Economic Development, Technological Change, and Growth

Fiscal Policy and Exchange Rate Movement in Nigeria

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Abstract: Issues on exchange rate movement have continued to generate concern among economists given its implication on the macroeconomic variables – inflation, imports, domestic interest rate and investment among others. Although studies have examined the determinants of exchange rate movement, there is paucity of knowledge on the relationship between fiscal policy and exchange rate movement. Also, both theoretical and empirical literatures on fiscal policy and exchange rate movement were inconclusive. Therefore, this study examines the relationship between fiscal policy and exchange rate movement in Nigeria for the period 1980 to 2015. The study employed the Ordinary Least Square (OLS) and the regression estimate showed that fiscal policy variables were statistically significant in influencing exchange rate in Nigeria. This suggests that fiscal policy variables are significant determinants of exchange rate movement in Nigeria. Based on the findings, it was recommended that there is the need for prudent management of revenue, expenditure and debt in reducing exchange rate depreciation and ensuring stable exchange rate.

Keywords: revenue; expenditure; debt; exchange rate

JEL Classification: F31; H27; H63

1. Introduction

Issues on exchange rate movement have continued to generate concern among economists given the implications of such movement on the macroeconomic variables – inflation, imports, domestic interest rate and investment among others. Fiscal policy influences exchange rate through income changes, price changes and interest rates via expansionary and contraction fiscal measures (Richard, 2007). Through expansionary fiscal policy; as personal income tax reduces, disposable income increase and so does consumption. For a country like Nigeria with high taste for foreign commodity, the demand for imported goods results in the demand for more foreign currencies (such as dollars and pounds) leading to an appreciation of the foreign currency and a depreciation of the domestic currency.

Also, as spending government increases there is a tendency for an inflationary pressure if such spending is not accompanied by an increase in domestic productive

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activities. Such increase in domestic price makes the price of local commodity expensive at the international market and also makes foreign goods cheaper. The low price of foreign goods results in high demand for foreign goods which will further depreciate the domestic currency and appreciate the foreign currency. Besides, the huge inflows of foreign exchange revenue usually accompanied by rising oil price provides strong bases for a stable exchange rate through its influence on the country's foreign reserves. In contrast, the decline in oil price such as the current situation in which the oil price has declined has been accompanied a rising exchange rate depreciation of the domestic currency.

In addition to the foregoing, the theoretical relationship between fiscal action and exchange rate depends on the associated changes in sovereign default risk, capital account liberalization and the exchange rate system. Under high capital mobility, a constant country premium and a flexible exchange rate system, a fiscal expansion is supposed to lead, albeit temporarily, to an appreciation of the exchange rate. Conversely, with low capital mobility, the exchange rate is expected to depreciate as the fiscal expansion boosts import and the current account deficit (Edda, 2005). From an empirical perspective, the relationship between fiscal policy and exchange rate is mixed. While some studies found a positive and significant relationship between fiscal policy and the exchange rate[1] other studies found insignificant relationship between the variables (Mc Millin & Koray, 1990; Koray & Chan, 1991). Despite the numerous studies that have examined the relationship between fiscal policy and exchange rate, local studies have not considered this issue with respect to Nigeria economy. Most studies in Nigeria had only focused on government spending and economic growth[2] while others focused on exchange rate policy and price determination in Nigeria[3]. The neglect of the previous studies made it worthwhile to examine the relationship between fiscal policy and exchange rate in Nigeria for the period 1980 to 2015.

The paucity of knowledge on this issue is surprisingly especially in the light of the voluminous literature that now exists on the estimation of various factors determining exchange rate movement. This is in view of the fact that overall goal of the fiscal policy is to stabilize the economy. Thus, economic relevance of studying the impact of fiscal policy on exchange rate needs not to be overemphasized. This study is imperative for fiscal authorities in Nigeria to revive her domestic currency from fluctuations in the international market through government revenue collection (mainly taxes) and expenditure (spending) in Nigeria. Consequently, this study will assist the nation's economic planners in their economic development planning on how to safeguard the value of the nation

[1] See (Feldstein, 1986; Melvin et al., 1989; Beck, 1993; Caramazza, 1993).
[2] See (Adeoye, 2006; Aregbeyan, 2007).
[3] See (Adesoye, 2012).

currency and also pinpoint on how fiscal policy can be used to impact Nigeria currency.

Given the current economic situation faced by rapidly declining international oil price and foreign exchange earnings, there is every reason for the government to seek to set the price for foreign exchange right and provide incentives for stable investment in Nigeria (Ogiogio, 1996). Thus, the outcome of this study would provide a basic understanding of the impact of fiscal policy on exchange rate and thus provide relevant information that could guide further researcher on the subject matter. In the light of the above, this study seeks to address the research question "What is the impact of fiscal policy on exchange rate in Nigeria?" This study is divided into five sections. Section one is the introductory part, section two deals with the review of related literature while section three focused on the research methodology. In section four, the analysis and interpretation of empirical results were discussed while the conclusion and policy recommendations was the focus of section five.

2. Literature Review

Several studies have examined the relationship between fiscal policy variables other macroeconomic variables while some focused on the link between exchange rate and other macroeconomic variables. Only a few have analyzed the relationship between fiscal policy and exchange rate. With respect to conceptual issues on fiscal policy, Buhari (1993) noted that fiscal policy is concerned with deliberate actions of the government on expenditures and revenue with the aim of influencing macroeconomic variables - aggregate output, employment level, aggregate demand level, general price level among other in a desired direction. Bhatia (2008) noted that fiscal policy consists of steps and measures taken by the government on revenue and expenditure sides of its budget and that it is the aggregate effects of government expenditures and taxation on income, production and employment. Dwivedi (2009) stated fiscal policy entails government's program of taxation, expenditure and other financial operations to achieve certain national goals. Dwivedi stressed that the two basic instruments of fiscal policy used in achieving macroeconomic objectives are taxation and public expenditure. Again, Ijeh (2008) refer to fiscal policy as government action plan concerning how to raise funds and disburse funds in order to achieve desired goals such as achieving full employment, stable price level, aggregate demand and sustained economic growth and development. The author noted that the instruments of fiscal policy are taxation, government expenditure, government budget, public debts and subsidy (Osuala & Ebieri, 2014).

Conceptually, exchange rate implies the price of one currency in terms of another; in the Nigerian context, it is the units of naira needed to purchase one unit of

another country's currency such as the United States dollar (Campbell, 2010). The management of any country's foreign exchange market is carried out within the ambit of a foreign exchange policy controlled by the monetary authority. According to Obaseki (2001) foreign exchange policy is the institutional framework and measures put in place to gravitate the exchange rate towards desired levels in order to stimulate the productive sectors, curtail inflation, ensure internal balance, improve the level of exports and attract direct foreign investment and other capital inflows. More so, exchange rate policy determines the mechanism for channeling foreign exchange to end-users and thus, reflects the institutional framework, system of exchange rate determination and allocation of foreign exchange as well as the policy options for managing the exchange rate (Fapetu & Oloyede, 2014).

On empirical literature, Ezeh and Obi (2016) examined the relationship between currency devaluation and fiscal adjustment in Nigeria for the period spanning 1981 to 2014. Specifically, the study examined the extent to which currency devaluation affects government expenditure and revenue in Nigeria. The study employed co-integration, Vector Error Correction, Ordinary Least Square and Granger Causality. The result of the study showed that a positive and causal relationship exists between currency devaluation and some selected fiscal variables. Thus, the study recommended that the Nigerian government should rationalize and restructure her expenditures towards productive economic activities and reduce fiscal deficits significantly. Alagidede and Ibrahim (2016) investigated the drivers of exchange rate volatility, and examined the effects of excessive fluctuations in the exchange rate on economic growth in Ghana. The results of the study showed that while shocks to the exchange rate are mean reverting, misalignments tend to correct very sluggishly, with painful consequences in the short run as economic agents recalibrate their consumption and investment choices. About three quarters of shocks to the real exchange rate are self-driven while the remaining one quarter or so is attributed to factors such as government expenditure and money supply growth, terms of trade and output shocks. Specifically, the results showed that in the short-run, output is the most important driver of exchange rate fluctuations while in the long run; exchange rate volatility is significantly influenced by government expenditure and money supply growth and terms of trade shocks. Also, excessive volatility was found to be detrimental to economic growth; however, this was only up to a point as growth-enhancing effect can also emanate from innovation, and more efficient resource allocation.

Kuncoro (2015) analyze the impact of fiscal policy credibility on the exchange rates stabilization in Indonesia over the period 2001-2013. Utilizing quarterly data analysis, the study found that the impact of credible fiscal policy typically depends on characteristics of fiscal rules commitment. On one hand, the credible debt rule policy reduces the exchange rate fluctuation while on the other hand the deficit rule

policy – which is incredible – does not have any impact on the exchange rate and thus does not support to the exchange rates stabilization. The study concluded that credibility matters in stabilizing foreign exchange market and recommended that improving the credibility of fiscal policy should be an integral part of the exchange rates stabilization program. Shuaib, Ekeria, Augustine and Ogedengbe (2015) examined the impact of fiscal policy on the growth in Nigerian using time series data from 1960-2012. The result of the study showed that fiscal policy has a direct relationship with growth. The study recommended that government should ensure fiscal policy's effectiveness in such a way as achieving economic growth. Muse (2015) examined the influence of deregulation on the relationship between foreign aid and fiscal behaviour in Nigeria. The study employed Chow test to examine if there is any structural changes since the adoption of deregulation that has significantly affected the relationship between foreign aid and fiscal behaviour. The result of the study showed that deregulation has positively and significantly affected the impact of fiscal behaviour in Nigeria on foreign aid accessibility. However, this effect was short-lived recently owing to the recent drastic fall in foreign aid available to Nigeria despite the sustained increase in both government revenue and expenditure. The study recommended that assessment of other shocks that can affect the fiscal behaviour in Nigeria should be conducted with a view to getting the reason why deregulation fails to maintain positive relationship that exists between fiscal behaviour and foreign aid in Nigeria.

Eke, Eke and Obafemi (2015) examined the effect of exchange rate on the balance of trade in Nigeria for the period 1970-2012 using annual data. The co-integration test confirmed the existence of a long run relationship between trade balances and the variables of interest. The regression estimate showed that the exchange rate has a significant negative influence on trade balance in Nigeria during the period. The study recommended that measures to stabilize exchange rate and check its continuous free all should be carefully considered as a policy option. Zakaree, Sani and Idakwoju (2015) examined the impact of public external debt on exchange rate in Nigeria. Employing the Ordinary Least Squares technique, the study observed that all the dependent variables, that is, external debt, debt service payment and foreign reserve had significant impact on exchange rate fluctuation in Nigeria. The study recommended that government should ensure that all public borrowings, where and when necessary are directed towards productive economic activities which can generate returns to service and pay up the debt at maturity. Odili (2015) investigated the potency of macroeconomic variables in influencing exchange rate behaviour in Nigeria for the period spanning 1980 to 2014. The study tested the impact of balance of payment, rate of inflation, current account balance, gross domestic product, total imports and exports on exchange rate in Nigeria. The result from the study showed that inflation rates, current account balance and balance of payment in Nigeria had weak positive association with exchange rate movement while imports, exports and gross domestic products had strong positive association

with exchange rate variations. The study recommended that there should be proper monitoring and regulation of Nigeria's foreign exchange markets.

Ogunsakin (2013) examined the causative factors in exchange rate behaviour and its impact on economic growth in Nigerian. The study employed con-integration and error correction method techniques. The results obtained from the study showed that all variables (exchange rate, inflation rate, foreign reserves, interest rate, money supply, balance of payment and propensity to import) employed in the study are significant determinants of economic growth in Nigerian. The study recommended that government should maintain more depreciated real exchange rate, higher saving to investment and lower expenditure relative to income. Luca (2012) investigated the impact of government spending on the real exchange rate and the trade balance in the US using a new VAR identification procedure based on spending forecast revisions. The study found that the real exchange rate appreciates and the trade balance deteriorates after a government spending shock, although the effects were quantitatively small. Mohsin and Lizondo (2008) examined the relationship among devaluation, fiscal deficits, and the real exchange rate. The study examined the use of fiscal policies to sustain the effects of a nominal devaluation on the real exchange rate. The result of the study showed that the magnitude of the change in the real exchange rate depends not only on the size of the devaluation and the degree of fiscal adjustment, but also on the means by which the fiscal deficit is reduced. Pelin (2007) examined the effect of fiscal and monetary policies on real exchange rates fin Turkey for the period 1990-2003. The results of the study suggested that expansionary fiscal policy appreciates real exchange rate whereas the effect of monetary shock is statistically insignificant. The results of variance decomposition suggested that the effects of fiscal policy on real exchange rates are more pronounced than the effects of monetary policy. Udoye (2009) examines the determinants of real exchange rate in Nigeria over the period of 1970 to 2006. The result study suggested that one year past value of real exchange rate and immediate past value of trade openness are the major determinants of real exchange rate in Nigeria. The result further indicated that there is evidence of long run relationship between real exchange rate and gross domestic product growth rate and trade openness.

Despite these numerous studies reviewed above, very few local studies had examined the relationship between fiscal policy and exchange rate. The focus of the previous studies had been on the impact of exchange rate stability on Nigeria economic growth; fiscal policy shocks and real exchange rates; and on fiscal theory of exchange rate determination. Still some other focused on exchange rate regimes and real exchange rate volatility. These studies failed to take into cognizance the relationship between fiscal policy and exchange rate thereby limiting the policy inference of the previous studies. Hence, this study seeks to establish the link between fiscal policy and exchange rate in Nigeria**.**

3. Research Methodology

To specify the model on the impact of fiscal policy on exchange rate in Nigeria, this study follows the model specified by Odili (2015) on the determinant of exchange rate and the model is given as:

$Y = f(X)$…….…… (1)

Y is the exchange rate and *X* is fiscal policy. Introducing other explanatory variables that have been identified as determinants of exchange rate in the literature - inflation (*IFR*), import (*IMP*), export (*EXP*), and economic growth (*GDP*); therefore equation (1) becomes:

$EXR = f(FP, IFR, IMP, EXP\ GDP,)$ ……..…… (2)

Equation (2) is stated in a semi-log linear form as thus,

$$EXR = \beta_0 + \beta_1 lnFP + \beta_2 INFLA + \beta_3 lnIMP + \beta_4 InEXP + \beta_5 InGDP + e_t. \quad (3)$$

Where, e_t is the stochastic error term while β_0, β_1, β_2, β_3, β_4 and β_5 are the parameters to be estimated. Exchange rate (*EXR*) is measured by the annual official of naira to dollar (#/$) exchange rate, fiscal policy (*FP*) is measured by government expenditure, total debt, fiscal deficient and oil revenue; inflation rate (*INF*) is measured by the annual inflation rate; import (*IMP*) is measured by the total import (oil import and non-oil import); export is measured by total export (oil export and non-oil export) and *GDP* is measured by the annual gross domestic product. Data on exchange rate, fiscal policy variables (government expenditure, total debt, fiscal deficient and oil revenue), inflation rate, import, export and gross domestic product is sourced from the central bank of Nigeria statistical bulletin, 2015 edition.

4. Data Analysis and Interpretation of Result

4.1. Descriptive Statistics, Unit Root Test and Co-integration Estimate

This study commences its empirical analysis by examining the characteristics of the variables of estimate. From table 1, the standard deviation showed that exchange rate (68.46) was the most volatile variable in the time series while total debt (1.94) was the least volatile variable. The skewness statistic showed that import (*IMP*), export (*EXP*), revenue (*REV*), government expenditure (*GXP*), and total debt (*DBT*) were negatively skewed while exchange rate (*EXT*), inflation rate (*IFR*) and trade openness (*OPNX*) were positively skewed. The kurtosis statistics showed that exchange rate, import, export, revenue, government expenditure, total debt and trade openness were platykurtic, suggesting that their distributions were flat relative to normal distribution while inflation rate was leptokurtic, suggesting that the distributions is peaked relative to normal distribution. Finally, the Jarque-Bera statistic rejected the null hypothesis of normal distribution for inflation rate at

five percent critical value while the null hypotheses of normal distribution for the other variables were accepted at the same critical value.

Table 1. Descriptive Statistics

Variables	*EXT*	*IFR*	*IMP*	*EXP*	*REV*	*GXP*	*DBT*	*OPNX*
Mean	68.419	20.635	5.969	6.371	6.192	12.633	13.777	2.780
Std. Dev.	64.462	18.641	2.543	2.658	2.463	2.176	1.941	2.886
Skewness	0.237	1.409	-0.335	-0.374	-0.283	-0.293	-0.754	0.796
Kurtosis	1.277	3.692	1.701	1.736	1.641	1.659	2.325	2.375
Jarque-Bera	4.524	11.925	3.027	3.056	3.069	3.034	3.867	4.146
Probability	0.104	0.003	0.220	0.217	0.216	0.219	0.145	0.126
Observations	34	34	34	34	34	34	34	34

Source: Authors' computation using e-views 7

The unit root estimate was based on the Augmented Dickey Fuller test and the result of the test is presented in table 2 below. From the table, it was observed that all the variables were integrated of order one, suggesting that the variables were I(1) series.

Table 2. Unit Root Test

Philips Perron (PP) Test			
Variables	**Level**	**1st Difference**	**Status**
EXT	0.0020	-5.4112*	I(1)
IFR	-2.8589	-7.8492*	I(1)
IMPT	-0.4634	-6.6329*	I(1)
EXP	-0.9911	-6.4665*	I(1)
REV	-0.8292	-6.4672*	I(1)
GXP	-0.9927	-6.8874*	I(1)
DBT	-2.8467	-4.9814*	I(1)
OPNX	0.2381	-7.3331	I(1)
Critical Values	**Level**	**1st Difference**	
1%	-3.6463	-3.6537	
5%	-2.9540	-2.9571	
10%	-2.6158	-2.6174	

*Source: Authors' computation using e-views 7. Note: *=1% and **=5% significance level. The automatic maximum lag length for the Philips Perron (PP) unit root test was based on Newey-West Bandwidth*

Consequent to the unit root test, the Johansen co-integration test is used to examine the existence of co-integration among variables. From the co-integration estimate presented on table 3 below, it was observed that the null hypothesis of no co-integration for None, At most 1, At most 2, and At most 3 were rejected by the

trace test because the statistic values were greater than the critical values while the null hypothesis of no co-integration for At most 4 was not rejected by trace test because the statistic value was less than the critical value, indicating the existence of four co-integrating equations. On the other hand, the null hypothesis of no co-integration for None, At most 1, and At most 2 were rejected by the max-eigen test because the statistic values were greater than the critical values while the null hypothesis of no co-integration for At most 3 was not rejected by max-eigen test because the statistic value was less than the critical value, indicating the existence of three co-integrating equations. Thus, the trace and maxi-eigen statistic asserted the existence of a long run relationship among the variables.

Table 3. Summary of the Co-integration Estimate

Trace Test			**Maximum Eigen value Test**		
Hypothesized No. of CE(s)	Statistics	0.05 Critical values	Hypothesized No. of CE(s)	Statistics	0.05 Critical values
None*	252.05	159.53	None*	86.66	52.36
At most 1*	165.39	125.62	At most 1*	46.65	46.23
At most 2*	118.75	95.75	At most 2*	40.53	40.08
At most 3*	78.21	69.82	At most 3	32.67	33.88
At most 4	45.55	47.86	At most 4	22.68	27.58

Source: Authors' computation using e-views

4.2. Regression Estimates on Fiscal Policy and Exchange rate in Nigeria

Sequel to the co-integration estimate, this study analyse the relationship between fiscal policy and exchange rate in Nigeria. From the regression estimate presented on table 4 below, the F-statistic (492.30) showed that the model is well specified and it is statistically significant at 1% level of significant. The coefficient of determination (R^2) of the model is very high (99%) indicating that independent variables explained total variation of about 99% of variations in exchange rate while the Durbin-Watson Stat. of 1.71 showed that the estimate from the regression model can be used for policy inference. The regression estimate showed that inflation rate, import and export had insignificant effect on exchange rate in Nigeria. Although inflation had positive effect on exchange rate; import and export had negative effect on exchange rate. As observed in the regression estimate presented on table 4, the effects of inflation, import and export were insignificant in influencing exchange rate over the study period. In contrast the three measures of fiscal policy (revenue, government expenditures and total debt) had positive and significant effects on exchange rate in Nigeria. Specifically, a unit increase in government revenue, government

expenditure and total would lead to an increase in exchange rate by 0.37, 0.51 and 0.58 respectively. With respect to trade openness, the regression estimate on table 4 showed that trade openness had negative but significant effect on exchange rate in Nigeria. This suggests that an increase in the trade openness would result in a decrease in exchange rate by 0.08. The intuition behind the negative relationship between trade openness and exchange rate is that when an economy is opened, it is supposed to motivated capital inflows and stimulates exports. The capital inflows and the foreign revenue resulting from domestic export cause currency of the domestic economy to appreciate.

Table 4. Long Run Estimate on Fiscal Policy and Exchange Rate Movement

Dependent variable	Regressors	Estimated Co-efficient	Standard Error	t-Statistic	Prob.
EXT	*C*	-11.193	1.340	-8.353	0.000
	IFR	0.062	0.051	1.219	0.234
	IMP	-0.299	0.154	-1.933	0.064
	EXPT	-0.095	0.173	-0.546	0.590
	REV	0.371	0.172	2.161	0.040
	GXP	0.514	0.196	2.618	0.015
	DBT	0.582	0.083	7.005	0.000
	OPNX	-0.086	0.034	-2.546	0.017
R-Square = 0.993			**Adjusted R-Square** = 0.990		
F-Stat. (Prob.) = 492.30 (0.000)			**Durbin-Watson Stat.** = 1.72		

Source: Authors' computation using e-views 7

With respect to the focus of this study, the regression estimate showed that fiscal policy variables positively and significantly influenced exchange rate in Nigeria. This implied that increase in government revenue, government expenditure and government debt over the period of this study had resulted in the depreciation of the domestic currency in Nigeria. This finding is in contrast to Pelin (2007) who observed that expansionary fiscal policy appreciates real exchange rate. In addition to the regression estimates, this study conducted the normality and Heteroskedasticity ARCH tests. From Figure 1, the Jarque-Bera statistics of the normality test was insignificant suggesting that the residual of the regression estimate is normally distributed. Also the F-statistics of the Heteroskedasticity ARCH test was insignificant confirming the absence of serial correlation in the residual of the regression estimate (see table 5). The implication is that the regression estimate was appropriately estimated.

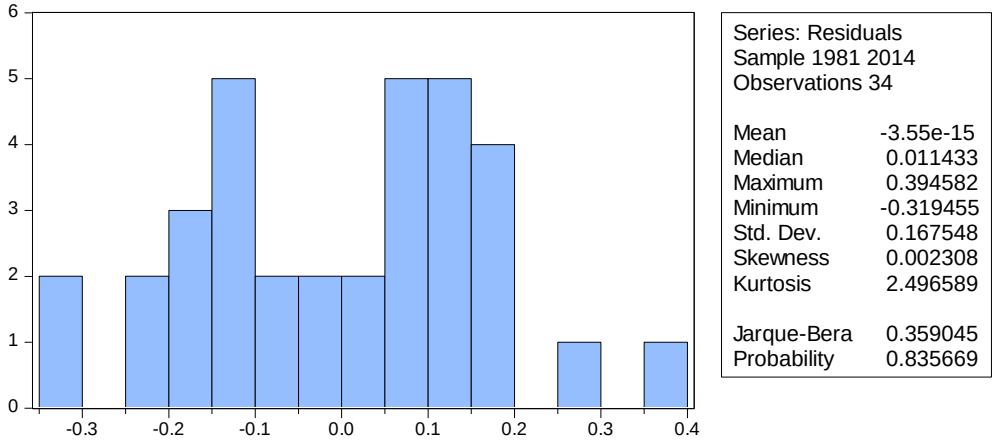

Figure 1. Normality Test

Source: Authors' computation using e-views 7

Table 5. Heteroskedasticity Test: ARCH

F-Statistic	0.1833	Prob. F(1,31)	0.6715
Obs*R-Squared	0.1940	Prob. Chi-Square (1)	0.6596

Source: Authors' computation using e-views 7

5. Conclusion and Policy Recommendation

This study analyzed the relationship between exchange rate movement and fiscal policy variables in Nigeria for the period 1980 to 2015. The result of from the ordinary least squares regression estimate showed that fiscal policy variables are significant determinants of exchange rate movement in Nigeria. Based on the findings, the study recommends the need for prudent management of revenue, expenditure and debt in reducing exchange rate depreciation and ensuring stable exchange rate. More so, effort should be made to increase the consumption of made in Nigeria goods, which includes the usage of raw material that can be sourced locally by Nigerian industries in order to increase foreign exchange earnings.

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