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## **Impact of Exchange Rate on Balance of Payment in Nigeria** (Pp. 73-88)

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### **Abstract**

*This paper empirically investigates the impact of exchange rate on the Nigeria External sector (the balance of payments position) using the Ordinary Least Square (OLS) method of estimation for data covering the period between 1970 and 2008. We found that exchange rate has a significant impact on the balance of payments position. The exchange rate depreciation can actually lead to improved balance of payments position if fiscal discipline is imposed. We also found out that improper allocation and misuse of domestic credit, fiscal indiscipline, and lack of appropriate expenditure control policies due to centralization of power in government are some of the causes of persistent balance of payments deficits in Nigeria. We recommend that appropriate monitoring machineries be set up to ensure judicious use of credit and available foreign exchange. Exchange rate policies have to be used along with the fiscal and monetary instruments to get meaningful results. This implies that our balance of payments problems can*

*be solved simultaneously from two angles, namely, boosting supply and managing demand. Export diversification and promotion, import substitution and frivolous import restriction cannot be over emphasized.*

**Key words:** Exchange rate volatility, Balance of Payments,

### **Introduction**

Exchange rate refers to the price of one currency (the domestic currency) in terms of another (the foreign currency). Exchange rate plays a key role in international economic transactions because no nation can remain in autarky due to varying factor endowment. Movements in the exchange rate have ripple effects on other economic variables such as interest rate, inflation rate, unemployment, money supply, etc. These facts underscore the importance of exchange rate to the economic well-being of every country that opens its doors to international trade in goods and services. The importance of exchange rate derives from the fact that it connects the price systems of two different countries making it possible for international trade to make direct comparison of traded goods. In other words, it links domestic prices with international prices. Through its effects on the volume of imports and exports, exchange rate exerts a powerful influence on a country's balance of payments position. Consequently, nations in the pursuit of the macro-economic goals of healthy external balances as reflected in their balance of payments (BOP) position, find it imperative to enunciate an exchange rate policy.

Exchange rate is a key determinant of the balance of payments (BOP) position of any country. If it is judiciously utilized, it can serve as nominal anchor for price stability. Changes in exchange rate have direct effect on demand and supply of goods, investment, employment as well as distribution of income and wealth. When Nigeria started recording huge balance of payments deficits and very low level of foreign reserve in the 1980s, it was felt that a depreciation of the naira would relieve pressures on the balance of payments. Consequently, the naira was devalued. The irony of this policy instrument is that our foreign trade structure did not satisfy the condition for a successful balance of payment policy. The country's foreign structure is characterized by export of crude petroleum and agricultural produce whose prices are predetermined in the world market and low import and export price elasticities of demand.

The study therefore aims to identify the variables that cause Balance of Payment (BOP) fluctuations. We want to find out if exchange rate

deregulation has had any significant impact on the external sector(balance of payment) of Nigeria economy.

### **Review of Literature**

Exchange rate is the price of one currency in terms of another. It is the amount of foreign currency that may be bought for one unit of the domestic currency or the cost in domestic currency of purchasing one unit of the foreign currency (Soderstine, 1998). It is the rate at which one currency exchanges for the other, and it is used to characterize the international monetary system (Iyoha, 1996). Anifowose (1994) describes foreign exchange as a monetary asset used on a daily basis to settle international transactions and to finance deficits in a country's balance of payments. He emphasizes that it is an important component of a country's stock of external reserve. Other components include holding of monetary gold and special drawing rights (SDRs). He considers foreign exchange management as a conscious effort to control and use available foreign resources optimally while ensuring to build up external reserves in order to avoid external shocks attributable to dwindling of foreign exchange receipts.

Obaseki (1991) observes that foreign exchange can be acquired by a country through exports of goods and services, direct investment inflow or external loans, aids and grants which can be used in settling international obligations. When there is disequilibrium in the foreign exchange market as a result of inadequate supply of foreign services, this may exert pressure on foreign exchange reserves, and if the foreign reserves are not adequate, this may deteriorate into balance of payments problems. Therefore, there is need to manage a nation's foreign exchange resources so as to reduce the adverse effects of foreign exchange fluctuations.

In the literature, there are two broad methods of exchange rate management namely fixed and flexible exchange rate regimes. Exchange rate regimes refer to different systems of managing the exchange of a nation's currency in terms of other currencies. According to Obadan (1996), fixed exchange rates are to promote orderliness in foreign exchange markets and certainly in international trade transactions. On the other hand, a flexible exchange rate system is one which the exchange rate at any time is determined by the interaction of the market forces of demand and supply for foreign exchange. Ojo (1990) opines that international experience has shown that no country leaves its exchange rate determination completely to market forces alone as some level of intervention is applied from time to time as situation demands.

Obadan and Nwobike (1991) opine that some countries with a weak balance of payments position adopt multiple exchange rate systems as an alternative to devaluation, which is viewed as too costly from a political or social perspective. They emphasize that a rationalized and properly administered dual exchange rate system can be very helpful to developing countries for ensuring the satisfaction of basic needs, ensuring fixed and balance of payments viability and general resource mobilization.

Khan and Lizondon (1987) observe that countries experiencing balance of payments problems should embark on devaluation or gradual depreciation of her currency to effect a change on the payments problems, since devaluation which is the reduction of the value of one's country is expected to have significant impact on international capital movements. Cooper (1976) examines the effect of devaluation on the balance of payments of some developing countries. He discovers that three quarter of the cases examined showed that the current account of the balance of payments improved. This implies that devaluation leads to higher exports and lowers imports, which in the long run would improve the balance of payments position of a country. Conversely, Birds (1984) is of the opinion that the improvements of balance of payments after devaluation does not necessarily suggest that the balance of payments always improve because of devaluation. Iyoha (1996) considers devaluation as the deliberate reduction of the value of a country's currency in terms of other currencies. It is an increase in the exchange rate from one par value to another and could be used as a policy instrument by a nation under a fixed exchange rate system to correct a surplus of deficits in its balance of payments.

Kiguel and Ghei (1993) also shows that exchange rate affects balance of payments, using the ratio of non-gold reserve to import to study the impact of devaluation on the balance of payments. Their results show that the reserve position of the devaluing country improves as a result of devaluation. This means that devaluation improves the balance of payments, since a improvement on the reserve position constitutes an improvement on the balance of payments position. Olisadebe (1996), however, is of the opinion that the relationship between exchange and balance of payments arises out of international exchange, which determines the amount of payments involved in economic transactions. Obaseki (1991) observes that foreign exchange resources are derived and expended in the course of effecting economic transactions between the residents of one country and the rest of the world. He opines that there is a close link between foreign exchange transactions

and the balance of payments; but while foreign transactions reflects cash flow arising from internal operations, the balance of payments exhibit the dual movement of goods and services. Donovan (1981) study, however, suggests that devaluation would improve the current account without significant import liberation.

## **Theoretical Framework and Model Specification**

### **Theoretical Framework**

The theoretical basis for this study is provided by those theories, which deal with the instruments for correcting balance of payments deficits. Such theories have existed in international trade theory as far back as 1752 when Hume David in his work on the balance of trade made a case for the automatic equilibrating mechanism provided by inflows and outflows of money stock in balance of payments adjustments. Detailed analysis of the theory of policy instruments for correcting balance of payments equilibrium is, however, clearly spelt out in the work of Meade (1954). Meade (1954) proposes that a country can offset adverse trends in its balance of payments by a change of financial policies. A policy of price adjustments, which involves changes in money wage and changes in the exchange rate, is devaluation. This is presently called expenditure – switching policy.

The aim of expenditure reducing policies is to reduce domestic expenditure on consumption and investment and thereby releases goods for export, while leaving aggregate output unchanged. On the other hand, the aim of expenditure switching policy is to switching domestic demand from imported to home made goods (Komolafe, 1996). The extent to which the switching is achieved depends on elasticity of supply and demand for tradable goods. However, expenditure – reducing policies have costs in terms of loss of output, investment and employment (Olisadebe, 1996). The loss would be minimized if resource can be easily moved to the tradeable goods sector. Alternatively, bridging external loans may be contracted to sustain an acceptable level of investment and output.

### **Balance of Payments Equation**

To express our balance of payments function, we look at various approaches used to analyze the effects of exchange rate volatility on the balance of payments. These approaches include the elasticity approach, the absorption approach and the monetary approach. Among these three approaches, the monetary approach describes the current state of art in the analysis of

exchange rate fluctuations/effects on balance of payment (Ozumba, 1978). We now consider these approaches.

### **The Elasticity Approach**

The elasticity approach focuses on the trade balance. It studies the responsiveness of the variables in the trade and services account, constituting of imports and exports of merchandise and services relative price changes induced by devaluation. The elasticity approach to balance of payments is built on the Marshall Learner condition (Sodersten, 1980), which states that the sum of elasticity of demand for a country's export and its demand for imports has to be greater than unity for a devaluation to have a positive effect on a country's balance of payments. If the sum of these elasticities is smaller than unity, then the country can instead improve its balance of trade by revaluation. This condition can be expressed mathematically as follows:

$$\Delta B = KXf(e_{1m} + e_{2m-1}) \dots\dots\dots 3.1$$

where:

$\Delta B$  = change in the trade balance

$K$  = The devaluation in percentage

$Xf$  = The value of exports expressed in foreign currency

$e_{1m}$  = The first (devaluing) country's demand elasticity for imports.

$e_{2m}$  = The second country's demand elasticity for exports from the devaluing country.

Thus,  $e_{1m} + e_{2m} > 1$  for Marshall Learner condition to be fulfilled.

This approach essentially detects the condition under which changes in exchange rate would restore balance of payments (BOP) equilibrium. It focuses on the current account of the balance of payment and requires that the demand elasticity be calculated, specifying the conditions under which a devaluation would improve the balance of payments. Crockett (1977) sees the elasticity approach to balance of payments as the most efficient mechanism of balance of payments adjustments and suggests the computation of demand elasticity as the analytical tool by which policies in the exchange field can be chosen, so as to form the equilibrium. In contrast, Ogun (1985) is of the view that most less developed countries who are exporters of raw materials or primary products, and importers of necessities may not successfully apply devaluation as a means of correcting balance of

payments disequilibrium, because of the low values for the elasticity of demand.

### **The Absorption Approach**

This approach summarily postulates that devaluation would only have positive effects on the balance of trade if the propensity to absorb is lower than the rate at which devaluation would induce increases in the national output of goods and services. It therefore advocates the need to achieve deliberate reduction of absorption capacity to accompany a currency devaluation. The basic tenet of this approach is that a favourable computation of price elasticity may not be enough to produce a balance of payments effect resulting from devaluation, if devaluation does not succeed in reducing domestic expenditure. The approach dwells on the national income relationship developed by Keynes and it tries to find out its implication on balance of payments (Machlup, 1955). It begins with the national income identity as shown below.

$$Y = C + I + G + X - M \dots\dots\dots 3.2$$

where,

Y = National income

C = Private consumption of goods and services

I = Total investment by firms and government

G = Government expenditure on goods and services

X = Export of goods and services

M = Import of goods and services.

We can represent domestic expenditure with expenditure terms such as:

$$C + I + G = \alpha$$

and the net export as

$$X - M = \beta.$$

Putting the two expressions together gives the equation  $Y = \alpha + \beta$ , which means that the trade balance equals national income minus total expenditure, i.e.

$$\beta = Y - \alpha$$

### **The Monetary Approach**

The monetary approach focuses on both the current and capital accounts of the balance of payments. This is quite different from the elasticity and absorption approaches, which focus on the current account only. As pointed out by Crockett (1977), the general view of monetary approach makes it possible to examine the balance of payments not only in terms of the demand for goods and services, but also in terms of the demand for the supply of money. This approach also provides a simplistic explanation to the long run devaluation as a means of improving the balance of payments, since devaluation represents an unnecessary and potentially distorting intervention in the process of equilibrating financial flows.

Dhliwayo (1966) emphasizes that the relationship between the foreign sector and the domestic sector of an economy through the working of the monetary sector can be traced by Humes David's price flow mechanism. The emphasis here is that balance of payments disequilibrium is associated with the disequilibrium between the demand for and supply of money, which are determined by variables such as income, interest rate, price level (both domestic and foreign) and exchange rate. The approach also sees balance of payments as regards international reserve to be associated with imbalances prevailing in the money market. This is because in a fixed exchange rate system, an increase in money supply would lead to an increase in expenditure in the forms of increased purchases of foreign goods and services by domestic residents. To finance such purchases, much of the foreign reserves would be used up, thereby worsening the balance of payments. As the foreign reserve flows out, money supply would continue to diminish until it equals money demand, at which point, monetary equilibrium is restored and outflow of foreign exchange reserve is stopped.

Conversely, excess demand for money would cause foreign exchange reserve inflows, domestic monetary expansion and eventually balance of payment equilibrium position is restored. The monetary approach is specifically geared towards an explanation of the overall settlement of a balance of payments deficit or surplus. If the supply of money increases through an expansion of domestic credit, it will cause a deficit in the balance of payments, an increase in the demand for goods and various assets and decrease in the aggregate in the economy.

### **Model Specification**

The model used by Magee (1976) is modified and used in this study. In Magee's work, he examines the effect of explanatory variables such as real output, price level, interest rate and nominal domestic credit on the balance of payment (BOP). In addition to the variables used by Magee we have included exchange rate and money supply in this study. Exchange rate is included because from theory, it is obvious that there is a relationship between exchange rate and the balance of payments. In this study, balance of payment (BOP) position is made the endogenous variable while exchange rates, money supply, real output, price level, interest rate and nominal domestic credit are the explanatory variables. This could be stated mathematically as follows:

$$\text{BOP} = f(\text{EXRT}, \text{MS}, \text{ROUT}, \text{PRICE}, \text{INTR}, \text{INF}, \text{DOMC})$$

Where;

BOP = Balance of Payments.

EXRT = Exchange rates

MS = Money supply

ROUT = Real Output

PRICE = Price level

INTR = Interest rate

INF = Inflation rate

DOMC = Nominal domestic credit

The econometric form of the model is given as:

$$\text{BOP} = \alpha_0 + \alpha_1\text{EXRT} + \alpha_2\text{MS} + \alpha_3\text{ROUT} + \alpha_4\text{PRICE} + \alpha_5\text{INTR} + \alpha_6\text{INFL} + \alpha_7\text{DOMC} + U_t$$

where,

$U_t$  is a random error term representing all other variables not specified in the model.

A-priori signs of the explanatory variables are as follows:

$$\text{EXRT} < 0$$

MS < 0

ROUT > 0

PRICE < 0

INTR < 0

INFL < 0

DOMS > 0

The a-priori signs come from economic theory, as exchange rate (EXRT) depreciates (falls), BOP position will improve since net export balance is increased. An increase in money supply (MS) raises the level of income, reduces interest rates and worsens balance of payments (BOP). The economic explanation of this fact is that expansionary monetary policy necessarily leads to a deficit in the balance of payments. As real output (ROUT) increases, BOP position improves, this is because with increase in real output, prices reduce, thereby making domestic products more attractive both in the internal and external markets. Increase in domestic price level (PRICE) leads to a fall in balance of payments position. Also, increase in interest rate (INTR) worsens the balance of payments position. An increase in inflation rate (INFL) would worsen the balance of payment position. With increase in availability for domestic credit (DOMS), there will be more credit available for investment and increased production of domestic products.

### **Model Estimation Technique**

Our estimation technique is the Ordinary Least Squares Method of estimation, for single equation model. The OLS method is chosen because of the considerable advantages associated with it (Wallace and Silver, 1988). These advantages include: Best Linear Unbiasedness (BLU), minimum variance, efficiency, Least mean square-error (MSE) and sufficiency. The summary statistics such as  $R^2$ , t-value, F-Statistics, DW-statistics and so on are computed to enable us test the statistical and econometric reliability of the regression results obtained. The data employed in this study were obtained from the publications of the Central Bank of Nigeria (CBN), particularly statistical Bulletin, Annual report and other official publications.

### **Presentation and Interpretation of Results**

This section deals with the presentation and interpretation of regression results. Two estimation techniques were employed in order to achieve good

estimates of the regression equation specified in section three. The estimation equations are presented below.

### **Presentation of Results**

The following results were obtained from the estimation of the model specified in section three.

#### **i. Ordinary Least square results**

Results of the Ordinary Least Square regression method are as follows.

$$\text{BOP} = -49881.3 - 1379.4\text{EXR} - 1461.2\text{MS} + 0.84575\text{ROUT} - 328.5920\text{INF} - 758.3802\text{INT} + 4.4382\text{DOMC}$$

$$(-2.3361) \quad (-1.4669) \quad (2.1419) \quad (-1.8593) \quad (-1.3998) \quad (-0.37463) \\ (4.0004)$$

$$R^2 = 0.98700; R^2 \text{ bar} = 0.97301; \text{S.E.E.} = 10961.1; F(14,13) = 70.5255; \text{MD} = -9465.70; \text{DW} = 1.4580.$$

#### **ii. Cochrane – Orcutt estimation results**

We employed Cochrane Orcutt method to correct for serial correlation as shown by DW of 1.458., the problem usually observed in ordinary least square estimation involving time series.

$$\text{BOP} = -105740.5 - 2477.6 \text{EXR} - 505.0619\text{MS} + 0.47105\text{ROUT} - 45.6040\text{INF} - 170.5371 \text{INT} + 1.1412 \text{DOMC}$$

$$(-3.0329) \quad (-6.7995) \quad (-1.0698) \quad (2.4446) \quad (-0.46778) \quad (-0.20240) \\ (0.77321)$$

$$R^2 = 0.99801; R^2 \text{ bar} = 0.99447; \text{S.E.E.} = 5152.1; F(16,9) = 281.9597 \text{ MD} = -9465.70; \text{DW} = 2.2830$$

The figures in parenthesis are the t –values of the various coefficients; other test statistics included are the  $R^2$ ,  $R^2 \text{ bar}$ , F –test, standard error of regression (SEE), mean of deviation variable (MD), Durbin Watson statistics (DW). The t –test helps us determine whether or not a particular independent variable is statistically significant in the regression equation. That is, whether it is good or reliable predictor of the changes in the dependent variable. The F –test is a test, which enables us to ascertain whether all the independent variables taken together in a particular regression equation are significant in the determination of changes or variations in the dependent variable. This test is

also a measure of overall goodness of fit. The Durbin Watson statistic is testing for the existence of serial correlation.

### **Interpretation of Results**

In trying to explain the impact of exchange rate on the balance of payments, six explanatory variables are employed: exchange rate, money supply, real output, inflation rate, interest rate, and domestic credit in Nigeria. From the results of the OLS the  $R^2$  of 0.98700 shows that 98% of variations in balance of payments are explained by the independent variables. The a-priori signs expectation were correctly specified, however, there was the problem of serial correlation as indicated by the value of DW statistics of 1.4580. In order to solve this problem, the Cochrane Orcutt method was employed. The regression equation under the Cochrane Orcutt method with  $R^2$  of 0.99801 indicates that 99% of the variations in the balance of payments are explained by the explanatory variables. The problem of serial correlation appears to have been taken care of as indicated by the DW of 2.2830. The F statistics was significant at 1% level, which shows that there exists a linear relationship between the explanatory variables. The t-value shows that all variables are statistically significant at 5% level; the signs are consistent with the a-priori expectations.

Exchange rate remained consistently negative and significant in the two methods employed in the estimation. This shows that there is a negative relationship between exchange rate and balance of payments, indicating that higher exchange rate worsens the balance of payments position. Testing for individual significance of the independent variables using the t-test, we find out that the explanatory variables lagged one period are significant at the 5% level in explaining movements in the balance of payments (BOP). Money supply is also consistently negative and significant in the two methods employed. This also shows that there is a negative significant relationship between money supply and balance of payments, indicating that as more money is pumped into the economy, it is likely to worsen the balance of payments position.

Although interest and inflation rates were negatively related to balance of payments, yet they are statistically insignificant. From our estimation results also, it can be seen that both real output and domestic credit are positively related to the balance of payments position, and they are statistically significant. From our results, increase in both real output and domestic credit will improve the balance of payments position. Also, from the results in the

regression equation (1), a unit change in exchange rate generates 2.33 units decrease in balance of payments position, since a negative relationship exists between interest rate and the balance of payments position. A unit increase in money supply generates 1.46 units decrease in balance of payments position. This is in line with economic theory where increased production of goods and services increases the Gross Domestic Product of an economy. A unit increase in inflation generates a 1.39 decrease in balance of payments; also a unit increase interest rate generates 0.37 decrease in balance of payments position, while a unit increase in domestic credits leads to a 4.04 increase in balance of payments.

However, employing the Cochrane orcutt method, the results reported in equation (ii) above, converged after 20 iterations [AR (2)]. The results obtained here are slightly better than the previous results obtained. Put differently, the the Cochrane orcutt method has a higher goodness of fit. From the results shown in the Cochrane orcutt method in equation (ii), a unit increase in exchange rate generates a 6.79 decrease in balance of payments; a unit increase in money supply leads to a 1.06 decrease in balance of payments; a unit increase in real output generates 2.44 increases in balance of payments position. Also, a unit increase in inflation generates 0.46 decrease in balance of payments; a unit increase in interest rate leads to a 0.20 decrease in balance of payments while a unit increase in domestic credit brings about a 0.77 increase in balance of payments position. All these are correct according to a-priori expectations.

### **Policy Implications**

From our findings, the following policy implications have become imperative. Fiscal indiscipline is a serious problem that has to be curbed by introducing appropriate monetary and fiscal policies in order to reduce any persistent balance of payment deficits as is reflected by the sign of our time period lagged. A proper means of monitoring has to be introduced in order for available credit to be channelled to the right sectors and not wastefully spent on importation of consumables. It is also important that exchange rate has to be properly monitored in order to improve our balance of payments position.

### **Summary, Recommendation and Conclusion**

#### **Summary of Research Findings**

The main objective of this study is to analyze the impact of exchange rate on the balance of payments position in Nigeria. To carry out this study, a linear

econometric model was specified, which consisted of the balance of payments function as the dependent variable, while the exchange rate, interest rate, inflation rate, domestic credit, real output and money supply constitute the independent variables. The model was estimated using the Ordinary Least Square (OLS) method and then the Cochrane Orcutt method to correct the problem of serial correlation which is often associated with the OLS method of estimation. The results obtained showed that exchange rate has a significant relationship (negative) with balance of payments while domestic credit and real output has a significant (positive) relationship with the balance of payment of payment position.

### **Recommendations**

From the foregoing the following recommendations have become necessary.

- (1) Our external sector problem has to be tackled simultaneously from two angles namely: boosting supply of goods and other services to other economies and managing demand. In this regard, debt service ratio has to be looked at so that it does not become so high as to erode the stability of domestic economy. Also, frivolous imports should be cut down to free more resources for meaningful investments.
- (2) It is therefore also important that monetary and fiscal policies have to be properly coordinated and harmonized in order to achieve macroeconomic stability. The situation where monetary policy adjusts passively to the expansionary fiscal operations of government should be avoided.
- (3) Appropriate monitoring machinery should be set up at the levels of the Central Bank, National Planning Commission, Federal Office of Statistics, Federal Ministry of Industries and the Custom Department to ensure that foreign exchange and available credit are properly allocated and not abused.
- (4) Discipline has to be maintained in the foreign exchange market and the parallel foreign exchange market considered illegal in order to achieve the objective of having a realistic exchange rate.
- (5) It is important that the exchange rate is not over valued, because this will result in unsustainable balance of payments and escalating external debt stock. In contrast, the exchange rate should find its equilibrium level to make the balance of payments position viable.

- (6) Foreign private investment, which includes foreign private direct investment is an important component of aggregate investment, thus it must be encouraged in Nigeria. Thus, macroeconomic policies designed to bring about low inflation, viable balance of payments position and stable exchange rates will go a long way to encouraging a resurgence of foreign private investment in Nigeria
- (7) During the past two decades, uncertainty in the Nigerian economy has been brought about by economic factors (mainly macroeconomic policy inadequacies) as well as the social and political instability. In addition, there is the perennial problem of governance and lack of grass root participation and democratic principles. Resolution of these stubborn social – political problems will go a long way to reducing perceived uncertainty and increasing foreign confidence in the stability of the Nigeria economy. In turn, this will clear the way for more foreign participation that will mean increase in foreign investment in Nigeria.

### **Conclusion**

In conclusion, we found that exchange rate is a determinant of balance of payments position, and its fluctuations steadily affect the balance of payments position. Therefore there is need for export diversification, since the prospects of traditional agricultural export products in the world market are not bright. We hope that the balance of payments position can be improved, if the recommendations made in this study are implemented without compromise.

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