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Exchange rate policy for whom? The political economy of exchange rate liberalization in Nigeria

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Abstract. The choice between a liberalized or administratively controlled exchange rate system have been a great dilemma in Nigeria. This study advances the exchange rate politics research by examining the political economy factors influencing the decision to liberalize Nigeria's foreign exchange market. Using the Probit regression model and data for the period 1987 to 2019, the study finds that liberalization of Nigeria's foreign exchange market is affected by politically influential economic sectors and urban consumers, especially the elite who benefit from the dirigiste exchange rate policy. The results are also consistent with the popular argument that Nigeria's heavy dependence on importation which translate to persistent trade deficit makes the adoption of a liberalized market-determined exchange rate rather unfeasible. However, the limited flexibility in foreign exchange transactions has the unintended consequences of delivering little benefits to the economy due to the distortions created in the form of rent-seeking and corruption. The findings have implication for the need to pursue a pragmatic exchange rate policy by Nigerian authorities; and for international policy advisors to consider the policymakers' domestic constraints and degree to which policies can be politically implemented in developing countries like Nigeria.
Keywords. Exchange rate policy; Foreign exchange liberalization; Political economy; Nigeria.
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1. Introduction

Exchange rate policy is a major subject of macroeconomic policy discourse in Nigeria since the implementation of Structural Adjustment programme (SAP) in 1986. Policymakers have been experimenting different strategies of managing the naira (Nigerian currency) exchange rate. The initial exchange rate management strategy in 1986 was the introduction of a Second-Tier Foreign Exchange Market (SFEM) where the exchange rate is determined by market forces (authorized dealers-banks) through foreign currency auction by the Central Bank of Nigeria (CBN). On the other hand, there is a fixed official rate which the government controls and allocate to selected sectors and activities. This system still prevails, though it has evolved through different methods of administrative control and intervention in the foreign exchange market.

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Whether to continue controlling the naira exchange rate, often at overvalued level, or allow the currency's value to reflect market forces is a heavily debated subject in Nigeria given the dilemma it present. The proponents of control argue that abolishing the official exchange rate and other administrative restrictions would be disastrous, due to the country's foreign trade structure that is dominated by crude oil exports.[1] On the other hand, the advocates of liberalization view the official exchange rate as a 'currency subsidy' that benefits only those with privileged access, and should thus, be abolished. The legendary champions of this liberalization perspective are the international financial institutions (the World Bank and International Monetary Fund). Other private sector participants in Nigeria also align with this view.

Nigeria's problematic exchange rate policies have often been analyzed from the 'monocultural economy' perspective, that the country mainly produces and exports a few primary commodities but imports most industrial and other consumer goods. From the choice of exchange rate regime to the rationale for maintaining multiple and overvalued exchange rates, explanations by policymakers and other stakeholders have mostly leaned towards the argument of preventing inflation due to excess demand for foreign currency relative to supply. The notion here is that a market-driven exchange rate will cause hyperinflation because demand for foreign currency is considerably larger than the limited supply coming mainly through exports of energy products.

However, this argument is incomplete according to an opposite view (Pinto, 1987; 2016; Gray, 2021). Exchange rate adjustment entailing floating the naira to merge the official and parallel market exchange rates would undoubtedly cause a significant depreciation of the currency, but this would not trigger inflationary bout because the increased prices attributed to exchange rate are largely driven by the parallel rate (Pinto, 1987; 2016; Gray, 2021). In other words, the inflation that CBN may be trying to control has already occurred through the parallel market exchange rate (Pinto, 2016). This perspective may be plausible because the parallel market is the only option for most foreign currency demand as a result of the difficulty of accessing the official rate. In effect, the exchange rate management strategies designed to prevent a sharp depreciation of the naira and to stimulate the growth of priority sectors through foreign currency allocation at the (subsidized) official rate have achieved little success. Some have argued that the exchange rate policies "have been at best dysfunctional, and at worst reinforced the mechanisms to support the extraction of rents by the politically powerful with access to the attractive official exchange rate" (Roy *et al.*, 2022, p.22). The recommendation to resolve this problem by the International financial institutions and other stakeholders in Nigeria is to allow a market-determined exchange rates under a managed floating regime where the CBN can intervene to stabilize the currency when there is large volatility. It is unclear whether the policymakers are reluctant to implement this policy largely because it is not politically feasible even though it seems economically appropriate.

Although, there is growing scholarly interest in understanding the political dimension of exchange rate policy, particularly in new democratic states and transition economies, it is an area of research that is still not sufficiently explored in Nigeria despite the intense debate on the appropriate policy for determination and management of the exchange rate. There is need to fill this

literature gap through empirical analysis of the political economy context within which the decisions concerning Nigeria's exchange rate policies are implemented. This analysis is important because policymakers often respond to the needs of their (priority) constituents, especially in a democratic country like Nigeria. These constituents could be urban consumers, rural inhabitants, powerful elites or influential business and social groups. Therefore, the study examines the political economy determinants of foreign exchange liberalization in Nigeria. It aims to address two questions: What are the factors influencing the choice of Nigeria's monetary authority to liberalize the foreign exchange market or otherwise? Whose interest does the exchange rate policy seek to protect? To the best of our knowledge, there is no research based on Nigeria that employs the empirical approach of this study, especially using the probit regression model and data for some of the key variables, such as, exchange rate regime classification.

The remainder of the paper is organized as follows: The next section briefly discusses the conduct of Nigeria's exchange rate policy since SAP. Section 3 analyzed the literature of the political economy of exchange rate policy choice. In section 4, the data and methodology used in the study were discussed. Section 5 present the results and discussion. Section 6 concludes.

2. The conduct of exchange rate policy after (SAP)

Exchange rate reform was one of the integral components of the International Monetary Fund's Structural Adjustment Programme (SAP) in 1986. As a result, Nigeria's exchange rate regime shifted from fixed to flexible exchange rate system. Since then, the naira have been volatile, and continuously losing its value relative to the US dollar and other foreign currencies.

The succession of exchange rate policies by the CBN since 1986 have focused, almost exclusively, on prescribing the methodology for the Bank's intervention in the foreign exchange market to determine a 'realistic exchange rate for the naira'. The official exchange rate, and the second-tier foreign exchange market introduced during SAP, were merged to form a single market (Amaghionyeodiwe & Osinubi, 2005; Research & Statistics Department, CBN, 2007). Thereafter, the bureau de change market was introduced in 1988 to facilitate supply of the foreign currency to small scale users (Research & Statistics Department, CBN, 2007). The CBN devised further method of direct sale of foreign currency to end users through the introduction of the Autonomous Foreign Exchange Market (AFEM) in 1995; but it was later replaced with the Inter-bank Foreign Exchange Market (IFEM) in 1999. The IFEM also gave way to the Dutch Auction System (DAS) in 2002. The DAS was attested to have assisted in minimizing arbitrage opportunities as well as maintaining relative stability of the naira against the US dollar (Sanusi, 2004; Sanni, 2006; Research & Statistics Department, CBN, 2007). However, the DAS also had some pitfalls, which includes capital flights, speculation, and rent seeking behavior (Akanji, 2006).

To further liberalize and improve the framework for exchange rate determination at the foreign exchange market, the procedures of the DAS (which is essentially in form of retail transaction, that is, RDAS) was modified with the introduction of the Wholesale Dutch Auction System (WDAS) in 2006 (Sanni, 2006; Research & Statistics Department, CBN, 2007; Aliyu, 2012).

In 2013 the CBN suspended the WDAS and reverted to the RDAS again, with new guidelines for conducting auctions at the foreign exchange market (Trade & Exchange Department, CBN, 2013). This lasted for about two years before it was also abolished. In 2015, the CBN announced the closure of RDAS/WDAS windows of foreign exchange supply, and replaced it with the interbank foreign exchange market. The basis for this action according to the Bank was due to the "widening margin between the exchange rate in the interbank and the RDAS window" (Central Bank of Nigeria, 2015, para.2) which open the gates of malpractices (rent seeking) that put unbearable pressure on the country's foreign reserves coupled with falling oil prices and slow economic performance.

A combination of domestic challenges and external shocks plunged the Nigerian economy in to recession in 2016. As a result, the exchange rate policy becomes unsustainable and the CBN adopted a new strategy to stabilize the naira exchange rate with the introduction of an interbank system that is based on two segments- interbank and autonomous segments respectively (Tule, 2018). This was followed with further changes aimed at increasing the availability of foreign currency in the foreign exchange market, such as the introduction of the Investors and Exporters (I&E) foreign exchange window.[2] The I&E window was established in 2017 as a special medium to boost foreign currency liquidity so as to accommodate foreign exchange obligations for eligible transactions (Central Bank of Nigeria, 2017). The benchmarking of the currency in this window is determined by a system known as the Nigerian Autonomous Foreign Exchange Fixing (NAFEX) developed and operated by FMDQ Securities Exchange Limited (FMDQ, 2020). All the exchange rate adjustments discussed above were in relation to the officially administered multiple channels of foreign exchange supply at different rates.

In what seems to be a decisive action towards unification of the multiple naira exchange rates, in May 2021, the CBN abandoned the fixed official exchange rate and adopted the NAFEX rate used in the I & E window. Therefore, the naira exchange rates were reduced to two, from the three or more rates operated prior to this period.[3] However, "The NAFEX rate, which is now the guiding exchange rate for the economy, continues to be managed and is not fully reflective of market conditions. The parallel market premium over the NAFEX rate reached 29 percent in August 2021 after the CBN cut off its weekly supply of US$20,000 per bureau de change (BDC). The CBN has intermittently supplied forex to BDCs since 2005, providing ample opportunities for currency round-tripping" (The World Bank, 2021, p.24).

2.1. Foreign Exchange Restriction, Liberalization, and Fear of Policy Transition

Nigeria's foreign exchange market has evolved through episodes of de jure liberalization and administrative control since 1986 as noted above. The exchange rate policies were all geared towards developing a mechanism of intervention by the CBN to control supply and manage the demand for foreign currency-mainly the US dollar. After all the intermittent changes of exchange rate policies within the last three decades, "the exchange rate policy in 2022 remains focused on maintaining the IEFX [Investors and Exporters] rate and the official exchange rate artificially stable through foreign exchange restrictions and administrative measures" (The World Bank, 2022, p.4). While the demand for forex by individuals and businesses continue to build up in the

wake of declining inflows, the June, 2022 World Bank report also noted that forex supply for importation of about 45 products (including some raw materials) is still restricted by the CBN, thus, resulting in widespread outcry by affected firms (p.4).

What constitute exchange rate restriction in Nigeria?

Nigeria maintains three dimensions of exchange restrictions and a complex multiple exchange rate system. The 2021 IMF country report on Nigeria outlined the restrictions which include; first, the prohibition to access foreign exchange at the official channels for the importation of more than 40 items. Secondly, the available foreign exchange is being rationed according to what the CBN determines as priority categories of transactions. Thirdly, there are limits on the maximum amounts of foreign exchange available for business and personal travel allowances (IMF, 2021). On the other hand, the multiple exchange rate system has three features. (1) There is an official exchange rate for government and other transactions established by the CBN which differ by more than 2 percent from the rate used by commercial banks in other CBN forex windows and by money transfer operators. (2) A large spread exists between exchange rates used by the CBN in its forex windows and the rates in the parallel market due to CBN's limitation on the availability of foreign exchange to meet various demands as noted above. (3) The potential spread of more than 2 percent in the exchange rates at which the CBN sells foreign exchange to successful auction bidders in the secondary market intervention sales window (IMF, 2021, p.76).

What does liberalization imply?

Exchange rate liberalization entails loosening the monetary authority's grip on the foreign exchange market. Accordingly, it should abandon the interventionist regime characterized by multiple windows with opaque forex allocation mechanism, and shift towards a unified market-clearing rate which eliminates the multiple exchange rates (IMF, 2021). It is important to note that a market-clearing rate does not necessarily imply a free-floating exchange rate, and may not cause free fall of the currency's value as the experiences of some countries have shown in the last decade (Gray, 2021). Thus, pursuing the market-driven exchange rate policy has at least two advantages. First, "an appropriately valued exchange rate would foster domestic industrialization more effectively than through a system of forex rationing where winners are chosen and protected, and relative prices do not move. Second, a clear exchange rate policy would also help attract larger capital inflows, including foreign direct investments, which have significantly dropped in recent years" (p.16).

As noted earlier, CBN's adoption of the NAFEX rate indicates a remarkable step in the liberalization process to unify the multiple exchange rates. However, different windows still exist, and the parallel market premium rose to about 39 percent over the official IEFX rate in March 2022 (The World Bank, 2022, pp. 18–19). The CBN continues to supply forex to least four windows, at different rates. These windows include; the Investors & Exporters, secondary market intervention sales retail, small and medium-size enterprises; and the window for invisibles (p.19).

Fear of transition: Political obstacles to pragmatic exchange policy shift

The structure of incentives and constraints of economic policymakers vary by political systems, structural features of the domestic economy, and the

condition of the global political economy. Additionally, political contestations over policies tends to be more prevalent in a relatively democratic system than in autocracies. This means political pressures from powerful groups and individuals may constitute a fundamental obstacle to policy reform such as a market driven flexible exchange rate system. Gray (2021) highlighted some of the reasons why monetary authorities (central banks and finance ministries) may be reluctant to pursue a market-based exchange rate policy. The principal concerns have to do with uncertainties about the transition process and its impacts on other crucial variables such as the national budget. The budgetary impact would partly be determined by government's foreign currency demand for debt servicing and subsidies on imported fuel and food. This seeming fear of policy transition may be rooted more in political considerations than the economic risk concerns expressed by the authorities.

3. Political economy of exchange rate policy choice

Scholarly research on the political economy of exchange rates explores how interest groups, political institutions, electioneering periods and globalization affect exchange rate policy (Bodea, 2010; Frieden *et al.,* 2010; Berdiev *et al.,* 2012; Frieden, 2015; Suggett, 2016). In addition, the selection of an exchange rate regime is also associated with a country's political structure (Edwards, 1999; Leblang, 1999; Klein & Shambaugh, 2010; Rose, 2011). The constraints and incentives of policymakers in economic policymaking has generally changed in most countries due to increased democratization. Implementing important policies such as the exchange rate depends not only on economic efficiency but on political feasibility as well.

Generally speaking, the appropriate exchange rate policy for a country is contingent on economic structure, institutions, and the prevailing economic and political conditions at different periods (Barth, 1992). However, developing countries share some common characteristics that essentially determine their exchange rate policies. First, the composition of exports is dominated by primary commodities (such as natural resources and agricultural crops). Secondly, they are characterized by low production of import-competing products and rely to a great extent on the importation of intermediate and capital goods. Thirdly, they tend to have underdeveloped financial markets, and foreign direct investment is of paramount importance for capital inflows (Barth, 1992, p.35).

Exchange rate policymakers must determine both the value (price) and stability (regime) of the currency (Walter, 2014; Frieden, 2015). The level of the exchange rate indicates the rate at which a domestic currency is exchanged for a foreign currency. This is called the nominal exchange rate. It is however, more meaningful from analytical perspective, to consider the real exchange rate, which adjusts for inflation by measuring the relative prices of a similar basket of goods in domestic and foreign currencies (Frieden, 2015; Steinberg, 2016). The exchange rate regime, broadly, implies the choice among a fixed, floating, or intermediate arrangements (Walter, 2014; Broz *et al.,* 2008; Yagci, 2001). Fixing or floating a currency's exchange rate is indeed a crucial policy decision, especially in developing countries. Since the exchange rate is "recognized as a decisive link between the internal economy of a country and the international economy" (Williamson, 2009, p.124), exchange rate policy may be the single most important economic policy of a government because

it is the most important price in an economy (Yagci, 2001; Frieden, 2015). This makes it a contentious policy issue given the multifaceted outcomes it produces, ranging from distributional concerns to the pursuit of economic growth and stability objectives, or even the popularity of a government.

The large volume of literature on exchange rate policy mostly focused on the economic explanation for the rationale and choice of the policy. However, there is a growing scholarly interest in understanding the political dimension of exchange rate policy, particularly in new democratic states and transition economies. The exchange rate policy is therefore economically and politically important due to the distributional consequences of a devalued or an overvalued currency on different groups (Leblang 1999; Walter, 2008; Quinn & Weymouth, 2017). It is important to understand the enormity of pressures faced by policymakers from their constituents in order to appreciate the motives for certain policy decisions (Frieden, 2015).

Political economy approaches to exchange rate policy have evolved since the work of Frieden (1991). Studies in this area of research have enriched our understanding of the political dimension of exchange rate policies. The main crux of such political economy analysis is to examine the demand side determinants of exchange rate policy, focusing, in part, on how the pressure from interest groups and other constituents influences the direction of policies. The nature and formation of preferences of these groups and the political implications of policies present both constraints and incentives for the policymaker in deciding among alternative policy options.

3.1 Factors influencing exchange rate policymaking

Exchange rate policymaking is generally influenced by the preferences of powerful interest groups, the ideas/ideology of policymakers, and the international monetary structure. The literature (Kettell, 2004; Frieden, 2008; 2015; Walter, 2014) described at least four different interest groups whose exchange rate policy preferences vary by the nature of their businesses and degree of exposure to foreign competition. The first group is those who are likely to prefer a fixed exchange rate because their activities are global-market oriented and thus, have a greater risk of exposure to currency volatility and international competition. Secondly, those groups whose businesses are primarily domestic tend to favor a floating exchange rate because monetary authorities will have the freedom to make necessary policy adjustments when the need arises. The third group would prefer currency appreciation because they rely on foreign inputs and materials for production. And the fourth group comprises those who are competing in the domestic market with foreign producers; therefore, they would prefer a depreciated currency to make the prices of their products lower than the imported ones. However, some scholars argue that the interest groups models of exchange rate preferences seem to overstate the influence of private interest in exchange rate policy. This is because in some countries policymakers have a high degree of autonomy and insulation from political influence (Helleiner, 2005; Steinberg & Walter, 2013), and can bring their ideas and discretionary choices to bear in implementing policies.

On the other hand, the ideational explanation of exchange rate policy emphasizes the role of ideas and beliefs of policymakers. This implies that ideas of policymakers take precedence over political pressure in selecting an optimal policy that is based on economic objective function, including

economic growth and general macroeconomic stability. However, Steinberg & Walter (2013) observed that ideational theories on the one hand seems to exaggerate the ability of policymakers to choose optimal exchange rate policies while on the other hand, downplay how political pressures condition the choices of decision makers. In addition, the perspectives of individual policymakers may not necessarily be based on the logic of the policy but rather influenced by ideological stance and partisan considerations (Levy Yeyati *et al.,* 2020).

The extent to which economies are integrated with one another is also important in determining the choice of exchange rate regimes. The international monetary system approach of exchange rate looks at the policy coordination and cooperation issues among countries in regional and international monetary relations. Coordination requires consensus among countries with regards to fixing national currencies against a common anchor (gold, dollar, or euro) for instance (Broz & Frieden, 2006) . Cooperation on the other hand implies aligning national policies towards maintaining the commitment to a fixed exchange rate regime. This may sometimes involve adjustment policies to support the regime that are often painful and thus, politically unpopular (p.589). In effect, international monetary coordination and cooperation is contingent on domestic policies which are constrained by both economic and political factors. Further, according to the international system approach of exchange rate policy, cooperation among countries on common monetary principles may be influenced by a powerful international hegemon or interstate negotiation (Steinberg, 2010; Hall, 2020).

As highlighted above, policies that are economically viable may not necessarily be politically feasible. The local conditions of countries vary across time and space which has implication for adopting the type of policies that are supposedly optimal, such as a common regional currency. In regions where local politics is preventing the emergence of a currency union despite meeting the optimum currency area conditions, McKinnon (1999) cited in Yagci, (2001), recommends that the countries cooperate on efficient exchange rate rules to maintain currency stability under a common arrangement, and avoid competitive devaluation.

The preceding discussion have attempted to demonstrate how the interplay of political consideration and economic conditions shape economic policies. The political explanation for the choice of exchange rate does not receive as much attention as the economic dimension of the policy. Unlike in most developed economies, especially the United States, debate on the appropriate exchange rate policy is a key political issue in many other countries (Klein & Shambaugh, 2010). This is especially true in developing countries like Nigeria that have a high degree of exposure to exchange rate fluctuations because of their economic structures and other common features shared with other countries.

The large number of studies on exchange rate in Nigeria largely focused on the effect of exchange rate policies on specific economic sectors such as the agricultural sector (see, for instance, Essien *et al.,* 2011; Ammani, 2012; Oyinbo *et al.,* 2014; Okorie, 2017; Adekunle & Ndukwe, 2018; Mbam *et al.,* 2020; Obiageli, 2020; Ogunjimi, 2020); or the manufacturing sector (David *et al.,* 2010; Uzochukwu & Emmanuel, 2014; Orji *et al.,* 2018; Akeem, 2019; Ezenwakwelu *et al.,* 2019; Kenny, 2019). Other studies attempted to examine the relationship between exchange rate volatility or misalignment and

Nigeria's economic growth (Akpan & Atan, 2011; Ali *et al.*, 2015; Okorontah & Odoemena, 2016; Amassoma, 2017; Ehikioya, 2019; Moses *et al.*, 2020).

Empirical investigation of the political dimension of exchange rate policy in Nigeria has not received adequate attention despite the evolving scholarly interest in the area and the implication it has for policymaking particularly in democratic countries. However, there are some attempts to analyze the political logic underlying Nigeria's exchange policy reform following the Structural Adjustment Programme in the late 1980s (Uzodike, 1999), and how political considerations influence exchange rate policies and capital controls in the country (Urama & Iloh, 2018).

Uzodike (1999) expounded the preferences of influential interest groups and actors over the exchange rate policy in Nigeria. The study provided some important insights on the politics of exchange rate in Nigeria, especially the role and consequences of elite pressure on policymakers during the military regimes between 1987 and 1995. Many of the arguments presented by Uzordike still have merits. However, the analysis did not link the political dynamics to the choices of fixed or flexible exchange rate regimes adopted during the period studied. Additionally, the timeframe was limited to the military rule era during which the Central Bank of Nigeria was less independent and economic policies were generally concentrated in the hands of few technocratic elites.

Urama & Illoh (2018) on the other hand, only highlighted the theoretical prediction of political influence on exchange rate policy and capital control and the response of policymakers to political pressure, but did not prove such scenario in the case of Nigeria. The study conjecturally suggested that politics, institutional incentives, and group interest play a significant role in the determination of Nigeria's exchange rate regime without empirical evidence to support this assertion. Unlike Uzodike (1999) that discussed specific interest groups and their possible influence, Urama & Illoh (2018) did not mention any interest group.

There is a dearth of systematic studies on the political economy drivers of the exchange rate policy in Nigeria beyond the technical economic modelling and statistical analysis of the effect of exchange rate misalignment on economic variables that dominate the literature. It is imperative to conduct an empirical study through a political economy lens to analyze the factors influencing important policy decisions such as liberalization of the foreign exchange market, and whose interest the policy serves.

4. Data and methodology

The empirical analysis focuses on the political economy factors that explain the likelihood of liberalizing the foreign currency market in Nigeria. The intermittent changes and policy reversals may indicate the presence of political motives influencing these dynamics in addition to the economic conditions giving rise to the decisions.

Dependent variable

Most studies on exchange rate regime choices analyzed a panel of countries with often large number of observations. We draw from this literature and adapt the variables as well as estimation technique in a country-specific case. The traditional approach of examining the determinants of exchange rate

regimes mostly utilize the de facto exchange rate regime classification developed by the IMF, Reinhart & Rogoff (2004), and Levy-Yeyati & Sturzenegger (2005). However, Dąbrowski *et al.,* (2020) draw on the strength of these three classifications to construct a new de facto classification adopted by countries between 1995 to 2014. In the present study, the data for exchange rate liberalization (1) or otherwise (0) corresponds to flexible and fixed exchange rate regime classification constructed by Levy-Yeyati & Sturzenegger (2005) and Dabrowski *et al.,* (2020). Accordingly, we extract the annual exchange rate regime adopted in Nigeria from 1987-1994 (Levy-Yeyati & Sturzenegger, 2005) and 1995-2014 (Dabrowski *et al.,* 2020). Since there were no changes in exchange rate policy in 2015, that is about a year after Dabrowski *et al.,* (2020)'s data ended, we maintain the same classification as that of 2014.

In 2016, CBN adjusted the nominal naira exchange rate and announced a new floating arrangement for the currency. However, the CBN often announced a policy of forex market liberalization de jure but, it does not allow sufficient flexibility that enables a truly market-determined exchange rate. To the extent that there is no sufficient flexibility in the forex market, such that the CBN maintain official rates that diverge widely from parallel markets, we classify the regime as illiberal corresponding to a fixed exchange rate regime for the period 2016-2019.

Independent variables

The independent variables comprise a set of proxies used in the extant literature to represent sectoral/societal interest groups, macroeconomic determinants, and institutional factors explaining the choice of exchange rate regime (see table 1). Consistent with the political economy of exchange rate policy literature (Frieden *et al.,* 2010; Steinberg, 2010; Rodriguez, 2016), we measure the influence of economic sectors (Agriculture, Manufacturing, and Services) by their share in national output.

Table 1. *Variables Description*

Variable	Proxy	Source
Sectoral and societal determinants		
AGRIC - measures the influence of agricultural sector	Agriculture value added % GDP	WDI
MANUF - measures the influence of manufacturing sector	Manufacturing value added % GDP	WDI
SERV - measures the influence of financial and other non-tradable sectors.	Services value added % GDP	WDI
URBAN - captures the interest of urban consumers	Urban population % total population	WDI
Macroeconomic and Institutional determinants		
INFLA- inflation level as indicator of macroeconomic stability	Inflation, consumer prices (annual %)	WDI
DEFICT - measures trade deficit	Current account balance (% of GDP)	WDI
CBNI- Indicate the autonomy of Central Bank of Nigeria to formulate and implement policies	CBI index proposed by Romelli, D. (2022)	Romelli, (2022)
DEBT- Measures public debt burden	Total debt service (% of GNI)	WDI
DEMOC -Measures the Level of democratization	Polity 2 index, Center for systemic peace	CSP
Forex liberalize- Binary variable measuring the probability of liberalizing exchange rate	Fixed and Flexible Exchange rate regime classification	Levy-Yeyati & Sturzenegger (2005); Dabrowski *et. al.,* (2020)

To examine the societal interests - specifically urban consumers, we use the size of urban population. The economic and institutional factors include inflation, current account deficit, public debt, level of democratization, and central bank independence. Inflation is measured as the average annual

percentage change in consumer prices (Sfia, 2011; Aliyev, 2014; Bearce, 2014). Current account balance % GDP measures trade deficit. To examine the impact of public debt on the decision to liberalize exchange rate we use the total debt service % GNI. Our indicator of democracy is the Polity 2 index developed by the Center for Systemic Peace and Societal System Research (Marshall & Gurr, 2020). It is included in the model to measure how democratization affect the choice of exchange rate policy. For the autonomy of the monetary authority to formulate and implement policies, there are many measures of central bank independence utilized in the literature. We however, use the one recently proposed by Romelli (2022). The advantage of this new index is that "it incorporates and extends previous indices by including new information on central bank financial independence and disclosure" (Romelli, 2022, p.31).

4.1. Empirical model: Probit regression

The probit regression estimates the probability that Y=1 using the cumulative standard normal distribution function Ψ(Z) evaluated at z=$\beta_0 + \beta_1 X$.

The probit regression model with more than one independent variable is written as:

$$\Pr(Y=1/X_1, X_2, \ldots, X_k) = \Psi(\beta_0 + \beta_1 X1 + \beta_2 X2 \ldots + \beta_k Xk).$$

The predicted probability that $Y = 1$, given values of X_1, X_2, . . . Xk, is calculated by computing the z-value (or z index of the probit model), $z = \beta_0 + \beta_1 X1 + \beta_2 X2 \ldots + \beta_k Xk$. The probit coefficient (β) is the change in the z-value associated with a unit change in X. For instance, if β_1 is positive, an increase in X increases the z-value and thus increases the probability that Y = 1; if β_1 is negative, an increase in X decreases the probability that Y = 1 (Stock & Watson, 2015, pp.437–440). Y corresponds to our binary dependent variable Forex liberalize (1) or otherwise (0). While, X1, X2,..., Xk corresponds to the regressors.

4.2. Descriptive statistics and correlations

Summary statistics for the explanatory variables are presented in Table 2. Except CBNI and DEMOC which are measured as indexes all other variables are percentages. Table 3 presents the pairwise correlation matrix among the variables. There is no problem of multicollinearity that may potentially produce unreliable estimates due to high correlation among the variables.

Table 2. *Summary Statistics*

Variable	N	Minimum	Maximum	Mean	Std. Dev.
AGRIC	33	19.99	36.97	24.1014	3.79989
MANUF	33	6.55	21.02	13.2831	4.86379
SERV	33	35.36	59.79	46.104	6.18813
URBAN	33	27.21	51.16	38.3083	7.26105
INFLA	33	5.39	72.84	20.1217	18.16789
DEFICT	33	-6.29	20.74	3.4054	5.69837
CBNI	33	0.54	0.6	0.5834	0.02065
DEBT	33	0.1	6.52	2.5627	2.13015
DEMOC	33	-7	7	0.97	5.229

Table 3. *Correlations*

	AGRIC	MANUF	SERV	URBAN	INFLA	DEFICT	CBNI	DEBT	DEMOC
AGRIC	1								
MANUF	0.416	1							
SERV	0.735	0.282	1						
URBAN	0.147	0.56	-0.286	1					
INFLA	-0.116	-0.008	0.039	-0.139	1				
DEFICT	0.48	0.791	0.359	0.409	0.13	1			
CBNI	0.22	0.178	0.287	-0.399	-0.012	0.257	1		
DEBT	0.064	-0.445	0.035	-0.131	-0.062	-0.423	0.046	1	
DEMOC	-0.341	-0.117	-0.076	-0.45	0.447	-0.271	0.229	0.333	1

5. Results and discussion

The empirical analysis focuses on the factors explaining the probability of liberalizing Nigeria's exchange rate. The variables representing sectoral interest AGRIC, MANUF, and SERV all have negative coefficients, suggesting that an increase in the influence of these sectors decreases the likelihood of liberalizing the foreign exchange market and, by implication, a devalued currency. However, the manufacturing sector is the only statistically significant variable among the three sectors. This finding is consistent with the third group of the interest groups theory discussed in section 3.1 which prefer currency appreciation because their production depends largely on imported inputs. The result is also supported by the observed reality of the fact that the Manufacturers Association of Nigeria (MAN) is very influential in economic policy arena. Although manufacturing contributes an average of 13% to Nigeria's GDP within the period under study (see table 2), MAN remains (politically) powerful. Manufacturers have been advocating for exchange rate policy that enables both cheap imported inputs using subsidized exchange rate and protection against competition through the exclusion of certain items from foreign exchange allocation by the CBN.

Table 4. *Probit Results*

Dependent variable: Forex liberalize (1) otherwise (0)								
Independent variables								
AGRIC	MANUF	SERV	URBAN	INFLA	DEFICT	DEBT	CBNI	DEMOC
-0.151	-0.649	-0.033	-0.52	0.006	-0.227	0.175	-0.79	0.166
(0.256)	(0.013) *	(0.818)	(0.008) **	(0.81)	(0.033) *	(0.592)	(0.974)	(0.343)
Number of observations: 33 (1987-2019)								
P-values reported in parenthesis.								
Significance: * 5%, ** 1%								

The proxy variable for societal interest URBAN, is highly significant and has the expected sign. The negative sign of the variable indicates that the growing influence of urban residents, especially the elite, is associated with lower probability of liberalizing the exchange rate. This is consistent with the urban bias hypothesis which argues that the pressure of urban consumers causes Africa governments to maintain an overvalued exchange rate (Bates, 1981; 2008). Urban consumers in Nigeria have greater demand for strong currency because it provides higher purchasing power that satisfy their taste for foreign goods, and payment for educational and health tourism abroad. The CBN has dedicated some exchange rate windows to supply a subsidized foreign currency for those purposes. These and other evidence provide good reasons to argue that the primary constituency of successive governments in Nigeria when formulating public policies and delivering public goods is the urban

centers. A pronounced urban bias clearly exists despite having most of the population living in the rural areas. The urban population was about 30 % in 1990 and only slightly above 50 % as of 2020 (see World Bank's *World Development Indicators*).

The dominant argument of policymakers for maintaining administrative grip on the exchange rate to deter liberalization stem from the fact that Nigeria has an unfavorable current account position. Therefore, an exchange rate policy shift could lead to sharp naira devaluation that will translate to higher levels of inflation. Our results confirm this sentiment, as the variable DEFICIT shows a negative and statistically significant coefficient, meaning that greater current account deficits decrease the likelihood of liberalizing the forex market.

INFLA and DEMOC are both positive but not statistically significant. Nevertheless, the positive sign of INFLA is consistent with the findings of other studies (Sfia, 2011; Aliyev, 2014; Rodriguez, 2016; Maraoui *et al.,* 2021), implying that higher inflation might necessitate liberalization of the exchange rate and make fixed exchange rate regime less likely. Positive coefficient of DEMOC on the other hand indicate that greater democratization increases the likelihood of liberalization. Rodriquez (2016) and Aliyev (2014) also find that stronger democracies tend to reduce the likelihood of choosing a fixed exchange rate regime and thus more likely to choose flexible regimes which corresponds to liberalized exchange rate system.

Another factor that may influence liberalization is government's foreign currency denominated debt. The variable DEBT, though not statistically significant, has the expected negative sign. Democratic regimes in Nigeria often attempt to deliver short term benefits as an imperative for maintaining political office. The so-called 'dividends of democracy' are mostly financed with borrowed funds from domestic and international sources notwithstanding the future implication of current debt liabilities. Nigerian politicians seem to exhibit little concern for accumulating and passing the burden of debt to their successors in office. This may partly explain the lack of significance of DEBT in determining whether to liberalize the exchange rate or not.

CBNI is also negative but statistically insignificant. Theoretically, central bank independence should increase the tendency for a liberalized foreign exchange. Aliyev (2014) find empirical support for this proposition. The negative sign for the case of Nigeria may suggest that the CBN may not be supporting full liberalization of the exchange rate. The views expressed by the CBN governor Godwin Emiefele at many interviews corroborate this result.[4] Furthermore, the result may reflect the weak autonomy of the CBN given that it is being influenced by political authorities, especially the president of Nigeria. For instance, President Buhari who consistently opposes any move that is likely to cause a naira devaluation, could ultimately prevent any attempt in that direction by the apex bank even when realities proved it is the right path. As noted by Savage (2017) when the CBN remove the peg of the naira exchange rate in 2016 but later reversed the decision, "the CBN governor Emiefele may have acquiesced to Buhari's desire for a strong naira" (para.3).

6. Conclusion

This study contributes to the political economy of exchange rates literature by highlighting the influential role of societal and business interest groups in shaping exchange rate policies in the Nigerian context. The study demonstrated how economically beneficial policies may not necessarily fly politically, because the extent to which an economic policy can be successfully implemented greatly depends on the sentiments/preferences of government's constituents and the support of powerful groups. Such political influence imposes constraint on the policymaker's decision. This study reveals that the decision to liberalize Nigeria's foreign exchange market is influenced by the manufacturing sector- a politically powerful economic sector, and urban consumers, especially the elite who benefit from the dirigiste exchange rate policy. The results also confirm the general argument that the heavy dependence of the Nigerian economy on importation which translate to persistent trade deficit makes the adoption of a liberalized market-determined exchange rate rather unfeasible. However, the limited flexibility in foreign exchange transactions has the unintended consequences of delivering little benefits to the economy as a whole because of the distortions it created in the form of rent-seeking and corruption. While the structural argument for the exchange rate restriction has merits, this study argues that the political motive to maintain the support of urban constituents has significant impact on the choice of exchange rate policies adopted in Nigeria.

The implication of this findings is that Nigerian authorities should face reality and take bold step towards a pragmatic exchange rate policy that depart from the current dirigisme. For long term gain to be realized, some degree of pain must be tolerated during the policy transition period. There are many countries that have allowed the official exchange rate to move to a market-clearing levels without necessarily triggering a free fall of the currency's value (see, Gray, 2021, p.15). Though, some comparable countries with Nigeria have pursued the liberalization policy under an IMF's economic stabilization programme.[5] There is tendency for the conditionalities of international financial institutions to also necessitate a policy shift in the management of Nigeria's exchange rate.

The findings also yield insights that are relevant for international policy advisors, particularly the IMF and the World Bank. These institutions should consider the policymakers' political constraints and the degree to which policies can be politically implemented based on domestic needs of Nigeria and other developing economies. A promising avenue for further studies is to incorporate the influence of international political economy factors in analyzing Nigeria's exchange rate policies. Future studies may also provide alternative statistical estimations using other proxies of the variables.

Notes

1. The emphasis on this line of thinking tends to deflect attention from some of the salient political economy factors influencing the decisions to maintain government's grip on the naira exchange rate apart from the structural impediments. The structural deficiencies associated with Nigeria's exchange rate problem receives substantial attention. However, as observed in many countries, it is less common for scholars, observers, and analysts to incorporate political considerations in analyzing the exchange rate policy (Frieden, 1994, 93).
2. See [Retrieved from]. [Retrieved from].
3. See [Retrieved from].
4. see for example [Retrieved from].
5. These countries include: Indonesia (1997); Egypt (2016); and Angola (2018).

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