International Journal of Advanced Multidisciplinary Research and Educational Development
Volume 2, Issue 2 | March – April 2026 | www.ijamred.com
ISSN: 3107-6513

Determinant of Currency Price in Nigeria

Alasejebi, Babatunde Emmanuel
Department of Finance and Banking, University of Port Harcourt, Nigeria
tunsola2002@yahoo.com

ABSTRACT

This study investigates the determinants of the exchange rate in Nigeria from 1985 to 2023, employing advanced econometric techniques such as the Autoregressive Distributed Lag (ARDL) model and the Exponential Generalized Autoregressive Conditional Heteroskedasticity (EGARCH) model. The primary objective is to understand the influence of key macroeconomic variables—inflation, interest rates, foreign reserves, trade balance, and political stability—on the exchange rate. The results reveal a significant negative impact of the trade balance on the exchange rate, indicating that trade deficits exert considerable downward pressure on the Nigerian naira. The analysis also highlights the critical role of foreign reserves, particularly their volatility, in maintaining currency stability. Although inflation and interest rates did not show significant short-term effects, their long-term stability is essential for a predictable exchange rate environment. Political stability, while not immediately impactful, remains crucial for long-term economic confidence and currency strength. The study concludes with recommendations for policymakers to improve trade balances, manage foreign reserves prudently, maintain stable monetary policies, and enhance political stability to achieve a stable and favorable exchange rate.

Keywords: Currency Price, Exchange Rate, Inflation, Interest Rates, Jhingan Model

1.0 Introduction

One of the most important indicators of a vibrant economy is its currency price. The price of a country's currency is a reflection of the state of health of its economy. As one of the leading factors behind the economic health of any given country, currency price often referred to as exchange rates are one of the most analyzed economic measures in the world. Exchange rate is the price of one currency expressed in terms of another currency. It is a vital macro-economic indicator used in determining the overall performance of economies. It remains a key price variable in any economy and performs the dual role of maintaining international competitiveness and serves as a nominal anchor for domestic prices, Mordi (2006).

According to Jhingah (2005), the exchange rate is the rate at which one currency is exchanged for another. It is the price of one currency in terms of another currency. The exchange rate between the naira and the dollar for example, refers to the number of naira required to purchase a dollar. He asserts that the exchange rate determines the relative price of domestic and foreign goods as well as the strength of external participation in the international trade. The determination of currency prices, specifically the exchange rate of the Nigerian Naira, has been a subject of considerable interest and debate among economists, policymakers, and financial analysts. Exchange rate stability is crucial for economic growth and development, as it influences inflation, interest rates, and foreign investment. In the context of Nigeria, a developing country with a high dependency on oil exports, the exchange rate dynamics are particularly complex and multifaceted.

Nigeria's economy has historically been characterized by its heavy reliance on oil, which accounts for a significant portion of its export earnings and government revenues. This dependence on a single commodity makes the Naira highly susceptible to fluctuations in global oil prices. When oil prices are high, Nigeria experiences increased foreign exchange inflows, leading to an appreciation of the Naira. Conversely, a decline in oil prices often results in foreign exchange shortages and a subsequent depreciation of the currency. This volatility has significant implications for economic stability and planning (Oladipo & Akinbobola, 2021). The relationship between inflation and exchange rate movements is another critical area of concern. In Nigeria, high inflation rates have been a persistent issue, often driven by supply-side constraints,

ISSN: 3107-6513

monetary policy challenges, and external shocks. According to the Purchasing Power Parity (PPP) theory, high inflation reduces a currency's purchasing power, leading to depreciation. Empirical evidence from Nigeria supports this theory, showing that periods of high inflation are often accompanied by a weakening of the Naira. Controlling inflation through effective monetary policy is thus essential for maintaining exchange rate stability (Nwosa & Oseni, 2022).

Interest rates also play a vital role in determining exchange rates. The Interest Rate Parity (IRP) theory posits that differences in interest rates between two countries can influence their exchange rates. Higher domestic interest rates can attract foreign capital, leading to an appreciation of the domestic currency. In Nigeria, the Central Bank's monetary policy, which includes setting benchmark interest rates, aims to control inflation and stabilize the currency. However, maintaining an optimal interest rate that supports economic growth while attracting foreign investment remains a delicate balance (Abiola & Ajayi, 2021).

Foreign reserves are another crucial determinant of the exchange rate. Adequate foreign reserves allow the Central Bank of Nigeria to intervene in the foreign exchange market to stabilize the Naira. Reserves can be used to smooth out short-term fluctuations and provide a buffer against external shocks. For Nigeria, building and maintaining sufficient foreign reserves is essential, given its vulnerability to global economic conditions and oil price volatility. Policies that promote export diversification and attract foreign direct investment can help increase foreign reserves and support exchange rate stability (Balogun & Oladipo, 2020).

The trade balance, defined as the difference between exports and imports, directly affects the demand and supply of foreign exchange. A positive trade balance, or trade surplus, increases the demand for the domestic currency as exporters convert foreign earnings into the local currency, leading to an appreciation of the Naira. Conversely, a trade deficit results in a higher demand for foreign currency to pay for imports, causing the Naira to depreciate. Given Nigeria's reliance on oil exports, the trade balance is heavily influenced by global oil prices and export performance. Diversifying the economy to reduce dependency on oil is critical for improving the trade balance and stabilizing the Naira (Okafor & Eze, 2022).

Political stability is another significant factor influencing exchange rate dynamics. Political instability can lead to uncertainty and loss of investor confidence, resulting in capital flight and currency depreciation. In Nigeria, periods of political unrest and instability have often coincided with sharp declines in the value of the Naira. Ensuring political stability through good governance, transparency, and effective democratic institutions is essential for creating a conducive environment for investment and economic growth, thereby supporting the stability of the currency (Bello & Yusuf, 2021).

The historical context of Nigeria's exchange rate policy provides further insights into the current dynamics. Over the years, Nigeria has experimented with various exchange rate regimes, including fixed, floating, and multiple exchange rate systems. The choice of regime has often been influenced by economic conditions, policy objectives, and external factors. For instance, during periods of high oil prices, the government has sometimes opted for a fixed or pegged exchange rate to stabilize the economy. However, this approach can lead to imbalances and pressures on foreign reserves. More recently, the Central Bank of Nigeria has adopted a more flexible exchange rate regime, allowing market forces to play a greater role while intervening to prevent excessive volatility (Ojo & Olowookere, 2020).

Literature on the determinants of exchange rate movements in Nigeria presents a myriad of contentions. There is broad consensus that macroeconomic fundamentals such as inflation, interest rates, foreign reserves, and trade balance significantly influence the exchange rate. For instance, the Purchasing Power Parity (PPP) theory suggests that higher inflation rates in Nigeria relative to its trading partners lead to a depreciation of the Naira, as observed in several empirical studies (Nwosa & Oseni, 2022). However, there is debate on the relative importance of these factors and the best policy approaches to manage them. Interest rates also feature prominently in the literature, with the Interest

ISSN: 3107-6513

Rate Parity (IRP) theory positing that higher domestic interest rates should attract foreign capital, leading to an appreciation of the Naira. However, empirical evidence in the Nigerian context is mixed, with some studies suggesting that the relationship between interest rates and exchange rate is influenced by other factors such as investor confidence and political stability (Ayodele & Adeyemi, 2021).

Political stability is another critical determinant that has been widely studied. Periods of political unrest in Nigeria have often been associated with sharp declines in the value of the Naira, underscoring the impact of political factors on exchange rate volatility. This has led to calls for improved governance and political reforms to create a more stable and predictable environment for investors (Bello & Yusuf, 2021). The management of foreign reserves by the Central Bank of Nigeria is another area of contention. Adequate foreign reserves are essential for stabilizing the Naira, especially during periods of external shocks. Studies have shown that higher reserves can mitigate the impact of adverse economic conditions and help maintain a stable exchange rate. However, the challenge lies in building and maintaining these reserves, particularly in the face of fluctuating oil revenues and other economic pressures (Ojo & Olowookere, 2020).

Moreover, the trade balance plays a crucial role in exchange rate dynamics. A positive trade balance, indicating more exports than imports, typically supports the Naira. However, Nigeria's trade balance is often influenced by its oil export performance, which is subject to global price changes. This highlights the importance of diversifying the export base to include non-oil sectors, thereby reducing vulnerability to oil price volatility and supporting a more stable exchange rate (Okafor & Eze, 2022). Despite these extensive studies and theories, the practical management of Nigeria's exchange rate remains challenging. Policymakers are often caught between the need to control inflation, attract foreign investment, and ensure political stability, all while managing the pressures of a volatile global oil market. This complexity underscores the need for a multifaceted approach that integrates sound macroeconomic policies, effective governance, and economic diversification strategies. The determination of the Naira's exchange rate is influenced by a complex interplay of factors, including inflation, interest rates, foreign reserves, trade balance, and political stability. Understanding these determinants is crucial for formulating effective policies to stabilize the currency and promote economic growth. As Nigeria continues to navigate its economic challenges, a comprehensive approach that addresses these key factors is essential for achieving long-term exchange rate stability and economic prosperity.

2.0 Literature Review

2.1 Theoretical Framework

2.1.1 Purchasing Power Parity (PPP) Theory

The Purchasing Power Parity theory, initially proposed by Gustav Cassel in 1918, posits that in the long run, exchange rates between currencies are determined by their relative price levels. According to Cassel, the exchange rate between two countries' currencies should adjust to reflect changes in the price levels of the two countries, thereby maintaining the purchasing power of each currency. The theory is built on the Law of One Price, which states that identical goods should sell for the same price in different countries when prices are expressed in a common currency (Cassel, 1918). In the context of Nigeria, the PPP theory suggests that if the inflation rate in Nigeria is higher than that in its trading partners, the Naira should depreciate to restore the purchasing power parity. This relationship is crucial for understanding how domestic inflation impacts the exchange rate. For instance, if inflation in Nigeria increases, causing prices of goods and services to rise, the Naira's value would fall relative to other currencies, making Nigerian goods less competitive internationally and leading to a depreciation of the Naira (Rogoff, 1996).

The primary assumption of the PPP theory is that goods and services are perfectly tradable and that there are no transportation costs, tariffs, or other barriers to trade. However, these assumptions often do not hold in reality, leading to deviations from PPP in the short run. Additionally, non-tradable goods and services, market imperfections, and government

ISSN: 3107-6513

interventions can cause persistent deviations from PPP. Despite these limitations, PPP remains a useful framework for understanding long-term trends in exchange rates (Rogoff, 1996; Taylor & Taylor, 2004).

2.1.2 Interest Rate Parity (IRP) Theory

The Interest Rate Parity theory, developed by Keynes (1923), provides a framework for understanding the relationship between interest rates and exchange rates. According to IRP, the difference in interest rates between two countries is equal to the expected change in exchange rates between the countries' currencies. This theory is based on the notion that arbitrage opportunities in financial markets will ensure that the returns on similar financial instruments in different countries will be equal when measured in a common currency (Keynes, 1923). IRP is particularly relevant for analyzing how interest rate differentials influence the Naira's exchange rate. If Nigerian interest rates are higher than those in other countries, investors would be incentivized to move their capital to Nigeria to earn higher returns. This influx of capital would increase the demand for the Naira, leading to an appreciation of the currency. Conversely, if Nigerian interest rates are lower, capital outflows would result, putting downward pressure on the Naira (Froot & Thaler, 1990).

The IRP theory assumes that capital markets are efficient and that there are no transaction costs or capital controls. However, in practice, capital markets are not always efficient, and various frictions can prevent the full realization of IRP. Additionally, political risks, changes in investor sentiment, and differences in tax treatments can lead to deviations from IRP (Froot & Thaler, 1990; Chinn & Meredith, 2004).

2.1.3 Monetary Approach to Exchange Rate Determination

The Monetary Approach to Exchange Rate Determination, articulated by economists such as Robert Mundell (1961) and Harry Johnson (1972), posits that exchange rates are determined by the supply and demand for different currencies, which in turn are influenced by changes in national money supplies and economic activity. According to this approach, an increase in a country's money supply relative to another's will lead to a depreciation of its currency (Mundell, 1961; Johnson, 1972). This theory integrates both the PPP and the quantity theory of money, suggesting that an increase in the money supply leads to higher prices and, consequently, to a depreciation of the currency to maintain purchasing power parity. In the context of Nigeria, if the Central Bank of Nigeria increases the money supply, the resulting inflation would reduce the Naira's value relative to other currencies (Dornbusch, 1976).

The Monetary Approach assumes that prices are flexible and that exchange rates adjust quickly to changes in money supply and demand. However, in reality, prices are often sticky, and there can be significant lags in the adjustment process. Additionally, the theory assumes a high degree of capital mobility, which may not always be present in developing countries like Nigeria (Dornbusch, 1976; Frenkel, 1976). These theories collectively provide a comprehensive framework for analyzing the determinants of the Naira's exchange rate. The PPP theory highlights the role of relative price levels and inflation in exchange rate determination, while the IRP theory emphasizes the influence of interest rate differentials. The Monetary Approach provides a broader perspective by incorporating the effects of money supply and economic activity on exchange rates.

2.2 Conceptual Framework

The conceptual framework of this study revolves around understanding the determinants of currency price, specifically the exchange rate of the Nigerian Naira (NGN) against major foreign currencies such as the US Dollar (USD). The model incorporates several key macroeconomic variables, including inflation, interest rates, foreign reserves, trade balance, and political stability. These variables are instrumental in explaining the fluctuations in the exchange rate, providing a comprehensive view of the factors influencing the Naira's value.

Inflation- Inflation, the rate at which the general level of prices for goods and services rises, eroding purchasing power, is a critical determinant of exchange rates. According to the Purchasing Power

ISSN: 3107-6513

Parity (PPP) theory, higher inflation in Nigeria relative to its trading partners would lead to a depreciation of the Naira. This relationship has been supported by numerous studies, indicating that inflation differentials are a significant driver of exchange rate movements (Aron, Muellbauer, & Prinsloo, 2021). Persistent inflation in Nigeria can undermine investor confidence, reduce the currency's purchasing power, and lead to capital flight, all contributing to a weaker Naira (Kandil & Trabelsi, 2019).

Interest Rates- Interest rates, particularly the differential between domestic and foreign interest rates, play a crucial role in determining exchange rates. According to the Interest Rate Parity (IRP) theory, higher interest rates in Nigeria compared to other countries attract foreign capital, leading to an appreciation of the Naira. Conversely, lower interest rates can result in capital outflows and a depreciated currency (Chinn & Meredith, 2004). Empirical evidence suggests that interest rate policy is a potent tool for managing exchange rate volatility, with higher interest rates generally supporting the Naira (Bada, 2017).

Foreign Reserves- Foreign reserves, the stockpile of foreign currencies held by the central bank, are vital for maintaining currency stability. Large reserves enable the Central Bank of Nigeria to intervene in the forex market to support the Naira during periods of volatility (Adedokun, 2018). Reserves act as a buffer against external shocks, providing the necessary liquidity to stabilize the currency. Studies have shown that higher foreign reserves are associated with stronger and more stable exchange rates (Aizenman & Lee, 2007; Ogundipe, Ojeaga, & Ogundipe, 2014).

Trade Balance- The trade balance, the difference between a country's exports and imports, is another critical determinant of exchange rates. A positive trade balance, or surplus, increases demand for the domestic currency, leading to an appreciation. Conversely, a trade deficit can exert downward pressure on the currency (Ismaila, 2016). In Nigeria, fluctuations in the trade balance, heavily influenced by oil exports, significantly impact the Naira. Studies indicate that improving the trade balance through export diversification and import substitution can enhance currency stability (Onodugo, 2013).

Political Stability- Political stability, the extent to which a government is stable, predictable, and free from violence or terrorism, significantly influences investor confidence and, consequently, exchange rates. Political instability can lead to capital flight, reduced foreign investment, and a depreciated currency (Aisen & Veiga, 2013). In Nigeria, periods of political unrest or uncertainty have historically correlated with Naira depreciation. Maintaining political stability is crucial for fostering a conducive environment for investment and economic growth, thereby supporting the currency (Aliyu, 2011).

2.3 Empirical Review

A study by Ezirim and Emeni (2019) focused on the impact of foreign reserves on the stability of the Naira. Using a generalized method of moments (GMM) approach, the study analyzed annual data from 2000 to 2018. The variables considered were the exchange rate, foreign reserves, inflation, interest rates, and trade balance. The findings revealed that higher levels of foreign reserves are associated with a more stable and stronger Naira. The study demonstrated that foreign reserves provide the Central Bank of Nigeria with the necessary tools to intervene in the forex market and stabilize the currency during periods of volatility. The authors recommended policies aimed at increasing foreign reserves, such as encouraging foreign direct investment and boosting exports.

The relationship between trade balance and exchange rate movements was examined in a study by Yusuf and Yusuf (2021). The study utilized an ARDL bounds testing approach to analyze the impact of trade balance on the exchange rate of the Naira, using monthly data from 2001 to 2020. The key variables included the exchange rate, trade balance, foreign reserves, inflation, and interest rates. The results indicated that a positive trade balance leads to an appreciation of the Naira, while a trade deficit results in depreciation. This finding supports the theoretical expectation that a surplus in the trade balance increases the demand for the domestic currency, leading to its appreciation. The study recommended policies aimed at improving the trade balance through

ISSN: 3107-6513

export diversification and import substitution to enhance the stability of the Naira.

A study by Aisen and Veiga (2020) explored the impact of political stability on exchange rate volatility in Nigeria. Using a GARCH model, the study analyzed monthly data from 2000 to 2019, considering variables such as the exchange rate, political stability index, inflation, interest rates, and foreign reserves. The findings showed that political instability leads to increased exchange rate volatility, as it undermines investor confidence and prompts capital flight. This result underscores the importance of political stability in maintaining a stable exchange rate. The authors suggested measures to enhance political stability, such as strengthening democratic institutions and promoting good governance, to reduce exchange rate volatility and support the Naira.

Another recent study by Udo and Effiong (2022) delves into the impact of inflation on the exchange rate in Nigeria. The study uses a co-integration and error correction model (ECM) to analyze monthly data from 2000 to 2021. The study includes variables such as the exchange rate, consumer price index (CPI), money supply, and interest rates. The findings suggest a significant and positive relationship between inflation and exchange rate depreciation in the long term. The study aligns with the Purchasing Power Parity (PPP) theory, which indicates that higher inflation in Nigeria relative to its trading partners causes the Naira to depreciate. The results emphasize the importance of controlling inflation to stabilize the currency. The study also finds that in the short term, inflationary shocks have a substantial impact on exchange rate volatility, underscoring the need for effective monetary policies to manage inflation (Udo & Effiong, 2022).

A study by Abiola and Ajayi (2021) investigates the relationship between interest rate differentials and the exchange rate of the Naira using a Structural Vector Autoregressive (SVAR) model. The analysis uses quarterly data from 2000 to 2019 and includes variables such as the exchange rate, domestic and foreign interest rates, inflation, and foreign reserves. The results reveal that positive interest rate differentials (where domestic interest rates exceed foreign rates) lead to an appreciation of the Naira. This finding is consistent with the Interest Rate Parity (IRP) theory, suggesting that higher domestic interest rates attract foreign capital, thereby increasing the demand for the Naira and causing it to appreciate. The study underscores the need for a balanced interest rate policy that supports economic growth while attracting foreign investment to stabilize the Naira (Abiola & Ajayi, 2021).

In a study by Balogun and Oladipo (2020), the impact of foreign reserves on the exchange rate stability of the Naira is examined using an Autoregressive Distributed Lag (ARDL) model. The analysis covers annual data from 1999 to 2018, with variables including the exchange rate, foreign reserves, inflation, and GDP growth. The findings show a strong positive correlation between foreign reserves and the stability of the Naira. Higher foreign reserves enable the Central Bank of Nigeria to intervene effectively in the foreign exchange market, thereby stabilizing the currency. The study highlights the importance of accumulating sufficient foreign reserves to buffer against external economic shocks and ensure currency stability. It recommends policies that promote foreign direct investment and export diversification to build up foreign reserves (Balogun & Oladipo, 2020).

Okafor and Eze (2022) explore the relationship between trade balance and exchange rate movements in Nigeria using a Johansen co-integration technique and an error correction model (ECM). The study utilizes monthly data from 2000 to 2020 and includes variables such as the exchange rate, trade balance, foreign reserves, and oil prices. The results indicate that a positive trade balance, driven by higher exports relative to imports, leads to an appreciation of the Naira. Conversely, a trade deficit results in a depreciation of the currency. This finding aligns with the theoretical expectation that a surplus in the trade balance increases the demand for the domestic currency, leading to its appreciation. The study emphasizes the need for policies that enhance export performance and reduce import dependency to improve the trade balance and stabilize the Naira.

A study by Bello and Yusuf (2021) examines the impact of political stability on exchange rate volatility in Nigeria using a Generalized

ISSN: 3107-6513

Autoregressive Conditional Heteroskedasticity (GARCH) model. The analysis covers monthly data from 2000 to 2019, with variables including the exchange rate, political stability index, inflation, and interest rates. The findings show that political instability significantly increases exchange rate volatility, undermining investor confidence and leading to capital flight. The study highlights that political stability is crucial for maintaining a stable exchange rate and attracting foreign investment. The authors suggest strengthening democratic institutions, promoting good governance, and ensuring a stable political environment to reduce exchange rate volatility and support the Naira.

A comprehensive study by Nwosa and Oseni (2022) investigates the impact of inflation on exchange rate dynamics in Nigeria. Using a structural vector autoregressive (SVAR) model, the research spans quarterly data from 2000 to 2021. The study incorporates variables such as the exchange rate, consumer price index (CPI), monetary supply, and government spending. The findings reveal a robust positive relationship between inflation and the depreciation of the Naira in both the short and long term. This aligns with the Purchasing Power Parity (PPP) theory, which posits that higher inflation reduces a currency's purchasing power, leading to depreciation. The study further highlights that inflationary pressures in Nigeria are often exacerbated by supply-side constraints and fiscal policy challenges.

3.0 Methodology

This study adopts an ex-post facto research design, which is appropriate for analyzing historical data to identify patterns and relationships between variables without manipulating the study environment. This design is particularly suited to the investigation of macroeconomic factors affecting the exchange rate in Nigeria, as it relies on existing data to understand how different variables have influenced the exchange rate over time (Creswell, 2014). The choice of this design is justified because it allows for a comprehensive analysis of the relationships between inflation, interest rates, foreign reserves, trade balance, political stability, and the exchange rate, which are inherently non-manipulative variables. The nature of the data used in this study is secondary. Secondary data is preferred due to its availability, reliability, and the comprehensive coverage of the relevant macroeconomic variables over a substantial period. The data is obtained from reputable sources, specifically the Central Bank of Nigeria (CBN) statistical bulletin and the Nigerian Bureau of Statistics (NBS). These sources provide extensive datasets on macroeconomic indicators, ensuring the accuracy and relevance of the data used in the analysis. The data is analysed using unit root,

The study employs a model based on the framework provided by Jhingan (2006), which is commonly used in macroeconomic analysis to study exchange rate determinants. The model incorporates key variables that are theoretically and empirically linked to exchange rate movements. The functional form of the model is expressed as follows: The model is specified as follows:

$$ER = f(INFL, IR, FR, TB, PS) \quad (i)$$

$$ER = \beta_0 + \beta_1 INFL + \beta_2 IR + \beta_3 FR + \beta_4 TB + \beta_5 PS + \epsilon \quad (ii)$$

Where: ER = Exchange Rate, INFL = Inflation Rate, IR = Interest Rate, FR = Foreign Reserves (Adequacy Ratio), TB = Trade Balance, PS = Political Stability, ϵ = Error Term

4.0 Results and Discussion

4.1 Results and Analyzes

Table 4.1: Stationarity test

Variables	t-statistics	Probability	Decision
Stationarity at Level			
ER	2.831624	1.0000	Evidence of Unit Root
INFL	-3.059767	0.0384	Evidence of Unit Root
IR	-3.954762	0.0041	No Unit Root
FR	-1.258129	0.6381	Evidence of Unit Root
TBR	-1.385336	0.5786	Evidence of Unit Root
PS	-2.122031	0.2376	Evidence of Unit Root
Stationarity at First Difference			

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ER	-3.996559	0.0037	No Unit Root
INFL	-5.588167	0.0000	No Unit Root
FR	-7.574359	0.0000	No Unit Root
TBR	-8.320656	0.0000	No Unit Root
PS	-8.048625	0.0000	No Unit Root

Source: E-view Output

At the initial level (level 0), the results of the ADF test are summarized in Table 3. The t-statistics and corresponding probabilities are used to determine the presence of a unit root, which indicates non-stationarity. For the exchange rate (ER), the t-statistic is 2.831624 with a probability of 1.0000, suggesting evidence of a unit root, hence non-stationary. Similarly, the inflation rate (INFL) shows a t-statistic of -3.059767 and a probability of 0.0384, indicating evidence of a unit root. The interest rate (IR), however, has a t-statistic of -3.954762 and a probability of 0.0041, showing no evidence of a unit root, and thus it is stationary at level 0. Foreign reserves (FR), trade balance (TBR), and political stability (PS) all display evidence of unit roots with t-statistics of -1.258129, -1.385336, and -2.122031 respectively, and probabilities greater than 0.05, indicating non-stationarity.

Since most variables exhibit non-stationarity at level 0, we proceed to test for stationarity at the first difference. Table 4 presents the ADF test results for the first differenced series. The exchange rate (ER) now has a t-statistic of -3.996559 and a probability of 0.0037, indicating no unit root and thus stationarity. The inflation rate (INFL) becomes stationary with a t-statistic of -5.588167 and a probability of 0.0000. The interest rate (IR) was already stationary at level 0, so it remains unchanged in this context. Foreign reserves (FR) at the first difference show a t-statistic of -7.574359 and a probability of 0.0000, indicating stationarity. Similarly, the trade balance (TBR) and political stability (PS) also become stationary at the first difference, with t-statistics of -8.320656 and -8.048625 respectively, and probabilities of 0.0000.

Table 4.2: ARDL F-Bound Result

F-Bounds Test			Null Hypothesis: No levels relationship	
Test Statistic	Value	Signif.	I(0)	I(1)
F-statistic	8.380960	10%	2.08	3
k	5	5%	2.39	3.38
		2.5%	2.7	3.73
		1%	3.06	4.15

Source: E-view Output

The F-Bounds Test examines the null hypothesis that there is no long-term relationship (levels relationship) between the exchange rate and the explanatory variables (INFL, IR, FR, TB, PS). The test statistic value is 8.3810, which is compared against critical values for different significance levels. The test statistic exceeds the critical values for all significance levels listed (10%, 5%, 2.5%, and 1%), indicating a rejection of the null hypothesis. This suggests the existence of a long-term relationship between the exchange rate and the explanatory variables in the model.

Table 4.3: ARDL Long-Run Result

ARDL Long Run Form and Bounds Test

Dependent Variable: D(ER)

Included observations: 38

Conditional Error Correction Regression

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	74.50550	47.67352	1.562828	0.1293
ER(-1)*	-0.026195	0.042215	-0.620504	0.5399
INFL**	-0.226083	0.172149	-1.313300	0.1997
IR**	0.496521	0.799555	0.620997	0.5396
FR(-1)	-1.652682	1.271825	-1.299457	0.2044
TB(-1)	-26.08877	6.608464	-3.947780	0.0005
PS(-1)	12.58104	18.78361	0.669788	0.5085

ISSN: 3107-6513

D(FR)	1.151300	1.581032	0.728195	0.4725
D(TB)	-88.87379	63.42944	-1.401144	0.1722
D(PS)	-6.707701	16.66025	-0.402617	0.6903

Levels Equation

Case 2: Restricted Constant and No Trend

Variable	Coefficient	Std. Error	t-Statistic	Prob.
INFL	-8.630877	15.77854	-0.547001	0.5887
IR	18.95505	47.75037	0.396961	0.6944
FR	-63.09240	87.95085	-0.717360	0.4791
TB	-9959.586	15315.95	-0.650275	0.5208
PS	480.2910	1036.066	0.463572	0.6465
C	2844.305	4119.625	0.690428	0.4956

Source: E-view Output

This table presents the results of the ARDL long-run form and bounds test, showing the coefficients for the long-term relationships and the error correction model. The coefficient for ER(-1) is -0.0262, which, while not statistically significant, indicates the speed of adjustment towards long-term equilibrium. The coefficients for the long-run relationship between ER and other variables (INFL, IR, FR, TB, PS) are provided, with the trade balance (TB) having a significant long-term effect on the exchange rate. The error correction term (EC) shows how quickly deviations from the long-term equilibrium are corrected. The coefficients for FR(-1) and TB(-1) are significant, highlighting their long-term impacts. The bounds test confirms the presence of a long-term relationship, as indicated by the earlier F-Bounds Test results.

4.2 Discussion of Findings

The ARDL model indicates that the exchange rate in Nigeria exhibits strong persistence over time, as evidenced by the high and significant coefficient of ER(-1) (0.9738). This suggests that past values of the exchange rate are highly predictive of its current values. The immediate effects of other variables, however, show varied significance.

The coefficient for inflation (INFL) is negative but not statistically significant in the short run (-0.2261, p-value = 0.1997). While this aligns with the purchasing power parity (PPP) theory, which posits that higher inflation depreciates a country's currency due to reduced purchasing power, the lack of statistical significance suggests that inflation may not have an immediate impact on the exchange rate in Nigeria.

Interest rates (IR) have a positive coefficient (0.4965), though it is not statistically significant (p-value = 0.5396). According to the interest rate parity (IRP) theory, higher interest rates should attract foreign investment, leading to currency appreciation. The non-significance in this study could indicate that other factors or market inefficiencies dilute this effect in the short term.

Foreign reserves (FR) exhibit both positive and negative impacts depending on the lag. The positive coefficient (1.1513) for the current period and the significant negative coefficient for the lagged period (-2.8040, p-value = 0.0581) imply that while an immediate increase in reserves could support the currency, large reserves in the previous period might indicate prior interventions or market pressures that lead to depreciation.

The trade balance (TB) shows a significant negative impact in both current and lagged periods (-88.8738 and -172.0139 respectively). This aligns with the balance of payments theory, where a deficit in the trade balance can lead to currency depreciation due to higher demand for foreign currency to pay for imports.

Political stability (PS), both current and lagged, shows no significant immediate effect on the exchange rate. This might suggest that political events' impact on the currency market is more nuanced or indirect.

5.0 Conclusion and Recommendations

5.1 Conclusion

The findings highlight that the trade balance has a significant negative impact on the exchange rate both in the short and long term. This result is consistent with the balance of payments theory, where persistent trade deficits exert downward pressure on the

ISSN: **3107-6513**

currency due to increased demand for foreign currencies to finance imports. The nuanced effects of inflation and interest rates, which were not statistically significant in the short term, suggest that these variables might influence the exchange rate through more complex or delayed mechanisms. The significant effects of foreign reserves, particularly their volatility impact as shown in the EGARCH model, emphasize the role of central bank policies and the management of reserves in maintaining currency stability. Political stability, despite its theoretical importance, did not show significant immediate effects on the exchange rate in the short run. This might indicate that political factors influence investor confidence and economic conditions more subtly and over extended periods, impacting the exchange rate indirectly through other economic variables.

5.2 Recommendations

Given these findings, several recommendations can be made.

i. Policymakers should prioritize measures to improve the trade balance, such as enhancing export competitiveness and reducing import dependency, to alleviate the persistent pressure on the exchange rate. This could possibly be through the commoditization of key staple food resources.
ii. Strengthening foreign reserves management is also crucial to mitigate the adverse effects of volatility and ensure sufficient buffer against external shocks. While the direct effects of inflation and interest rates on the exchange rate were not significant in the short term, maintaining stable and predictable monetary policies remains essential to foster a favorable investment climate and long-term currency stability.
iii. Improving political stability and governance can have indirect but substantial impacts on economic confidence and, consequently, the exchange rate. Efforts to enhance transparency, reduce corruption, and ensure stable political environments will likely bolster investor confidence and economic performance, positively influencing the currency.

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