AB Journals

African Journal of Accounting and Financial Research
ISSN 2682-6690 • Volume 9, Issue 4, 2026 • pp. 1–13

RESEARCH ARTICLE Received: 29 Jan 2026, Accepted: 20 Feb 2026, Published: 21 Sep 2026

Effect of External Reserves Management on Foreign Exchange Rate of Nigeria: Implication for Foreign Exchange Stability on Nigeria's Economy, 2000 – 2024

Ogwuma Madubuike Mike[1*]; Koinyan Ekpolador-Ebi Amafa[2]

[1]Department of Banking and Finance, Nnamdi Azikiwe University, Awka, Anambra State.
[2]School of Management, University of Bradford.

[*]Corresponding Author's Email: ogwumamikemadu@gmail.com

Abstract

The study examined the effect of external reserves management on foreign exchange rate of Nigeria spanning from 2000 2024. The model of analysis included the following variables, External Reserves (EXT), Foreign Exchange Rate (FER), Imports (IM), Foreign Direct Investments (FDI), and External Debt Servicing (EDS). The study made use of Johansen Cointegration equations on the existence of the long-run equilibrium relationship amongst the variables. Error Correction mechanism (ECM) technique was used in order to determine the relationship between imports, FDI, external debt servicing, foreign exchange rate, and external reserves management. The study showed that 1 percent increase in external reserves has positive and significant effects on foreign exchange rate in Nigeria. The study recommends that Nigerian government should fashion out ways of steadily increasing its external reserves in order to stabilize the nation's foreign exchange rate and the government should vigorously pursue more and realistic import substitution policies.

Keywords: Foreign Exchange Rate; External Reserves; Import; External Debt Servicing; Foreign Direct Investment.

How to Cite: Ogwuma, M. M., & Koinyan, E. A. (2026). Effect of External Reserves Management on Foreign Exchange Rate of Nigeria: Implication for Foreign Exchange Stability on Nigeria's Economy, 2000 – 2024. African Journal of Accounting and Financial Research, 9(4), 1–13. https://doi.org/10.52589/AJAFR-LN9HQYSP

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INTRODUCTION

Many countries of the world are found to be on stiff economic competitions. These competitions are aimed at repositioning their respective economies and encourage their economic growth and development. The positive effect of these economic competitions do not only add much value to the external reserves of advantageous countries alone, but also help to boost confidence in their respective economic system.

Nigeria as a member of global economic community has been coming up with various economic strategies that can assist in boosting of her foreign reserves. Nigeria as a sovereign nation has been actively involved in the international financial operations and other services aimed at enhancing the growth and development of the country.

Nigeria has said to have had much exploitation in her numerous natural endowments in agricultural products prior to the discovery of oil in 1956 at Olobiri in the present day Bayelsea State. These natural endowments are in no doubt contributed to a large extent in enhancing the country's external reserves and the relative stability in the country's foreign exchange management. Ogwuma, et al., 2024.

External resources management has been a daunting task given higher economic volatility and other swings that are capable of affecting the general economy in the negative form.

Management of external reserves stands as one of the integral and core functions of the central bank of Nigeria. It involves maintaining of an adequate volume of reserves in order to safeguard the value and exchange rate of the domestic currency, Akinwunmi, and Adekoya (2015)

As stated by Central Bank of Nigeria, external reserves consists of official public sector international assets that are readily available to and controlled by the monetary authorities for direct financing of payment imbalances, and directly regulating the magnitude of such imbalances through their involvement in the exchange market to affect the currency exchange rate and or for other purposes; CBN (2007).

The robustness of any countries external reserves is the function of her external sector growth and development. This singular economic catalyst is anchored on a country's international business operations, exchange rate stability, volume of export, Annual debt servicing and other economic indications that have direct influence on the effective external reserves management, Alasan and Shaib (2011)

For a country like Nigeria that operates a managed float exchange rate system, the relationship between external reserves and foreign exchange supply is very vital. This is principally because; reserves are used to influence the exchange rate, as a result of changes in the demand for foreign exchange. Expectedly, supply of foreign exchange following high demand, should lead to a fall in the level of reserves to stabilize the exchange rate. Rapu, Gaiya, Eboreime, Nkang, Audu, Golit and Okafor, (2016).

Exchange rate system in Nigeria has undergone series of changes in its policies and methods for over five decades now. 1960s had fixed exchange rate system of operation till 1970s via mid 1980s of pegged exchange rate system. In 1986, Nigeria introduced an exchange rate policy under structural adjustment programme (SAP) which ushered in floating exchange rate system

Prior to the introduction of floating exchange rate policy, the first exchange rate system was believed to have induced the over valuation of the Naira, which caused higher leakages in the economy with resultant effect on massive importation of finished goods. In the same vein, Nigeria's domestic production started dwindling, as well as the country's external reserves, given imbalances in the balance of trade positions. Akinbobola and Osetayo (2010)

As noted by Ogwuma, Nwachukwu, Avoaja and Nwabeke (2025), Nigeria's foreign reserves dropped by US$ 881.84 million and closed at US$ 34.11 million in the second quarter of 2023. Prior to May 29, 2023, Nigeria's total external reserves was US$ 35.14 billion and dropped to US$ 1.91 million between may 29, 2023 and June 30, 2023. The US$ 33.23 billion external reserves reported in the third quarter 2023 stood as the lowest in two years since hitting US$ 33.22 billion on July, 2021. (Central bank of Nigeria, 2023)

Nigeria's external reserves declined to US$ 38.74 billion as of February 20, 2025, marking a 5.3% decrease (US$ 2.1 Billion) from the year as high as US$ 40.92 billion recorded on January 6, 2025. The decline is attributed to the CBN'S effort to settle a portion of its 361 - day Open Market Operation (OMO) and 364 - day Treasury Bill obligations owed to foreign portfolio investors (FPIs) with maturities between January, 6 and march 27, 2025. (National bureau of statistics, 2025).

The Nigeria's external reserves remain robust at US$ 38.74 billion as at 14th February 2025, translating to an import cover of 9.6 months for goods and services, and will not create unexpected panic on the stability of the exchange rate.

REVIEW OF THE RELATED LITERATURE

Conceptual Review

Nigeria as an economic entity within the global economic environment is believed to have vast untapped human and natural resource endowments.

Nigeria in the same vein competes in the world economic activities in other to, not just show economic strength in the global market, but also to grow and groom her domestic economy.

Nigeria has over the years been enacting and modifying laws and policies aimed at encouraging exports of locally manufactured goods and services in other to boost domestic economy earn foreign exchange and grow the country's external reserves. Among some regulations are the 2004 amended export of Nigeria produce Act, 2004 export incentive Act, 2004 export processing zone act and among others. Adeyemi (2012)

The enacted and modified laws are aimed at creating more glaring avenues in enhancing the full potential of Nigeria in their international export market opportunities.

These regulations and amended laws has helped Nigeria exploit those export opportunities in competing favorably to some extent, earn foreign exchange, increased the foreign reserves, stabilize foreign exchange rate and as well as instilling confidence in the general economy, Ogwuma, et al., 2016.

Key Challenges Facing External Reserves Management in Nigeria:

The following are some of the challenges facing Nigeria's external reserves management,

which directly or indirectly affect the country's foreign exchange management.

1. **Import Dependence**: In recent times, Nigeria has been regarded as an import based economy. This assertion corroborates Nigeria's continuous unfavorable trade balances and the country's narrow economic system anchored on oil as its main sources of foreign exchange earnings. The near dearth of diversification in Nigeria's economic system and also near zero export oriented has put pressure on the country's citizens to consume virtually everything imported.

2. **Low-Productivity:** The domestic economy of Nigeria has been witnessing lower productivity compared with her external economic sector. Nigeria is believed to have been endowed with abundant human and material resources. But be that it may, the country has been witnessing lower productivity which affect and put more pressure on her external reserves and distort exchange rate stability.

3. **High Exposure to Foreign Loans:** Foreign loans should be stimulus and critical ingredients of economic growth and development. Especially, when it involves accessing external loans to support critical infrastructure which will help to spur growth. But it seems that the reverse is the case in Nigeria. Nigeria has been much exposed to foreign loans which in turn have been a source of worry on the stability of foreign exchange and the control of the inflation in the domestic economy. Nigeria is highly exposed to external borrowing through Eurobond and other non - concessional loans. It is believed that, maintaining a favorable trade balance, as well as adequate inflows of foreign investments, will contribute significantly to improving the net flows of foreign exchange through the economy.

Theoretical Review

Nigeria's economic trajectory has been anchored on periodic trends of economic activities. Given all these, Theoretical review on this work is based on the following theories.

Mercantist Theory: This theory posits that many countries accumulate foreign reserves as a means for a control and much more effective exchange rate management. This theory is also of the view that countries accumulate foreign exchange rate in order to promote trade and international trade competitiveness

Debt Overhang Theories: As maintained by krugsman (1998) and Sachs (1988 - 1989) debt overhang is a suituation in which future debt burden is perceived to be very high that brings disincentive to present investment, as investors will believe that there will be a higher tax burdern for the service of pre-existing debt.

The Balance of Payment Theory: This theory stipulates that under free exchange rates system, the exchange rate of the currency of a country depends upon its balance of payment. A favourable balance of payment raises the exchange rate, while an unfavourable balance of payment reduces its exchange rates, thus the theory implies that the exchange rate is determined by the demand and supply of foreign exchange.

The Purchasing Power Parity Theory: The Purchasing Power Parity Theory is of the view that spot exchange rate between currencies will change to be differential in inflation rate between countries. The theory states that the equilibrium exchange rate between two inconvertible paper currencies is determined by the equality of their purchasing power . That is, the exchange rate between two countries is determined by the relative price level.

Empirical Review

Ahmad and Pentecost (2009) examined the long-run relationship between exchange rate and internationl reserves in a sample of African countries for 34 years, using the Threshold Co-Integration Technique. They found that a long run dynamics exist between the series. Although it was evident in their study that the threshold point estimate varies from country to country, as a result of different country's exchange rate regimes. They concluded that floating exchange rate regimes seems to have higher threshold than the pegged exchange rate regimes.

Gokhale and Raju (2013), examined the "Causality between exchange rate and foreign exchange reserves in Indian context. Contrary to the most research works. Their finding showed that the huge foreign exchange reserves do not essentially exhibit a long run or short run correlation with the exchange rate.

Ibrahim (2011) investigated the impact of change in external reserves positions of Nigeria and domestic investment, inflation and exchange rate between 1988 and 2006. A combination of Ordinary Least Square and Vector Error Correction Models were employed. The result showed that changes in reserves influence only foreign direct investment and inflation rates.

Taiwo, Akinbobola and Ikotun (2017), examined exchange rate reforms policies and trade balances in Nigeria between 1970 - 2012. Annual data was collected from the Central Bank of Nigeria's Statistical Bulletin, and World Development Indicator of the World Bank. Co-Integration and Error Correction Methods were used for the estimation. Their findings are that, the level of income of the country as well as its trading partners were strong determinants of the trading activities in Nigerian economy, the effect of exchange rate on trade balance was significant in the long-run, but contrary to the aspiration of the policy makers and in contrast to the J-Curve hypothesis, exchange rate had an increased relationship with the trade balance in Nigeria.

Petrovic and Gligoric (2010) examined whether exchange rate depreciation improves trade balances, and whether appreciation worsens it. The paper shows that exchange rate depreciation in Serbia improves trade balance in the long-run, while giving rise to J-Curve effect in the short run.

Ani, Ugwunta and Akanya (2013), Investigated the effect of foreign exchange reforms on financial deepening. Evidence from Nigeria from 1960 to 2013. The explanatory variables were developed and selected in line with the theoretical framework. OLS were used to determine the overall effect of foreign exchange reforms on financial depth of the economy. Findings on FDI and GDP, ratio of market capitalization on listed equites to GDP and real interest rate have positive relationship with financial deepening and secondly, among the determinants of financial depth only the ratio of GDP to real interest rates posted a significant relationship with foreign exchange. The paper therefore recommends strong diversification of the Nigeria economy away from the mono economy and its peculiarities with other non-oil sectors so as to enhance commodities export and reap the benefit of stable exchange rate.

RESEARCH METHODOLOGY

Research Design

The study adopted the *ex-post facto* research design. The *ex-post facto* research design was considered appropriate because it helps in foisting a link between the dependent and independent variables using already existing secondary data. The beauty of using the *ex-post facto* research design is that the researcher relies on already existing data devoid of manipulation by the researcher (Osuala, 2010).

Nature, Sources and Methods of Data Collection

The study made use of secondary data which were collected from the Central Bank of Nigeria (CBN) Statistical Bulletin (various years). Hence, the data on foreign exchange rate, external reserves, imports, exports, foreign direct investment and external debt servicing which are the variables used in the study were collected from the Central Bank of Nigeria (CBN) Statistical Bulletin for the years under review.

Model Specification

Fapetu*et al* (2023) specified the relationship between Nigeria foreign exchange rates and its external reserves position as:

$EXR = \int (EXCH, GDP, INF)$ …… (1)

Where

EXR = External reserves

EXCH = Exchange rate

GDP = Gross domestic product

INF = Inflation rate

In line with Fapetu*et al* (2023), the model for the study is modified and specified as:

$FER = \int (EXT, IMP, EXP, FDI, EDS)$ ……...……. (2)

Transforming equation (2) into its linear econometric form, we obtain

$LOG(FER_t) = \beta_0 + \beta_1 LOG(EXT_t) + \beta_2 LOG(IMP_t) + \beta_3 LOG(EXP_t) + \beta_4 LOG(FDI_t) + \beta_5 LOG(EDS_t) + e_t$ ……...……... (3)

Where

FER= Foreign exchange

EXT = External reserves

IMP = Imports

EXP = Exports

FDI = Foreign direct investment

EDS = External debt servicing

LOG = Logarithm

β_0 = Constant (intercept) term

$\beta_1, \beta_2, \beta_3, \beta_4, \beta_5$= Coefficient parameters of the explanatory variables

e = Stochastic error term

t = time series notation

By a priori, $\beta_0 > 0$, $\beta_1 > 0$, $\beta_2 < 0$, $\beta_3 > 0$, $\beta_4 > 0$, $\beta_5 < 0$

Method of Data Analysis

The study employed error correction mechanism (ECM) technique in order to determine the effect of external reserves, imports, exports, FDI and external debt servicing. The study thereafter made use of the inferential statistics such as t-statistic, F-statistic, R-squared statistic and Durbin-Watson in order to establish the effect of the independent variables on the dependent variable (GDP)

T-statistic

The t-statistic helps in establishing the impact of each of the independent variable of interest on the dependent variable. Where the probability value of an independent variable is less than the test significant level, we reject the null hypothesis and vice versa.

F-statistic

The F-statistic helps in determining whether the model formulated (specified) for a study is significant and reliable or not. Where the probability value of the F-statistic exceeds the test significant level, we say that the model is not significant.

R-squared

This helps in determining the percentage changes in the dependent variable which is as a result of changes in the dependent variable. The higher the R-squared, the higher the goodness of fit and thus the higher the explanatory power of the model.

Durbin-Watson statistic

This measures the degree of autocorrelation in a regression result. The closer the value of the Durbin-Watson is to 2, the more there is an indication of an absence of autocorrelation.

RESULTS

Unit Root Test

Table 1: ADF Unit Root Test Result

Variable	ADF Values		0.05 Critical Values		Decision
	Levels	1st Difference	Levels	1st Difference	
D(FER)	-2.127946	-3.906379	-2.933158	-2.935001	I(1)
DLOG(EXT)	-1.749374	-3.530813	-2.933158	-2.935001	I(1)
DLOG(IMP)	-1.740330	-5.947457	-2.933158	-2.935001	I(1)
DLOG(EXP)	-1.567829	-9.442125	-2.951125	-2.936942	I(1)
DLOG(FDI)	-0.571298	-3.699629	-2.933158	-2.935001	I(1)
DLOG(EDS)	-2.071353	-8.485911	-2.935001	-2.936942	I(1)

D = Change notation; LOG = Logarithm
Source: Author's computation (2025)

The study relied on the ADF unit root test to determine the stationarity of the variables. From the result in table 1 above showed that all the variables were not stationary at level as their ADF values were less than the critical values at 5 percent level of significance. However, at first differencing, the variables became stationary given that their ADF values exceeded the critical values at 5 percent level of significance. With this, the variables are said to be integrated of order 1 (i.e. I(1)).

Cointegration Test

Table 2: Johansen Cointegration Test Result

Hypothesized No. of CE(s)	Trace Statistic	Max-Eigen Statistic	0.05 Critical Value Trace Statistic	0.05 Critical Value Max-Eigen Statistic
None*	119.2753	47.71709	69.81889	33.87687
At most 1*	71.55817	37.92098	47.85613	27.58434
At most 2*	33.63719	24.76647	29.79707	21.13162
At most 3	8.870715	6.132804	15.49471	14.26460
At most 4	2.737912	2.737912	3.841466	3.841466

Source: Author's computation (2025)

Johansen cointegration test was employed to determine the number of cointegrating equations or the existence of long run equilibrium relationship amongst the variables. The test adopted Trace statistic and Max-Eigen statistic to do this. From the Johansen cointegration test result in table 4 above, it could be seen that there were three (3) cointegrating equations given that 119.2753, 71.55817 and 33.63719 which were the Trace statistic exceeded their 0.05 critical values which were 69.81889, 47.85613 and 29.79707, respectively. Similarly, Max-Eigen statistic indicated that there exist three (3) cointegrating equations as its values 47.71709, 37.92098 and 24.76647 exceeded their critical values which were 33.87687, 27.58434 and 21.13162, respectively. Based on these outcomes, the study concluded that there exists long run equilibrium relationship among the variables.

Lag Length Selection Test Result

Table 3: VAR Lag Order Selection Criteria

Lag	AIC	SC	HO
0	-3.724445	-3.477598	-3.662363
1	-8.245825*	-6.764745*	-7.873337*

Source: Author's computation (2025)

Having established that the variables were I(1) process and there was long run equilibrium relationship among the variables, the study employed error correction mechanism (ECM) technique. However, it was important to determine the appropriate lag to be used in carrying out the error correction mechanism (ECM) test. From the result of the selection criteria test, it was evident that lag 1 was the appropriate lag given that its information criterion (AIC, SC and HQ) was smaller than that of lag zero.

Error Correction Mechanism (ECM) Test Result

Table 4: Parsimonious Error Correction Mechanism (ECM) Result

Dependent variable: DLOG(FER)

Variable	Coefficient	Std. Error	t-statistic	Prob. Value
C	-0.017419	0.072721	-0.239527	0.8142
D(LOGEXT)	0.323063	0.136443	2.367751	0.0466*
D(LOGIMP(-1))	-0.172320	0.429901	-0.400837	0.6946
D(LOGEXP)	0.091302	0.498510	0.183189	0.8573
D(LOGFDI)	0.380696	0.147368	2.583302	0.0213*
D(LOGEDS(-1))	-0.034571	0.046918	-0.736845	0.4673
ECM(-1)	-0.608113	0.320323	-1.898438	0.0736**
R-squared = 0.659182				
Adjusted R-squared = 0.511227				
F-statistic = 5.699718				
Prob. F-statistic = 0.042538				
DW-statistic = 2.105053				

**indicates significant at 5%; **indicates significant at 10%*

Source: Author's computation (2025)

From the result in table 4, there is evidence of a positive relationship between foreign exchange rate and external reserves in Nigeria. The study showed that 1 percent increase in external reserves led to 0.32 percent appreciation of foreign exchange in Nigeria. The probability value of EXT (0.0446) was less than the test significant level (0.05). Thus, the study concluded that external reserves had significant effect on foreign exchange (FER) in Nigeria.

Imports had negative relationship with foreign exchange in Nigeria. 1 percent increase in imports into Nigeria led to 0.17 depreciation of foreign exchange in Nigeria. The probability value of IMP (0.6946) exceeded the test significant level (0.05) and with this, the study concluded that imports had no significant effect on foreign exchange in Nigeria.

Result also showed that foreign exchange rate had positive relationship with exports in Nigeria. 1 percent increase in exports from Nigeria led to 0.09 percent appreciation of foreign exchange in the country. The probability value of EXP(0.8573) was greater than the test significant level (0.05). Thus, the study concluded that exports had no significant effect on foreign exchange (FER) in Nigeria.

Foreign direct investment (FDI) had positive and significant link with foreign exchange in Nigeria given that 1 percent increase in FDI led to 0.38 percent appreciation of foreign exchange in Nigeria. The probability value of FDI (0.0213) was less than the test significant level (0.05) and this indicated that foreign direct investment had significant effect on foreign exchange in Nigeria.

External debt servicing had negative and insignificant nexus with foreign exchange in Nigeria. The study showed that 1 percent increase in external debt servicing led to 0.03 percent depreciation of Nigeria's foreign exchange. The probability value of EDS (0.4673) exceeded the test significant level (0.05) which indicated that external debt servicing had insignificant effect on exchange rate in Nigeria.

Error correction term (ECM) appeared with the correct negative sign as expected and it was significant at 10 percent given that its probability value was less than the test significant level (0.10). Its value (-0.608113) showed that speed of adjustment of foreign exchange rate from short run to long run was about 61 percent. This implied that short run disequilibrium in foreign exchange rate in Nigeria is adjusted to long run equilibrium position at the speed of 61percent.

Adjusted R-squared (0.511227) indicated that 51 percent of changes in foreign exchange in Nigeria are due to changes in external reserves, imports, exports, foreign direct investment and external debt servicing. Therefore, the remaining 49 percent are due to factors not included in the model. Probability F-statistic (0.042538) was less than the test significant level (0.05) and this indicated that the model adopted for the study was reliable, appropriate and significant and could be used for sound policymaking.

Using the rule-of-thumb as established by Iyeli (2010), DW-statistic (2.105053) lies within the acceptable threshold since $2 \leq 2.105053 < 4$. This indicated that there was no presence of autocorrelation.

DISCUSSION OF FINDINGS

First, the study showed that external reserves exerted positive and significant effect on foreign exchange in Nigeria. This finding conforms to economic theoretical expectation given that robust external reserves of a country ensure stability of macroeconomic fundamentals including the exchange rate. This outcome contrasts Fapetu, Oluwole, Olokoyo, Olabisi and Owoeye (2023) which found that a negative relationship existed between foreign exchange rate and external reserves in Nigeria although their study focused on determining the effect of foreign exchange rate on external reserves. Perhaps, this finding might be attributed to the efforts of the government to shore-up the nation's external reserves since the inception of democratic administration in Nigeria. From a paltry $91,089.20 million in 2000, the nation's external reserves have increased to $429,493.67 million in 2020 not minding the fluctuations that have occurred in between the years. This is an indication that the government takes interest and has made efforts in boosting the external reserves.

Second, the study showed that imports negatively and insignificantly affected foreign exchange in Nigeria. This outcome might be attributed to the high demand for foreign currency which is often associated with high importation activities in Nigeria. The high demand for foreign currency mounts pressure on the local currency (naira) resulting in more of the local currency (naira) being exchanged for less of the foreign currencies such as dollar, pounds, euro just to mention but a few (i.e. depreciation of the local currency). Nigeria remains an import-dependent nation relying heavily on importation of semi-finished and finished products into the country.

Third, the study showed that exports had positive and insignificant effect on foreign exchange in Nigeria. This finding implied that increasing the exports of commodities has the potentialities of stabilizing Nigeria's foreign exchange. Perhaps, this finding might be attributed to the concerted efforts of government at all levels towards diversifying Nigeria's economy away from oil to the non-oil sectors. With such efforts, Nigeria's foreign earnings have increased. However, the insignificant effect of exports on foreign exchange in Nigeria might be an indication that more needs to be done.

Forth, the study showed that foreign direct investment (FDI) positively and significantly led to stability of Nigeria's foreign exchange. This finding corroborates Nwachukwu, Ali, Abdullahi, Shettima, Zirra, Falade and Alenyi (2016) which argued that external reserves accumulation increased flow of investment into an economy thereby being a veritable tool for exchange rate management. Interestingly, Nigeria has been classified among the top recipients of FDI in sub-Saharan Africa and this outcome lays credence to the enormous importance of FDI in ensuring stability. Increased FDI meant more domestic investment, increased economic activities and conservation/stability of foreign exchange in Nigeria.

CONCLUSION

The high volatility of Nigeria's exchange rate has increasingly become worrisome to Nigerians especially those staying back home. To tame the volatility, government has resorted to barrage of policies and measures aimed at making the foreign exchange stable. These measures include fixed exchange rate regime, floating exchange rate, export promotion strategy just to mention but a few. In spite of the efforts of the government, exchange rate volatility has persisted in Nigeria. Based on this scenario, the study attempted to determine the nexus between external reserves and Nigeria's foreign exchange rate. Specifically, this study examined the effect of external reserves, exports, imports, foreign direct investment and external debt servicing on foreign exchange rate in Nigeria. Apart from external reserves, the other variables such as exports, imports, foreign direct investment and external debt servicing were considered control variables in the study Empirical analysis showed that external reserves had significant stabilizing effect on Nigeria's foreign exchange. This implied that boosting Nigeria's external reserves has the potential of making the nation attract higher flow of investment (foreign investment) and with increased foreign investment; exchange rate management in Nigeria would become enhanced.

Recommendations

The study made the under-listed recommendations:

(i) Nigerian government should fashion out ways of steadily increasing its external reserves in order to stabilize the nation's foreign exchange rate. This can be achieved

through improved national savings.

(ii) Import substitution policies should be vigorously pursued by the government in order to reduce Nigeria's import-dependence and achieve stability in Nigeria's foreign exchange.

(iii) Nigerian government should not relent in its economic/export diversification programmes in order to earn more foreign exchange and stabilize the nation's foreign exchange rate.

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