study suggest some policy recommendations which would be helpful and applicable to the Nigerian economy. Since all the coefficients are statistically significant and exhibit the correct signs according to theory.

5.3 Recommendation

However, Nigeria should adopt more policies on trade liberalization like reducing non-tariff barriers, reducing tariffs, reducing or eliminating quotas that will enable the economy to grow at spectacular rates. The finding with respect to exchange rate implies that policy makers should adopt long term policies because in the long term, a strong currency depends on economic fundamentals. To have a stronger exchange rate, countries will need a combination of low inflation, productivity growth, economic and political stability.

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