

## **Exchange Rate Policy Appropriateness in a Less Developed Country: The Nigerian Case**

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### **Abstract**

This paper investigated the appropriateness of the exchange rate regime in Nigeria. The method of analysis adopted in this work is the characteristics of the economy based choice of an exchange rate regime.

The findings show that almost all the requirements point to the fact that the ideal regime for Nigeria is the flexible regime. But because Nigeria has shown frequent variability in her performance in the characteristics as benchmark, it is not a match for a free float. Hence the managed float that has been adopted again since 2016 is appropriate considering for instance the level of the country size, openness, diversification, economic shocks and level of financial and economic development. It was suggested that to have a good result from the system element of check on the operation should be introduced to curtail issues of round tripping that can cause failure to the system.

**Keywords:** Exchange Rate Determination, Appropriate Regime, Characteristics of an Economy-Based Choice.

### **Introduction**

There was no dissembling regional superiority in economic development of developing countries before 1950. While per capita incomes were generally low and displayed no systematic patterns per capita incomes were higher in Latin America than Asia and Africa but from 1950 – 2000 the rate of growth of global GDP began to accelerate with Asia especially East Asia showing the most noticeable increase. While the growth performance in Latin America was pedestrian that of African countries with the exception of a few small countries like Mauritius and Botswana was quite unimpressive perhaps even atrocious (Iyoha, 2002). It is generally agreed that Asia has had more outward looking trade and exchange rate policies

than Latin America or Africa with trade regimes in the Asian Tigers- Hong Kong, Singapore, South Korea and Taiwan the newly industrializing countries been left to market forces

On the issue of macroeconomic performance in Nigeria using poverty level indicator Okojie (2002) using data from Federal Office of Statistics and World Bank estimates has concluded that the end result of several development plans for Nigerians is increased poverty. This view is also in line with the Human Development Report account of Nigerians Human Poverty Index at 40.5 which ranks 54 out of 77 developing countries for which the index was available. The HPI index measures the extent of deprivation the proportion of people in the community who are left out of progress. The persistence of poverty despite the many shocks and jolts every economy raises in the normal course of its existence raises the suspicion that underdevelopment is a state of equilibrium and that there are forces at work that tend to restore the equilibrium every time there is a small disturbance. It is this suspicion which gives rise to the idea of vicious circle. A vicious cycle of poverty is a circular constellation of forces tending to act and react upon one another in such away as to keep a poor country in state of poverty Nurkse (1953) as in (Bau, 1998). The above analysis shows that poverty trap is a state of equilibrium in the sense that once there the economy has a tendency to remain there; small shocks do not disturb it. And also the use of the word 'trap' suggests that one can be out of it.

One link between the poverty trap and the international economy arises via an economy's access to foreign exchange markets. This access may take different avenues it may be through international trade through aids or grants it may take the form of loans which ever form the access may take they have their various drawbacks. In any case it is poor countries belief that they are trapped at levels of production below capacity that makes them want to be a net recipient of foreign exchange.

In the paper the analysis of the appropriateness of foreign exchange in Nigeria made use of the knowledge of concept on the two gap models of growth. This model emphasizes two major areas of importance of foreign exchange to the economic development of LCDS. In the first case a greater availability of foreign exchange can be used by less developed economy to break out the small savings small growth vicious circle. Secondly it can enable LCD to acquire essential capital equipment's which it is unable to produce indigenously.

This goes to show that the appropriateness of a particular exchange rate regime is evaluated based on how it is able to accomplish the following; encourage inflow of foreign currency outside the official source; reduce pressure on demand through avoidance of speculative arbitrage especially between official and parallel segments of the market recognition of the goings on in the international economy cannot be ruled out of the question. For instance, a change in the value of a currency which is another country's currency has a fixed parity which may affect the value of the later currency.

In the final analysis for a more objective basis of analysis the criteria as spelt out considerations in the choice of an appropriate exchange rate regime was explained even as they are not free from some forms of trade off which calls for some art in their application.

### **Literature Review**

The literature on exchange rate management policy in developing countries has grown significantly in recent years. Much concern for this area of policy grew considerably in the 1980s when most sub Saharan African countries embarked on an economic stabilization are structural adjustment programs. Apart from the effect of political instability, the economic crisis facing most African countries is the result of inappropriate exchange rate policy effects

imports and exports and inflow of foreign exchange provide impetus for a flourishing parallel market for the foreign exchange creates economic rents for public officials who allocated import licenses and enforce import control measures and distorts the level of tariff protection in the domestic economy (Ogiogio, 1996).

Iyoha and Unugbro (2002) explained foreign exchange to mean any convertible national currency national currency that is widely accepted for the payment of international debts or transactions e.g. the US Dollar, the British pound sterling, the Japanese yen etc. Anyaanwu (1993) explains foreign exchange as referring to the means of payment or instrument of short term credits for various countries with different monetary units regarded from the point of view of their purchase or sale against the national money or that of their holding as reserves To avoid the confusing arising from the price and volume quotation systems Dunn and Mutti (2004) consider the informal usage of the exchange rate as decided by the volume quotation system. To this the exchange rate of a currency is the number of units of foreign currency required to purchase one unit of the domestic currency in question

Exchange rate systems establish the structural framework within which foreign exchange transactions are conducted. These systems range from perfect inflexibility to perfect flexible rates. Fischer (2001) following IMF's Annual Report 2000 format categorized exchange rate systems or regimes into three broad groups. The group described as hard pegs consists of economies with currency boards or those with no separate currency. The intermediate group consists of economies with conventional fixed pegs, crawling, horizontal bands, and crawling bands. These are sometimes referred to as soft pegs. The floating group consists of economies whose systems are described either as a managed float with no specified central rate or as independently floating.

It is generally agreed that there is no perfect exchange rate system and that the advantage and disadvantage of each form has to be evaluated against the background of the particular economic and financial environment within which they operate. Among these systems include the gold standard floating exchange rate the managed floating system the crawling peg the snake in the tunnel and the European Monetary System.

Drawing on Goacher (1986) we explain the various regimes thus. The gold standard was a system of rigidly fixed exchange rate that did not allow for periodic alternations of currency parties. Within this regime gold formed the international means of payment and it was also the reserve based asset for the domestic currency. However an efficiently operating gold standard is characterized by a stable exchange rate fluctuating within narrow clearly defined limits.

**Adjustable peg exchange rate system:** In this case each country taking part in the system pledged to maintain its exchange rate within a narrow margin of the declared dollar parity. However unlike a pure fixed rate system where a country had a fundamental BOP problem and could not hold its existing parity under the Bretton Wood System it was allowed to move to a new parity by devaluation.

**The Clean Float Exchange Rate:** this system of freely floating exchange rates is one within which the determination of exchange rates is left purely to market forces and in particular there is no international office intervention to manipulate rates. This system makes unnecessary the need for international reserve of gold and foreign reserve.

**Managed Float Exchange Rate:** also known as dirty float this system is one variant of floating exchange rate system in which the rate was not permitted to float freely but was subject to discretionary intervention to avoid excessive exchange rate fluctuations which are presumed to be temporary or cyclical.

**The Crawling Peg System:** under this system the exchange rate is pegged at a given value but it is allowed to crawl in response to changing market situations this system is an attempt to combine the advantage of fixed exchange rate system with flexibility of the floating exchange rate system. A succession of frequent modest devaluations refers to a crawling peg while periodic revaluations is known as upward crawling peg.

**The Snake in the Tunnel:** as a first step along the road to European monetary union action was taken in 1972 though abandoned in 1973 by Belgium Denmark West Germany France Norway and Sweden to reduce the fluctuation of exchange rates between the currencies of European Economic Community EEC member states. The snake: member states would limit the fluctuations in their own exchange rates to within 2 1/2% bands around all their respective currencies. The tunnel: All EEC currencies taken together would move a bloc within a 4 1/2 % band against the dollar

**The European Monetary System (Ems):** in order to lay the foundation for a greater financial cooperation among EEC nation's proposals for the EMS was formulated. The general principle was that the EMS would concentrate solely on the intra EEC financial arrangements which would be required to bring a stable currency exchange rate regime among member states. The proposals envisaged two major elements to the EMS: (a) an exchange rate stabilization mechanism. It was agreed that the currency market intervention, required to limit exchange rate fluctuations would take place on the basis of two sets of criteria (ai) a parity rate arrangement. Here each currency is initially given central exchange rate expressed in European Currency Unit, the ECU being a weighted basket of all EEC members' currencies. (a ii) the ECU divergence indicator. This is an early warning device designed to indicate that a currency is moving too close to its parity limits with the ECU. (b) An exchange rate stabilization fund. This was to be established in order to support the fixed exchange rate system. 'On the issue of appropriate exchange rate regime Fischer 2001 drew the following conclusions the middle has hollowed out and the hard peg and floating categories have expanded. Almost all the expansions and the hard peg side results from the creation of EMU that economics open to international capital flows have been and are in the process of moving away from adjustable peg exchange rate systems some towards harder peg more towards systems with greater exchange rate flexibility. This conclusion is in line with his account of others authorities: (i) the choice of appropriate exchange rate regime which for economics with access to international capital market increasingly means a move away from the middle ground of pegged but adjustable fixed exchange rates towards the two corner regimes of either flexible exchange rates or a fixed exchange rate supported of necessary by a commitment to give up altogether independent monetary policy'

The above analysis points to the fact that the intermediate policy regimes between hard pegs and floating are not sustainable for countries open to international capital flows.

**Exchange Rate Regimes in Nigeria and Their Appropriateness to Economic Development**

Until the mid-1980s Nigeria operated a fixed exchange rate system. Categorically speaking, between 1960-1967, the Nigerian pound was equal to the pound sterling. While the gold standard was adopted for some time the crawling peg system was adopted from 1984 to 1986. The second tier foreign exchange market came into existence on 29<sup>th</sup> September 1986 with the deregulation of the foreign exchange market and the free play of the market forces in determining exchange rates until 1994 when the Naira was once more pegged to the US dollar. Today Nigeria is categorized into an exchange rate regime of managed float with no pre announced exchange rate path IMF Annual Report 2000 as in (Fischer 2001) the fixed exchange system which involved the strict application of exchange control between 1967 and 1981 contributed in correcting BOP deficits and stemmed illegal foreign outflow. However substantial BOP surplus hailed from other factors especially favorable oil prices. Unfortunately, exchange control imposed some social costs such as malpractices, evasion, bottlenecks, and other forms of corruption that eventually affected production adversely. In historical perspective Nigeria has adopt different shades of foreign exchange rate regime. Between 1959 and 1977 Nigerian currency was in fixed parity either with the British pound sterling or the US dollar or both of them at the same time. In 1978 the Nigerian currency was fixed to basket of currencies seven of them which include the British pound sterling, the American dollar, German mark, French franc, Japanese Yen, Dutch guilder and Swiss franc. In 1986 two tiers for the exchange rate market were introduced. 1987 witnessed the merger of the two tiers of the exchange market. The interbank foreign exchange market was established in 1988. In 1994 a fixed exchange rate regime was introduced and the naira was fixed at #21.9960 to the US dollar. This action was consequent on the continuous depreciation of the naira. It should be noted that licensing of Bureaux de change took place in 1989 while in 1992 the foreign exchange market was completely deregulated as the floating exchange rate was adopted

Between 1995 and 2013, the autonomous retail dutch auction and whole dutch system were adopted with changes from one of the system to the other as each of them experience introduction suspension and reintroduction during the period in question.

In 2014, with the drop in crude oil the price of the naira continuous downward trend but this measure failed in 2015 the CBN intervened by closing both its retail and whole sale windows. As all these measures failed in June 2016 the CBN reintroduced the managed float referred to as flexible exchange rate interbank market a system in operation to date in 2020 in Nigeria. (Osagie, 2015; Urama & Iloh, 2018).

A critical requirement for a freely floating exchange rate regime is the absence of any form of economic rigidity. The Nigerian economy is characterized by structural rigidities and bottlenecks. Most of our exports and imports are characterized by inelasticity either on the demand or supply or both, restraint on the free flow of goods and services by our trading partners. The guidelines of the CBN on the purchase of foreign exchange users are to patronize the parallel market. There is always a gap between supply and demand for foreign exchange. The Nigerian economy is import dependent. Non-oil export is under reported and proceeds are hardly repatriated into the country thus compounding the supply rigidity. With the above expositions it could be seen that the practice of the bipolar exchange rate regime have resulted in a non-perfect market efficiency.

Before looking at the appropriateness of the exchange rates regime to the level of development in Nigeria, it is important to get the concept of development into its implied

perspective. Drawing from Odozi (2001) the issue of development has been discussed with growth of the Gross Domestic Product as an index of development and partly because of analytical convenience. However because there can be growth without development there has been a fundamental shift in the focus of development economics from growth of income to income distribution and wellbeing with strong emphasis on poverty reduction and improvement of health and education as both developmental goals and instruments for accelerating the growth of income. Development is essentially and broadly viewed from both quantitative and qualitative growth. Therefore stimulating sustained growth and improvements in the welfare calls for balanced investment in physical and financial assets human and social capital and natural and environment capital At a time of diminishing flow of developmental finance such as we have been experiencing in Nigeria for some time now the role of ideas in determining the pace of developmental becomes fundamental and developing countries need not only to bridge the savings and foreign exchange gaps but also called knowledge gap between them and the developed countries.

Nigeria as a developing country has the following characteristics of a developing economy; a low rate of real income per capita; low savings ratio; low capital labour ratio; a high illiteracy rate low level of technology low life expectancy of birth; inadequate health services; high infant mortality; low monetized subsector. All these conditions puts Nigeria on a low income level equilibrium trap. As income is low population growth is high leading to low per capita income hence the vicious cycle of poverty; low income results in low saving and investment which in turn results in continued low income. This is why underdevelopment has persisted. The issue of savings has taken a prominent position in the discussion of economic development, Thomas Malthus fear of population explosion was informed by fear of dis-saving in land nutrient; Rostow and others defined the take off stage as a situation where countries that are able to save 15% to 20% of GDP could grow at much faster rate than those that saved less. The tricks of economic growth and development therefore are simply a matter of increasing national saving and investment. Harrod – Domar, Arthur Lewis all sing the praise of saving in economic development

**Channels of Impacts:** foreign exchange regime and economic development in Nigeria. This issue will be discussed with a special reference to the concept of two gap model. External finance, play a critical role in supplementing domestic resources in order to relieve savings of foreign exchange bottlenecks. The basic argument of the two gap model is that most developing countries face either a shortage of domestic savings to match investments opportunities assume that the savings gap and the foreign exchange gap are unequal in magnitude and that they are independent that is that there is no substitutability between savings and foreign exchange.

The implication that follows is that one of the two gaps will be binding or dominant for any LDC at a given point in time now suppose there is a bottle neck in foreign capital equipment, then growth does not respond to increase in savings. An increase in savings rate causes a pileup of inventories while leaving growth unaffected in a situation where the foreign capital constraint is effective if domestic capital is increased it will remain utilized and growth will remain constant with the capital output ratio rising.

Also we may want to look at the determination of foreign exchange rates. As is true in almost every economic sector of a free society prices are determined by supply and demand. But as is also true whenever this simplistic statement is made it fails to say much about the reality of supply and demand the supply of foreign currencies in Nigeria results from our exports of

goods supply of services to foreigners the foreign tourists entertained here the amounts our nationals borrow abroad repayment of debts to us the sale of the securities of our corporations and of our government to foreigners and their direct investment in productive facilities in Nigeria. The demand for foreign currencies is the obverse of each of the above items. One proviso is always added that the list of these demand elements assumes that the naira proceeds of the transactions are repatriated by the foreign holders. While there are other issues of complication in the foreign exchange market perhaps the greatest is that of the economic circumstances that lie behind each transaction. Their translator may be a businessman, a traveler, a borrower or a lender, a speculator, or even a central bank acting as a monetary authority for its nation. To get at the root causes of why transactors want to transact business the best expository device is the BOP of an individual country. Since Nigeria has found it difficult to solve the savings requirement for sustainable growth 12.5% of income with a recent development in South East Asian countries putting his figure within the neighborhood of 30% and above the next available option has been to attract foreign investment to complement the limited domestic investments. A corollary to this is that foreign investment serves as a stimulus to additional domestic investment in Nigeria. Additional domestic investment could arise from the positive externalities generated by foreign investments. This could arise from forward and backward linkages as being currently experienced in the south East Asia. And given a good corporate reserves policy domestic corporate savings and investment would increase thereby further bringing the savings as long as the foreign investment does not serve as a substitute to domestic investment which could result in saving investment gap further widened which would result in regarding the growth process (Oduola, 2002).

## **Theoretical Review**

### **Theories of Exchange Rate Movements**

#### **Introduction**

Academic models of exchange rate determination with reference to flexible exchange rate system are granted that the fixed/adjusted pegged methods of exchange rate determination are activities purely of the government. But then it must be noted that in the past government have adopted global choices as implied in the periods of the gold standard which countries fixed their currencies to gold and the gold exchange standard or Bretton wood system when countries fixed their currencies to the US Dollar.

Next in this system of the paper is a brief review of some theories of exchange rate determination

#### **Purchasing Power Parity Model**

This theory generally attributed to Cassel (1923) links the exchange rate to movements in the level of inflation. Either in the absolute or relative versions, the main issue is that the value of a country's currency is inversely related to the level of inflation. The more realistic of the two versions, the relative version explains that the change in exchange rate is proportional to the relative change in the price levels in the two nations in question.

#### **The Monetarist Model**

This model by Robert Mundell and Harry Johnson got to its full development in the 1970s. This theory relates the value of a country's currency to the money demand and supply of a country. It argues that an increase in the money supply of a country leads to the depreciation

of the country while an increase in the money demand leads to an appreciation of the currency.

### The Portfolio Balance Model

This model by Zauri (1978), is also known as Asset market model. It can be said that the monetarist is a subset of the asset market model. This is because while the monetary approach only recognizes domestic demand and supply of money. But in the case of the Asset market model wealth owners keep a portfolio made up of domestic bond, foreign bond with foreign currencies denomination and the domestic money. The state of the portfolio at any point of time is a function of the returns on both bonds and the level of loss from loss of interest on money balance. The exchange rate is influenced in the process of making adjustment to the portfolio. There are some variants of the asset market approach such as the extended asset market approach by Zijl (1984). This is concerned with extension of the variables that influence the three basic factors in the so called simple asset market approach explained above.

Empirical evidences have showed that none of the models explained above have performed well. In the case of the purchasing power parity, structural changes and the presence of non-traded goods are held accountable for its nonperformance in the short and medium run. In the case of the monetary and portfolio approaches they are hindered by the occurrence of news which are not predictable as well as speculative bubbles which diverts exchange rates away from fundamentals. (Gandolfo, 2002; Dunn & Multi, 2004; Salvatore, 2006)

### Characteristics of an economy-based choice of an exchange rate regime

Size of the economy	The larger the economy the stronger is the case for a flexible rate
Openness	The more open the economy, the less attractive is a flexible exchange rate
Diversified production structure	The more diversified the economy, the more feasible is a flexible exchange rate
Geographical concentration of trade	The larger the proportion of an economy's trade with one larger country, the greater is the incentive to peg to the currency of that country
Divergence of domestic inflation from world inflation	The more divergent of a country's inflation rate is from that of its main trade partner the greater is the need for frequent exchange rate adjustment. But for a country with extremely high inflation a fixed exchange rate may provide greater policy discipline and credibility to a stabilization program



Degree of economic development	The greater the degree of economic and financial development the more feasible is a flexible regime
Labour mobility	The greater the degree of labour mobility when wages and prices are downwardly sticky, the less difficult is adjustment to external shocks with a fixed exchange rate
Capital mobility	The higher the degree of capital mobility the more difficult it is to sustain a pegged but adjustable exchange rate
Foreign nominal shocks	The more prevalent are foreign nominal shocks the more attractive is a fixed exchange rate
Domestic nominal shocks	The more prevalent are domestic nominal shocks the more desirable is a fixed exchange rate
Real shocks	The greater an economy susceptibility to real shocks whether foreign or domestic the more advantageous is a flexible exchange rate
Credibility of policy makers	The lower the anti-inflation credibility of policy makers the greater is the attraction of a fixed exchange rate as a nominal anchor

Source: Adopted from Obadan (2012)

The low performance of the academic models as explained earlier can be partly explained by the fact that various attributes of an economy influence the appropriateness of an exchange rate regime. The factors listed in the table above require some element of art in drawing conclusions considering the fact that there are some trades off among them in the trade process

### Empirical Review

This section benefited from the works of Salvatore (2006), Gandolf (2002) and Okechuku (2017). One the earliest studies to test the predictive accuracy of the economic models of exchange rate determination was that of Meese and Rogoff (1983a; 1983b) where they found out that none of the models could outperform the random walk model. The random walk model was taken as a bench mark which was accorded the status of a naïve agent who only has the idea with point five probability of increase or decrease in the exchange rate at any point in time. Frankel (1993) test which showed that an increase in the German money supply led to an appreciation in the value of the mark rather than the other way round rejected the efficiency of the monetary model. This is not to say that there are no studies with some level of support for the models. These include those of MacDonald and Taylor (1993); and Razzak and Grennes (1997).

Back home as in Okechuku (2017); Eze and Okpala (2014) found no statistical relationship between either the fixed or flexible exchange rate regimes of the growth of Nigerian economy.

In his work Okechuku found that the flexible exchange rate is better for Nigeria. The truth of the matter is that there is scarcity of work in testing the models of exchange rate determination especially from, the local perspective

### Methodology of the Study

The main objective of this study is to contribute to the question of the seeming failure of the choice of exchange rate regime in Nigeria.

This method of analysis adopted in this work is the characteristics of the economy based choice of an exchange rate regime. This method involves the use of at least twelve characteristics to access the choice of exchange rate in Nigeria

### Data Presentation and Analysis

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The table reproduced for convenience and easy of reference

In terms of size and openness, the adoption of flexible exchange rate regime is appropriate for Nigeria. Increased GDP as a measure of the size of a country implies increased demand for both domestic and foreign goods. The increased demand for foreign goods and serviced implies increase demand for foreign currencies and hence depreciation of domestic currency. This will involve continued intervention if fixed exchange regime is adopted. The case of openness which should qualify Nigeria for a fixed exchange rate regime has a serious trade off with macro-economic shocks especially external trade shocks. This is so because Nigeria a mono economy is very susceptible to external trade stock. Hence if a fixed exchange rate was adopted, say for this period of COVID 19 when Nigeria experienced trade shock the country would have experienced deep recession and early enough. This would have come from the activity of the monetary authorities in their attempt to defend the fixed rate by buying domestic currency the naira. This would have caused contraction of the supply of the naira. This would have meant a reinforcement of the initial contraction of the demand for the domestic product, with the final result of adding to the recession.

When an economy is well diversified in its production structure the source of supply foreign currency is also diverse and hence the more efficient the market system. This calls for less government intervention and fixed exchange rate regime. In the case of geographical concentration of trade, Nigeria, like many other developing countries have special case. Nigeria with her mono economy depends so much on oil export with the American dollar as the unit of account. So by implication the naira should be pegged to the dollar. The realization and the solution to this problem was sort in the currency swap with china. The requirement for labour mobility is more relevant in the question of optimum currency area. When we consider the fact that there are many instances when inflation in Nigeria is at high level of divergence from that of her trading partners and this requires a flexible exchange rate regime. Also of importance is the issue of the level of economic and financial development of the economy. The higher the levels of development, the more the market system are efficient which supports the classical view of the economy. Nigeria has not done well here to recommend flexible exchange rate regime. From the above analysis one can justify the frequent change in the Nigerian exchange rate regime as can be seen in what happened from 1972 to 1978, 1985 to 1988, 1994 to 1999 and 2009 to 2013. These are evidences of a country that has alternated affluence with poverty – inability to save for the rainy day, as it affected the exchange rate regime. One last point outside our reference point of analysis is the issue of corruption in Nigeria. This again can make fixed exchange rate regime unsuccessful. Even as managed float is the practice it is still subject to corrupt practice especially for a case of round tripping. In the absence of corruption, it is also important to note that policy makers

are not God so they are not error free. Hence failures of any regime could have risen from exogenous factors such as COVID-19 pandemic.

### **Summary and Conclusion**

This study looked into the appropriateness of the Nigerian exchange rate regimes. The study employed the use of characteristics of the economy based choice of an exchange rate regime. It was discovered that in the main, most of the requirements matched with Nigerian characteristics favored flexible exchange rate regime. But because the country is not fully ready for a free float the practices of managed float in operation currently is adequate. The cry for the seeming failure of the current regime can be seen from the frequent government intervention because of the instability in the rate may be attributable to the following corruption that involves round tripping improper timing of the intervention and exogenous such as external shocks.

The system can do better if systems are put in place to avoid round tripping also a system of saving for the rainy day should be adopted to help support the resilience of the foreign exchange market and hence the exchange rate regime.

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