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The impact of monetary policy on exchange rate dynamics in Nigeria: ARDL Bound Testing Approach

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ABSTRACT

Using monthly data from 2012 to 2025, this study examines the impact of monetary policy on Nigerian exchange rate dynamics and international trade. The Autoregressive Distributed Lag (ARDL) Bound Testing Approach is used in the study to determine long-run relationships, while Vector Autoregression (VAR) tools, such as impulse response and variance decomposition, are used for dynamic analysis. The findings show that monetary policy rates and inflation have statistically insignificant effects on exchange rate movements, whereas the All Share Index (LASI) has a significant impact on exchange rate dynamics. The ARDL bounds test reveals no long-run co-integration among the variables, implying that monetary policy has limited ability to stabilize the exchange rate. The findings imply that financial market performance and structural factors have a greater influence on exchange rate behavior and international trade outcomes. According to the study, Nigeria's monetary policy framework should be strengthened by strong financial market development, policy consistency, and economic diversification in order to improve its effectiveness in managing exchange rate volatility.

ARTICLE INFO

Keywords:
Monetary Policy, Exchange Rate Dynamics, ARDL, International Trade, Nigeria.

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1. INTRODUCTION

Monetary policy in Nigeria is anchored on monetary targeting framework, and price stability which represents the overall objective of monetary policy. This is a clear departure from the past where the major objective of the monetary policy is purely rapid economic growth and employment. The special attention on price stability derives from new developments in monetary theories and empirical evidences which show that sustainable growth can only be achieved when there is stability in the price level (Nnanna, 2002). Therefore, the centrality of exchange rate in the formulation of monetary policy derives from the fact that for most countries, the prevailing objective of monetary policy is price stability. Volatility in exchange rate is always seen to be counter-productive to the goals of price stability. There is indeed, a general consensus that domestic price volatility undermines the value of money as a store of value, and frustrates investments and growth. There is a widespread presumption that volatility on the exchange rates of developing countries is one of the main sources of economic instability around the world. The impact of the global economy on emerging countries like Nigeria is driven significantly by swings among the currencies of the major economic powers like United State. In recent years these swings have been enormous, volatile and frequently unrelated to underlying economic fundamentals. This has prompted monetary authorities in developing countries that keep close ties with the economic powers to intervene on totally ad hoc and episodic basis, without any clear sense of a sustainable equilibrium. Such exchange rate stability intervention typically comes too late to prevent severe currency misalignment and volatility. These imbalances, in turn, trigger major economic distortions, protectionist trade pressures, and inevitably sharp currency reversals (Philippe et al., 2006). Though, currency instability and volatility could only exist during flexible exchange rate regime. In Nigeria, maintaining a realistic exchange rate for the naira is very crucial, given the structure of the economy, and the need to minimize distortions in production and consumption, increase the inflow of non-oil export receipts and attract foreign direct investment. Moreover, the persisting problems of import dependency, capital flight, and lack of motivation for backward linkages in the production process need to be addressed, amongst others. Exchange rate and monetary policy are therefore key tools in economic management and in the stabilization and adjustment policies in developing countries like Nigeria. In most developing countries, low inflation and international competitiveness have become major policy targets. The real exchange rate is a measure of international competitiveness, while inflation mostly emanates from monetary expansion, currency devaluations and other structural factors. Despite the importance of monetary and exchange rate policies in economic management, a few studies have been done on Nigeria to assess the relationship between them (Khan et al., 2020; Wasiu & Muibi, 2014)

2. LITERATURE REVIEW

Beldjebel et al. (2024) examine the relationship between money supply and the exchange rate of the Algerian dinar over the period 1990-2023. The study employs a Structural Vector Autoregressive (VAR) model, utilizing time series data on money supply and exchange rates. The findings reveal a significant but limited interaction between money supply and exchange rates. Money supply impacts exchange rates primarily in the short term, with inflationary effects causing initial depreciation of the dinar. The results also highlight the self-driven nature of each variable, with limited cross-variable influence. The study recommended that coordinated monetary policies aimed at stabilizing exchange rates and mitigating volatility. Policymakers should consider both short- and long-term dynamics when adjusting monetary tools, particularly in resource-dependent economies. Ugochukwu et al. (2025) revalidate the nexus between monetary policies and export sector performance in Nigeria from 2014 to 2023. The study employee the Error Correction Model (ECM). The findings reveal that historical export levels are the primary predictor of current export behavior, while exchange rates positively influence export sector performance. Martinez-Zarzoso and Johannsen (2017), using firm-level data, examined the impact of monetary uncertainty and political instability on the extensive and intensive margins of trade (exports and imports) in Eastern Europe and Central Asia. Their study revealed that exchange rate volatility negatively affects both the likelihood of firms exporting and the intensity of their exports.

Elechi, Kasie and Chijindu (2016) examine the contribution of the Nigerian banks to the promotion of non-oil exports 1990-2013, results of co-integration and granger causality test, demonstrate that even though there is existence of long-run relationship, banks credit failed to promote non-oil export. Danmola and Olateju (2013) adopt error correction model and OLS to examine the influence of monetary policy on the components of current account from 1970 to 2010 in Nigeria, findings revealed that money supply has positive influences on import, export and industrial output while the exchange rate influences import, export and industrial output negatively. Ikkatai et al. (2024). Examines the response of the nominal exchange rate (U.S.

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dollar-yen exchange rates) to the monetary policy changes, focusing on the effects of various unconventional monetary policy measures implemented by the Bank of Japan over the past 25 years. The study used functional projection method. The results show that the yen depreciated against the U.S. dollar in many cases in response to Japan's expansionary monetary policy shocks, and that non-interest rate differential channel – e.g., the shifts in future exchange rate expectations – accounts for the larger parts of such responses than conventional interest rate differential channel. The findings suggest that the responses of the exchange rate to unconventional monetary policies have been state-dependent in the sense that they could vary significantly depending on global financial market conditions and investors' herding behavior at each point in time. Nakamura et al. (2021) analyses the impact of monetary policy shocks identified from changes in Euroyen futures rates up to one year ahead over the 30-minute window around the monetary policy announcements, and show that unconventional monetary policies, as well as conventional monetary policies, have a significant impact on the exchange rate. Banerjee S. et al. (2021), examine the effect of US monetary policy on EMEs is one of the fiercely debated issues in international finance. Using time series data from 2004-2019. Using a dynamic panel estimation model of non-financial firms, using a sign identified VAR model. The result shows that contractionary US monetary policy leads to a significant downturn in the domestic credit and business cycles (Akram et al., 2023). The responses of firms and the impact on the domestic credit cycle suggest that the financial channel of the exchange rate is one of the conduits transmitting US monetary policy to India. Jonathan Kearns & Phil Manners (2006) investigated the impact of monetary policy on the exchange rate using an event study with intraday data for four countries. The result show that the impact depends on how the surprise affects expectations of future monetary policy. Overall, the evidence from the existing body of literature appears to indicate a scarcity of studies that investigated the impact of monetary policy on exchange rate dynamics and international trade in Nigeria and other developing countries. Furthermore, no empirical study has yet been published to examine the relationship using new data from the most recent economic recession and the country's removal of oil subsidies, as well as the implementation of a flexible exchange rate that gripped Nigeria between 2023 and 2024.

3. METHODOLOGY

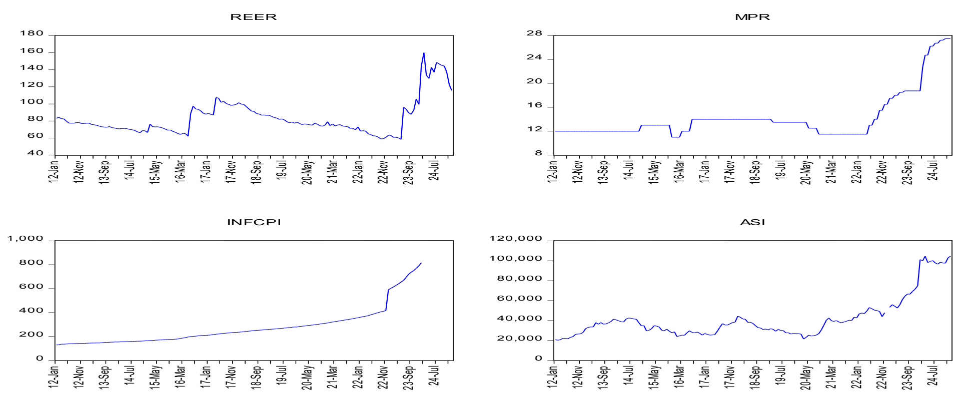
This study uses monthly time-series data from January 2012 to January 2025 to investigate the relationship between monetary policy on exchange rate dynamics and international trade. The study's data sources include the Central Bank of Nigeria (CBN) statistical bulletin, the National Bureau of Statistics, and the World Bank. The study employs the ARDL bound testing approach to determine the presence of long-run relationships between variables with varying order of integration. However, an important requirement for applying ARDL is that the series not be I (2). Rather, the combination of I(0) and I(1) should support the use of the ARDL Bound testing method. As a result, Dickey fuller GLS and NG-Peron tests were used to determine whether the series are I(0) or I(1). If the hypothesis of no cointegration is rejected, we use the restricted ECM model to calculate the short-run dynamic effect and long-run equilibrium relationship between the variables. However, if the hypothesis of no co-integration is accepted, then unrestricted VAR should be applied.

3.1 Model specification

The function relationship among the variables is:
REER =f (INFR, MPR, ASI)................................. (1)
After converting all share index variable into logarithm form, the model is modified as follows:
REER =f (INFR, MPR, LASI)...................... (2)
Thus, the ARDL regression model is specified as:
$REER_t = \alpha_0 + \alpha_1 INFR_{t-1} + \alpha_2 MPR_{t-1} + \alpha_3 LASI_{t-1} + \varepsilon t$............ (3)
Where α_0 is the constant term, and αi (i=1 to 3) are the parameters of the model. It is the random error term which has to be serially independent.

4. DISCUSSIONS OF RESULTS

Figure 1 below shows a graphical representation of the variables (Real exchange rate, monetary policy rate, inflation rate, and all share index) from January 2012 to January 2025.



The figures above show a steady trend in the real exchange rate, monetary policy rate, inflation rate and all share index with fluctuations from 2012-2024. REER was exponentially and subsequently declined from 2012 to 2025, then rise very slowly in 2017. All the remaining variables were trending upward, but slowly from 2012 to 2020, before rising further and seemed to reach the peak point in 2025.

Table 1: Descriptive Statistics

	REER	MPR	INFR	LASI
Mean	78.955	13.290	274.341	36476.53
Median	76.170	13.000	234.625	34600.10
Maximum	144.500	18.750	815.930	101154.5
Minimum	58.510	11.000	129.110	20123.51
Std. Dev.	12.860	1.930	154.872	12239.24
Skewness	1.265	1.563	1.880	1.826
Kurtosis	6.443	5.022	6.149	8.344
Jarque-Bera	109.556	83.168	144.264	251.326
Probability	0.000	0.000	0.000	0.000
Sum	11369.51	1913.750	39505.12	5252620.
Sum Sq. Dev.	23648.51	532.583	3429912.	2.14E+10
Observations	144	144	144	144

Source: Authors Computation Using Eviews Version 10 (2025)

According to Table 1, ASI have higher mean, maximum, and minimum values than the other variables, as does the standard deviation why because ASI measures in millions. INFR and REER rank second and third, respectively. However, the positive skewness of all variables implies that the distribution has a long right tail, indicates that the distribution is right-skewed. A long right tail is visible as a result of the rightward skew in the distributions of the variables. Furthermore, all variables have kurtosis greater than three, indicating that their distributions are more peaked than the normal distribution. The Jarque-Bera test results show that all of the series, are not normally distributed, implying that they are significant at the 1% probability level, rejecting the null hypothesis for the distribution of REER, MPR, INFR and ASI. Hence, the variables cannot be described as normally distributed.

4.1 Unit Root Tests

The results of both DF-GLS method of Elliott, Rothenberg and Stock (1996) and the Ng-Perron (1995) unit root tests are presented in Table 2 below.

Table 2: Result of Unit root test

	Dickey fuller GLS (DF-GLS)		Ng-Perron	
	Intercept &Trend		Intercept & Trend	
	Level I (0)	1st diff I(1)	Level I(0)	1st diff I(1)
LASI	--------------	-6.440***	--------------	-70.163***
EXCR	--------------	-11.281***	-46.795***	----------------
INFR	--------------	-11.075***	--------------	-71.135***
MPR	--------------	-6.917***	--------------	-54.926***

*Note: ***,** Denoted the series is stationary at, 1% & 5% probability levels.*
Source: Authors Computation Using Eviews Version 10 (2025)

According to table 2, all variables are stationary at first difference under Dickey fuller GLS. However Ng-Perron has also demonstrated that exchange rate are stationary at level while the remaining variables turn out to be stationary at first difference, both with trend and intercept. Thus, we have a combination of variables (LASI, INFR, and MPR) that are I (1) and another variable (EXCR) that is I (0). This allows the use of ARDL model to ascertain the co integration relation among the series found to have a different order of integration. The optimal lag length are selected based on six criteria namely; LL, LR, FPE, AIC, SIC and HQ. Therefore, we first of all estimate the unrestricted VAR model, and use the result to identify the lag (of each of the variable) to include in estimating the ARDL model. From the result one lag values for all the variables is the identified as the optimal lag. However, one fixed lag dependent variable and two lags regressors are used to arrive at the estimated ARDL model devoid of the problem of multicollinearity

Table 3: ARDL Regression

Variables	Coefficient	T- statistics	Prob.*
REER(-1)	0.829	17.211	0.000***
MPR	1.003	0.834	0.406
MPR(-1)	0.668	0.403	0.688
MPR(-2)	-0.074	-0.058	0.954
INFR	-0.340	-1.071	0.286
INFR(-1)	0.578	1.095	0.278
INFR(-2)	-0.246	-0.752	0.454
LASI	0.001	6.885	0.000***
LASI(-1)	-0.007	-2.749	0.006*
LASI(-2)	-0.004	-1.790	0.076*
C	-4.806	-0.910	0.364
@TREND	0.006	0.180	0.857
R-squared	0.860	F sta= 71.912 (0.000) DW = 2.117	
Adjusted R-squared	0.848		

Dependent Variable: REER
*Note: *, **, *** indicate significant at 10%, 5% and 1% level respectively*
Source: Authors Computation Using Eviews Version 10 (2025)

The above result can be writing as: REER = -4.80 + 0.829 REER (-1) 1.003 MPR +0.668 MPR (-1) -0.04 MPR (-2) -0.340 INFR + 0.578 INFR (-1) - 0.246 INF (-2) + 0.001 LASI - 0.007 LASI (-1) -0.004 LASI (-2).................. (4)

According to the probability values, all variables are statistically insignificant with the exception of LASI, which is significant at 1% probability level. The estimated coefficients of MPR shows insignificant positive relationship with REER. Furthermore INFR shows insignificant negative relationship with REER, but LASI shows significant positive relationship with REER at 1% probability level. The ARDL regression result further shows high R^2 value (0.86) and adjusted R^2 value (0.84), suggesting that the model is a good fit, because 86% of the observed variation in the REER is accounted by both the positive and negative changes of the explanatory variables, namely; LASI, INFR, and MPR.

Table 4: ARDL Bound test result

Test statistics	Value	K	Significance	I (0) Lower Bound	I (1) Upper Bound
F- statistics	3.16	3	10%	3.47	4.45
			5%	4.01	5.07
			1%	5.17	6.36

Source: Authors Computation Using Eviews Version 10 (2025)

If the computed F statistic is less than the lower bounds, we can conclude that the variables are I(0), which means that no co-integration is possible. If the F statistics exceed the upper bounds, we can conclude that there is co-integration or that the variables are co-integrated I (1). If the F statistics fall within the bounds, the test is inconclusive. Because the F statistics value (3.16) is less than the lower bound even at a 10% level, all of our variables I (0) and I (1) are not co integrated. As a result, given that ARDL bound testing revealed that there is no long-run relationship between the variables of interest, the VAR model is the most appropriate. As a result, we proceed with the VAR model, which is explained using the VAR tools (Impulse response and variance decomposition).

The impulse response function in the first raw showed the response of real REER to a one-standard deviation (S.D) in any of the innovations (Inflation rate, Monetary policy rate, and All share index in logarithm form). A one-standard deviation shock to REER has a positive effect on itself, with an unsteady decline from the first to the last period of the forecast horizon. REER's response to one standard deviation shock of MPP has shown a steady increase in the second periods, while third and fourth tend to be normal, however from the fifth to the last period, LRGDP does not respond well to MPR

4.2 Impulse response function (IRF) graphs

The issue of non-exogeneity in some of the variables has been addressed using IRFs, which capture the variables' endogeneity. IRFs show the response of a particular variable to one standard deviation shock on each of the variables in the system.

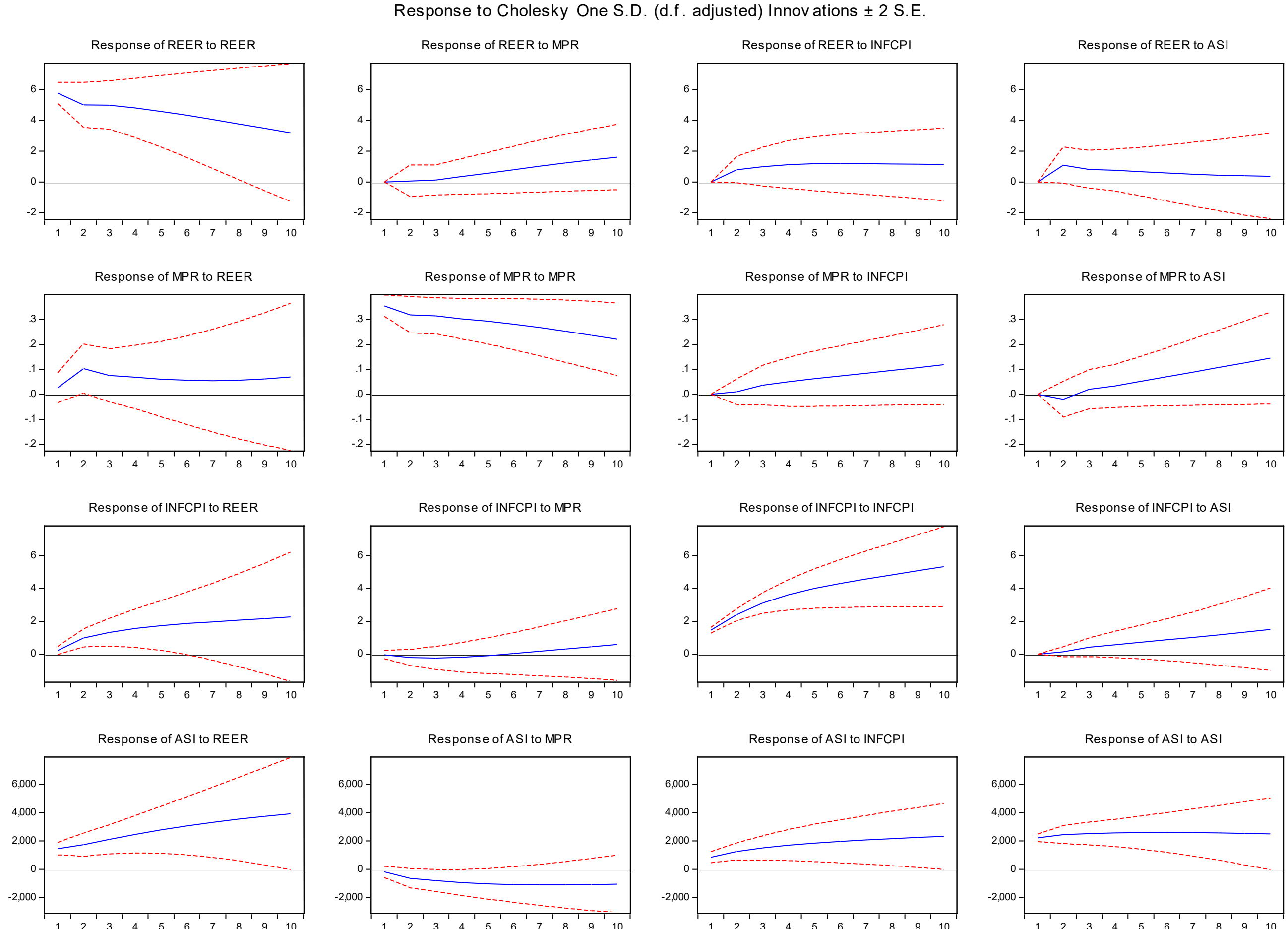


Table 5: Variance Decomposition

Variance decomposition of REER of period				
Period	REER	MPR	INFR	LASI
2	96.95903	0.008280	1.070059	1.962634
3	95.96162	0.023596	1.879077	2.135704
4	95.08947	0.130105	2.597453	2.182975
5	94.33210	0.349509	3.184443	2.133948
6	93.55585	0.713382	3.671046	2.059726
7	92.70882	1.234835	4.077492	1.978849
8	91.75383	1.919329	4.424200	1.902642
9	90.67436	2.762364	4.727286	1.835990
10	89.46759	3.751320	4.999761	1.781330
Variance decomposition of MPR period				
2	4.753486	95.04622	0.043049	0.157241
3	4.948114	94.39825	0.423406	0.230224
4	4.915899	93.75230	0.900328	0.431477
5	4.728985	92.92949	1.476847	0.864673
6	4.540593	91.80892	2.130101	1.520389
7	4.390750	90.32041	2.864396	2.424442
8	4.307021	88.41838	3.686450	3.588149
9	4.308829	86.06948	4.604093	5.017602
10	4.417393	83.25507	5.621802	6.705735
Variance decomposition of INFR period				
2	11.57330	0.421185	87.75009	0.255428
3	13.63186	0.419937	84.98059	0.967606
4	14.52401	0.327388	83.65598	1.492629
5	14.89994	0.226069	82.92493	1.949059
6	15.03811	0.162985	82.42907	2.369832
7	15.04557	0.153155	82.01626	2.785022
8	14.98301	0.196275	81.60869	3.212028
9	14.88713	0.284273	81.16605	3.662548
10	14.78295	0.405553	80.66758	4.143914
Variance decomposition of LASI period				
2	27.15564	2.301373	12.34285	58.20014
3	29.34067	3.323886	14.15776	53.17768
4	31.92521	3.990161	15.30236	48.78227
5	34.42747	4.419526	16.07037	45.08264
6	36.78510	4.674945	16.60675	41.93320
7	38.98230	4.795581	17.00020	39.22191
8	41.02101	4.810933	17.30614	36.86192
9	42.90648	4.744006	17.56043	34.78908
10	44.64458	4.613588	17.78667	32.95516

Source: Authors Computation Using Eviews Version 10 (2025)

The variance decomposition in the first section of table 6 above shows that a change in the all share index in logarithmic form is the most important factor in determining a change in real exchange rate, because it has accounted for about 1.96% variations to real exchange rate in the 2nd period, later moved to 2.13% and 2.18% in the 3rd and 4th periods respectively. In the 5th to 10th period inflation rate was reported to influence real exchange rate by 3.18% to 4.99% respectively. Similarly, the second section of the table shows that log of all share index has significantly contributed to the variation of MPR, increasing from 3.58% in the 8th period to approximately 5.01% in the 9th and 6.70% in the 10th period. However the third section of table shows a variation in INFR has been explained by the change in real exchange rate, which contributed approximately 11.57% to 15.04% between the second and seventh periods, as well as the change in all share index in logarithm form, which contributed significantly to the variations of INFR, ranging from 1.49% to 4.14% between the third and tenth periods. Furthermore, the final section of the table shows that real exchange rate contributed more to the variation of LASI, which ranged from 27.15% in the second year to 44.65% in the last year.

Table 6: Findings from Diagnostic Tests

Test	Test statistics	Prob. value	
Normality (Jarque –Bera Test Statistics)	494.602 (0.000)		Not applicable
Serial Correlation (Breusch - Godfrey LM Test)	1.337	0.266	
Heteroscedasticity (Breusch – pagan – Godfrey)	4.171	0.000	

Source: Authors Computation Using Eviews Version 10 (2025)

The Jarque-Bera test statistic in the table above shows that the series are not normally distributed, as evidenced by the significant p-value (0.000). This results in the rejection of the null hypothesis, which states that the series has normal distribution. Furthermore, the Breusch-Godfrey serial correlations test showed that the LM version is statistically insignificant, thus we can conclude that there is no autocorrelation at 5% level. The Breusch - Pagan - Godfrey test is a Lagrange multiplier that checks the null hypothesis of no heteroscedasticity. The heteroscedasticity test result produced a 1% significant P-value, indicating that it is statistically significant. This implies that we reject the null hypothesis and conclude that the residual variance is non constant (heteroscedasticity).

4.3 Test of stability

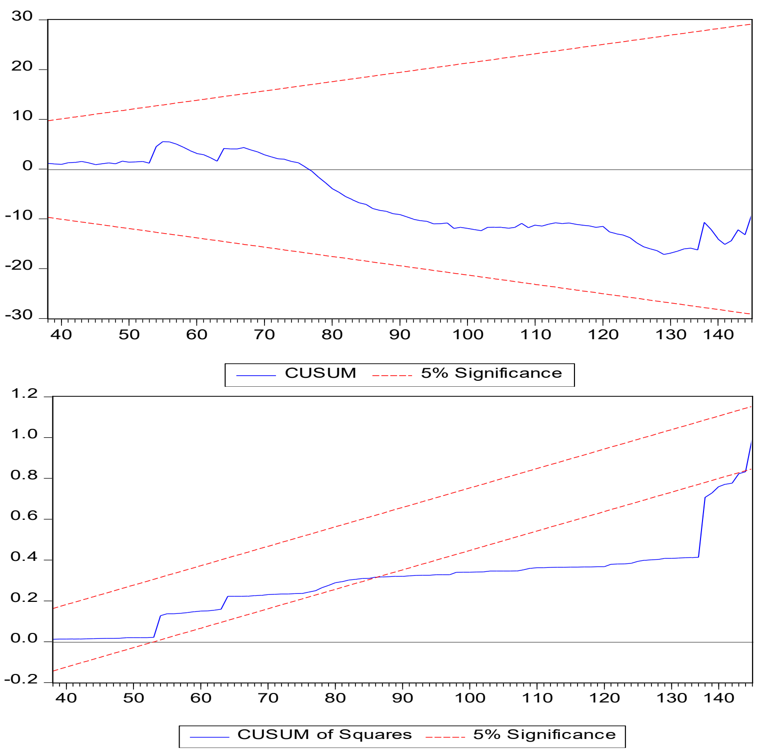


Figure 2: Plot of the CUSUM and CUSUM of squares

Stability tests were carried out using the plots of cumulative sums of squared residuals and cumulative sums of recursive residuals shown in Figure 2 above. The CUSUM test results show that the model is stable, as the lines remain within the 5 percent critical boundaries represented by the blue lines. The CUSUMQ plot shows that the model is unstable during the study period when the red line occasionally crosses the 5 percent critical upper and lower bounds and the instability may be related to periods of global economic crisis, as well as political instability and economic difficulties in the country, such as oil theft, which could influence future exchange rate predictions.

5. DISCUSSION OF FINDINGS

The findings show that monetary policy variables like the Monetary Policy Rate (MPR) and inflation rate (INFR) have an impact on exchange rate dynamics, but they are statistically insignificant in explaining variations in Nigeria's real exchange rate over the study period (2012-2025). In contrast, the All Share Index (LASI) has a statistically significant positive relationship with the Real Effective Exchange Rate (REER), implying that capital market performance and investor confidence are more influential in determining exchange rate behaviour than traditional monetary policy tools. These findings support Elechi, Kasie, and Chijindu (2016), who discovered that the financial sector's activities have a significant impact on Nigerian trade and investment outcomes. Similarly, Beldjebel et al. (2024) discovered that the money supply has a limited short-term impact on exchange rates, supporting the current study's finding that monetary variables have weak long-run explanatory power. Furthermore, Ugochukwu et al. (2025) argued that structural and market-related factors, rather than monetary policy adjustments, drive export performance in Nigeria, which is consistent with the current findings. The findings, however, contradict Danmola and Olateju (2013), who claimed that monetary policy has a significant impact on current account components such as import and export volumes. They also differ from Banerjee and Mohanty (2021), who discovered that contractionary US monetary policy has a strong impact on emerging markets via exchange rate channels. The weaker impact of monetary policy observed in this study could be attributed to Nigeria's import reliance, policy inconsistency, and structural rigidities that limit the effectiveness of inflation targeting and interest rate changes. The impulse response and variance decomposition analyses confirm that capital market and inflation rate shocks have a greater impact on exchange rate behavior than policy rate changes. The CUSUM and CUSUMSQ tests show that the estimated model is mostly stable, though some periods of instability correspond to global and domestic economic disruptions like oil price volatility and policy shifts. Overall, the findings suggest that structural and financial market factors, rather than traditional monetary policy, primarily influence Nigeria's exchange rate dynamics and international trade performance.

6. CONCLUSION AND RECOMMENDATIONS

This study used the ARDL Bound Testing and VAR approaches to investigate how monetary policy affects exchange rate dynamics and international trade in Nigeria from 2012 to 2025. The findings indicate that while the Monetary Policy Rate (MPR) and inflation have an impact on exchange rate movements, their effects are statistically insignificant. In contrast, the All Share Index (LASI), which measures capital market performance, has a significant positive relationship with the real exchange rate, highlighting the importance of financial market activity in determining exchange rate behavior. According to the ARDL bounds test and VAR analysis, monetary policy has no significant long-run impact on Nigerian exchange rate dynamics or international trade. The All Share Index (LASI), which represents capital market activities, has a stronger and more consistent impact on exchange rate fluctuations, highlighting the growing importance of financial markets in macroeconomic stability. The findings indicate that, while monetary policy tools remain important for preserving short-term liquidity and controlling inflation, they are insufficient to ensure exchange rate stability or improve trade competitiveness. To supplement monetary measures, broader structural and institutional reforms are needed. The study concludes that structural rigidities, import dependence, and inconsistent policy implementation make monetary policy ineffective in ensuring exchange rate stability in Nigeria. It advocates greater coordination between monetary and fiscal policies, capital market development, economic diversification, and policy transparency in order to improve monetary management effectiveness and promote stable trade performance.

6.1 Recommendations

- Strengthen Policy Coordination: The Central Bank of Nigeria (CBN) should improve coordination among monetary, fiscal, and trade policies to ensure consistent responses to exchange rate volatility.
- Enhance the Capital Market: Because the All Share Index has a significant impact on exchange rate movements, the government should develop and diversify Nigeria's capital market in order to attract long-term investment and stabilize foreign exchange flows.
- Diversify Economic Base: Reducing reliance on oil exports and promoting non-oil sectors (agriculture, manufacturing, and services) can help to mitigate external shocks that threaten the exchange rate.
- Establish Policy Consistency and Transparency: Investor confidence is eroded by frequent policy changes and inconsistent communication. A predictable policy environment strengthens the credibility and transmission of monetary policy.
- Improve Financial Infrastructure: Payment system improvements, capital market transparency, and the adoption of technology-driven financial products all have the potential to improve the effectiveness of monetary transmission mechanisms.
- Implement a mixed policy framework: Combining inflation targeting with an exchange rate management framework has the potential to help balance internal and external economic stability.

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