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EXCHANGE RATE STABILITY AND POVERTY REDUCTION IN NIGERIA[1]

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Introduction

Nigeria's economy is growing at an impressive rate compared to the historical. This reflects in part increased investor confidence due to the improvements in macroeconomic management and positive dividends of the new found economic direction and general political stability. However, the renewed optimism is unlikely to be sustained if appreciable progress is not made to advance growth, general macroeconomic stability and poverty reduction.

The increased awareness of the need to tackle poverty has focused attention on the role of macroeconomic policy in achieving social as well as macroeconomic objectives. However, the preservation of macroeconomic stability is important, not as an end to itself, but as a necessary precondition for sustained economic growth, which is the single most important factor influencing poverty reduction. Without a disciplined macroeconomic stance, the achievement of sustained economic growth and social objectives becomes much difficult. With responsible growth which embraces both environmental sustainability and social development, human welfare is increased through improved consumption, human capital, social equity, all of which target poverty reduction.

In order to formulate sustainable macroeconomic and social policies, there is a need to understand the diversities in the country, the social context and how they are linked to poverty and livelihoods. Macroeconomic policies are those policies that have direct or indirect impact on key variables such as the inflation rate, the exchange rate, the external current account balance, the fiscal deficit or the level of international reserves. These policies are primarily fiscal, monetary, or relate to the exchange rate. They are usually formulated with a view to their impact on the economy as a whole, rather than on individuals, groups or sectors. However, a given policy change may have differential impacts on different groups. Structural policies on the other hand, aim at improving the efficiency of resource allocation; strengthening economic incentives; removing impediments to the smooth function of markets and to private sector development; and expanding the overall productive capacity of the economy.

Exchange Rate Basics

Money serves as a medium of exchange that simplifies transactions between millions of people interacting in a market place. Transactions between people who live in different countries use different mediums of exchange. Cross-border transactions therefore typically require a corresponding exchange of one currency for another. An exchange rate describes the price of one currency in terms of another.

The ***nominal exchange rate*** between two countries is the one country's currency in terms of the other country's currency. It is the domestic currency units per unit of foreign currency. So the Nigerian naira/U.S. Dollar exchange rate is given as 129 Naira per U.S. Dollar instead of 0077519 Dollars per Naira. Nonetheless, we can multiply the price of a good denominated in foreign currency by the nominal exchange rate to convert it to domestic currency terms; we can divide the price of goods denominated in domestic currency by the nominal exchange rate to convert them to foreign currency terms. An increase in the nominal exchange rate is called depreciation of the domestic currency, i.e. the Nigerian Naira has decreased in value (more naira are needed to buy one unit of foreign currency). A decrease in the nominal exchange rate is an appreciation of the domestic currency, i.e. the naira has increased in value (fewer naira are needed to buy one unit of foreign currency.)

Changes in the exchange rate change the relative price of goods in two countries. However, the nominal exchange rate is not the only variable that affects the relative price of goods in two countries, the price levels in each country matter as well. Hence the use of real exchange rate to

[1] *The content of this paper does not in any way represent the views of the World Bank but are solely the responsibility of the author.*

compare prices in two countries. I will use the symbol **R** to denote the real exchange rate, which can be defined as

$$R = \frac{eP^*}{P}$$

R is the relative price of foreign goods and can be further elaborated as

$$R = \frac{\$/\text{foreign currency} * \text{foreign currency price of goods}}{\$ \text{ price of domestic goods}} = \frac{\$ \text{ price of foreign goods}}{\$ \text{ price of domestic goods}}$$

An increase in **R** is known as a depreciation of the real exchange rate (foreign goods become more expensive) and a decrease in R is an appreciation of the real exchange rate (foreign goods become cheaper). However, nominal exchange rate appreciation can cause real exchange rate appreciation, all else equal, i.e. if relative prices in the two economies do not change. Also, changes in prices can cause the real exchange rate to fluctuate without an underlying change in the nominal exchange rate. An increase in domestic prices, all else equal, will cause the real exchange rate to appreciate; a decrease in foreign prices, all else equal, will cause a real exchange rate appreciation. A decrease in domestic prices, all else equal, will cause the real exchange rate to depreciate, but an increase in foreign prices, will also cause a real exchange rate depreciation.

Exchange Rate Policy

Allowing for an overvalued currency to depreciate can enhance export competitiveness and raise the local currency income of exporters. However, the cost of imported inputs and consumables (and, possibly, of services such as urban transport) will also rise, leading to an erosion of the real purchasing power of household incomes. Changes in exchange rates will thus have both income-raising and price-raising effects, giving rise to net benefits or detriments that differ across socioeconomic groups. Key factors that determine the net impact are the composition of the consumption basket and who purchases what within the household. For example, women may not benefit as much as men from a depreciation/devaluation[2]. Real earnings in the informal sector (where more women than men are employed) and nontraded sector may fall, affect overall consumption and welfare. The urban poor may be more adversely affected as consumers, but may also benefit if their output is exportable or is an import substitute.

There is also some social impact arising from various exchange rate policies. For instance, in the area of health care, increased costs of imported medicines may lead poor people to use more traditional local medicines or go untreated. These differential impacts mean that attenuating measures may be necessary to protect some vulnerable groups, even though the net benefit for the society as a whole remains positive.

Classifying Regimes

Beyond the traditional fixed-floating dichotomy lies a spectrum of exchange rate regimes. The de facto behavior of an exchange rate, moreover, may diverge from its de jure classification.

While it is customary to speak of fixed, stable and floating exchange rates, regimes actually span a continuum, ranging from pegs to target zones, to floats with heavy, light, or no intervention. The traditional dichotomy can mask important differences among regimes. Accordingly, this analysis uses a three-way classification: pegged, intermediate (i.e., floating rates, but within a predetermined range), and floating.

Regimes can be classified according to either the publicly stated commitment of the central bank (a *de jure* classification) or the observed behavior of the exchange rate (a *de facto* classification). Neither method is entirely satisfactory. A country that claims to have a pegged exchange rate might in fact instigate frequent changes in parity. On the other hand, a country might experience very small exchange rate movements, even though the central bank has no obligation to maintain parity.

Inflation

Pegging the exchange rate can lower inflation by inducing greater policy discipline and instilling greater confidence in the currency. Empirically, both effects are important.

Policymakers have long

[2] *Women are often involved in the food crop sector and will have to face higher costs of transportation, fertilizers, and other imported inputs. These higher costs may also raise food prices, again affecting women, who are responsible for feeding the family within the household. A currency depreciation may make export crops, usually under the control of men, more profitable, but may not benefit the household as a whole since income may not be pooled. Meanwhile, women are responsible for buying food and medicines with their own resources, which may not have increased in value.*

maintained that a pegged exchange rate can be an anti-inflationary tool. Two reasons are typically cited. A pegged exchange rate provides a highly visible commitment and thus raises the political costs of loose monetary and fiscal policies. To the extent that the peg is credible, there is a stronger readiness to hold domestic currency, which reduces the inflationary consequences of a *given* expansion in the money supply.

Inflation Performance

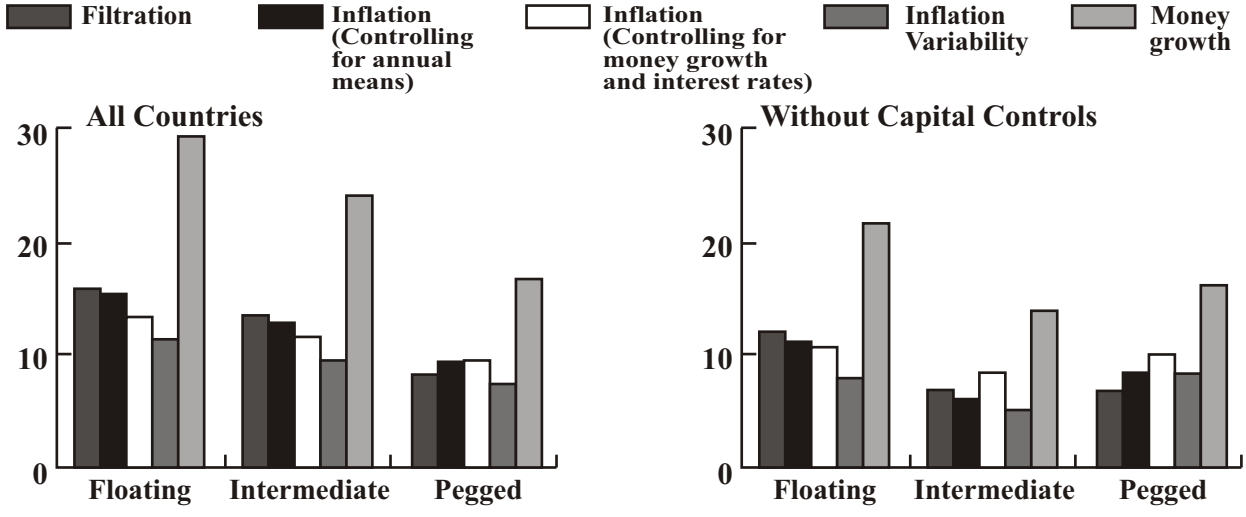
Inflation over our sample averaged 10 percent a year, with pronounced differences in various exchange rate regimes (Chart 1). Countries with pegged or stable exchange rates had an average annual inflation rate of 8 percent, compared with 14 percent for intermediate regimes, and 16 percent for floating regimes.

The differences among regimes are starker for the lower-income countries, where the differential between pegged and floating rates was almost 10 percentage points. As might be expected, countries without capital controls tended to have lower inflation in general. Even for these countries, however, inflation was lower under pegged regimes compared with either intermediate or floating exchange rates.

Although inflation performance is generally better under pegged exchange rates, the last panel in Chart 1 illustrates an important caveat: mere declaration of a pegged exchange rate is insufficient to reap the full anti-inflationary benefits. Countries that changed their parity frequently--though notionally maintaining a pegged exchange rate--on average experienced 13 percent inflation. While this is still better than the performance under nonpegged exchange rates (17 percent), it is significantly worse than countries that maintained a stable parity (7 percent).

Since there was a preponderance of pegged exchange rate regimes in the 1960s--when inflation rates were low--the association between low inflation and pegged rates might be more an artifact of the general macroeconomic climate than a property of the regime itself. One way to purge the data of such effects is to measure inflation rates for each regime relative to the average inflation rate (across all regimes) in that year. Doing so, however, leaves the story largely unchanged: as

Chart 1. Inflation Performance
(In percent per year)



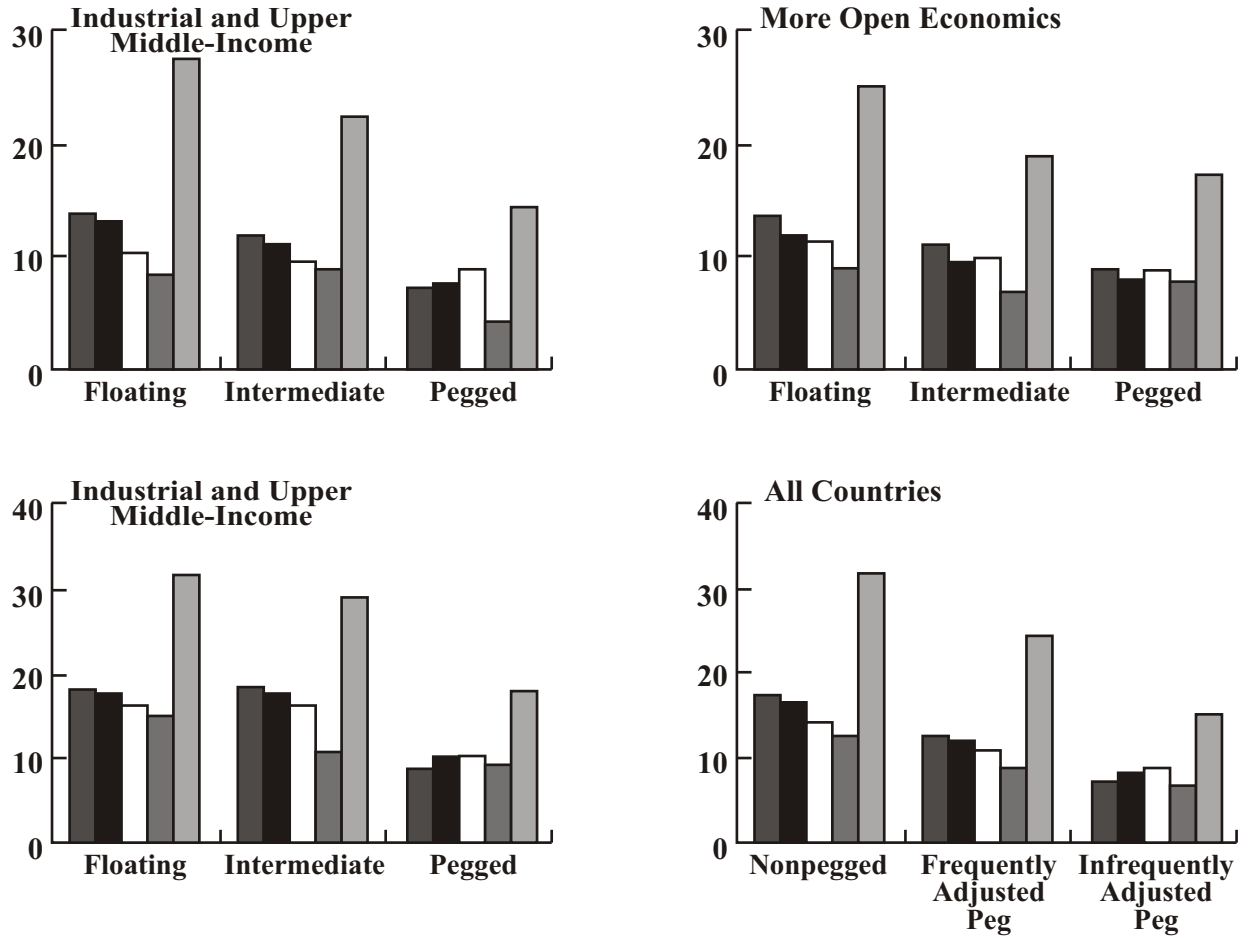


Chart 1 shows, under pegged rates, inflation was 3 percentage points lower than under intermediate and 6 percentage points less than under floating regimes. Again, countries with only occasional changes in parity fared significantly better than those with frequent changes.

Explaining the Differences

What accounts for these results? They derive, in fact, from two separate effects. The first is discipline. Countries with pegged exchange rates have lower rates of growth in money supply, presumably because of the political costs of abandoning a peg. The growth of broad money (currency and deposits) averaged 17 percent a year under pegged exchange rates compared with almost 30 percent under floating regimes. This difference holds regardless of the income level of the country.

In addition, for a *given* growth rate of the money supply, higher money demand (the desire to hold money rather than spend it) will imply lower inflation. Pegged exchange rates, by enhancing confidence, can engender a greater demand for the domestic currency. This will be reflected in a lower velocity of circulation and a faster decline of domestic interest rates. In the extreme case of perfect credibility, domestic interest rates--even in countries with a history of high inflation--should fall immediately to the world level. Over the sample period, nominal interest rates have tended to rise, but the rate of increase for countries with floating rates was almost 6 percent, as against 2 percent for countries with pegged rates. It was actually highest for countries with intermediate regimes, where the growth rate of interest rates was almost 9 percent. A change in nominal interest rates is of importance because a fall in these rates will lead to a stronger demand for money. But the level of real interest rates (i.e., the nominal rates adjusted for inflation) also gives a direct measure of confidence. On average, the real interest rates were 0.2 percent a year under pegged regimes, 1.8 percent under intermediate regimes, and 2.3 percent under floating regimes.

For a variety of reasons--including interest rates that are set by the authorities rather than being determined by the market--the greater confidence that pegged exchanges can bring may not be fully reflected in the observed domestic interest rate. Nonetheless, it is possible to identify the "confidence effect" of various regimes by considering the residual inflation once the effects of money expansion, real growth, and domestic interest rates have been removed. A higher residual inflation implies lower confidence.

Do pegged rates lead to greater confidence? They do. Chart 1 shows the residual inflation rates. Countries with pegged exchange rates had inflation 2 percentage points lower than those with intermediate regimes, and 4 percentage points lower than those with floating regimes. This differential in favor of pegged rates is as large as 6 percentage points in the lower-income countries, but only 3 percentage points for countries without capital controls--perhaps because abjuring capital controls itself inspires confidence in the domestic currency.

Not only do countries with pegged exchange rates have lower inflation on average, they are also associated with lower inflation variability.

Growth

The exchange rate regime can influence economic growth through investment or increased productivity. Pegged regimes have higher investment; floating regimes have faster productivity growth. On net, per capita GDP growth was slightly faster under floating regimes.

Economic theory has relatively little to say about the effects of the nominal exchange rate regime on the growth of output. Typically, arguments focus on the impact on investment and international trade. Advocates argue that pegged exchange rates foster investment by reducing policy uncertainties and lowering real interest rates. But equally, by eliminating an important adjustment mechanism, fixed exchange rates can increase protectionist pressure, distort price signals in the economy, and prevent the efficient allocation of resources across sectors.

Growth Performance

Annual GDP growth per capita averaged 1.6 percent over our sample. Although differences exist across exchange rate regimes, these are generally less marked than the differences in inflation rates (Chart 2). Different samples, moreover, lead to varied conclusions about growth under fixed and floating exchange rates. Growth was actually fastest under the intermediate regimes, averaging more than 2 percent a year. It was 1.4 percent a year under pegged exchange rates and 1.7 percent under floating rates. This pattern emerges mainly because of the lower middle-income and low-income countries; growth was somewhat higher under pegged rates for the industrial and upper middle-income countries.

Just as inflation was generally lower in the 1960s, growth rates tended to be higher. Controlling for this widens the differential in favor of floating exchange rates to 0.8 percent over all countries, and as much as 1.5 percent for the lower-income countries.

Explaining the Differences

By definition, economic growth can be explained by the use of more capital and labor (the factors of production) or by residual productivity growth. This productivity growth reflects both technological progress and--perhaps more important--changes in the economic efficiency with which capital and labor are used.

Investment rates were highest under pegged exchange rates--by as much as 2 percentage points of GDP--with the largest difference for the industrial and upper middle-income countries and almost none for the lower-income countries. With higher investment rates and lower output growth, productivity increases must have been smaller under fixed exchange rates.

Part of the higher productivity growth under floating rates is reflected in faster growth of external trade. Trade growth (measured as the sum of export growth and import growth) is almost 3 percentage points higher under floating rates. The lower-income countries--where real exchange rate misalignments under fixed rates have been more common--show an even larger difference in trade growth between pegged and floating exchange rates.

While not overwhelming, the evidence suggests that fixing the nominal exchange rate can prevent relative prices (including, perhaps, real wages) from adjusting. This lowers economic efficiency. Part, though not all, of this lower productivity growth is offset by higher investment under pegged exchange rates. A comparison of countries that switched regimes shows that a move to floating exchange rates results in an increase of GDP growth of 0.3 percentage points one year after the switch and of more than 1 percentage point three years after the switch. One manifestation of the rigidities that pegged exchange

rates can engender is the higher volatility of GDP growth and of employment. As the last rows of Charts 7-12 indicate, GDP growth was more volatile under pegged exchange rates, as was employment.

Poverty in Nigeria

Poverty has been defined in various ways. These include the inability to attain a minimum standard of living (World Bank, 1990) and in "relative" (e.g., unable to buy a pre-specified consumption basket) and "absolute" terms (i.e. below US $ 1 per day per person), among others. There are different types of poverty, that is, income poverty and basic needs (food, education, health care etc.) poverty. While poverty in the developed countries is basically income determined, in the developing countries, it is, in addition, the result of deprivation and lack of access to basic services (e.g. safe drinking water, health care, education and housing). Other dimensions of poverty are cultural, climatic, ecological and historical.

The relative conceptualization of poverty is largely income based. Accordingly, poverty depicts a situation in which a given material means of sustenance, within a given society, is hardly enough for subsistence (Townsend, 1962). It is important that poverty must be conceived, defined and measured in absolute quantitative ways relevant for policy analysis. Poverty in Nigeria is widespread and deep. The country progressively slipped from being one of the middle-income oil producing countries in the late 1970s and early 1980s to one of the lowest-income countries in the early 1990s. Moreover, the 2004 edition of the UNDP's Human Development Report placed Nigeria in the 151st position, based on the Human Development Index. Casual evidence of the growing intensity of poverty in the country can be glimpsed from rising incidence of mass unemployment, urban vagrancies and homelessness among the poorest groups, diminished access to quality foods and nutrition, health-care and educational facilities, and the rising incidence of street begging, among others. Other factors that encourage and can aggravate poverty, especially in low-income countries include poor governance and corruption.

Concern about poverty in Nigeria is very great: The Nigerian situation is a paradox. It is a rich country inhabited by poor people-poverty in the midst of plenty. The country is richly endowed with a diversity of human and natural resources from which the bulk of its wealth is derived. The immense waste of human resources in Nigeria due to poverty can be partly attributed to the unhealthy state of the Nigerian economy. The growth rate of the real gross domestic product of Nigeria since the early 1990s has not been encouraging. The rates have been very low in the last five years. From the rate of 8.3 percent in 1990, it declined to 1.0 percent in 1994 and then rose to 2.2 percent in 1995 and to 3.7 percent in 1997. By 1998, it dropped to 2.6 percent and gradually increased to 3.9 percent in 2001, but by 2002, it had dropped again to 3.3 percent, (see table 2.2). These figures, when viewed in comparison to the population growth of an average 2.8 percent (UNSN, 2001) per annum, leave little room for substantial improvement in living standards. A petroleum and gas producing country, Nigeria has, since the mid-1970s, been heavily dependent on revenue from crude oil for much of its domestic and foreign expenditure requirements. As Table 2.2 illustrates, crude oil export has accounted for over 95% of the country's total export earnings over the past two decades. The country currently (2004) produces 2.65 million barrels of crude oil per day, which, at the prevailing international prices of $53-$54 per barrel, represent a huge resource inflow. The contribution of the primary sector has remained relatively stable over the period, 52.2 per cent in 1990 to 52.3 percent in 1999 and 47.8 percent by 2002, while that of the secondary sector has consistently declined from 1991 except for 2002 when it rose slightly to 10.5 percent. The tertiary sector's contribution has increased marginally over the years, from 37.2 per cent in 1990 to 39.4 percent by 1999. It rose to 45.2 percent in 2000 before declining to 41.7 percent by 2002. The diversification index has remained relatively stable, suggesting that no fundamental structural changes have taken place in the country.

Causes of Poverty

The worsening of poverty in Nigeria has been traced to several factors: poor and inconsistent macroeconomic policies, weak diversification of the economic base, gross economic mismanagement, weak intersectoral linkages, persistence of structural bottlenecks in the economy, high import dependence and heavy reliance on crude oil exports, are high on the list of its causes. Other factors include the long absence of democracy and the usurpation of political power by the military elite, lack of transparency and high level of corruption, declining productivity and low morale in the public service, as well as ineffective implementation of

relevant policies and programmes (UNSN, 2001).

The basic causes of poverty in Nigeria have been identified to include, inadequate access to employment opportunities for the poor, lack or inadequate access to assets such as land and capital by the poor; inadequate access to the means of fostering rural development in poor regions; inadequate access to markets for the goods and services that the poor produce; inadequate access to education, health, sanitation and water services; the destruction of the natural resource endowments which has led to reduced productivity of agriculture, forestry and fisheries; the inadequate access to assistance by those who are the victims of transitory poverty such as droughts, floods, pests and civil disturbances and inadequate involvement of the poor in the design of development programmes. These multidimensional causes of material and non-material deprivation make poverty to be very endemic in Nigeria (FOS, 1996)

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Similarly, poverty in Nigeria has geographical and gender perspectives. According to the UNDP (2001), the poverty level in Nigeria is lowest in South East (53.5 per cent), and highest in the North West (77 per cent). The agricultural sector has the highest population of poor people, increasing from 31.5 per cent in 1980 to 70 per cent in 1996 (FOS, 1999). Findings from the poverty and development study conducted by the CBN/World Bank (1999) indicated that women are more prone to poverty than men. The study asserted that the consequences of being a woman in Nigeria include the following: the likelihood of having fewer opportunities than men; of coping with the material aspects of well being; of having very limited strategies and safety nets; and of constantly living with a sense of insecurity. While poverty tends to cluster geographically, there are other macroeconomic shocks that affect poor households in every region. Among them, inflation has been identified as one significant cause of poverty deepening. The inflation rate has been growing rapidly since 1990, as shown in Table 2.2. From a figure of 7.4 percent in 1990, it increased to 72.8 percent in 1995. The rate dropped substantially to 6.6 percent in 1999 and by 2002, it had increased to 12.9 percent, which was still lower than the 18.9 percent recorded in 2001(CBN, 2002). The implication of this is that the purchasing power of the poor has been eroded over the years and consequently aggravated the poverty phenomenon among the poor. The continued pressure on the price level may be attributed to the high government fiscal deficit financed largely by the CBN2, which resulted in excess liquidity in the banking system and a substantial increase in domestic aggregate demand. Other factors were increases in production costs, including interest rates and high transportation costs, arising from a sharp rise in the price of petroleum products. The rise in the price level was mainly induced during this period by the depreciation of the Naira exchange rate and the excessive growth in domestic liquidity (CBN, 2002).

According to the NLSS 2004**,** the incidence of poverty in Nigeria, using the three objective measures, viz: relative poverty line, absolute poverty line and one dollar per day measure, declined compared to the 1996 figures. The three measures show the incidence of poverty as ranging from 51.6 per cent (one dollar per day measure to 54.7 per cent (absolute poverty line). The incidence of poverty (also known as poverty headcount) is the proportion of the population whose consumption falls below the poverty line.

The poverty incidence reduced from 65.6 per cent in 1996 to 54.7 per cent in 2004 but the number of poor people increased substantially from about 67 million to 71 million using the absolute poverty line index. Moreover, the results of the people's self-assessment of their own poverty status indicate over 75.0 per cent poverty incidence. In other words, three out of every four Nigerians believe that they are poor, thus creating doubts on the observed poverty reduction.

Nigeria: Population and Poverty Incidence Trends

Year	Estimated Total Population (million)	Poverty Incidence (Per cent)	Population in Poverty (million)
1980	65	28.1	18.26
1985	75	46.3	34.73
1992	91.5	42.7	39.07
1996	102.3	65.6	67.11
2004	126.3	54.4	68.70

Table 2: Nature of Poverty Incidence[3]

	Extreme poor	**Moderate poor**	**Non poor**
National	22.04	32.38	45.58
Urban	15.64	27.54	56.81
Rural	27.08	36.19	36.73

Table 3: Poverty Incidence by Gender of Household Head[4]

	Male Headed		Female Headed	
	Poor	Non Poor	Poor	Non Poor
All	56.49	43.51	36.54	63.46
Urban	44.28	55.72	34.77	65.23
Rural	65.90	34.10	38.23	61.77

[3] *Table 2 shows that both extreme poverty and moderate poverty are higher in the rural sector than in the urban sector.*

[4] *Table 3 shows that male-headed households have more poverty on the average than female-headed households at the national level as well as in the rural and urban sectors*

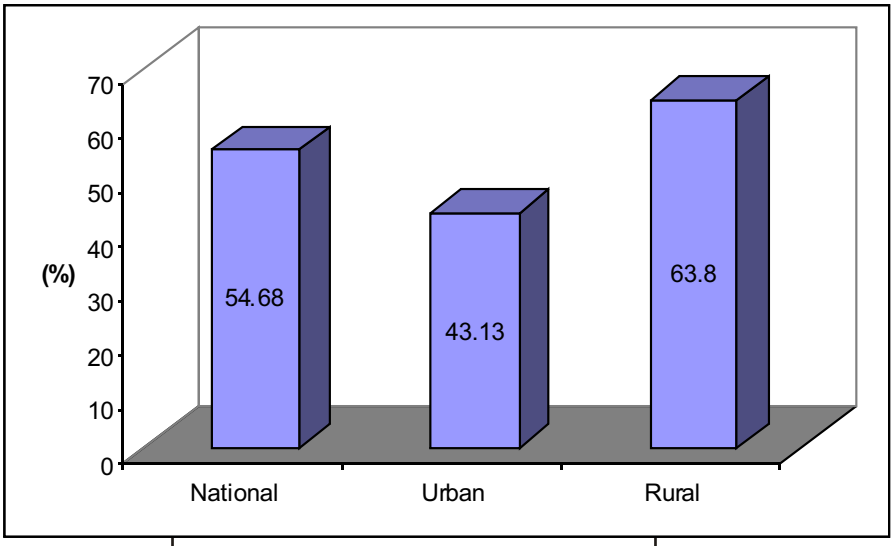
Table 4: Poverty Incidence by Different Poverty Lines

Poverty line	Poor	Non-poor
Relative poverty line	54.41	45.59
Absolute poverty line	54.68	45.32
One dollar per day poverty line	51.55	48.45
Self Assessment	75.50	24.50

Nevertheless, perhaps, the reduction in poverty incidence is due to the observed improved growth rate in recent years. But in the absence of time series data on inequality, it is not clear if improvement in inequality contributed to the observed reduction in poverty. Also, data limitation prevents a definitive statement as to whether or not the growth is pro-poor. The point though is that the relatively high economic growth between 1997 and 2004 succeeded in lifting out of poverty only 17 persons out of every 100.

Poverty in Nigeria is largely a rural phenomenon. The incidence of poverty as well as its depth and severity are higher in the rural areas then in the urban areas. More than half of rural households are absolutely poor while the proportion is much less in the urban areas. The high incidence of poverty in the rural areas is due to their dependence on low productivity agriculture, lack of access to opportunities and poor social and economic infrastructure.

Figure 2:1 Poverty Incidence in Nigeria



Exchange Rate Stability

Exchange rate stability refers to the lack of movement over time (usually two years) of the exchange rate of a country. It requires the observance of the normal fluctuation margins provided by the Exchange Rate Mechanism for at least two years, without devaluing against the currency of any other member state, on its own initiative, and without severe tensions. Exchange rate stability is one of the principal factors for any successful effort to increase private sector development, economic growth and macroeconomic stability. Although it is difficult to prove, macroeconomic instability has generally been associated with poor growth performance. Without macroeconomic stability, without exchange rate stability, growth in

investment will be frustrated because foreign investors will stay away and resources will be diverted elsewhere.

Macroeconomic policies influence and contribute to the attainment of rapid, sustainable economic growth aimed at poverty reduction in a variety of ways. By pursuing sound economic policies, policymakers send clear signals to the private sector. The extent to which policy makers are able to establish a track record of policy implementation will influence private sector confidence, which will, in turn, impact upon investment, economic growth , and poverty outcomes.

Macroeconomic volatility and high output fluctuation, resulting from exogenous shocks and instable policy regimes, may impact on poverty (Breen/Garcia-Penalosa 1999). The income of the poor may be affected by a negative impact of macroeconomic volatility on investment and growth due to distorted price signals and expected rate of return. Increased precautionary savings caused by higher uncertainty about future income may also lead to either decreased or increased economic growth. In addition, credit market effects, i.e. higher incidence of credit rationing or increased risk premium and borrowing rates for private firms may negatively affect the income of the poor.

Identifying the predominant economic shocks and the structural features of a specific country and choosing the exchange rate regimes which best insulates the economy against shocks could be seen as one reason for different impact of exchange rate arrangements on pro-poor growth. This is based on the assumption that exchange rate regimes dampen or amplify the negative effects of exogenous shocks and adjustment processes. From Mundell-Flemming framework, fixed exchange rate regimes are assumed to stabilize output in case of nominal shocks to domestic asset markets, while real shocks are more easily absorbed by flexible exchange rate regimes.

Prudent macroeconomic policies can result in low and stable inflation. Inflation hurts the poor by lowering growth and by redistributing real incomes and wealth to the detriment of those in society least able to defend their economic interests. High inflation can also introduce high volatility in relative prices and make investment a risky decision.

Exchange rate instability may impact the poor through the following: (a) inefficient allocation of resources between foreign and domestic goods and price distortions due to misalignments. It could also lead to reduced investment and competitiveness of the tradeable sector with its negative impact on the poor. Furthermore, the cost to the poor may be increased by the extent of financial integration in the international capital markets. Inappropriate exchange rate policies distort the competition of growth by influencing the price of tradeable versus nontradeable goods. Apart from distorting trade and inhibiting growth, an overly appreciated exchange rate can impair the relative incomes and purchasing power of the poor

Exchange rate policies can affect the poor through three channels: inflation, output, and the real exchange rate. Inflation hurts the poor because it acts as a regressive tax and curbs growth. Fluctuations in output have direct impact upon the incomes of the poor. Also a chosen exchange rate regime can buffer, or amplify, exogenous shocks. The real exchange rate can affect the poor in two ways first, it influences the country's external competitiveness and hence its growth rate; secondly, a change in the real exchange rate (through, for example, a devaluation of the nominal rate), can have a direct impact on the poor.
Specifically, exchange rate instability can affect the poor through the following channels:

- Investment growth. Instability tends to distort price signals and the expected rate of return for investors; in the presence of irreversibility effects, the decision to wait may lead to lower private investment and lower growth rates.

- Precautionary savings. The propensity to save for both rich and poor households may increase if exchange rate instability or macroeconomic instability translates into higher income uncertainty or an increased probability of facing borrowing constraints in “bad times”. However, higher savings may also increase resources available for financial intermediaries to lend to potential investors, thereby stimulating growth.

- Credit market effects. A higher degree of exchange rate or macroeconomic instability may heighten the perceived risk of default by lenders and increase the incidence of credit rationing, or lead to a higher risk premium and borrowing rates for private firms. This may have adverse effect on labor demand and the poor.

- Distributional effects. High and variable inflation may explain large changes in the distribution of income and wealth; such effects may be of considerable importance. Inflation affects income distribution through the relative value of different assets and liabilities may be by lowering the real value of both nominal assets and liabilities; favors debtors and holders of real equity over lenders and owners of nominal assets; could also affect negatively suppliers of labor locked in long-term employment contracts. The poor may suffer from inflation through an erosion of their nominal assets, whereas the middle class may benefit from an erosion of its nominal liabilities. High inflation may also affect income distribution indirectly by lowering output and employment

through a variety of channels, including distortions in relative price signals and their effects on allocative efficiency.

Exchange rate instability impacts on the poor through unemployment, higher price of foodstuffs, pressure on the employed to accept lower or no wage increases, higher costs of borrowing, reduction in the purchasing power of financial assets. It could also mean increased return for the goods of those households in the tradeable sector. It is also well known that macroeconomic volatility, high output fluctuation and unstable exchange rate regime impact on poverty. For instance, the income of the poor may be affected by a negative impact of macroeconomic volatility on investment and growth due to distorted price signals and expected rate of return. Increased precautionary savings caused by higher uncertainty about future income may also lead to either decreased or increased economic growth.

Some Recommendations and Conclusion

The worsening of poverty in Nigeria has been traced to several factors: poor and inconsistent macroeconomic policies, weak diversification of the economic base, gross economic mismanagement, weak intersectoral linkages as well as persistence of structural bottlenecks in the economy. The basic causes of poverty in Nigeria have been identified to include, inadequate access to employment opportunities for the poor, lack or inadequate access to assets such as land and capital by the poor; inadequate access to the means of fostering rural development in poor regions; inadequate access to markets for the goods and services that the poor produce; inadequate access to education, health, sanitation and water services. Exchange rate instability fuels other macroeconomic shocks including inflation. The implication of this is that the purchasing power of the poor is eroded and consequently aggravates the poverty phenomenon among the poor.

Most studies on poverty in Nigeria have not, as such, examined the impact of macroeconomic shocks on the welfare of the poor. Yet, macroeconomic shocks have a direct effect on the livings standards of poor households, through the goods, services and financial markets. Furthermore, the Nigerian economy is highly susceptible to exchange rate changes because of the import-dependent nature of its largely uncompetitive manufacturing industries. There is a negative relationship between exchange rate, depreciation and poverty. For instance, a depreciated exchange rate could boost exports and the expansion of import competing industries; it could raise the cost of living for consumers, including the poor. The overall expected effect is increased employment, greater output and consequently improved welfare for the poor. But exchange rate instability or unwholesome exchange market behavior in the country tend to aggravate poverty. Persistent depreciation of the currency exchange rate has led to considerable capital flights in recent years. It also resulted in round-tripping activities by some of the financial houses generating opportunities for corruption. The implication is that the poor is made to suffer.

Some Recommendations

Macroeconomic stability is a key component of a growth-promoting environment and is indirectly, therefore, a foundation for any successful poverty reduction strategy. The link is that macroeconomic stability encourages investment and promotes productivity growth and employment creation. In this sense, macroeconomic stability is a public good. In recent years Nigeria's macroeconomic environment has been relatively volatile and, unfortunately, trapped in an adverse loose fiscal/tight monetary policy mix.

A labor-shedding restructuring and reforms in both the public sector that was not matched with an environment conducive to employment creation by the private sector (particularly by small and medium enterprises) on the demand side, as well as the unchecked access to social safety nets amidst increasing population growth rate on the supply side, have contributed to a dramatic worsening of labor market conditions, a consequent rise in unemployment, and the resulting poverty increase.

Hence, a return to robust growth (as the main factor in poverty reduction) requires a stable macroeconomic environment with a balanced fiscal-monetary policy mix and stable exchange rate regime. To prevent the re-emergence of economic imbalances, a fiscal consolidation and the reduction of overall deficits are needed to complement the recent monetary policy measures. A parallel reduction in the size of the government budget would provide greater space for private sector development. Together with an additional and necessary recomposition of government expenditures from consumption to investment, these policies would significantly strengthen Nigeria's growth prospects.

In order for growth to be poverty-reducing, the link between economic development and labor market improvement must be strengthened significantly (or perhaps even re-established). In other words, the growth environment must be made more labor-friendly. In the short to medium term this would involve a necessary reduction in the tax wedge (payroll taxes) as well as an increase in the flexibility of the labor market. In the longer run, policies are needed that will close the mismatch of skills between labor demand and supply, which means promoting investment in human capital and education.

Price stability is an essential component of a poverty alleviation policy. Inflation predominantly hurts the poor, who have little opportunity to protect their assets. For this reason, low inflation in general, and particularly low food price inflation, should be perceived as a genuine achievement of recent years. In addition, the decline in nominal and real interest rates brought about by the monetary easing should work to the advantage of the poor by increasing their capacity to smooth consumption.

Fiscal policy works best if it is pro-poor. Since the poor have a higher propensity to spend, leaving more resources with them during hard times provides an effective tool against cyclical downturns of the economy, contributes to the well-being of the vulnerable, and feeds back positively to overall macroeconomic stability.

The tax component of fiscal policy appears to perform its anticipated stabilization role. Any changes to the system to improve its pro-poor impact should be considered carefully, so that they do not further increase the distortions that taxes bring to the economy, particularly that they do not increase the overall tax burden. The elimination of exemptions (tax expenditures are directed mainly toward the rich) complemented by an overall reduction in payroll taxes in at least a budget neutral way is a plausible recommendation.

The social transfers mechanism is still underdeveloped in Nigeria but when properly harnessed and efficiently managed, could play an important role in poverty alleviation. Currently, the major part of the resources is not going to the most needy. If these funds were targeted properly, rather than being spread more or less uniformly over the entire consumption distribution, they could eradicate poverty completely twice over. Therefore, improving the targeting of social transfers should be an immediate necessity. Poor targeting not only leaves many of them vulnerable without the help of the state, but it also skews incentives to work and poses a significant burden on government finances.

Given the revenue flows from oil exports, the Nigerian economy is becoming wealthier but at the same time more polarized. Therefore, there is a strong case for good poverty/social monitoring that involves going beyond aggregations and applying more complex analytical tools, such as various decompositions, growth incidence, benefit incidence, etc. Such monitoring can provide both the public and policymakers with a better knowledge of whether and how the economy is changing, and with the ability to identify the sources of such changes. It can also make it possible to assess winners and losers, and, in particular, it can become a basis for judging whether these inequalities are acceptable or not. Moreover, an ex ante assessment of the impact of social programs on income distribution and poverty could become a valuable tradition.

An efficient exchange rate regime is that which promotes economic growth and addressing employment policies for poverty reduction. This is because the essence of the poverty reduction is to encourage (a) a high rate of labor-absorbing growth; (b) promoting the self-employment of the poor by converting them into productive entrepreneurs; (c) increasing the productivity of the poor workers both in wage employment and in self-employment; (d) ensuring favorable terms of exchange for the products of the poor's labor; and (e) specially designed employment opportunities for the households with unusual and/or unfavorable labor endowment.

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