Unstraining Productivity Growth in Nigeria: The Exchange Rate Perspective

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Abstract

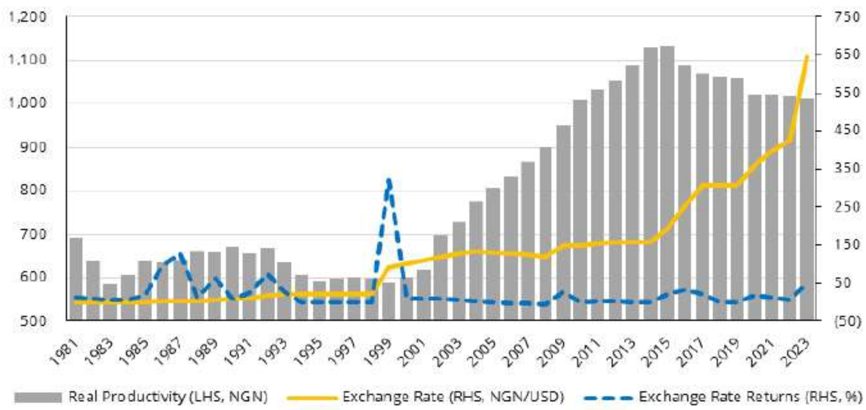
The volatile movement in Nigeria's exchange rate constitutes a severe headwind to the economic activity in the country and the eventual performance of productivity and economic growth. This article explored the interrelationship between exchange rate volatility and productivity in Nigeria. It reviewed the literature on the linkages between productivity and exchange rate volatility and highlighted the different dimensions of relations between the two economic variables. The article highlighted the drivers of the recent turbulent movement in the Nigerian foreign exchange market, categorising them based on the demand and supply sides of the market. On both sides, the escalation of market players' speculative behaviours has amplified the pressure on Naira. Meanwhile, the dependence on imports for raw materials, intermediate inputs and finished products primarily drives exchange rate volatility. The article also strongly emphasised the need for harmonising foreign exchange management guidelines and clarity and transparency in managing the foreign exchange market.

Introduction

Nigeria’s poor growth performance over the years has been due to low productivity across many sectors of the economy. The abrupt and drastic movement in the exchange rate has recently been cited as a major factor adversely impacting productivity, particularly as Nigeria depends on importation for major raw materials and intermediate inputs. Over the past decade, Nigeria has experienced immense volatility in the exchange rate, depreciating from NGN158.6/US$ in 2014 to an average of N645/US$ in 2023 (see Figure 1). As of the first quarter of 2024, the Naira exchange rate has depreciated to an average of N1338.21/US$.

The turbulent exchange rate movements in Nigeria have not only resulted in subdued economic growth, averaging 1.98 percent between 2014 and 2023, down from the average growth of 6.73 percent in the previous decade but have also significantly stifled productivity. The compound annual productivity growth rate has been a meagre 1.95 percent over the past decade (see the trend in Figure 1). The exchange rate volatility has not only curtailed access to Forex for importing raw materials and intermediate inputs but has also escalated the operating costs of businesses, thereby severely constraining their productivity potential and competitiveness.

Figure 1: Trajectory of Exchange Rate and Real Productivity in Nigeria



Source: NBS, CBN & WDI

Despite the Central Bank of Nigeria's (CBN) persistent efforts to manage the exchange rate market, adopting variants of fixed, managed float, and free float regimes, the impact on stabilising the Naira and supporting productivity remains insignificant. This underscores the urgency of exploring the link between exchange rates and productivity growth, identifying the key drivers of exchange rate volatility in Nigeria, and proposing potential policy recommendations to alleviate the pressure in the foreign exchange market.

The remaining part of this paper is structured as follows: Section 2 briefly discusses the literature on exchange rates and economic activities, Section 3 presents the dynamism of the exchange rate market, Section 4 highlights the recommendations and Section 5 concludes the paper.

Understanding the Literature

Abrupt and drastic movements in the exchange rate are major factors adversely impacting productivity and economic growth in Nigeria. Currently, Nigeria has a dysfunctional dependence on imports of raw materials, intermediate inputs, and finished goods. Nigeria still depends on importing petroleum products despite being a major oil-exporting country. Therefore, drastic movements in the exchange rate impact the core of business operations and suppress productivity growth in the economy.

The literature on the relationship between exchange rate volatility and economic activities remains diverse and inconclusive. The perspectives on understanding the relationship between exchange rates and economic activities appear numerous in the literature. One major way of understanding the movement of exchange rates includes the analysis of changes in exchange rates over time, subjecting the series to ARCH/GARCH transformation. Findings from the literature appear inconclusive, especially at the aggregate level. Studies such as Iqbal et al. (2023), Abbasi and Iqbal (2021), Ehikioya (2019), Jehan and Irshad (2020), Rashid et al. (2021), Ramoni-Perazzi and Romero (2022), emphasises the negative impact of exchange rates volatility on economic activities. Folarin (2020) and Orisadare and Olofin (2024) especially found that exchange rate volatility negatively impacts productivity. Nevertheless, Rapetti (2020) and Jayathilaka et al. (2023) reported that exchange rate volatility positively impacts the economy. Meanwhile, Omoregie and Olofin (2020, 2024) emphasised the time-varying impact of the exchange rate on the economic outcomes of businesses as it motivates immediate adverse impact but positive impact in the long run.

Some other studies have considered the misalignment of exchange rates from the long-run path, causing overvaluation and undervaluation. Studies such as Nwachukwu et al (2016), Mao et al. (2019), Jehan and Irshad (2020), Mahraddika (2020), Jiang et al. (2022), Amor et al. (2023), del Carmen Ramos-Herrera and Sosvilla-Rivero (2023) emphasised the role of real exchange rate undervaluation and overvaluation on domestic economic activities. Popular opinion favours currency devaluation to promote economic growth, while overvaluation stifles it. This evidence is especially true in many developing countries, but studies in wealthy nations support a floating exchange rate system reflecting the long-term real exchange rate (Guzman et al., 2018; Ramoni-Perazzi & Romero, 2022).

Findings from Nigeria do not deviate from the developing economy due to the low level of development in the financial sector and dependence on imports for finished goods. Ehikioya (2019), Folarin (2020), Moses et al. (2020), Omoregie and Olofin (2020, 2024), and Orisadare and Olofin (2024) reported that exchange rate volatility significantly negatively affects the Nigerian economy. Further evidence from Ehikioya (2019) emphasised the pass-through effects of financial development and oil price movement in the relationship between exchange rate volatility and economic activity in Nigeria.

Market Dynamics of Exchange Rate Volatility in Nigeria

Despite CBN's reforms and interventions, the persistent fall in the value of the Naira demonstrates inherent structural illiquidity in the foreign exchange market. The persistent devaluation of the Naira has had various effects on firms, depending on their sector (Rashid et al., 2021; Eklou, 2023). While stakeholders have applauded the CBN's recent unification of the exchange rate market, it has had a disastrous effect on the financial books of significant corporations in the Manufacturing and other productive sectors. Coupled with the ensuing further devaluation, the Naira's collapse has harmed these enterprises' financial position by making servicing their dollar-dominated loans more expensive and increasing the cost of importing intermediate inputs. However, the financial sector's performance improves without necessarily enhancing its function as an intermediary, benefiting solely from speculations. Therefore, this section highlights the demand and supply side drivers of exchange rate fluctuations in Nigeria.

Supply-side

The supply side of the foreign exchange market encompasses the channels of foreign exchange inflow in Nigeria. In the face of growing imports, the supply of foreign exchange has been limited, creating scarcity. The following highlights some of the issues on the supply side that drive exchange volatility in Nigeria.

- **Concentration of Forex inflows:** Nigeria relies heavily on Forex inflows from crude oil sales, which are currently under threat due to production concerns. Over the years, oil exports have been Nigeria's major foreign exchange source, accounting for the lion's share of its exports. As of 2023, oil exports accounted for 91.26 percent of Nigeria's total exports. This has often been reflected in Nigeria’s external vulnerability and unfavourable movement in oil prices, adversely impacting supply, productivity and the economy at large.

- **Weak Investors’ Confidence:** In recent times, Nigeria has seen a significant plummet in investment inflows. From the height of US$24.00 billion in 2019, foreign investment inflows have dipped to US$3.9 billion as of 2023. Worst still, the foreign investment inflows are often dominated by impatient portfolio investments that seek to take advantage of short-term gains. This reflects the weakening of investors’ confidence in Nigeria. The use of unsustainable sources such as remittances, SDRs, forward contracts and borrowings, among others, further weaken investors' confidence.

- **Concentration of Distribution Channel:** Dollar distribution channels are also highly concentrated with the CBN, which conducts swaps instead of allowing beneficiaries direct access. Neither government institutions nor households and businesses that are beneficiaries of foreign exchange have access to it. This causes structural illiquidity that limits the turnover of foreign exchange inflows.

- **Speculative Behaviour of Market Players:** Due to the persistent fall in the value of the Operators in the foreign exchange market, the speculative attitude has become aggravated. As such, players in the market hoard foreign exchange for gains, further pressuring the value of the Naira downwards.

- **Low Accretion to the Foreign Reserves:** The foreign reserves that the government relies on to intervene in the Forex market have been on a downward trend for many years due to low accretion. Besides, the recent financial statement of the CBN has shown that Nigeria does not have as much leverage to intervene in the market due to associated guarantees and forward and swap contracts attached to the reserves. This is due to the low performance of the Oil sector, which has been in recession since 2020.

Demand-side

The supply side of the foreign exchange market encompasses the outlays of the usage and demand for foreign exchange in Nigeria. With growing dependence on imports for primary, intermediate, and finished goods, Nigeria’s foreign exchange market is under tremendous pressure to source foreign exchange to cater to the growing demand for imports. Beyond import demand, there is an increasing demand for foreign exchange for other speculative uses, further pressuring the market. The following highlights major issues on the demand side that drive exchange volatility in Nigeria.

- **Heavy Dependence on Imports:** Nigeria has a dysfunctional dependence on imports. The country imports almost everything, including raw materials, intermediate inputs, food and consumer items, machinery, electronics, and transport equipment. Worse still, Nigeria depends on imports of finished petroleum products, which account for over 35 percent of its imports. Nigeria can significantly reduce the pressure on the Naira by facilitating local production of petroleum products.

- **Backlog of Forex Demand:** There has been a build-up in excess dollar demand due to a long-standing shortfall in dollar liquidity. Industry estimates put it at about US$10 billion. Clearing this backlog is critical to achieving stability in the Nigerian Forex market. The government recently announced the clearing of legitimate backlogs. However, the opacity in the process, pricing, and mode of accessing Forex continue to put the market under pressure.

- **Market Speculative Sentiments:** Due to the persistent downward trend in the value of the Naira, both institutional and retail investors, alongside citizens, have become speculative, hoarding dollars in anticipation of gain. As such, investors are confident and take positions for a depreciated Naira.

- **Dollar, a store of value and asset:** The dollar has become a store of value and has proven to be a profitable asset over the years – incentivising hoarding. Therefore, any intervention, such as the NNPC Limited loan or IMF SDR, does not yield an impact as a substantial part of the dollar inflows would have ended up as dollar savings.

Policy Recommendations

- **Facilitate uniform and appropriate pricing of Forex:** The government needs to get the pricing of Forex right in Nigeria to ensure stability in the foreign exchange market. Contrary to the harmonisation policy, the government operates various prices for different market users. This allows arbitrage and limits the government's capacity to intervene in the market effectively. Market stability does not necessarily mean low prices. Rather, it means maintaining stable and steady movement in the currency value, as such, enhancing certainty for business planning that leads to productivity growth. Therefore, even when there might be a justifiable need for market access differential, the government must ensure it closes the gap in rate differential across markets. This aids business planning a

- **Efficient Management of Access:** The effective demand for foreign exchange far outweighs the need for imports and inflows from exports, as the speculative demand from Forex trading constitutes excess demand in the market. To ensure the real sector has access to Forex to boost productivity, the government must effectively manage the level of access to foreign exchange in the economy. Access to Forex needs to be strict to facilitate international transactions. Any need for foreign exchange outside international transactions needs to be curtailed and conducted in local currency.

- **Enhance domestic productivity to boost the availability of Forex:** To boost foreign exchange availability, the monetary policy unit needs to create a functional mechanism that guarantees the availability of Forex to legitimate users. Nevertheless, the fiscal policy unit has a significant role in stabilising the exchange rate market by facilitating seamless productive activities and unlocking the structural binding constraints on the production process—such as policy and regulatory inconsistency, infrastructural deficiency, and proliferation of non-state actors.

- **Clarity and Transparency in Market Operations:** The government needs to ensure clarity in managing the foreign exchange market. The process of accessing foreign exchange must be clearly stated and transparently managed to build confidence and trust in the market. Any form of opacity allows for speculation, hoarding, and diversion of Forex away from legitimate productive needs.

- **Implement Capital Mobility Policy and Harmonisation of Guidelines:** The current management approach relies on ad hoc publication of guidelines that do not provide needed clarity in the operation of the foreign exchange market. The government needs to harmonise all the operating guidelines in the foreign exchange market. Besides, the government needs to provide clarity on the inward and outward movement of capital. Irrespective of the foreign exchange regime, the clarity in capital flows supports foreign investors' decision-making and endears the economy for potential investment. China runs a regulated capital mobility law, but because of the clarity, investors understand what needs to be done. As such, China is among the first-choice locations in the world for FDI.

- **Effective consequence management in the financial system:** In recent times, many market players have acted in a way that compromised the stability of the market and violated some rules. The government needs to establish an effective consequence management system that can deter a potential violation of market rules or unfair market practices. This is important to guarantee the sanctity of the market and further ease Forex access for productive use.

Conclusion

Exchange rate volatility has been a major bane of productivity growth in Nigeria over the past decade. This is due to its impact on input costs, as Nigeria has a maladjusted dependence on imported raw materials and intermediate inputs, especially equipment. Hence, this article explored the relationship between exchange rate volatility and productivity in Nigeria descriptively, beaming light on the drivers of exchange rate volatility and potential policy imperatives to ameliorate the situation.

This article explores the literature on the relationship between exchange rate volatility and productivity, highlighting various dimensions of interrelations—volatility, misalignment, and pass-through. It further dimensions the drivers of exchange rate volatility into demand- and supply-side drivers and highlights factors that contributed to the volatile movements in the value of Naira over the past years. Alongside other recommendations, this article emphasises the importance of clarity and transparency in managing the foreign exchange market.

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