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ABSTRACT

The purpose of this research is to describe and investigate the monetary policy and exchange rate in Nigeria and effect on economy over the period 1990-2010, using Econometrics technique. The researcher used Regression Analysis to analyze the data with the help of social science statistical package SPSS. Two models were used by the researcher; the first model is to determine the relationship between Gross Domestic product, money supply and inflation while the second model is to determine the relationship between Gross Domestic Product and Exchange Rate.

The Empirical results of this study shows that out of total variation in Gross Domestic Product only 87% was explained by the independent variables (money supply and inflation) which mean that there is positive correlation between dependent and independent variables. There is positive relationship between GDP and money while inflation shows negative relationship with Gross Domestic Product.

The second model also shows that there is strong positive correlation between Gross Domestic Product and Exchange Rate and out total variation in GDP only 80.4% was explained by Exchange Rate. The results of this study revealed that money and Exchange Rate are statistically significant while inflation is not statistically significant.

For overall level of significant from the ANOVA results, F-calculated is greater than F -tabulated in the models ,the researcher conclude that there is significant relationship between money supply, inflation, Exchange Rate and Economic Growth in Nigeria. The alternative hypotheses were accepted while null hypothesis were rejected.

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CHAPTER ONE

1.1 INTRODUCTION

Monetary policy and exchange rate are keys tools in economic management and in macroeconomic stabilization and adjustment process in developing countries like Nigeria, where non-inflationary growth and international competitiveness have become major policy targets. Real exchange rate is one broad measure of international competitiveness, while inflation emanates, largely, from monetary expansion, currency devaluation and other structural rigidities in the economy. The question of the exchange rate regime that a small open economy should choose has no definite answer, since such a choice depends on the objectives and focus of monetary authorities, as well as on assumptions about the structural characteristics of the economy. A structural characteristic of the economy in this sense implies the degree of openness, of capital mobility, of wage indexation, and of the level of economic growth and development.

Monetary policy formulation and implementation thus influence macroeconomic variables (hence, macroeconomic stability) in any economy be it developed or underdeveloped. The critical distinction is the degree to which movements in the exchange rate pass-through to affect domestic macroeconomic variables, most especially, consumer prices, output (as measured by the gross domestic product GDP) and private consumption. The choice of an exchange rate regime is linked, to some extent, to the achievement of specific targets set by the monetary authorities. Most of the times, these targets are related to internal and external imbalances. Therefore, a correlation between the choice of the exchange rate regime and real output, prices, balance of payments stabilization, and the sources of shocks hitting the economy, is expected. When the goal is balance of payments stabilization, it is preferable to adopt a flexible exchange rate system to overturn any current or capital account disequilibrium. Here consideration has to be taken on the Marshall-Lerner conditions, the degree of capital mobility and foreign reserve constraints. When the objective is to stabilize domestic prices, the financial discipline issue becomes relevant. Many economists believe that the exchange rate can be used as an anchor for financial stability since it is one price of the economy. In this sense, a fixed exchange rate imposes a degree of financial discipline by discouraging recourse to inflationary finance. In contrast to this reasoning, proponents of exchange rate flexibility argue that the announcement of a fixed exchange rate would only cause financial crises followed by continuous devaluation. Finally, when the objective is to stabilize real output, the role of exchange rate regime is mainly viewed as a shock absorber. That is, the choice of the exchange rate regime is used to spread these effects. Therefore, this choice will depend on the nature of the shocks and the structural characteristics of the economy. Hence, it seems there is a clear trade-off between output/consumption volatility and inflation volatility. With a very high exchange rate pass-through, all monetary rules face a significant trade-off. The nature of the trade-off is also seen between "fixed and flexible" exchange rates. The central argument is that the nature of the trade-off will be quite different in mature industrial economies than in emerging market or

transition economies. Monetary policy, which aims at stabilizing output require high exchange rate volatility. This implies high inflation volatility, but with limited or delayed pass-through, this trade -off is much less pronounced. A flexible exchange rate policy, which stabilizes output, can do so without high inflation volatility. Devereux (2001), argues that the best monetary policy rule in an open economy is one which stabilizes non-traded goods price inflation and that policy of strict inflation targeting is much more desirable in an economy with limited pass-through. If the monetary authorities are concerned with consumer prices inflation {over and above non-traded goods inflation}, then the flexible exchange rate regime brings some costs as well as benefits. Moreover, the same logic implies that a policy of strict inflation targeting is quite undesirable in an open economy, Since it effectively amounts to a requirement of fixing the exchange rate. It stabilizes inflation at the expense of a lot of output instability. The main aim of this research is to examine the implications of the exchange rate regime on the ability of monetary policy to stabilize the economy and effective of exchange rate volatility on economic growth in Nigeria.

1.2 STATEMENT OF PROBLEM

Nigeria has experienced continuous rise in the prices of goods and services in the mid 1970s due to fixed exchange rate policy introduced. It was worst during the period surrounding exchange rate deregulation policy in the mid 1980s. Inflation in the 1970s was due to civil war, salary awards (Ndogwi award) and excess government spending. Although, Nigerians economy generated a lot of revenue from oil boom it goes a long way to cater for its increased expenditure. Inflation in the mid 1990s became terrible due to sanction on Nigeria by international community. Inflation rate has been reduced due to policy maker adoption of deregulation and privatization policy in mid 2000s while Exchange rate as well reduced from double digit to a single digit due to adoption of Dutch auction system (DAS) introduced in 2002. There are various studies on the subject matter. Elbadawi (1990) concludes that devaluation of the official exchange rate is not inflationary; he further stated that prices have adjusted to the parallel exchange rate. Greene and Canetti (1991) in their study on ten Africa countries arrived at the conclusion that exchange rate movement explains the inflationary change. Moser (1994) found that monetary expansion driven mainly by expansionary fiscal policies, and devaluation of the naira as well as agro--climatic conditions, explains the inflationary process in Nigeria. The different views held by these schools of thought mentioned above as to what obtainable in the Nigeria economy motivated the research to go into this research to exchange rate volatility and monetary policy on Nigeria economy.

1.3 OBJECTIVES OF THE STUDY

The general objective of this study is to determine the relationship between exchange rate and monetary policy on Gross Domestic Product in Nigeria. Specific objectives are:

1. To determine the exchange rate situation in Nigeria

ii. To examine the effects of exchange rate, money supply, inflation on Nigerias Gross Domestic Product.

iii. To examine the consequences of exchange rate volatility in Nigeria economy.

1.4 RESEARCH QUESTIONS

What are the factors responsible for causes of exchange rate volatility in Nigeria?

i. Does exchange rate policy have any impact on Nigeria Economy?

ii. Does monetary policy have any effect of exchange rate volatility in Nigeria?

iii. What is the relationship between exchange rate, money supply, inflation and Nigerias GOP (Gross Domestic Product?)

1.5 STATEMENT OF HYPOTHESIS

Hypothesis 1

Ho: There is no significant relationship between money supply, inflation and economy in Nigeria

Hi: There is significant relationship between money supply, inflation and economy in Nigeria

Hypothesis 2

Ho: There is no positive effect of exchange rate on Nigerias economic growth.

Hi: There is no positive effect of exchange rate on Nigerias economic growth.

1.6 MODEL SPECIFICATION

This research focuses on the Impact of monetary policy and exchange rate volatility in Nigeria.

MODEL 1

GDP = f(MS, INF,) …………….(1)

Where:

GDP = Gross Domestic Product

MS = Money supply

INFL. = Inflation rate

GDP =bo+b1 MS+b2INF +U ------- Equation 1

Where

bo = Constant

b1 = coefficient of money supply

b2 = coefficient of inflation rate

b3 = coefficient of exchange rate

u = Error term.

MODEL 2

GDP = f(EXR.) ……..... (2)

Where:

GDP = Gross Domestic Product

EXR. = Exchange rate

GDP = bo + bi EXR + e ---------------- Equation 2

Where:

bO = the intercept for equations

b1 = the parameter estimate of EXR.

E = the random variable or error term.

1.7 SIGNIFICANCE OF THE STUDY

This study is important in a number of ways

It improves our understanding of the behavior of money supply and exchange rate volatility on economy of Nigeria. It will also enable the policy maker or government to formulate policy that will help to achieve macroeconomic objectives in the country. This research will go a long way to contribute to Nigeria economy and serve as reference for further research by any researchers in Nigeria and other part of the world.

1.8 SCOPE AND LIMITATIONOF STUDY

This study will cover a period of 20 years (1990 - 2010) for a detail analysis of the work. In the cause of this study emphasis shall be on exchange rate, money supply (MS), Gross Domestic Product, inflation from Central Bank of Nigeria Bulletin and National Bureau Statistic. The major limitation in this research is data collection from the relevant source, the researcher find it difficult to gather information or data needed for this study.

1.9 **METHOD OF DATA COLLECTION**

The data used for this research were mainly secondary source .The data for .he study is based on annual data from 20 years (1990. 2010), CBN and national bureau statistic sources This study will adopt the Analysis of variance for overall level of significance (ANOVA) as well as regression analysis test and the data shall analyzed using statistic package for social science (SPSS).

1.10 ORGANIZATION OF STUDY

The study will be in five chapters with each being subdivided with respect to it concerns. Chapter one contains the introduction ; the problem statement, research question objectives of the study, statement of hypothesis ,significance of the study, study methodology ,scope of the study and plan of the study .Chapter two focuses constitutes the literature review. Chapter three deals with research methodology. Chapter four is all about data analysis and interpretation of the result. Chapter five comprises of the summary, Recommendation and conclusion.

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