



## EXCHANGE RATE FLOATING AND ITS IMPLICATIONS ON NIGERIA'S ECONOMY

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### Abstracts

*This paper examined the effect of exchange rate floating on economic growth of Nigeria. After critical evaluation of relevant literature, the researcher found out that floating of the naira caused more volatility, instability and depreciation in the currency rates, and these volatility and instability triggered a decline in investor's confidence, and endangered the stability of the financial system. The researcher therefore recommends amongst others that there is need for government to set up policies that would be favourable to exporters and promote exports, so as to motivate companies to produce high quality goods for export. This will generate revenue and boost the inflow of foreign exchange to create a more secure economy and stabilize the exchange rate. Also, support and priority should be given to the agricultural and manufacturing industries to increase productivity, reduce imports and increase exports of quality products with a view to attracting more foreign currencies that could help to stem the tide of foreign currency demand pressure.*

**Keywords:** Exchange rate, exchange rate floating, exchange rate volatility, exchange rate fluctuating.

## Introduction

The exchange rate is seen as a measure of the value of a nation's currency against that of other countries, which reflects the economic situation of the country compared to other countries (Obadan, 1994). Exchange rate is the amount of a local currency needed to obtain a unit of another country's currency. It indicates the strength of a country's economy. A weak economy requires a higher amount of its currency to obtain a unit of its trading partner country's currency while a strong economy requires less. Ajinaja, Popoola & Ogunlade (2017) defined exchange rate as the price of one currency expressed in terms of another currency, or against a basket of other currencies. It is also regarded as the value of one country's currency in relation to another currency. In other words, it represents how many units of a foreign currency a consumer can buy with one unit of their home currency. Piana (2001) defined exchange rates as ratios that are used across all international markets, including finance, trading, and investment. Businesses and investors use these rates to compare their currency's purchasing power with another country. They also use this to determine the comparative strength of their domestic currency against foreign currencies. Backman (2006), the exchange rate is defined as the price of one currency in terms of another currency.

Since the establishment of Central bank of Nigeria in 1958, Nigeria's exchange rate policy has been aimed at preserving the external value of the domestic currency and maintaining a healthy balance of payments

position. Foreign exchange policies influence the economic activities and to a large extent, dictate the direction of the macroeconomic variables of a country. According to Udoe, (2009), the mechanism of exchange rate determination are different systems of managing the exchange rate of a nation's currency in terms of other currencies and this should be properly done in a way that will bring about efficient allocation of scarce resources so as to achieve growth and development. It is customary to distinguish nominal exchange rates from real exchange rates. Nominal exchange rates are established on currency financial markets called "forex markets", which are similar to stock exchange markets. Central bank may also fix the nominal exchange rate. Real exchange rates are nominal rate corrected somehow by inflation measures.. Another classification of exchange rates is based on the number of currencies taken into account. That is, bilateral exchange rates which relate to two countries' currencies and multilateral exchange rates which are computed in order to judge the general dynamics of a country's currency towards the rest of the world. In terms of currency regime, when the exchange rate is determined freely by the value of demand and supply, is called "freely floating exchange rate" or "flexible" exchange rate. However, if the central bank timely and significantly intervenes on the currency market, a "managed floating exchange rate regime" takes place. In "flexible" and "managed" exchange rate regimes, a loss in currency value is conventionally called "depreciation", whereas an increase of currency's

international value will be called "appreciation" (Jones & Kenen, 1990). On the other hand, when the central banks declare a fixed exchange rate, offering to supply or buy any quantity of domestic or foreign currencies at that rate is called a "fixed exchange rate" regime. Under this regime, a loss of value, usually forced by market or a purposeful policy action, is called "devaluation", whereas an increase of international value is a "revaluation". The subject of exchange rate floating has become a topical issue in Nigeria. This is because it is the goal of every economy to have a stable rate of exchange with its trading partners.

Exchange rate is an asset price and an important exogenous variable that determines the movement of other variables all centered on macroeconomic stability and resource flow in and out of a country (Emerenini & Ajudua, 2014). The importance of exchange rate cannot be overemphasized as it plays a key role in international trade by allowing for the comparison of prices of goods and services produced in different countries, and its stability over time is vital in stimulating economic growth. Akpan (2008) conducted a study on foreign exchange market and economic growth in an emerging petroleum-based economy from 1970-2003 in Nigeria. Positive relationship was found to exist between exchange rate and economic growth. Obansa et al. (2013) investigated the relationship between exchange rate and economic growth in Nigeria between 1970 and 2010. The findings of the study revealed that exchange rate has a strong impact on economic growth. The study recommended

that exchange rate liberalization will promote Nigerian economy. Furthermore, Azeez, Kolapo & Ajayi (2012) examined the effect of exchange rate volatility on macroeconomic performance in Nigeria between 1986 and 2010. The study showed that exchange rate is positively related to gross domestic product. Adeniran, Yusuf & Adeyemi (2014) adopted correlation and regression of Ordinary Least Square (OLS) to analyze the impact of exchange rate fluctuation on the Nigeria economic growth between 1986 and 2013. The study found that exchange rate has positive impact but not significant on Nigeria economy. Their findings further revealed that interest and inflation rates have negative impact on Nigeria economic growth.

Nigeria, one of the Africa's largest economies, has a long standing history of grappling with currency instability and exchange rate challenge. Over the years, the Nigeria's government has employed various measures to manage its currency, the naira, including pegging it to a specific exchange rate. This naturally created two exchange rates, the official and the black market. This disparity between the two provided an avenue for people with access to dollars to buy at the official rate and resell at the black market. Many millionaires and few billionaires were created through this distorted system. With a view to curbing this anomaly, on the 14th of June 2023, the Central Bank of Nigeria (CBN) published a press release on the operational changes to the Foreign Exchange Market. The information disseminated to the public was to notify it of the abolishment of segmentation, and collapse into the Investors

and Exporters (I&E) window. The CBN re-introduced the "willing buyer, willing seller" model at the I&E window. Simply put, the agreed price by the buyer and seller will determine the rate at which the naira is exchanged for any foreign currency, otherwise, known as exchange rate floating.

Floating the naira means that the government of Nigeria has allowed the value of the naira to be determined by supply and demand in the foreign exchange market. With this move, the fixed exchange rate for trading forex within the country and the CBN's direct intervention in the forex market has been eliminated. The idea of floating the naira has however remained a subject of debate. Experts concede that it holds both potential advantage and risks. According to Ogo (1990), the exchange rate should be, in principle, left in the vagaries of the market forces of demand and supply. In this system, the currency's exchange rate fluctuates freely in response to various economic factors, including inflation, interest rates, trade balances, and capital flows. Under a floating exchange rate regime, the government or the central bank does not fix or peg the currency to a specific value against another currency or a basket of currencies. Instead, the rate of exchange is determined by the interactions of buyers and sellers in the foreign exchange market. Supply and demand dynamics influence the currency's value, and its exchange rate can appreciate or depreciate relative to other currencies (currency appreciation) in the exchange market.

## **Factors that Determine Exchange Rate**

Some of the factors that determine exchange rate as stated in Bergen (2017) include:

- **Differentials in Inflation**

Generally, an economy with a steadily lower inflation rate is characterized by a rising currency value, as its purchasing power increases relative to other currencies. During the last half of the 20th century, the countries with low inflation included Japan, Germany and Switzerland, while the U.S. and Canada achieved low inflation only later. Those countries with higher inflation typically see depreciation in their currency in relation to the currencies of their trading partners. This is also usually accompanied by higher interest rates.

- **Differentials in Interest Rates**

Interest rates, inflation and exchange rates are all highly correlated. By manipulating interest rates, central banks exert influence over both inflation and exchange rates, and changing interest rates impact inflation and currency values. Higher interest rates offer lenders in an economy a higher return relative to other countries. Therefore, higher interest rates attract foreign capital and cause the exchange rate to rise. The impact of higher interest rates is mitigated, however, if inflation in the country is much higher than in others, or if additional factors serve to drive the currency down. The opposite relationship exists for decreasing interest

rates - that is, lower interest rates tend to decrease exchange rates.

- **Terms of Trade**

A ratio comparing export prices to import prices, the terms of trade is related to current accounts and the balance of payments. If the price of a country's exports rises by a greater rate than that of its imports, its terms of trade have favorably improved. Increasing terms of trade, shows greater demand for the country's exports. This, in turn, results in rising revenues from exports, which provides increased demand for the country's currency (and an increase in the currency's value). If the price of exports rises by a smaller rate than that of its imports, the currency's value will decrease in relation to its trading partners (Bergen, 2017).

- **Political Stability and Economic Performance**

Foreign investors inevitably seek out stable countries with strong economic performance in which to invest their capital. A country with such positive attributes will draw investment funds away from other countries perceived to have more political and economic risk. Political turmoil, for example, can cause a loss of confidence in a currency and a movement of capital to the currencies of more stable countries.

- **Oil Prices**

Furthermore, Olomola (2006) and Akpan (2009) argued that oil prices are the primary driver of exchange rate volatility. High prices lead to

appreciation through increased dollar inflow, while crashes cause rapid depreciation.

- Mayowa & Olushola (2013), using error correction model (ECM) identified GDP as a core macroeconomic factor linked to exchange rate fluctuation

### **Nigeria's Exchange Rate Regimes**

The Central Bank of Nigeria (CBN) is the only institution in Nigeria mandated by law to manage Nigeria's foreign exchange reserves and determine the exchange rate regime to be adopted in Nigeria.

#### **Managed-float exchange rate regime**

The CBN operated a managed-float exchange rate regime between 2014 and mid-2023. Simply put, a managed float exchange rate system is an exchange rate regime in which the exchange rate is neither entirely floating nor fixed, thereby allowing the central bank to keep the exchange rate within a range of another currency or keep the exchange rate at a level determined by the central bank. In 2014, the CBN adopted the managed float regime because it enabled the CBN to set the exchange rate at a level that would support the attainment of sustainable economic growth, low inflation and to boost non-oil revenue. During this period, there were multiple exchange rates (i.e., the CBN exchange rate, the Investors and Exporters (I&E) FX rate, and the parallel market exchange rate). The CBN also engaged in quasi-fiscal activities through extensive development finance interventions. The intervention activities led

the CBN to fix the exchange rate at a level that would support the attainment of the goals of CBN at the time, including its development finance intervention goals. The CBN offered a cheaper exchange rate to non-oil exporters while oil exporters had to source for foreign exchange at a higher exchange rate. Although it led to price distortions in the foreign exchange market, it also revived non-oil export activities and led to an exponential increase in non-oil GDP. The managed float regime was strongly criticized for creating price distortions and for forcing oil importers to access foreign exchange at a higher rate which translated to higher fuel subsidy payment which amounted to over N7 trillion (US\$15.2bn) in 2022. While the managed float exchange rate regime was not bad in itself, the major criticism leveled against the managed float exchange rate regime was that the CBN did not put in place appropriate controls to prevent price arbitrage in the foreign exchange rate market. As a result, the managed float regime encouraged unproductive arbitrage, rent seeking, round tripping and unfair competition which had adverse effects on the Nigerian economy. Musa & Sanusi (2020), while acknowledging the need for some control, they criticized the inconsistency use of monetary policy tools within the float framework, which they argue undermines the credibility of the exchange rate.

### **Willing-Buyer and Willing-Seller Exchange Rate Regime (Floating of exchange rate)**

In mid-2023, the CBN ended the managed float exchange rate regime. The CBN also

lifted the ban on 43 items from accessing the foreign exchange market and announced the unification of the official and parallel market exchange rates so that the exchange rate would be determined based on the Willing Buyer – Willing Seller principle which is an imperfect type of the floating exchange rate regime. The purpose of these policies was to ensure stability, curb speculation, and restore confidence in the foreign exchange market. The CBN, under the President Tinubu administration unified the exchange rate to ensure that the dollar sells at the same price in all recognised segments of the foreign exchange markets. Unifying the exchange rate will make the low official exchange rate to converge towards the high parallel exchange rate, leading to a high unified exchange rate. It is expected that a high unified exchange rate will attract foreign investments, increase foreign exchange inflows, lead to reduced demand in the parallel market and lead to decrease (currency appreciation) in the exchange rate.

### **The Effect of the Free Float of Naira on the Nigerian Economy**

The free float of the Nigerian economy has had counterintuitive effects so far and the researcher is looking forward to seeing a bright light at the end of the tunnel soon. Some of the effects are as follows:

- **Volatility in currency rates**

Floating the naira causes more volatility in the currency rates. In a system with a floating exchange rate, supply and demand in the market

determines how much a currency is worth. Therefore, the value of the naira will change in reaction to a variety of economic factors, such as interest rates and foreign investment. There may be an upward surge in the economy and increased competition with this volatility.

- **Increase in exports**

There may be increase in exports as a result of the Naira float. The value of the Naira may decline with the free float, thereby making Nigerian goods for foreign consumers less expensive. This can encourage companies that are focused on exports, boost revenue from foreign exchange, and lessen the nation's dependency on oil exports. It would encourage economic diversification and contribute to the creation of a stronger, more durable economic system.

- **Increase competitiveness and entice international investment**

A floating exchange rate has the potential to increase competitiveness and entice international investment. It can also encourage home manufacturing and lessen the country's dependency on foreign goods. In addition, a currency with a floating exchange rate can better withstand economic shocks from outside sources

- **Inflation on imports**

The increased costs for businesses and consumers may result from a major depreciation in the value of the Naira. This might raise the cost of imported goods and raw materials. Nigeria has always depended on imports, and now with the devaluation, these imports will become more expensive to maintain.

- **Foreign debt and financial instability**

The foreign debt and financial stability of Nigeria will be impacted by the naira's float. A lot of these debts are in foreign currency, and the country's debt commitments will rise when converted if the Naira fell in value. This might make it harder for the government to repay its debts.

- **Decline in investor confidence**

The naira volatility may trigger a decline in investor confidence, and endanger the stability of the financial system. Any country that hopes to trade in foreign exchange needs to have investors that have confidence in its currency. As a result of this float, any decline in the Naira value will cause investors to lose confidence and refuse to transact with any industry in the country.

### **Conclusion**

Floating of exchange rate has the capacity of boosting the investor's confidence, streamline international trade activities and speed-up a country's ability to implement market-driven policies, and stimulate economic growth. For a free float of the naira to have a desired positive effect on the Nigerian economy, it requires careful monitoring and appropriate policy interventions by the government and the CBN. Implementing measures to manage exchange rate volatility, promoting export-oriented industries, and encouraging investment in critical sectors can help maximize the benefits while mitigating potential risks.

### **Recommendations**

1. Measures should be taken to increase the value of naira and reduce naira volatility so as to build investor confidence, encourage economic adjustments and boost competition.

When investor's confidence rise in the economy, then more investors will want to transact in various industries in the country.

2. To control inflation and uphold price stability, the government would need to undertake efficient monetary policies and measures, such as interest rate changes and stringent fiscal controls. Tariffs should be instituted on foreign imports in order to protect businesses and consumers and promote use of domestic products. Price control regulations and measures should be put in place to prevent hikes due to the devaluation of the Naira. Support and priority should be given to the agricultural industry to increase productivity, reduce imports and increase exports of quality products.
3. The government should set up policies that would be favourable and promote exports, so as to motivate companies to produce high quality goods for export. This will generate revenue and boost the inflow of foreign exchange to create a more secure economy with a view to attracting more foreign currencies that could help to stem the tide of foreign currency demand pressure.
4. The government should encourage the export promotion strategies in order to maintain a surplus balance of trade.

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