

CAUSAL RELATIONSHIP BETWEEN EXCHANGE RATE MISALIGNMENT AND INFLATION IN NIGERIA: EVIDENCE FROM STRUCTURAL VECTOR AUTOREGRESSION (SVAR)

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Abstract

A well-known view in international macroeconomics literature states that a misaligned exchange rate provokes costs to the domestic economy. In other words, an overvalued currency may cause competitiveness loss in international trade, while an undervalued currency may cause inflationary pressures. Based on this, this paper tests the conjecture that exchange rate misalignment is related to inflation using the SVAR framework to compute exchange rate misalignment and subsequently testing the conjecture. The SVAR model is utilized among the competing models in understanding the dynamics of real exchange rate because it has a better empirical fit and allows for greater identification of shocks that make economic sense. Compared to other models, the kind of SVAR model used for this study is based on the Blanchard & Quah, (1989) methodology. Where variables in the model attain their stationarity at first difference, the empirical model should be estimated as a vector auto-regression model in first differences. In order to achieve the objective of the study, this paper uses Toda-Yamamoto Granger noncausality test and the result demonstrate a significant Granger causality from inflation to exchange rate misalignment but the converse is not true which support the view that inflation persistence is responsible for overvaluation of the naira (misalignment) which is inimical to competitiveness and growth, this necessitated the need for appropriate response to bring the real effective exchange rate (REER) on its equilibrium path via embarking on disinflation policies.

Keywords: Exchange Rate Misalignment, Inflation, Oil price, Structural Vector Autoregression