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Floating exchange rate and economic growth in Nigeria

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Abstract

The exchange rate, when solely determined through the interplay of market forces of demand and supply, is expected to be self-adjusting, realistic, and without the need for official intervention by Central Banks. However, despite the managed floating exchange rate policy being practiced in Nigeria, a realistic exchange rate has remained elusive to the detriment of the economy. Hence, this study examined the impact of floating exchange rate regime on economic growth in Nigeria from 1986 to 2023, using the Autoregressive Distributed Lag (ARDL) estimation technique in line with the study objectives. The secondary data used in this study were sourced from the Central Bank of Nigeria Statistical Bulletin of various issues. The variables used include GDP growth rate, the dependent variable and a measure for economic growth. The independent variables include exchange rate, interest rate, inflation rate, foreign reserve, and oil revenue. The findings revealed that exchange rate had a negative and significant impact on Nigeria GDP growth rate, both in the short and long-run, highlighting the vulnerability of Nigeria's economy to exchange rate volatility. The study, therefore, recommended policies geared at expanding foreign exchange reserves, promoting non-oil exports, and ensuring greater efficiency in the foreign exchange market, in order to mitigate the adverse effect of exchange rate volatility on economic growth in Nigeria.

Keywords: Exchange Rate, Economic Growth, Interest Rate, Foreign Reserve, Inflation Rate.

INTRODUCTION

Currency exchange rate is a relative price of one currency expressed in terms of another currency or group of currencies. It is an important economic variable that affects other economic activities such as inflation and the nation's balance of payments anytime it changes

(Bordo, 2003). A nation's currency exchange rate can be fixed or floating depending on the nation's economic policy.

A fixed exchange rate, also known as pegged rate is set and maintained by the nation's central bank. The central bank links its currency to ensure the stability of its rate. Most often countries peg their rate to the U.S. dollar, euro, Japanese Yen or a basket of currencies (Abdullina et al, 2006). In order for countries to maintain the value of their currency under this system, the central bank must intervene by keeping a high level of foreign reserves, which is used in adjusting currency market fluctuations (Mordi, 2006). In comparison, floating exchange rate is dependent on market forces of supply and demand. This means that when the demand for a currency is high, its value will increase, while a low demand results to a decrease in value of the currency (Obadan, 2006). While each country makes its own decision to enter the market with a fixed or floating exchange rate, it is rare that a currency is wholly fixed or floated. This gives room for a managed floating exchange rate, where the central bank occasionally intervenes to stabilize the exchange rate (Annsofie, 2005).

The Board of Directors of the Central Bank is statutorily responsible for exchange rate policy in Nigeria. Specifically, the CBN's exchange rate management policy is designed to ensure monetary and price stability, maintain external reserves to safeguard the international value of the currency, and promote a sound financial system in Nigeria (Akpan, 2008). In practice, Nigerian exchange rate regime is the floating type. However, exchange rate management has been characterized largely by official interventions in the foreign exchange market (Akanji, 2006).

Prior to the introduction of the second-tier foreign exchange market, the management of foreign exchange was through a fixed exchange rate regime. The major objective was to ensure price stability, which was necessary for import of capital goods for the development of the domestic economy. Over the years, the naira became over-valued with attendant economic problems such as massive imports of consumer goods, depletion of external reserves, worsening terms of trade,uncompetitiveness of exports, accumulation of payment arrears, and debt burden (Genevesi, 1996). Hence, the Second-Tier Foreign Exchange Market (SFEM) was introduced in 1986, under the Structural Adjustment Program (SAP) to address the aforementioned problems. Thus the floating exchange rate system was introduced in Nigeria with its variants being practiced till date.

The dual exchange rate system consists of the first and second-tier foreign exchange markets, while the first-tier was administered to serve official transactions, the second-tier (SFEM) was market driven and served all private sector uses (Sanni, 2006). To fine-tune the system and ensure professionalism, the Retail Dutch Auction System (RDAS) was introduced in 1987 to allow end-users of foreign currency to bid through their authorized dealers who specify the rates as requested by their customers. To achieve a realistic exchange rate of naira, an Autonomous Foreign Exchange Market (AFEM) was introduced in 1988 to encourage the inflow of non-oil foreign exchange earnings into banks as a measure to relieve the demand pressure on the CBN. Subsequently, an enlarged Interbank Foreign Exchange Market (IFEM) replaced the AFEM in 1989, where the banks traded among themselves, while the CBN was only expected to intervene to achieve a realistic rate (Obadan, 2006).

The failure of the IFEM compelled the CBN to re-introduce the Retails Dutch Auction System (RDAS) in 2002, to address the widening premium, reduce demand pressures, conserve external reserves, curb capital flight and ensure market transparency (Sanni, 2006). The RDAS, however, gave way to the Wholesale Dutch Auction System (WDAS) in 2006. This addressed the multiple exchange rate markets system as the convergence of the official and interbank exchange rates was attained at the end of May 2006 (Akanji, 2006). However RDAS was again re-introduced in 2009 to reduce capital outflow and draw down in reserves. Furthermore, the Nigerian foreign exchange market was further liberalized in 2016 following

the closure of the RDAS in February 2015 and the global shocks the economy experienced, such as the large drop in the price of crude oil, leading to a significant decline in foreign reserve (CBN, 2021). In a bid to access more foreign exchange to carry out eligible transactions, the Investor and Exporters (I & E) window was introduced in April 2017. This special window was introduced to deepen the forex market, and ensure timely execution and settlement of eligible transactions, as well as attract more foreign capital into Nigeria for various forms of investment (CBN, 2021). This policy continued until 2023, when the single forex rate policy was introduced to streamline the country's foreign exchange system. Despite the implementation of these variants of floating exchange rate regime, the foreign exchange market continued to experience profound instability as the exchange rate premium continued to widen (Olufemi, 2023).

There are several macroeconomic consequences and implications of exchange rate management, which are best analysed through the impact of exchange rate on inflation. The exchange rate affects the cost of imports and in turn, domestic prices. The level of interest rates in the economy could affect the demand for credit, foreign exchange, and aggregate demand generally, putting pressure on inflation. The sustained rise in domestic prices on its part results in the misalignment of the exchange rate. When the interest rate is adjusted upward to control inflation, it reduces demand pressures in the foreign exchange market. On the other hand, where import demand is somewhat inelastic, a significant drop in imports may not occur. This is because the additional cost can easily be transferred to the final consumers (CBN, 2021).

Theoretically, the exchange rate, when solely determined through the interplay of market forces of demand and supply, is expected to be self-adjusting. It attains market-clearing equilibrium without the need for official intervention by central banks. Under this circumstance, the central bank retains monetary policy independence. In addition, external reserves are protected from depletion as the system can adjust without the use of external resources. This has not been the case in Nigeria, where oil revenue has been the major source of foreign exchange. Despite the managed floating exchange rate policy being practiced, the economy has witnessed widening premium, depletion of external reserves and capital flight. This phenomenon has necessitated the need to investigate the impact of floating exchange rate regime on economic growth in Nigeria.

The quest to understand the interplay between floating exchange rate and economic growth has been explored by various studies.

Oleka and Okolie (2016) examined the impact of floating exchange rate regime on economic growth in Nigeria for the period 1986 to 2015. The study used GPD as dependent variable, while exchange rate, interest rate and inflation rate served as the independent variables. Ordinary Least Squares Regression (OLS) technique was used to analyse data obtained from the CBN Statistical Bulletin of various issues. The results revealed that exchange rate has positive impact on economic growth, suggesting that floating exchange rate was favourable to Nigeria's economic growth. Hence, the study suggested diversification of the economy, reduction in importation, increase in domestic production and exportation of non-oil goods and services, for the economy to achieve its full potentials.

An investigation of the effect of exchange rate fluctuations on Nigerian economy was carried out by Ufoeze, Okuma and Nwakoby (2017), covering the period from 1986 to 2015. The GDP was used as the dependent variable, while the independent variables include exchange rate, money supply, inflation and oil revenue. The study used the Ordinary Least Squares (OLS) to estimate the model. The results indicate that exchange rate has a significant negative effect on GDP during the era of floating exchange rate regime. The study however advocated for positive economic reforms that would reduce the adverse effect of unstable foreign exchange rate on the Nigerian economy with respect to trade flow.

An examination of the effect of floating exchange rate on Nigerian economic growth from 1986 to 2019 was done by Mamuda, Muhammed, Babangida and Jimoh (2021), using data sourced from CBN Statistical Bulletin of various issues. The variables of the modelinclude GDP, the dependent variable, while exchange rate, interest rate and inflation served as the independent variables. Using the OLS regression for data analysis, the results revealed that exchange rate has significant positive effect on economic growth while interest rate and inflation rate have significant negative effect on economic growth. The study recommended that government should encourage export promotion strategies, provide conducive environment, and effective fiscal and monetary policies in order to attract foreign investors.

Chiadikobi, Oladipo and Umezurike (2023) investigated the impact of exchange rate volatility on economic growth in Nigeria spanning 1986 to 2020. The variables of the study include real GDP, exchange rate, and exchange rate volatility. The study employedthe ARCH/GARCH model in measuring volatility, while ARDL was the estimation technique. The findings revealed that in the long-run, exchange rate volatility has a negative coefficient while the exchange rate has a positive coefficient but not statistically significant. However, in the short-run, exchange rate volatility was positive and statistically significant, while exchange rate was negative and significant. The study recommended that the CBN should continue with the managed floating exchange system, while encouraging policies that would move the economy from consumption to production.

The effect of floating exchange rate on GDP growth in Nigeria from 1986 to 2021 was examined by Nwikina and Ekere (2024), using World Bank's Development Indicator and Central Bank of Nigeria's Statistical Bulletin. The real GDP was used to measure economic growth as the dependent variable, while the independent variables include real exchange rate, trade openness, external reserves, and interest rate. The study used the autoregressive distributed lag technique to estimate the short and long-term effects of floating exchange rate on GDP growth. The ARDL analysis revealed a weak negative correlation between the exchange rate and real GDP. Also, trade openness has an insignificant but positive effect on real GPD, while foreign reserve has positive and significant effect on real GDP. There was also a negative and statistically significant relationship between interest rate and real GDP. The study advocated for monetary policies aimed at stabilizing exchange rates.

The impact of exchange rate on the Nigerian economic growth from 1986 to 2013 was investigated by Adeniran, Yusuf and Adeyemi (2014), using secondary data sourced from Central Bank of Nigeria Statistical Bulletin of various issues. The variables of the study include GDP as the dependent variable, while exchange rate, interest rate and inflation served as the independent variables. The ordinary least squares (OLS) regression was used in estimating the model. The results revealed that exchange rate has a positive but insignificant impact on economic growth. It also indicated that interest rate and rate of inflation have negative but insignificant impact on economic growth respectively. The study recommended that government should encourage export promotion strategies to achieve a surplus balance of trade. Adequate security, effective fiscal and monetary policies, as well as infrastructural facilities were also recommended.

Iyeli and Utting (2017) examined the effect of exchange rate volatility on economic growth in Nigeria from 1970 to 2011, using secondary data sourced from Central Bank of Nigeria Statistical Bulletin. The model formulated depicts real GDP as the dependent variable, while exchange rate, balance of payment, oil revenue, and inflation were the independent variables. The study employed the Johansen co-integration estimation technique to test for short and long-run effects of the independent variables on economic growth. The results revealed that oil revenue and exchange rate were positively related to real GDP in the long-run. The study recommended that corruption should be tackled in the oil sector, and that the monetary

authorities should pursue policies that would curb inflation and ensure stable exchange rate for sustainable economic growth.

The literature reviewed shows that findings from the different studies are mixed. Some of the studies found a positive and significant impact of floating exchange rate on Nigerian economic growth [Oleke& Okolie, 2016; Iyeli&Uttin, 2017; Mamuda et al, 2021]. Some others found a positive but not significant impact [Adeniran et al, 2014; Chiadikobi, 2023]. Ufoeze et al (2017) found a significant negative impact, while a negative but not significant impact was found by Nwikina and Ekere (2024). These conflicting findings indicates that this research topic has not been exhaustively investigated, giving room for more interrogation. This study examined the impact of floating exchange rate on economic growth in Nigeria using the vector autoregressive (VAR) technique. The variables of the model include gross domestic product growth rate as the dependent variable, while the independent variables include exchange rate, interest rate, foreign reserve, inflation, and oil revenue. This study however, attempted to provide answers on the impact of these independent variables on the dependent variable.

MATERIAL AND METHOD

The theoretical framework of this study is based on the Optimal Currency Areas (OCAS) theory propounded by Mundell (1961). An optimal currency area is the geographic area in which a single currency would create the greatest economic benefit. This allows for closer integration of capital markets and facilitates trade. The theory posits that if large asymmetric shocks are common and the criteria for an OCA are not met, then a system of separate currencies with floating exchange rates would be more suitable to deal with the negative effects of such shocks within the single country experiencing them. The study employed the Autoregressive Distributed Lag (ARDL) estimation technique for the analysis.

In this study, secondary data were sourced from the Central Bank of Nigeria (CBN) Statistical Bulletin of various issues and the study period covered from 1986 to 2023. The model used in this study was adapted from the exchange rate equation as used by Oleka and Okolie (2016) with little modification. According to the model, the gross domestic product (GDP) growth rate was used as the dependent variables, while exchange rate, interest rate and inflation rate were captured as independent variables. In order to integrate the country's financial capabilities into the model, this study have added foreign reserve and oil revenue into the model. The economic representation of the model is stated thus:

$Y = \beta o + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \ldots B_n + e \ldots 1$

Fitting the variables into the model becomes:

$GDPGR = \beta_0 + \beta_1 (ExRt) + \beta_2 (INTRt) + \beta_3 (INFRt) + \beta_4 (InFRt) + \beta_5 (LnOILRt) + et \ldots. 2$

Where:

GDPGR= Gross Domestic Product Growth Rate

EXR= Exchange Rate

INTR= Interest Rate

INFR= Inflation Rate

LnFR= Log of Foreign Reserve

LnOILR= Log of Oil Revenue

B_0= Intercept of the regression equation

B_1-β_5= Coefficient slope of the independent variables

e= Error term

Apriori expectations= $\beta_1, \beta_2, \beta_4, \beta_5 > o$ and $\beta_3 < o$

PRESENTATION OF RESULTS

Unit Root Test

The unit root test was conducted to assess the stationarity properties of the selected macroeconomic variables and is summarized in Table 1 below.

Table 1

Augmented Dickey-Fuller Unit Root Test

Variables	ADF Test Statistics	T-statistics at 5% level	Order of Integration
GDP Growth Rate	-10.68579	-3.540328	1(1)
Exchange Rate	-4.670952	-3.540328	1(1)
Interest Rate	-5.656335	-3.540328	1(1)
Inflation Rate	-7.939439	-3.540328	1(1)
Log of Foreign Reserve	-5.986498	-3.544284	1(1)
Log of Oil Revenue	-6.330199	-3.544284	1(1)

The results from the table above indicate that all variables were non-stationary at their levels but became stationary after first differencing. This confirms that the variables are integrated of order I(1), which justifies the application of the Autoregressive Distributed Lag (ARDL) model. The ARDL model is particularly suitable as it accommodates variables integrated at different orders, specifically I(0) and I(1), ensuring the robustness of subsequent econometric analyses.

Cointegration Test

To determine the presence of a long-run relationship between GDP growth and the macroeconomic indicators under study (exchange rate, interest rate, inflation rate, foreign reserves, and oil revenue), the Bounds Test for cointegration was applied. The F-statistic obtained was 6.303671, which exceeds the 5% critical value of 3.34, confirming the existence of a cointegrating relationship. This finding indicates that, despite short-term fluctuations, there exists a stable long-run equilibrium relationship among the variables, supporting the validity of the ARDL model in assessing both short-run and long-run dynamics. The long results are summarized in table 2 below.

Table 2

Long Run ARDL Estimation Results

Variable	Coefficient	T-statistics	Probability Value
EXR	-0.009856	-2.170086	0.0508
INTR	0.345341	2.660347	0.0208
INFR	-0.335713	-8.162657	0.0000
LNFR	0.618272	0.470607	0.6464
LNOILR	0.650051	0.599003	0.5603
F-statistics	6.303671 (3.34)		

The long-run estimation indicates that the exchange rate (EXR) negatively affects economic growth, with a coefficient of -0.009856 and a p-value of 0.0508, suggesting that a depreciation in the naira, under the floating exchange rate regime, weakens GDP growth. This finding aligns with concerns that exchange rate volatility discourages investment, raises production costs, and contributes to inflationary pressures.

Interest rate (INTR) positively impacts economic growth in the long run, with a statistically significant coefficient of 0.345341 This suggests that higher interest rates, potentially attracting foreign capital inflows and promoting financial stability, can have a long-term beneficial effect. However, inflation (INFR) has a strongly negative and highly significant impact on GDP growth, with a coefficient of -0.335713. This confirms that persistent inflation erodes purchasing power, increases business costs, and creates macroeconomic instability, thereby stifling growth.

The coefficients for foreign reserves (LNFR) and oil revenue (LNOILR) are 0.618272 and 0.650051, respectively, but neither is statistically significant. This suggests that while these factors may contribute to economic growth, their direct long-term impact is limited, possibly due to inefficiencies in managing reserves and the economy's overreliance on oil.

Short Run Results

Table 3

Short-Run ECM Estimation Results

Variable	Coefficient	T-statistics	Probability Value
EXR	-0.060940	-3.760217	0.0027
INTR	-0.467334	-0.313884	0.7590
INFR	-0.172574	-5.435260	0.0002
LNFR	-10.55280	-3.669465	0.0032
LNOILR	15.96439	4.132342	0.0014
R^2	0.932515		
Adj. R^2	0.865030		
Durbin Watson Stat	2.130077		

Table 3 above summarizes the short-run results obtained from the study. In the short run, GDP growth exhibits strong inertia, as indicated by the significant positive coefficients of its first and second lags (0.744987 and 0.579551). Exchange rate depreciation exerts a significantly negative effect on GDP growth, both concurrently (-0.060940) and at the second lag (-0.126368) This confirms that short-term exchange rate shocks have an immediate contractionary effect on economic activity, possibly due to increased import costs, capital flight, and uncertainty discouraging investment.

The impact of interest rates in the short run is negative but insignificant with a coefficient of -0.467334. This indicates that while higher interest rates may support long-term stability, they can suppress short-term economic activity by raising borrowing costs and discouraging investment.

Inflation (INFR) has a complex effect, with a direct negative impact on GDP growth in the short run with a coefficient value of -0.172574but positive lagged effects. This suggests that while high inflation initially dampens growth, some degree of price adjustment over time allows the economy to partially recover.Foreign reserves (LNFR) show a significant negative immediate effect at -10.55280followed by a positive effect at lag 1 (7.948473) and another negative effect at lag 2 (-18.40740). This mixed pattern may reflect the impact of capital inflows and outflows, where fluctuations in reserves initially cause instability before stabilizing economic activity.Oil revenue (LNOILR) positively affects GDP growth in the short run, with significant coefficients of 15.96439, reinforcing its importance as a primary driver of short-term growth in Nigeria.

The diagnostic tests validate the robustness of the model. The residuals are normally distributed, as indicated by the Jarque-Bera test with a p-value of 0.401788. Stability tests using the Ramsey RESET test (p-value = 0.6457) and the Cusum and Cusum of Squares tests confirm that the model is stable over the sample period. Furthermore, the Durbin-Watson statistic of 2.130 indicates the absence of autocorrelation. Finally, the R-squared and adjusted R-squared values of 0.932515 and 0.865030, respectively, reflect the model's strong explanatory power.

DISCUSSION OF FINDINGS

The results provide critical insights into the relationship between Floating exchange rate and economic growth in Nigeria. The exchange rate's negative and significant impact on GDP growth, both in the short and long run, highlights the vulnerability of Nigeria's growth to exchange rate volatility. Given Nigeria's import dependence on essential goods and production inputs, currency depreciation raises the cost of doing business, leading to slower growth. This finding supports concerns that an unstable exchange rate, in the absence of

robust domestic production, can be detrimental to economic performance.This result does not conform with that of Oleka and Okolie (2016) that exchange rate has a positive effect on Nigeria's economic growth but it was similar to that of Ufoeze, Okuma and Nwakoby (2017).Also, findings from the study suggest that sudden changes in the exchange rate do not immediately impact growth but manifest with a time lag and they exert a significant contractionary effect on the economy. These shocks likely reflect foreign capital movements, investor confidence, and inflation pass-through effects. Given that Nigeria's exchange rate is heavily influenced by external factors such as oil prices and capital inflows, sudden depreciations can have destabilizing consequences.

Interest rates show a dual effect, with a significant positive relationship in the long run but a negative impact in the short run. The long-run positive effect suggests that higher interest rates may attract foreign capital inflows and promote financial stability, which in turn fosters economic growth. However, the short-run negative effect aligns with theoretical expectations and is similar to studies carried out by Adeniran, Yusuf and Adeyemi (2014), as high borrowing costs discourage investment and consumption in the immediate term. This duality reflects the importance of balancing monetary policy to achieve long-term growth objectives without stifling short-term economic activity.

Inflation consistently exhibits a negative impact on GDP growth in the long run, with mixed effects in the short run. High inflation undermines economic growth by eroding consumer purchasing power, increasing production costs, and creating uncertainty that discourages investment. While the positive short-run lagged effects may indicate some level of price adjustment and recovery, the long-run findings emphasize the need to prioritize inflation control to stabilize the economy and support growth.

Foreign reserves, despite their theoretical importance for exchange rate stability and external financing, exhibit statistically insignificant effects on GDP growth in the long run. This result may reflect inefficiencies in the management of reserves or their insufficient utilization in supporting productive investments. However, the short-run mixed effects suggest that fluctuations in reserves can have significant impacts on economic stability, with immediate negative effects potentially linked to capital outflows or external shocks.

Oil revenue positively influences GDP growth in the short run, underscoring its importance as a critical driver of economic activity in Nigeria. However, its insignificance in the long run points to the limitations of oil dependency, including vulnerability to global oil price volatility and the lack of diversification in revenue utilization. This highlights the need for structural reforms to reduce the overreliance on oil and channel oil revenues into long-term productive investments.

CONCLUSION AND RECOMMENDATIONS

This study confirms that exchange rate fluctuations under a floating regime significantly impact Nigeria's economic growth. Exchange rate depreciation and inflation exert significant negative impacts on economic growth, highlighting their destabilizing effects. Interest rates, while constraining growth in the short term, exhibit positive long-term effects, reflecting their role in fostering financial stability and investment. Foreign reserves and oil revenue, though critical to Nigeria's economy, have limited long-term significance, reflecting structural inefficiencies and overreliance on oil. The results highlight the necessity of stabilizing the exchange rate, managing inflation, and diversifying the economy to reduce dependency on oil revenue.

To mitigate the adverse effects of exchange rate volatility on economic growth, the Nigerian government should prioritize policies that stabilize the naira. This includes expanding foreign exchange reserves, promoting non-oil exports, and ensuring greater efficiency in the foreign exchange market. A stable exchange rate would help reduce inflationary pressures and encourage both domestic and foreign investment. Furthermore, inflation control should

remain a key focus for policymakers. The government should adopt a mix of monetary and fiscal policies that target supply-side constraints, boost local production, and reduce the economy's dependence on imports. Strengthening domestic manufacturing and agriculture will help stabilize prices and improve economic resilience.

Additionally, interest rate policies must strike a balance between controlling inflation and fostering economic growth. While high interest rates may attract foreign capital and stabilize the financial sector, excessively tight monetary policy can hinder business expansion and investment. The Central Bank should explore policies that encourage credit availability for productive sectors while maintaining overall macroeconomic stability. Economic diversification is also crucial in reducing Nigeria's vulnerability to external shocks. The government must accelerate industrialization, develop a robust agricultural value chain, and promote innovation-driven sectors to reduce overreliance on oil revenue. Investing in infrastructure, human capital, and research and development will create a more resilient and sustainable economy.

Lastly, foreign reserves should be managed strategically to cushion external shocks rather than being held passively. Proactive use of reserves to stabilize the currency during periods of volatility can reduce uncertainty and enhance investor confidence. A well-coordinated approach that integrates exchange rate management, inflation control, investment-friendly policies, and economic diversification will ensure Nigeria achieves sustained and inclusive economic growth.

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