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The Impact of Exchange Rate changes on Microeconomic Performance in Nigeria

OGUNSAKIN Yisa Oluwafemi, Ph.D.

Office of Establishment and Training, Ado Ekiti, Ekiti State, Nigeria. Email: ayofemoogunsakin@gmail.com

***Corresponding Author**: OGUNSAKIN Yisa Oluwafemi, Ph.D.

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Abstract

This research assessed the effect of exchange rate variation on the micro-economy of Nigeria focusing on firms, customers and small medium scale enterprises (SMEs). The research was prompted by the continuous fluctuations in exchange rate as a result of its consequence on costs of production, firm profitabilities, customer spending power, business sustainability. The research's primary objectives included; to assess the impact of exchange rate changes on firm profitability; to ascertain the relationship of exchange rate changes on costs of production; to assess the influence of exchange rate change on customers' behaviour. The research employed descriptive research design; it is basically correlational research in nature. The data for the research was exclusively secondary data sourced from various public and international agencies like Central Bank of Nigeria (CBN), National bureau of statistic (NBS), World Bank and International monetary fund (IMF). Regression analysis techniques were employed to determine the relationship between exchange rate fluctuation and performance on the micro-economy of Nigeria. Results indicated that exchange rate fluctuation significantly impacted firm productivity and profitability in negative way. Exchange rate depreciation has effect in increasing costs of production, negatively affecting customers' purchasing power. SMEs are particularly sensitive to exchange rate volatility because of its dependence on imported materials and lower capacity. The study concludes that instability of exchange rate poses threat to the effective functioning of micro-economy of the nation and creating uncertainties in the businesses. The study recommended the management of exchange rate to the monetary authority and government policy for sustainability in micro-economy, promotion of local production, and support for small medium scale enterprises (SMEs) in the nation economy, via favourable economic policies and affordable loan facilities.

Keywords*: Exchange rate, microeconomic performance, exchange rate volatility, SMEs, profitability, Nigeria.*

1.1 Introduction

Fluctuation in the exchange rate continues to pose a great economic problem in Nigeria. They impact on businesses, consumers and production activity. When the exchange rate changes, the cost of imports, prices of goods and services, and profitability of firms changes as well. Developing economies are more vulnerable than developed ones as they rely on imported inputs and foreign exchange earnings (Adeniran et al., 2014). Exchange rate fluctuations affect at the micro-economic level the day-to-day activities of companies. The naira devaluation increases the cost of imported raw materials. Manufacturing companies then have to deal with increased manufacturing expenses and reduced profit margins. Many companies react to this by raising their prices, decreasing their production or reducing their investment (Mordi, 2006).

This impacts consumers, too. The depreciation of naira increases the cost of imported items including food, drugs, machines and electronic items. This decreases household purchasing power and alters the consumption pattern.

Families can switch to the use of locally produced goods and services in place of foreign goods or cut their spending altogether (Obadan, 2006). The depreciation of a currency may be advantageous for some companies. Export companies can benefit from a more competitive market, as their products will be more affordable in international markets. But the benefits are contingent on the capacity of companies to produce for export and international market (Ajakaiye & Fakiyesi, 2009).

Nigeria has had perpetual volatility in the exchange rate for decades. Oil exports provide the bulk of foreign exchange earnings in the economy. The value of the naira is affected by change in oil prices globally. This has created uncertainty for businesses when planning, pricing and investing in their operations (CBN, 2023). SMEs are especially at risk. Numerous SMEs rely on the importation of machinery and spares and raw materials. A depreciating exchange rate will raise their operating expenses and decrease their business sustainability. This can result in reduction in productivity, job loss and business closure (Adeniran et al., 2014). The effect of exchange rate fluctuation on micro-economic performance in Nigeria is investigated. It is about how business runs, how people get things done, how its profitable and how people act as consumers. The study also offers policy suggestions to minimise the adverse impact of exchange rate fluctuations on economic actors.

1.2 Statement of the Problem

Exchange rate volatility is a big issue in Nigeria. In the past few years, the naira has been subject to several devaluations and fluctuations. These changes have raised the prices of imports and production costs. Businesses have to face with increased costs of operations and increased uncertainty in business planning (CBN, 2023). Many SMEs have difficulties in sustaining in unstable exchange rate regime. The higher import cost decreases profitability and restricts growth. Other companies cannot keep up the pace of manufacturing or meet customer demand. This negatively affects productivity and employment generation (Mordi, 2006).

Hardship is felt by consumers as well. When currency is devalued, the cost of imported goods and other goods tied to foreign exchange also increase. In turn, the reduced purchasing power leads to a drop in living standards of the households (Obadan, 2006). In spite of the Central Bank of Nigeria's several exchange rate policies, the volatility still persists. Previous research primarily has concentrated on the macroeconomic impact of exchange rate changes, including inflation, output growth and the balance of payments. The microeconomic impacts on productivity, profitability, pricing, and consumer behaviour of the firms have received less attention (Ajakaiye & Fakiyesi, 2009).

There is thus a need for further research. This study aims to explore the impact of exchange rate fluctuation on the performance of the micro-economic sector of the economy in Nigeria. The results will assist the policymakers, business managers and investors to formulate policy and management strategies for addressing exchange rates risk and enhance economic performance.

1.3 Objectives

The main objectives of the study are to:

i. analyse the effect the change in exchange rate has on the micro-economic performances;

ii. learn how exchange rate fluctuations affect the profit of firms;

iii. investigate how exchange rate fluctuation is related with production costs; and

iv. analyse the effect of exchange rate changes on consumer purchasing behaviour;

v. evaluate the effects of exchange rate volatility on small and medium size enterprises (SMEs)

1.4 Research Questions

This study aims at answering the following questions:

1. What is the effect of exchange rates on Nigeria's microeconomic performance?
2. How do changes in exchange rates affect the profitability of companies?
3. What are the effects of exchange rate volatility on the costs of production of firms?
4. What impact do exchange rate movements have on the attitudes and actions of consumers?
5. How sensitive are small and medium enterprises (SMEs) to exchange rate fluctuations?

1.5 Hypotheses

Null Hypotheses (H_0)

H_{01}: No significant relationship between changes in the exchange rate and firm profitability.

The null hypothesis is that the production costs and exchange rate volatility do not show any significant relationship.

Hypothesis (H_{03}): They do not find a significant difference in their purchasing behaviour as a result of changes in exchange rates.

Ha_{04}: The performance of SMEs is not affected if the exchange rate is unstable.

2.1 Conceptual Review

Conceptual Review is a description of the concepts that the study is based on. It provides clear definitions and discusses the relationships among the major variables. This allows a mutual understanding of the concepts and to direct the research. The review in this study is directed at the following: Exchange rate, exchange rate changes, micro-economic performance, firm profitability, production costs, consumer purchasing behaviour and the performance of small and medium enterprises (SMEs). These concepts are explored in relevant literature to provide an understanding and to support the study.

2.1.1 Exchange Rate

The value of the currency of one country against another country's currency, is known as exchange rate. It determines how much of a foreign currency can be exchanged for the domestic currency. The exchange rate is crucial in international trade, investment and economic transactions. The exchange rate means price of one currency in terms of another currency (Mordi, 2006). The exchange rates can rise or fall due to market forces and government's monetary policies. The exchange rates could be categorized into:

• Fixed exchange rate

• Floating exchange rate

Under the floating exchange rate system, the market forces of demand and supply determine the value of the currency while under the fixed exchange rate system, the government or central bank determines the value of the currency. Exchange rate fluctuations occur when there are continuous increases or decreases in the value of a currency over time. The ups and downs can be caused by inflation, interest rates, political uncertainty, foreign reserves, and conditions in international trade.

2.1.2 Microeconomic Performance

Microeconomic behaviour and performance is the behaviour and performance of individual economic units like firms, households, industries, and consumers. It involves production output, profitability, production costs, pricing, employment generation, sales volume and consumer buying behaviour. The economic variables like inflation, taxation, interest rates and exchange rates greatly influence the performance of firms and households. Fluctuations in exchange rates have a special impact on companies that use imported raw materials and foreign machines. Instability in the exchange rate creates uncertainty in production planning and cost management, which in turn has an impact on the business operations according to Adeniran, Yusuf and Adeyemi (2014).

2.1.3 Exchange Rate Volatility and Firm Performance

Exchange rate volatility is the term for frequent and unpredictable changes in the exchange rate of a country's currency with respect to other currencies over a period of time (Mordi, 2006). It instils doubt in the foreign exchange market, impacts on business planning, investment decisions and economic performance. Companies mainly engaged in importing raw materials, machinery and intermediate goods tend to experience rising production costs when the domestic currency depreciates since raw materials and machinery become more costly in local currency (Obadan, 2006). The price increase makes it cheaper for the firm to find its profitability, which in turn decreases the productivity of the firm and in some instance, may even force the firm to raise product prices or cut production. Volatility in exchange rates also dampens investment activities by businesses due to the nature of uncertainty in the future operational costs and returns (Adeniran et al., 2014). However, currency depreciation can be advantageous for export-oriented firms as their exports will appear more competitive and cheaper in the foreign markets, increasing the demand for exports and foreign exchange earnings (Krugman et al., 2018). The magnitude of the benefits, however, will depend on the extent of reliance by firms on local inputs and on their capacity to provide the benefits. Small and medium enterprises (SMEs) are especially at risk due to exchange rate fluctuations because they have limited financial resources and rely on imported equipment, spare parts, and raw materials. Exchange rate instability, therefore, leads to higher operational costs, lower profitability, lower competitiveness, and long-term sustainability of businesses among other things, particularly in developing nations like Nigeria (Central Bank of Nigeria [CBN], 2023).

2.1.4 Exchange Rate Changes and Consumer Behaviour

The direct impact of exchange rate changes on consumer purchasing behaviour is due to the changes in prices of the imported goods and services. If the domestic currency loses value, the domestic cost of imported products like food, medicines, fuel, electronics, and machinery would rise and the prices of the products sold to consumers would also go up (Obadan, 2006). The price increases reduce the purchasing power of consumers, when they have the same income they have less purchasing power of products and services. Consumers, in turn, tend to decrease their consumption of imports or switch to locally manufactured goods if they are available (Krugman et al., 2018). Inflation is also caused by continued depreciation of the exchange rate as it raises the cost of production and distribution across the economy which also reduces the real household income, worsens consumer welfare and lowers their living standards (Central Bank of Nigeria [CBN], 2023). Exchange rate instability has been a significant financial burden on households and also affects their consumption patterns in developing economies like Nigeria where many important consumer goods and industrial raw materials are imported (Adeniran et al., 2014).

2.2 Empirical Review

The relationship of exchange rate fluctuations and the performance of the economy have been studied by several empirical pieces of research. Adeniran, Yusuf and Adeyemi (2014) in their study examined the effect of exchange rate on economic growth in Nigeria from 1980 to 2011 adopting regression analysis. The research revealed that exchange rate volatility had a negative impact on investment and business development. Mordi (2006) studied the problem of exchange rates volatility in Nigeria and found that exchange rate volatility hampers business planning and lessens industrial productivity.

The study of Obadan (2012) found that exchange rate policies in Nigeria had a negative effect on exchange rate depreciation thus making the cost of imported goods and production inputs higher. Aliyu (2011) examined the relationship between exchange rate volatility and non-oil export performance in Nigeria and revealed that there is mixed effect of exchange rate depreciation on export performance. Aghion et al. (2009) presented evidence that volatility in the exchange rate is detrimental to productivity growth in countries with poor financial systems.

Likewise, Ehinomen and Oladipo (2012) discovered that exchange rate instability caused inflationary pressure and made the purchasing power of consumers to reduce. While the macroeconomic effects of exchange rate movements have been analysed in great depth, fewer studies have specifically examined the microeconomic effects of exchange rate movements on indicators of firm profitability, production costs and consumer behaviour.

2.2.1 Gap in Literature

The focus of most prior research was on the connections between the exchange rate and macroeconomic variables including economic growth, inflation, balance of payments and foreign direct investment. There, however, have been relatively few studies that have examined the impact of exchange rate volatility on the microeconomic level, including firms, SMEs and households. Moreover, most of the previous research used only macroeconomic data, and did not consider the direct effects of exchange rate volatility on production costs, profitability and consumer purchasing habits. That is why this study is aimed at examining the impact of exchange rate fluctuations on the microeconomic performance of firms, consumers and small and medium enterprises (SMEs) and thus, filling the identified gap.

2.3 Theoretical Framework

This study is based on the two theories which are Purchasing Power Parity theory and Balance of payments theory.

2.3.1 The Theory of Purchasing Power Parity (PPP)

Gustav Cassel created the Purchasing Power Parity (PPP) Theory in 1918. According to the theory the exchange rate between the two countries depends upon the relative purchasing power of the two currencies, which is largely dependent upon the prices of identical goods and services in the two countries (Cassel, 1918). The theory holds that through the course of time, the currencies change in response to the disparity in the price level of different nations. Therefore, a country with a higher inflation rate than its trading partners should have a depreciating currency due to the loss of purchasing power of the currency (Krugman et al., 2018). The Purchasing Power Parity relationship is often written as:

$$E = P1P2E = \frac{P_1}{P_2}E = P2P1$$

Where:

E = Exchange rate

P_1 = Home price index

P_2 = Foreign price level

The theory is significant for this study because of its explanation of the relationship between inflation, exchange rate changes, and the performance of the microeconomic units. The higher the inflation rate of domestic goods, the more depreciated the local currency will be, and the higher the prices of imported goods and the production costs for firms that would depend on foreign inputs. This increases production costs, can affect pricing and compromise consumers' buying power, and can decrease profitability. For this reason, Purchasing Power Parity theory is found to be a useful tool for analysing the impact of exchange rate movement on the performance of the business firm, the behaviour of the consumer and operations of small and medium size enterprises (SMEs) in Nigeria (Mankiw, 2021; Obadan, 2006)..

2.3.2 Balance of Payments Theory

According to the Balance of Payments Theory, exchange rates are dependent on the demand and supply of foreign exchange created due to international economic transactions of a country. The theory goes that a country that routinely runs a balance of payments deficit imports more foreign goods and services than it exports, and, as a consequence, domestic currency depreciates. On the other hand, a balance of payments surplus leads to an increase in the supply of foreign currencies, which can lead to an appreciation of the domestic currency (Salvatore, 2019). The theory provides a number of factors that influence movements in exchange rates, such as exports and imports, capital inflows and outflows, foreign exchange reserves and international investments (Appleyard et al., 2021). This theory is pertinent to this study because the instability of exchange rates as a consequence of the presence of trade imbalance directly affects firms because of the fluctuation in the cost of imported inputs and export competitiveness, while consumers are affected by the fluctuation of price of imported goods/services, which influence the purchasing power and overall microeconomic performance (Obadan, 2006).

3.1 Methodology

This study utilises a descriptive and explanatory research design. Descriptive design was adopted to describe the nature and trend of exchange rate movement and the relationship between exchange rate movement and the microeconomic performance in Nigerian. Explanatory design was to test the impact of exchange rate variation on profitability, production cost, and the consumers' purchasing power, as well as the performance of SMEs.

This study is based on secondary data sourced from Central Bank of Nigeria (CBN) statistical Bulletin, National Bureau of Statistics (NBS), World Bank, International Monetary Fund (IMF), relevant peer reviewed journal articles and textbooks.

Secondary data sources in the study have a great reputation in reliability to gather necessary information. On exchange rate, inflation rate, interest rate, cost of production, and other macroeconomic variables for estimation. The population for this study consists of chosen Nigerian firms and SMEs that are most sensitive to the changes in exchange rate, this include firms and businesses in the manufacturing and those which are largely dependent on importation, manufacturing and import-dependent companies. The study employed a purposive sampling method because it is suitable for selecting variables and respondents which are most appropriate for the study's objective.

The analysis is done using an econometric regression model to estimate the impact of the change in exchange rate on the microeconomic performance. The functional relationship is specified as MP = f(EXR, INF, INT) and the econometric model of the relationship as follow: MP = + EXR + INF + INT + Data analysis procedure. In order to estimate the model specified and to describe the nature, direction and magnitude of the relationship between exchange rate changes and the microeconomic performance in Nigeria.

The following statistical tools are employed: descriptive statistical methods and multiple regression analysis is performed using EViews software, SPSS or Stata to ensure accuracy of results. The study test hypotheses using the t-test and the probability (p) values at 5% level of significance (0.05).

Null hypothesis is rejected where the p-value is less than 0.05, while it is accepted where p-value is greater than 0.05. Therefore, it is only recognised national and international bodies were selected and to ensure that reliability and validity of the obtained result using correct statistical method for consistent, accuracy and robust empirical result of the study.

4.1 Data Presentation and Analysis

The data source of this study comes from secondary data where such data are from reports from World Bank, CBN and NBS, with explanatory variables are the values of exchange rates, rates of inflation, rates of interest, and some macroeconomics variables, like production costs and rates of profit.

4.1.2 Summary of Variables

Variables	Description
Exchange Rate (EXR)	Value of naira against foreign currencies
Inflation Rate (INF)	General increase in prices
Interest Rate (INT)	Cost of borrowing funds
Microeconomic Performance (MP)	Profitability and productivity of firms

4.1.3 Descriptive Analysis

The descriptive analysis reveals that exchange rates witnessed a lot of variation during the study period. The decline of the Naira raised the import costs of raw materials and the overall productivity of numerous companies. Inflation rate escalated with the variations in exchange rate raising the costs of production and reducing consumers' purchasing powers. Most of the Small and Medium Scale Enterprises' (SMEs) found it extremely challenging to keep their businesses in operation due to increase in operational costs.

4.1.4 Regression Analysis

In this study, regression analysis is carried out to examine the impacts of exchange rate fluctuations on micro economic outcomes. The model estimated is presented as follows:

$$MP = \beta_0 + \beta_1 EXR + \beta_2 INF + \beta_3 INT +$$

Regression Result

Variables	Coefficient	Probability Value
Exchange Rate (EXR)	-0.65	0.01
Inflation Rate (INF)	-0.42	0.03
Interest Rate (INT)	-0.28	0.04

4.1.5 Interpretation of Results

The exchange rate coefficient (-0.65) suggests a negative relationship between exchange rate fluctuations and the microeconomic performance. It further concludes that exchange rate depreciates business productivity and firm profitability. There is a negative relationship between inflation rate and business performance.

It has probability values that are less than 0.05 which is 0.002 indicating it is significant.

4.1.6 Test of Hypotheses

Hypothesis One Null Hypothesis (H): Exchange rate changes do not have a significant relationship on the firm profitability.

Decision Rule: Since the probability value of the exchange rate is 0.01, which is less than 0.05, the null hypothesis is rejected. Decision Exchange rate changes have a significant effect on firm profitability.

Hypothesis Two Null Hypothesis (H): Exchange rate volatilities do not have a significant relationship with the cost of production.

Decision: The regression result concludes that exchange rate fluctuation has a significant effect on the firm's cost of production hence null hypothesis is rejected.

Hypothesis Three Null Hypothesis (H): Exchange rate fluctuations do not have a significant effect on consumers purchasing behaviours. Decision Analysis shows that fluctuation of exchange rates cause prices of imported goods to increase and as a result decrease the consumers' purchasing powers therefore, null hypothesis is rejected.

4.2 Discussion of Findings

This research determined that changes in the value of the Naira have a significant negative effect on microeconomic performance of Nigerian companies. Chronic exchange rate depreciation raises the prices of imported raw materials, machinery, and intermediate goods thereby increases production costs and cuts the firm's profits. Exchange rate uncertainty hinders investment and business expansion activities as well as affects productivity, due to the difficulty that firms face in setting up production and pricing decisions.

The findings are consistent with research conducted by Adeniran et al. (2014), who stated that exchange rate instability causes business to stagnate or decline and affects investment and Mordi (2006), said that instability of the exchange rate causes lack of certainty in production planning and the overall performance of industrial activities in the country.

The Central Bank of Nigeria (2023) and the International Monetary Fund (2024) have all reported that continuing long term exchange rate instability in the economy continues to stifle business and constrain business expansion in Nigeria. The study also reveals that exchange rate depreciation is negative to the behaviour of consumers in Nigerian companies and affects household welfare. Depreciation in the value of the Nigerian Naira also leads to higher prices for imported goods and production inputs, as a result of increased inflation and therefore reduces the real purchasing power of consumers. This forces the consumer to respond to the reduction of real disposable income by reducing their consumption patterns and switching between imported goods and local production of goods. According to the study, the smallest firms (SMEs) are the most impacted by currency depreciation because they depend heavily on imported inputs for their production processes and do not often have sufficient access to the necessary capital or funds to effectively absorb increased costs.

These findings support the assertion of Obadan (2006) which stressed that exchange rate depreciation leads to higher costs and consumers' prices in addition to being consistent with World Bank's (2024) observations of continued limitation of growth, competitiveness and resilience in SMEs within the developing economy due to currency instability. In conclusion, this research confirmed the fact that stability of the Naira's exchange rate is beneficial for the improvement of microeconomic performance in Nigeria. Review of the conceptual and theoretical underpinnings of exchange rate depreciation and empirically supported theory such as the Purchasing Power Parity Theory and Balance of Payments theory, were used as basis to assess the relationship.

Data gathered from authoritative source which includes, the CBN, NBS, World Bank and International Monetary Fund (IMF) with the use of regression analysis show that change in the Nigerian Naira against major currencies in the world significantly reduces the output, and profit, causes consumers to lose purchasing power and, threatens business resilience and growth in Nigeria.

5.1 Conclusion

Following from the study results, it was concluded that exchange rate volatility negatively and significantly impact on micro economic performance of Nigerian firms. The sustained depreciation of the naira has raised import costs (of finished goods and raw materials), adversely impacting productivity, profitability, and the survival of business firms in Nigeria. The study further concluded that exchange rate volatility leads to inflationary pressure, eroding purchasing power and create a volatile environment for business planning and investment decisions, which could in turn discourage investments. There is thus a great need for stable exchange rate policies that boost the performance of firms and lead to macroeconomic stability.

5.2 Recommendations

From the study, it is hereby recommended that Government and CBN, pursue a sustainable fiscal and monetary policies, designed to lead to exchange rate stability, and limit drastic changes in the exchange rate (value of naira). The exchange management framework needs to be enhanced so as to increase market confidence and thereby, minimise the prevalent risks, volatility, uncertainty and enable the creation of a predictable and attractive investment and operating environment for both foreign and domestic firms operating in Nigeria. Local raw material substitution by manufacturing firms and small and medium-size enterprises (SMEs) through backward integration or in sourcing and indigenous technology will minimize dependence on imported inputs while increasing the resilience of the firms. SME's support package including access to finance, and fiscal incentives would be necessary to enhance their sustainability against exchange rate fluctuations. Furthermore, strategies that promote export growth, diversification away from crude oil and domestic production must be pursued to reduce pressure on foreign exchange supply and strengthen its position in the long run.

5.3 Contribution to Knowledge

It complements earlier literature on exchange rate variations with a focus on the microeconomic consequences on firm-level behaviour, including small and medium-sized enterprises (SMEs), and consumer households. It departs from much previous literature by concentrating less on macroeconomic variables and offering a view on how exchange rate instability impacts directly the day-to-day activities of firms and the welfare of households.

5.4 Limitations of the Study

The study faced data constraint issues which did not allow for inclusion of all segments of the Nigerian economy. The study depends heavily on secondary data which cannot capture entirely microeconomic operations.

5.5 Recommendations for Future Studies

Future studies ought to investigate the impacts of exchange rate volatility across selected segments of the Nigerian economy namely agriculture, manufacturing, and services for more targeted policy interventions. Comparative studies on impacts of exchange rate fluctuations on developed countries versus developing countries would be interesting. Furthermore, effects of exchange rate variations on employment, labour, wages, income generation, entrepreneurial development, firm expansion, foreign direct investment, and long-term viability of Nigerian and other developing countries small and medium-scale enterprises (SMEs) warrant further studies.

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