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# POLICY INTERVENTIONS FOR MANAGING EXCHANGE RATE VARIATIONS AND PROMOTING SUSTAINABLE ECONOMIC GROWTH IN NIGERIA

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## Abstract

*This study evaluates policy interventions for managing exchange rate variations and promoting sustainable economic growth in Nigeria from 2012 – 2022. The specific objectives of the study are to examine the effect of the exchange rate on the gross domestic product of Nigeria, to determine the effect of the inflation rate on the gross domestic product of Nigeria and to assess the effect of interest rate on the gross domestic product of Nigeria. This study made use of secondary source of data collection. The research data were extracted from the CBN Statistical bulletin. It employs ordinary least square regression analysis to evaluate the effect of exchange rate, inflation rate and interest rate on GDP which is the dependent variable. The first hypothesis delves into the impact of exchange rates on GDP. The empirical findings strongly support this hypothesis, indicating a significant and positive influence of exchange rates on GDP. Exchange rate fluctuations have a notable effect on the economic performance of Nigeria. The second hypothesis investigates the effect of inflation rates on GDP. The results revealed that inflation rates exerted a significant and negative effect on GDP. High inflation rates are associated with decreased economic growth, emphasizing the importance of price stability for sustained economic development. The third hypothesis explores the effect of interest rates on GDP. The findings highlighted that interest rate have a significant and positive effect on GDP. This suggests that interest rate policies can be leveraged to stimulate economic growth. Therefore, the study provides empirical evidence of the intricate connections between exchange rates, inflation rates, interest rates, and GDP in Nigeria. These findings hold valuable implications for policymakers, emphasizing the need for a balanced and well-coordinated monetary policy framework that considers the interplay of these factors to foster sustainable economic growth.*

**Keywords:** Policy Interventions, Exchange Rate, Inflation Rate, Interest Rate and GDP

## 1.1 Introduction

The exchange rate is a vital determinant of a nation's economic performance, playing a crucial role in shaping its economic landscape. In the context of Nigeria, a country characterized by its rich natural resources and a rapidly growing population, exchange rate variations have significant implications for economic stability and growth. Managing these variations effectively is essential to ensure sustainable economic development and prosperity for the nation (Abdallah, 2016).

The Nigerian economy has experienced a history of exchange rate fluctuations, driven by both internal and external factors. These fluctuations have, at times, exerted considerable pressure on the country's economic performance, affecting its balance of trade, inflation rates, foreign investment, and overall macroeconomic stability. Bakare (2011) also posited that exchange rate reforms were anticipated to lead the Nigerian economy towards macroeconomic stability, recovery, and sustainable development. However, instead, the nation has found itself in a less favorable position in terms of its macroeconomic performance. The various policy regimes have been marked by instability and uncertainties. These uncertainties in exchange rates, resulting from macroeconomic reforms, can be broken down into two main components. The first component involves the systematic movement of the exchange rate, while the second pertains to exchange rate volatility. The volatility in exchange rates has far-reaching effects on economic performance, influencing various aspects such as savings, lending rates, and inflation. In sum, Nigeria grapples with a host of economic challenges stemming from exchange rate reforms. Among these challenges are high levels of unemployment and poverty, elevated inflation rates, and a low level of savings and investment (Adelowokan et al., 2015).

Therefore, it becomes imperative for policymakers to develop and implement well-considered interventions that can effectively manage exchange rate variations and, in turn, promote sustained economic growth. This study aims to delve into the intricacies of exchange rate variations in Nigeria and explore the policies and interventions that can be employed to mitigate their adverse effects while fostering a conducive environment for sustainable economic growth. In doing so, we will consider the unique challenges faced by Nigeria, such as its heavy reliance on oil exports, vulnerability to external shocks, and the need to diversify its economy.

The examination of policy interventions will encompass a range of strategies, including monetary and fiscal policies, trade policies, foreign exchange market management, and structural reforms. Through a comprehensive analysis of these strategies, this research endeavors to provide insights into which policies are most effective in managing exchange rate variations and facilitating long-term economic growth in the Nigerian context.

## 1.2 Statement of the Problem

In an ideal scenario, Nigeria's exchange rate should be stable and effectively managed to ensure macroeconomic stability and foster sustainable economic growth. This would involve policies and interventions that mitigate exchange rate variations and promote a conducive environment for economic development. The ideal situation would include a well-balanced economy, low inflation rates, reduced unemployment, and increased savings and investment.

However, the reality in Nigeria is far from the ideal scenario. Exchange rate variations have been a persistent challenge, characterized by frequent fluctuations and uncertainties. The problem lies in the inability to effectively manage these variations, which has adverse consequences on the country's economic performance. Exchange rate volatility affects

various aspects of the economy, such as trade, inflation, and investment decisions. As a result, Nigeria faces key problems such as Macroeconomic Instability, High Inflation, Unemployment, Low Savings and Investment to mention but a few.

If these problems related to exchange rate variations in Nigeria are not adequately resolved, the consequences would lead to severe Economic Stagnation, Poverty Persistence, High unemployment rates and inflation, Reduced Global Competitiveness and Foreign Investment Aversion. In light of these challenges, it is imperative to explore and implement effective policy interventions that can manage exchange rate variations, mitigate their adverse effects, and create an environment conducive to sustainable economic growth in Nigeria.

### **1.3 Objectives of the Study**

The main objective of this study is to assess policy interventions for managing exchange rate variations and promoting sustainable economic growth in Nigeria, while the specific objectives of the study are:

- i. To examine the effect of exchange rate on gross domestic product of Nigeria.
- ii. To determine the effect of inflation rate on gross domestic product of Nigeria.
- iii. To assess the effect of interest rate on gross domestic product of Nigeria.

### **1.4 Research Questions**

The following research questions were made for the study.

- i. To what extent has exchange rate affected gross domestic product of Nigeria?
- ii. What is the effect of inflation rate on gross domestic product of Nigeria?
- iii. What is the effect of interest rate on gross domestic product of Nigeria?

### **1.5 Research Hypotheses**

The following null hypotheses were formulated for the study.

- i.  $H_0$ : Exchange rate has no significant effect on gross domestic product of Nigeria.
- ii.  $H_0$ : Inflation rate has no significant effect on gross domestic product of Nigeria.
- iii.  $H_0$ : Interest rate has no significant effect on gross domestic product of Nigeria.

## **2 Conceptual Framework**

### **2.1 Exchange Rate**

Exchange rate represents the value of a nation's currency when measured against the United States Dollar, as explained by (Adeniran et al., 2014). In the context of Nigeria, it signifies the amount of Naira needed to acquire a unit of another country's currency, such as the US dollar. The management of a country's foreign exchange market is governed by a foreign exchange policy framework. Eichengreen and Leblang (2013) clarifies that this policy encompasses the collective institutional framework and strategies employed to guide the exchange rate toward specific objectives. These objectives encompass the stimulation of productive economic sectors, inflation control, domestic stability maintenance, augmentation of export levels, and the attraction of both direct foreign investments and other forms of capital inflow. Exchange rate policy also establishes the mechanisms for distributing foreign exchange to end-users, thus reflecting the institutional structure, the exchange rate determination process, allocation of foreign exchange, and the policy choices for exchange rate management, as noted by Yougbaré (2008).

In essence, the exchange rate serves as a benchmark for assessing the worth of one country's currency in comparison to another's. For instance, as highlighted by Adeniran et al. (2014), the Nigerian Naira is exchanged for the US dollar and various other currencies. This valuation can manifest as either a nominal exchange rate or a real exchange rate. The nominal exchange rate is a financial concept that assesses the relative value of two monetary

quantities, such as the Naira against the Dollar (N/\$). In contrast, the real exchange rate is a real-world concept that evaluates the relative value or purchasing power of products from different countries, as elucidated by Edward (2016). Exchange rate systems can also be categorized as either fixed or subject to fluctuations. In a fixed exchange rate system, a country's exchange rate remains stable or fluctuates within a narrow margin around a predetermined par value, as explained by Obstfeld (2011).

Economic growth, on the other hand, signifies the continuous expansion of an economic variable, often observed over successive periods. This variable may relate to either real or nominal aspects. Growth in a real economic variable, such as Gross Domestic Product (GDP), for shorter time frames or at lower rates, may result from the amplification of similar activities on a larger scale. Swift or enduring growth typically involves positive transformations, while fluctuations in exchange rates have the potential to either facilitate or hinder such growth (Eze & Okpala, 2014).

## **2.2 Inflation Rate**

Inflation is characterized by a persistent rise in the general price levels of goods and services within an economy over an extended period. When inflation occurs, each unit of a country's currency can purchase fewer goods and services, leading to a decrease in the purchasing power of that currency. In essence, inflation represents a decline in the real value of money as a medium of exchange and a unit of measurement within the economy. Conversely, the opposite of inflation is known as deflation, which involves a sustained decrease in the general price level of goods and services (Fapetu & Oloyede, 2014).

One of the primary measures used to gauge inflation is the inflation rate. This rate is calculated as the annualized percentage change in a general price index, typically based on indicators like the consumer price index, over a specified period. Economists generally agree that extremely high inflation rates and hyperinflation are primarily driven by an excessive expansion of the money supply. However, there is a range of perspectives regarding the factors responsible for low to moderate inflation rates. Lower or moderate inflation can be attributed to shifts in the real demand for goods and services or changes in the availability of resources, especially during times of scarcity. Nevertheless, the prevailing consensus is that prolonged periods of inflation stem from the money supply growing at a faster rate than the overall economic growth (Lawal, 2016).

Inflation can have both positive and negative impacts on economies. The adverse effects of inflation encompass an increase in the opportunity cost of holding money, heightened uncertainty about future inflation rates, which may discourage investments and savings, and, in cases of rapid inflation, shortages of goods as consumers hoard them out of concern that prices will continue to rise. Conversely, the positive effects include the potential to reduce unemployment due to nominal wage rigidity, grant the central bank greater flexibility in implementing monetary policies, encourage lending and investment instead of money hoarding, and help avoid the inefficiencies associated with deflation, which can stifle economic growth.

## **2.3 Interest Rate**

The interest rate, often referred to as the Bank rate or monetary policy rate (MPR), serves as one of the key intermediate tools within the Central Bank's arsenal for regulating the money supply and, consequently, managing the inflation rate (Michael et al., 2013). When the Central Bank aims to reduce the money supply, thereby limiting the financial capacity of participants, particularly commercial banks, it will opt to increase interest rates. Conversely,

in instances where an expansionary monetary policy is pursued, the opposite approach will be taken.

## 2.4 Economic Growth in Nigeria

Economic growth is a vital indicator of a nation's economic performance and development. In the context of Nigeria, a country located in West Africa with a diverse economy, understanding and measuring economic growth are of paramount importance. Nigeria, often referred to as the "Giant of Africa," has a mix of natural resources, a growing population, and a dynamic business environment. Examining economic growth in Nigeria involves both assessing the factors contributing to its growth and measuring it using appropriate indicators and formulas (Omorokunwa, & Ikponmwosa, 2014).

### Factors Contributing to Economic Growth in Nigeria:

Several factors contribute to economic growth in Nigeria:

**Natural Resources:** Nigeria is rich in oil, which has historically been a significant driver of economic growth and government revenue. However, the country's over-reliance on oil can also make its economy vulnerable to fluctuations in oil prices.

**Agriculture:** Agriculture is a key sector of the Nigerian economy, employing a significant portion of the population. Improvements in agricultural productivity can boost economic growth by increasing food production and reducing rural poverty.

**Infrastructure Development:** Investment in infrastructure, such as roads, power, and telecommunications, is essential for economic growth as it enhances productivity and attracts investments.

**Human Capital Development:** Education and healthcare are vital for human capital development. A well-educated and healthy workforce is more productive and can contribute to economic growth.

**Political Stability:** A stable political environment is crucial for attracting foreign investments and promoting economic growth.

### Formula for Computing Economic Growth:

Economic growth is typically measured using the Gross Domestic Product (GDP) growth rate. The GDP growth rate formula is:

$$\text{GDP Growth Rate} = \frac{(\text{GDP}_{\text{year2}} - \text{GDP}_{\text{year1}})}{\text{GDP}_{\text{year1}}} \times 100$$

#### where:

$\text{GDP}_{\text{year1}}$ : Represents the Gross Domestic Product for a specific base year.

$\text{GDP}_{\text{year2}}$ : Represents the GDP for the year following the base year.

The result of this formula is then multiplied by 100 to express the GDP growth rate as a percentage.

### 2.4.1 Sustainable Economic Growth

Sustainable economic growth refers to a long-term increase in a country's economic output while considering environmental, social, and economic factors. It encompasses not only the quantity of economic activity but also its quality and inclusivity (Osinubi & Amaghionyeodiwe, 2009). Achieving sustainable economic growth requires addressing various challenges, including unemployment, poverty reduction, income inequality, and

environmental sustainability. Effective policy interventions are essential to achieving these goals.

## 2.5 Policy Interventions

Policy interventions are measures implemented by governments and central banks to influence exchange rate dynamics and achieve specific economic objectives. These interventions can be categorized into two main approaches:

**Fixed Exchange Rate Regime:** Under a fixed exchange rate regime, the government or central bank commits to maintaining a stable exchange rate by buying or selling foreign currency reserves as needed. This approach aims to provide exchange rate stability, which can encourage foreign investment and trade.

**Floating Exchange Rate Regime:** In a floating exchange rate regime, the exchange rate is determined by market forces of supply and demand. Governments and central banks may intervene occasionally to mitigate extreme fluctuations, but the exchange rate largely adjusts to market conditions. This approach can enhance economic flexibility but may lead to volatility.

## 2.6 Linking Exchange Rate Management and Economic Growth

The connection between exchange rate management and economic growth in Nigeria is multifaceted. A stable exchange rate can provide certainty to businesses, promote investment, and boost exports, contributing to economic growth. However, an overvalued exchange rate can hinder export competitiveness, while an undervalued exchange rate may lead to inflation and trade imbalances.

Balancing the need for exchange rate stability with the imperatives of economic growth requires careful policy consideration. It necessitates a comprehensive understanding of Nigeria's economic structure, its dependence on oil exports, and the importance of diversifying the economy (Wood, et al., 2004).

## 2.2 Theoretical Framework

This study is underpinned on Purchasing Power Parity Theory.

### Purchasing Power Parity Theory

The Purchasing Power Parity Theory (PPP) is an economic theory that assesses different countries' currencies using a basket of goods approach. Essentially, PPP posits that a unit of any given currency should have the ability to purchase an equivalent quantity of goods in all countries. This theory takes into account variations in countries' inflation rates relative to the purchasing power of their currencies. In simpler terms, if a country experiences persistent high inflation, it would result in locally made goods becoming more expensive compared to foreign substitutes. Consequently, consumers are inclined to favor foreign products, leading to a higher demand for foreign currencies to purchase them. This increased demand for foreign currencies raises their value at the expense of the domestic currency, resulting in a depreciation of the nation's currency.

As the nation's currency depreciates, foreign currencies become more valuable and costly to acquire. This, in turn, escalates exchange costs. As exchange costs rise, production lines tend to consume fewer foreign inputs. The outcome is increased production costs, which may lead to higher product prices, reduced outputs, workforce layoffs, diminished profits, or even the complete shutdown of production units. Conversely, an increase in the exchange rate can

boost production, enhance employment opportunities, increase profit margins, or lead to the establishment of new production lines.

Furthermore, the purchasing power of a nation's currency, heavily influenced by inflation, plays a significant role in determining the direction of foreign exchange rate movements. The PPP theory can be articulated in two forms: absolute and relative. The absolute form asserts that the equilibrium exchange rate equalizes the general purchasing power of a given income concerning relative price levels. It links the exchange rate level to relative price levels. The relative form contends that changes in exchange rates, measured from a base period, reflect alterations in relative price levels. This study places particular emphasis on the Purchasing Power Parity Theory due to its broad applicability and its comprehensive consideration of key variables when addressing exchange rate fluctuations.

### **2.3 Empirical Framework**

Ikechukwu (2016) investigates the effects of volatility clustering in exchange rate on firm's performance in Nigeria from 2004-2013 using cross sectional data for the most active 20 companies listed on the Nigerian Stock Exchange. The results show that exchange rate fluctuation has significant negative impacts on the rate of return on assets, asset turnover ratio and the portfolio activity and resilience, thus, showing the significant negative impact of exchange rate fluctuation on firm performance in Nigeria

Jonathan and Kenneth (2016) analyze the link between exchange rate fluctuations and private domestic investment in Nigeria. The descriptive statistics of the variables included in the model show the existence of wide variations in the variables as depicted by the standard deviation of the exchange rate variable that was unusually high. The findings suggest that, the depreciation of the currency and interest rate does not stimulate private domestic investment activities in Nigeria.

Jongbo (2014) examines the impact of real exchange rate fluctuation on industrial output by investigating the effect of misalignment of real exchange rate on the output of the Nigeria industrial sector. The result shows that real exchange rate play a significant role in determining the industrial output. The study further reveals that the capacity utilization ratio is low, the case of which may not be too far away from, partly epileptic power supply, lack of adequate and appropriate technology and so on.

Dada and Oyeranti (2012) analyzed the impact of exchange rate on macroeconomic aggregates in Nigeria using annual time series data spanning from 1970 to 2009, the study examines the possible direct and indirect relationship between the real exchange rates and GDP growth. The relationship is derived in two ways using a simultaneous equations model within a fully specified Macroeconomic Model, and a vector-autoregressive model. The estimation results showed that there was no evidence of a strong direct relationship between changes in the exchange rate and GDP growth. Rather, Nigeria's economic growth had been directly affected by fiscal and monetary policies and other economic variables particularly the growth of oil exports. These factors have tended to sustain a pattern of real exchange rate over-valuation, which has been unfavourable for growth.

Asher (2012) examined the impact of exchange rate fluctuations on the Nigeria economic growth for period of 1980 - 2010. The result showed that real exchange rate has positive effect on economic growth. He also opined that exchange rate is used to determine the level of output of the country.

### 3. Methodology

The research design to be adopted in this study is the *ex post facto* research since it relied on published data. *Ex post facto* research design involves events that have already taken place. The nature of the data is secondary and the study employed Simple Regression Analysis to assess the exchange rate variation and economic growth.

The study utilized the model below:

$$GDP = \beta_0 + \beta_1 EXR + \beta_2 IF + \beta_3 IR + \varepsilon_t \dots\dots\dots i$$

Where,

- GDP = Gross Domestic Products
- EXR = Exchange Rate
- IF = Inflation Rate
- IR = Interest Rate
- $\varepsilon_t$  = error terms

### Results and Interpretation

**Table 1: Result of the Regression for Hypothesis One**

Dependent Variable: GDP

Method: Least Squares

Date: 07/19/23 Time: 19:08

Sample: 2012 2022

Included observations: 11

Variable	Coefficient	Std. Error	t-Statistic	Prob.
EXCHR	0.032592	0.010930	2.981788	0.0407
C	1.213284	3.591928	0.337781	0.7525
R-squared	0.689707	Mean dependent var		11.82833
Adjusted R-squared	0.612134	S.D. dependent var		1.880568
S.E. of regression	1.171197	Akaike info criterion		3.415131
Sum squared resid	5.486806	Schwarz criterion		3.345717
Log likelihood	-8.245392	Hannan-Quinn criter.		3.137263
F-statistic	8.891057	Durbin-Watson stat		2.043812
Prob(F-statistic)	0.040667			

**Source:** Author's E-views Output, 2023.

In Table 1, the regression result indicated that gross domestic product was influenced by exchange rate. The extent of the influence exerted on gross domestic product by exchange rate is significant and positive. This implies that a unit increase in exchange rate will have a corresponding increase in gross domestic product in Nigeria. The adjusted  $R^2$  is 0.612134 and this reveals that about 61% of the variations in gross domestic product could be explained by exchange rate while 39% could be explained by other factors.



**Table 2: Result of the Regression for Hypothesis Two**

Dependent Variable: GDP

Method: Least Squares

Date: 07/19/23 Time: 19:22

Sample: 2012 2022

Included observations: 11

Variable	Coefficient	Std. Error	t-Statistic	Prob.
INFR	-0.039734	0.293554	-0.135355	0.0009
C	12.35905	4.013339	3.079492	0.0369
R-squared	0.704559	Mean dependent var		11.82833
Adjusted R-squared	0.544301	S.D. dependent var		1.880568
S.E. of regression	2.097741	Akaike info criterion		4.580800
Sum squared resid	17.60206	Schwarz criterion		4.511387
Log likelihood	-11.74240	Hannan-Quinn criter.		4.302932
F-statistic	0.018321	Durbin-Watson stat		0.642342
Prob(F-statistic)	0.898870			

**Source:** Author's E-views Output, 2023.

In Table 2, the regression result indicated that gross domestic products was influenced by inflation rate. The extent of the influence exerted on gross domestic product by inflation rate is significant and negative. This implies that a unit increase in inflation rate will exert a corresponding decrease in gross domestic product in Nigeria. The adjusted  $R^2$  is 0.544301 and this reveals that about 54% of the variations in gross domestic product could be explained by inflation rate while 46% could be explained by other factors.

**Table 3: Result of the Regression for Hypothesis Three**

Dependent Variable: GDP

Method: Least Squares

Date: 07/19/23 Time: 19:23

Sample: 2012 2022

Included observations: 11

Variable	Coefficient	Std. Error	t-Statistic	Prob.
INTR	0.218139	0.977299	0.223205	0.0343
C	9.003076	12.68637	0.709665	0.5171
R-squared	0.612302	Mean dependent var		11.82833
Adjusted R-squared	0.534623	S.D. dependent var		1.880568
S.E. of regression	2.089566	Akaike info criterion		4.572992
Sum squared resid	17.46515	Schwarz criterion		4.503578
Log likelihood	-11.71898	Hannan-Quinn criter.		4.295124
F-statistic	0.049821	Durbin-Watson stat		0.669910
Prob(F-statistic)	0.834311			

**Source:** Author's E-views Output, 2023.

In Table 3, the regression result above indicated that gross domestic product was influenced by interest rate. The extent of the influence exerted on gross domestic product by interest rate is significant and positive. This implies that a unit increase in interest rate will exert a corresponding increase in gross domestic product in Nigeria. The adjusted  $R^2$  is 0.534623 and this reveals that about 53% of the variations in gross domestic product could be explained by interest rate while 47% could be explained by other factors.

### **5.1 Summary of Findings**

Findings arising from this research were summarized as follows:

1. Findings from hypothesis one revealed that gross domestic product was influenced by exchange rate. The extent of the influence exerted on gross domestic product by exchange rate is significant and positive.
2. Findings from test of hypothesis two shows that gross domestic products was influenced by inflation rate. The extent of the influence exerted on gross domestic product by inflation rate is significant and negative.
3. Findings from test of hypothesis three reveals that gross domestic product was influenced by interest rate. The extent of the influence exerted on gross domestic product by interest rate is significant and positive.

### **5.2 Conclusion**

This study has yielded several policy implications. Among them, it is evident that exchange rate volatility and inflation exert significant influence on both economic growth (GDP) and the dynamics of imports and exports within the Nigerian macroeconomic landscape. These findings underscore the importance of formulating a monetary policy framework that complements the existing policies in place.

In summary, this research, which focuses on policy interventions for managing exchange rate variations and promoting sustainable economic growth in Nigeria, offers empirical insights into the connections between exchange rates, inflation, interest rates, and GDP. The empirical findings indicate a direct and significant relationship between inflation, exchange rates, interest rates, and Gross Domestic Product in Nigeria. This relationship arises from the impact of exchange rate fluctuations on the pricing of goods and services, which, in turn, affects export and import activities, resulting in inflationary trends.

Furthermore, the regression analysis reveals a significant and co-integrated relationship between exchange rates and GDP. While over the long term, exchange rates and GDP may exhibit some divergence, in the short term, their relationship is robust and direct. This study underscores the importance of vigorously pursuing exchange rate stability to mitigate the adverse effects of inflation on the overall economy.

In conclusion, this research provides valuable insights into the complex interactions among exchange rates, inflation, interest rates, and economic growth in Nigeria. The policy implications derived from this study emphasize the need for a comprehensive and balanced monetary policy approach to address the challenges posed by exchange rate fluctuations and inflation, ultimately fostering economic stability and growth.

### **5.3 Recommendations**

In line with the findings of this study, the following policy recommendations are suggested to develop a more stable exchange rate as follows.

1. The government should influence the foreign exchange rate, by positive economic reforms that will reduce the adverse effect of unstable exchange rate on the Nigerian economy with respect to trade flow.
2. The government's monetary policies and regimes should address the incessant and recurrent high inflation issues so that the benefit associated with exchange rate stability and inflation rate reduction can be harnessed in the Nigeria.
3. Incentives in form of reduction of interest rate should be provided to ease cost of production and enable increase output level in terms of quality and volume production.

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