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EFFECT OF CURRENCY DEPRECIATION ON ECONOMIC GROWTH IN NIGERIA

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Abstract

This paper aims to study the effect of currency depreciation on economic growth in Nigeria. The impetus for this study stems from the paradoxical observation that, although Nigeria cannot operate a fixed exchange rate system (currency devaluation) because of its low reserves, but can still Endeavor to increase her reserve to adopt a fixed exchange rate as it has a lot of importance to her economy. The major objective of this research work is to examine how currency depreciation influences economic growth in Nigeria. In the process of carrying out this research work, various variables such as exports, imports, inflation, interest rate, gross domestic product and exchange rate were adopted. The data used in this research were secondary data obtained from the World Development Indicators (WDI). Findings were drawn from the research that the exchange rate has a significant impact on economic growth in Nigeria. Therefore, a recommendation is suggested that there is a need to maintain a stable exchange rate. The Autoregressive Distributed Lag Model (ARDL) was adopted as the estimation technique.

Keywords: Currency depreciation, Fixed exchange rate system and Economic growth

Introduction

Right from the early 1980s, it has been seen that Nigeria's economy was becoming increasingly unstable in the sense that the value of Nigerian naira depreciates periodically over the years. Since the introduction of market-determined exchange rate through the Second – Tier Foreign Exchange Market (SFEM) in Nigeria (1986), the Naira exchange rate to dollar has exhibited the features of continuous depreciation and instability in both the official and parallel rate of Naira to Dollar which has moved from ₦0.5926 / $1 in 1980 to ₦4.9322 / $1 in 1988 to ₦116.0525 / $1 in 2000 and finally to ₦199.0050 / $1 in 2015 according to the National Bureau of Statistics (NBS). The depreciation of currency occurs more in the 1980s to 2017 than in the 1960s to 1979. Considering these trends, the causes of currency depreciation over the years includes Excess demand for foreign goods, Inadequate funding of foreign exchange market, Low manufacturing which led to low productivity, Neglect of the agricultural sector, Debt overhang, etc. In the early seventies, Nigeria was based majorly on agricultural products. The major source of Nigeria revenue as at then was from agricultural products like groundnut, cocoa, palm oil, rice, etc. Many western industrialized countries always demand Nigeria agricultural products, which eventually made Nigeria balance of trade to be more favourable. But when Nigeria experienced oil-boom in 1971- 1977, it made the Nigeria economy to deviate from producing agricultural products and started focusing majorly on crude oil.

The effect of the depreciation of the naira in the Nigerian economy was numerous. Some of these effects include Low standard of living, increased in cost of production (this was because most of the equipment used in production in Nigeria were majorly imported into the country), Cost-push inflation, an even unemployment, etc. Bureau de change was established in 1989 to challenge the parallel market, but this was not effective because the parallel market was waxing stronger to the detriment of the official market and the economy at large. This led to the problem of the wide disparity between the rates in the official market in one hand and those in the bureau de change and parallel market on the other hand. Hence, this research seeks to proffer answers to questions such as: What is the impact of currency depreciation on economic growth in Nigeria? What is the effect of currency depreciation on the trade balance in Nigeria? What are the possible factors responsible for currency depreciation in Nigeria? While some specific questions such as; Does the exchange rate affect economic growth in Nigeria? If the exchange rate affects the economic growth in Nigeria? Then in what way? Has the exchange rate been depreciating or appreciating over the years (1980-2017)? What are the major causes of currency depreciation in Nigeria? Will be identified.

Literature Review

Currency depreciation is the reduction in the price of a country’s currency in terms of other countries’ currencies which is affected by the forces of demand and supply. This means that currency depreciation is usually determined by the forces of demand and supply which lowers the prices of the country’s exports and raises the prices of foreign imports, which ultimately results in greater domestic production. It is important to know the difference between currency depreciation and devaluation. Currency devaluation is a conscious action taken by the government of an economy to reduce the prices of their currency in relation to other country’s currency due to several reasons such as to increase their exports, to improve trade deficit over time and so on. For instance, When Nigeria reduces the value of her currency in relation to other neighbouring countries’ currencies, it makes Nigeria’s exports to be relatively cheaper to other countries. By doing this, other neighbouring countries will be much encouraged to purchase commodities from Nigeria's economy because the prices (exchange rate) of Nigeria currency is cheap; and therefore, increase Nigeria’s exports. A

government devalues its currency by actively selling it and buying foreign currencies through the foreign exchange market. Bahmani and Ratha (2004), currency depreciation is the decrease in the level of a currency in a floating exchange rate system due to market forces. Currency depreciation can occur due to any number of reasons such as economic fundamentals, interest rate differentials, political instability, and risk aversion amongst investors and so on. Countries with weak economic fundamentals such as chronic current account deficits and a high rate of inflation generally have a depreciating currency. A currency devaluation is not influenced by the forces of demand and supply but by the government. Here, the government decides on what basis must her currency be devalued. A well-structured currency devaluation improves a nation’s export competitiveness and may improve its trade deficit over time. But abrupt and sizeable currency depreciation may scare foreign investors who fear the currency may fall further, and lead to them pulling portfolio investments out of the country, putting further downward pressure on the currency. Monetary policy and high inflation are the two main causes of currency depreciation. In a low-interest rate economy, hundreds of billions of dollars chase the highest yield. Expected interest rate differentials can trigger a bout of currency depreciation. Inflation can also cause currency depreciation. This is because the higher input costs for export products made in a high inflation nation will make its exports uncompetitive in global markets, which will widen the trade deficit and cause the currency to depreciate. Further, inflation means too much money purchasing fewer goods in an economy. Fewer goods imply low productivity, low productivity will result in low exports, and when there are low exports the Balance of Payment will be unfavourable to the country. It will now result in purchasing for more imports which will eventually lead to currency depreciation because more of another country’s currency is been demanded. According to Mireille in Akpan & Atan (2011), he argues that overvaluation of exchange rate have constituted a major setback in the recovery process of Nigeria and Benin Republic. In addition, the author suggests that devaluation accompanied by well-targeted measures alongside an upward adjustment in the domestic price of tradable goods, could restore exchange rate equilibrium and improve economic performance. The author found that exchange rate pass-through in Nigeria during the period under consideration was low and declined along the price chain, which partly overturns the conventional wisdom in the literature that exchange rate pass-through is always considerably higher in developing countries than developed countries. Mireille also concludes that in the long run, pass-through would likely increase and monetary policy should be designed to accommodate the effect. Furthermore, Devaluation is a reduction in the value of a currency with those goods, services and other monetary units with which that currency can be exchanged. It also means official lowering of the value of a country’s currency within a fixed exchange rate system, by which the monetary authority formally set a new fixed rate with respect to a foreign reference currency. Devaluation is a monetary policy tool of countries that have a fixed exchange rate or semi-fixed exchange rate. This definition is by no means exhaustive of the term. Cook (2004) explained the underlying reasons for the devaluation of currencies by developing countries. In emerging markets, external debt is denominated almost entirely in large, developed country currencies such as the U.S. dollar. This liability dollarization offers a channel through which exchange rate variation can lead to business-cycle instability. When firms' assets are denominated in domestic currency and liabilities are denominated in foreign currency, an exchange rate depreciation worsens firms' balance sheets, which leads to higher capital costs and contractions in capital spending. El-Masry & Abdel-Salam (2007) Import competitors will benefit from a depreciation of the domestic currency, which makes their products price competitive in the home currency terms. Consequently, such firms can be expected to have a positive exchange exposure coefficient. Any depreciation will have the opposite effect on firms that distribute imported goods or rely

on imported factor inputs since more units of the pound are needed to purchase one unit of foreign currency. Imimole & Enoma (2011) noted that the growth rate of real total GDP was negative in 1975, 1978, 1982 through 1984 as well as in 1987. The drought that occurred in Northern Nigeria was linked to the negative growth rate in 1975. During this year, the total real GDP declined by 2.96% while agricultural output declined by 8.6% in the same year showing that agriculture was a drag on growth for that year. The decline in the real total GDP in 1978 could be linked to the liberalization of import controls in 1976 which threatened the domestic production of the agricultural and manufacturing sectors. Various policies were put in place to reverse the negative growth rate of GDP in 1979. Such measures included an increase in import duties on various commodities, the placing of some commodities under license or an outright ban. Others included concessions to local manufacturers to encourage them to expand their production capacities and the liberalization of the terms and the availability of credit to farmers. According to Yaqub (2010), the major negative fall-outs of the above were a persistent balance of payment deficit (external imbalance) and huge fiscal deficits (internal imbalance). The balance of payment problem was identified to be a consequence of the over-devaluation of the Naira. Under the SAP, therefore, the exchange rate was to reflect the scarcity value of the national currency. The devaluation of the Naira would enhance the level of non-oil exports; discourage import thus reducing the nominal value of imports while increasing the value of exports. Odusola and Akinlo (2003) examined the linkage in the exchange rate, inflation and output in Nigeria, A structural VAR model was employed which captured the interactions between exchange rate and output. Evidence from the contemporaneous models showed a contradictory impact of the parallel exchange rate on output only in the short term. Prices, parallel exchange rate, and the lending rate were found to be important sources of perturbations in the official exchange rate. In addition, output and parallel exchange rates were significant determinants of inflation dynamics in Nigeria. Odusola and Akinlo conclude by suggesting more concerted efforts by the Central Bank towards taming the parallel exchange rate behaviour and formulating monetary policies that enhance income growth. Largely, the findings were informative.

Methodology

3.1 Why Naira has been Depreciating again the US Dollar

The two-decade-long Naira depreciation against the US Dollar stems from a complex interplay of factors. Understanding these underlying causes provides valuable insights into ongoing Naira devaluation. Here, we explore five key influencers:

1. **Heavy Oil Reliance:** Nigeria's overreliance on oil exports, while a revenue source, leaves the Naira vulnerable to global oil price fluctuations, contributing to its volatility.
2. **Weak Diversification:** Struggles to diversify the economy beyond oil have exposed Nigeria to oil price shocks, further fueling Naira depreciation.
3. **Exchange Rate Policies:** Frequent changes in exchange rate policy, from fixed to floating rates, have bred uncertainty in the foreign exchange market, reducing investor confidence and pressuring the Naira.
4. **Foreign Reserve Depletion:** Depleted foreign exchange reserves, especially during low oil prices, limit the Central Bank's ability to defend the Naira.
5. **Rising Inflation:** Persistent inflation erodes Naira's purchasing power, making it less attractive to hold and contributing significantly to depreciation.

3.2 The depreciation of the Naira has significant implications for the people of Nigeria:

1. **Purchasing Power Erosion:** Depreciation leads to higher prices for imported goods, which, in turn, erodes the purchasing power of consumers. Everyday essentials, including food, fuel, and electronics, become more expensive, affecting ordinary citizens' living costs.
2. **More Expensive Living:** The Naira losing value can increase prices for many things we need, making it tough for families to keep up with their expenses.
3. **Business Uncertainty:** For businesses, exchange rate instability can create uncertainty. Firms that rely on imported raw materials or equipment may face increased costs, potentially leading to reduced profitability or layoffs.
4. **Investment Concerns:** Currency depreciation can deter foreign investment. Investors may be reluctant to commit capital in an environment of exchange rate volatility and uncertainty, limiting economic growth and job creation.
5. **Reduced Savings:** Citizens holding Naira-denominated savings may see the real value of their savings diminish as inflation rises alongside currency depreciation.
6. **Social Impact:** Currency devaluation can exacerbate income inequality, as the impact is often felt more acutely by lower-income households who spend a larger portion of their income on essentials.

Conclusion and Recommendations

Having seen that exchange rate fluctuation has an impact on the economy. Thus, there is a need to maintain a stable exchange rate. Hence with a stable exchange rate, it will help to curtail inflation, maintain a favourable balance of trade, boost export of domestic commodities and above all, maintains a steady growth of the economy.

Notwithstanding the obvious negative impacts which the devaluation of the Naira may have on the Nigerian economy, the decision to devalue the Naira seems somewhat justifiable when considered in light of some recent events vis a viz; the collapse of global oil prices, from which Nigeria derives about 80% of its foreign exchange revenue, and the reduction in external reserves, which has constrained the ability of the CBN to continually defend the Naira and sustain the exchange rate.

The challenges currently facing the Nigerian economy require the solution devaluation can help provide. The government can use devaluation to boost aggregate demand in the economy in an effort to fight unemployment. Also the price of foreign currency increases which makes import expensive and export cheaper. This causes expenditure to switch from foreign to domestic goods as the country's export rise and the country produces more to meet the domestic and foreign demand for goods with a reduction in imports. It reduces the foreign reserve which affects the economy in the long run which leads to an increase in unemployment and reduces economic growth.

Sequel to the finding of this study, the following policy recommendations are specifically made to the maintenance of a stable exchange rate. To control the exchange rate from fluctuating, these policies have to be adopted. The government should create incentives such as loans subsidy etc. to small scale industries, thereby encouraging them to process domestic goods into processed goods that will help boost our export. The government should encourage export promotion strategies in order to maintain a surplus balance of trade. An effective policy should be made based on the fiscal and monetary policies which should be

aimed at achieving a realistic exchange rate for naira. An appropriate environment and infrastructural facilities should be provided so that foreign investors will be attracted to invest in Nigeria. This will provide a job, increase income and level of the standard of living of the people. Strict foreign exchange control policies are adopted in order to help in the determination of In the case of import, tariffs can be placed to be a very high on imported goods thereby discouraging imports.

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