

## Response of Selected Macroeconomic Variables to Oil Price Shocks in Nigeria

Buhari Bello<sup>1\*</sup>, Dr. Yakubu Alfa<sup>2\*</sup>

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Lawal Ahmed Tanimu<sup>3\*</sup>

<sup>1</sup>Department of General Studies, Nuhu Bamalli Polytechnic, Zaria, Kaduna State, Nigeria

<sup>2</sup>Department of Economics, Nigerian Defence Academy, Kaduna

<sup>3</sup>Department of Business Administration and Management, Federal Polytechnic Kauran Namoda, Zamfara State, Nigeria

E- mail: buhari2023@gmail.com

### Abstract

*The question of how exchange rate, oil revenue, inflation rate and other macroeconomic variables response to oil price shocks in Nigeria has generated tremendous interests among economic scholars for decades. This study examines the responses of exchange rate, inflation rate, oil revenue and government expenditures as macroeconomic variables to oil price shocks in Nigeria using time series techniques of Vector Autoregressive (VAR) model, cointegration test, Impulse Response Function (IRFs) and Variance Decompositions (VDCs). The result of cointegration test suggests the presence of cointegration among variables. The estimated VAR model affirms the response of shocks in the macroeconomic variables. The results have shown that the oil price shocks have significant response on macroeconomic variables in Nigeria. The response of inflation rate to global oil price shocks is positive, indicating that increase in oil price leads to increase in inflation rate in Nigeria; while the response of exchange rate to oil price shocks is negative, indicating that an increase in global oil price leads to depreciation of exchange rate and fall in oil revenue thereby affecting government expenditure negatively in Nigeria. Hence, the study recommends that appropriate measures such as capacity utilization of oil sector and stable macroeconomic policies as well as diversification of economy should be emphasized by Nigerian government.*

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**Keyword:** Oil Price Shocks, Macroeconomic Variables, VAR Model, and Nigeria

### 1. Introduction

Oil and gas as well as other bio fuels are the major contributory sources of revenue and employment opportunities in Nigeria; and these have contributed larger to the economic growth and development for many decades. The oil price shocks has an effect on every other Nigerian macroeconomic variable especially oil GDP, exchange rate

volatility, interest rate, inflation rate, government expenditure, oil revenue through the sales of crude oil at international market. There are other Nigeria's macroeconomic variables such as: inflation rate, exchange rate, interest rate, stock prices, government expenditure, oil GDP, household consumption, economic size, net export, and even economic growth rate

which are all positively or negatively responded to global oil price shocks. It is however, noted that the exchange rate response to oil price shocks comes as a result of an increase in oil price leads to a rise in money supply and demand for money since there are more money after the sales of crude oil, then appreciation of exchange rate of US dollar over Nigerian Naira since the crude oil prices are exchanged in foreign currency, thereby leading to a rise on consumer and producer price indices.

However, the response of inflation rate to oil price shocks could be seen through demand side and supply side channels framework whereby in demand side shock, an increase in oil price leads to fall in consumption and investment patterns of households and firms thereby leading to a rise in cost of living that negatively affects consumer price index as well as a rise in inflation in the Nigeria. While, the response of inflation rate to oil price shocks through the supply side channel is when there is an increase in oil price leads to a rise in marginal cost of production which leads to a fall in capacity utilization and output level, the worker will demand a higher wages which will complement an increase in cost of living that will subsequently allow firms to lay-off some workers so as to maintain the same profit margins (Buhari, *et al.* 2023). In addition, the response of oil revenue and government expenditure to oil price can be seen through the inability of Nigerian government to fulfill its quota in producing over 2 million barrels per day occasioned by the activities of Niger Delta militants through pipelines vandalism, oil theft and illegal oil refineries

in the Nigeria's oil producing states which leads to dwindling of oil GDP and oil revenue that has a multiplier effect on government expenditures and budget implementation so as to meet its financial obligations as and when due .

The trend patterns in prices of global oil in the past years, reached its record nominal high of US \$98.94bpd in 2014 and a sharp drop to US \$46bpd in August 2015, down to less than US \$40 a barrel in 2016 leading to high concern about its implications on economic activities and macroeconomic variables within and outside Nigeria (Buhari, 2020). However, the Covid-19 pandemic era in 2020, coupled with Russia – Ukraine war in 2022 which caused a lot of energy crises also impacted negatively on every macroeconomic variable in the world as well as the world oil price shocks that led to fall in the price of oil at international oil market to less than \$10/pb in 2020 thereby leading to negative effects on the world's economy including Nigeria's macroeconomic indicators such as: exchange rate, inflation rate, oil revenue, interest rate and total government expenditure. This has forced the government of Nigeria to review its budget benchmark downward from \$65 to \$45.

Nigeria is known as an import dependent economy, that highly depended on the foreign exchange through the sales of her crude oil in order to finance its enormous expenditures. Nigeria continued heavily depended on oil as major export product is perceived to continue impacting on all macroeconomic variables in Nigeria.

Nigeria is highly affected by the oil price shocks at a global oil market despite being the 2nd and 5th positions of oil producing country in Africa and the World in 2022 respectively. Theoretically, if oil-price increase, it leads to a movement of labour and resources from importing to exporting countries through the terms of trade. The extent of the direct effect of an oil-price increase depends on the movement of tradable to non-tradable and services sector in the country. The rise in the price of oil leads to rise domestic cost of production, then the supplier price index will also increase, the wages will also rise thereby reducing the level of employment and level of output which will lead to rise in the both consumer and producer price indices (Aminu & Buhari, 2018).

Nigeria is however, endowed with abundant oil and gas resources, in which its production constituted about almost one-third of her GDP for over decades. Similarly, the immediate effect of rise in oil price is the rise in oil revenue, then rise in oil GDP that has a short term and long run effect. The short term effect is the appreciation exchange rate, then rise in wages because of the rise in money supply in oil sector thereby leading to a rise in the cost of production which leads to a reduction in the level of output and unemployment will rise as well as rise in inflation in Nigeria. In the long run, however, the rise in wages of labour in resource and oil sector, leads a movement of labour from productive because the people are moving to oil sector since most of the investments are centred to oil and service

sector due to more profits in the sector thereby leading to a shortage of goods and services from non-oil (productive) sector which consequently leads to a domestic inflation in Nigeria. Moreover, the macroeconomic performance of Nigeria has been strongly associated with the oil sector. Although Nigeria remains second Africa's largest oil producer after Angola in 2022, the country has inadequate refining capacity, hence imports refined petroleum products to meet the local demand. Thus, government kept subsidizing petroleum products so as to maintain its controlled price despite the changes in prices at international oil market and the exchange rate (Bawa, Ismail, Abdullahi, Sani & Yusuf 2020).

Nigeria is both an importing and exporting country, importing refined oil products and other products from the rest of the world, since her refineries were incapacitated and not functional since 1990s, this led to an increase in the cost of imported fuel products which affects its local currency by weakening Naira over Dollar, since these refined products are exchanged in foreign currency. The fall in the oil price globally at international oil market has led to depreciation of Nigerian currency between ₦168 in October, 2015 and ₦347.52 in August 2016 which represents almost 106.7 per cent within a year; the Nigerian government also depreciated its currency from about 400 naira per Dollar up to official rate of ₦423 per USD in July, 2022 due to shocks in oil price that affecting Nigerian and the world economy respectively. However, the Nigerian inflation rate is also affected by the shocks

in oil price because both consumption and investment were adversely affected due to a rise in oil price which affects disposable income of households, domestic of tradable and non-tradable goods and services. During the period under study, the year-on-year inflation rate jumped from 9.3% in the 10th of 2015 to 17.6 percent in August 2016, and there was also recent increment of inflation rate to 18.1 percent in July, 2022 to 20.3 in December 2022.

The declining in prices of crude oil in the globe that occurred in July 2014 has negatively affected Nigeria, particularly in the areas of currency crises, inflation rate, declining government revenue, government expenditure, and eventually threatening the ability to meet financial bounds as and when due. The price of oil came down from its all-time high between USD105.87 in 2013 and USD 98.94 in 2014 and to USD40.76 in 2016. This means that from 2013 to 2016 oil price declined sharply by more than half (64.5%) in 2016, but in 2017 the oil price started rising to \$70/bpd to an ever decrease of \$10/bpd in 2020 (Barkindo, 2022). The resultant impact has been a huge cause of policies and programs especially to policy makers and debate among scholars on the best policy intervention to reverse the situation.

It is against this background that the study put forward the following research question. What is the response of selected macroeconomic variables to oil price shocks in Nigeria? In order to answer the above research question, the following objective arises. The objective of this study is to

empirically analyze the response of selected macroeconomic variables to shocks in oil price in Nigeria.

## **2.0 Literature Review**

**Concept of Oil Price Shocks:** According to Lippi and Nobili (2008), Crude Oil Price Shocks is a source of oil shocks that affect economic performance differently: oil price increase due to higher oil demand shocks affect output differently than oil price increase due to lower world oil supply shocks. They argued that positive oil supply shocks decrease domestic production. However, the crude oil fluctuation could be either in the oil prices or in the production process which positively and negatively affect macroeconomic variables and even every sector of economy either directly or indirectly.

**Concept of Exchange Rate:** According to Buhari (2020), exchange rate as the country's currency value in terms of another country's currency. It is normally expressed as the number of units/elements of a local currency which will buy a one unit of other country's currency or the number of units/elements of other country's currency that will purchase one unit of a domestic currency, for example, the Naira per United States Dollar (N/USD) or US dollars per naira (USD/N). Essentially, exchange rate changes affect the prices of both imported and exported goods, services.

**Concept of Inflation:** Krugman (1998) defined "Inflation" as a continuous increase in the general or average price level in the economy, usually measured through the calculation of consumer price index. The

word “persistent” is of greater importance in understanding the inflation concept. A single increase in prices is not inflation. When inflation occurs, there is a continuous increase in the price level. Prices of individual goods and services are determined in many ways. In competitive markets, the interaction of large buyers and sellers. In imperfectly competitive markets, prices are determined by producer’s decisions (Friedman, 1963).

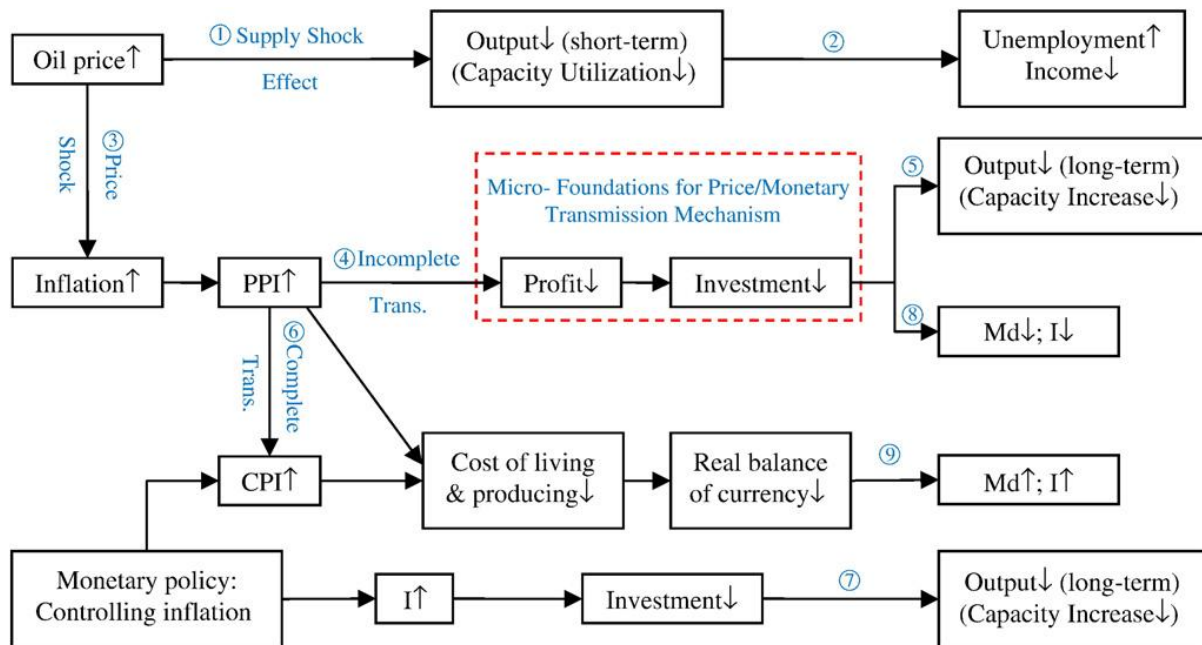
**Concept of Oil revenue:** It is defined as a form of government revenues earned after the sales of crude oil at international oil market which make the government of a country to have means (resources) in financing both capital and recurrent expenditure for the benefits of its citizens in a country. According to Keynes (1936), change in government revenue would have positive/negative impact on growth. Increase in oil revenue could be in two give ways: either through increasing the payment rate by existing tax payers or increasing the number of tax payers. The combine effects of the shocks in oil prices that brought about influx of petrodollar oil revenue and over appreciation of domestic exchange rate also have had effects on domestic prices of products and services in Nigeria.

**Concept of Government Expenditure:** Usman & Buhari (2018), Government Expenditure defined as a total government spending on both recurrent and capital expenditures. By recurrent expenditure, it means the government expenditures on the day-to-day activities such as payments of workers’ salaries and wages, retirees ‘pensions, fueling machines and equipment,

and other recurrent spending. By capital expenditure, we mean the government spending on white elephant projects such as: building road networks, rail networks, stadia, hospitals, housing estates, and rest of others.

## **2.1 Theoretical Framework**

The macroeconomic responses to oil price shock in Nigeria can be explained by using both supply and demand channels. According to economic theory, crude oil price changes affect real economic activity through both supply and demand channels. Supply side effects could be explained based on the fact that oil is an important input in production. Therefore, crude oil price increases reduce the demand for crude oil, decreasing the productivity of other input factors which induce firm to lower output. Supply-side is on the argument that rising oil prices is an evidence of a disruption in the productive techniques within the economy, thereby leading to decline in the level of output. This indicates that a rise in the cost of production per average unit of output leads to slow down the growth rate of product and profitability. The demand side shocks are derived from the based on oil prices changes affect both consumption and investment decisions. Consumption is negatively affected because a rise in oil price changes disposable income and the domestic price of tradable goods. Investment is negatively affected because such rise in oil price thus affects firms’ input prices and thereby increasing their costs. Demand side effect depicts that rise in oil price could lead to decrease in consumption, investment and expenditure prices.



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## 2.2 Empirical Literature

Buhari, *et al.*, (2023) empirically examine how shocks in oil prices affect Nigeria's inflation and exchange rate using yearly time series data from 1981 to 2021 applying the NARDL (Nonlinear Autoregressive Distributed Lags) technique. The findings demonstrate that, both in the short and long terms, global oil price shocks have a significant impact on the exchange rate and inflation rates. Specifically, the response of oil price shocks to inflation rates is positive,

indicating that rising oil prices cause Nigerian inflation to rise, while the response of oil price shocks to exchange rates is negative, indicating rising global oil prices cause Nigerian interest rates to rise and the exchange rate to depreciate.

Eric (2020) empirically examines the responses of consumer price index (CPI) to international oil price shocks in the pre- and post-2008 global financial crisis in Nigeria. The study used the Structural Vector Autoregressive model to analyze monthly data from 2000M01 to 2019M12. The impulse response functions showed that for pre as well as post-crisis periods, oil price shocks have a positive impact on CPI. This effect was an insignificant direct perpetual increase in pre-crisis CPI before use up. However, the study adopted various theoretical literatures so as to explain different kinds of model such as: The supply-push and demand-pull factors. The change in the prices of oil as a result of increase in demand is said to bring about wealth transfer impact in oil exporting economies and inflation outcome in oil importing economies. Whereas, changes in the prices of as a result of positive changes in supply of the commodity translate to supply side shock effects.

Ahmad, *et al.*, (2020) investigate the Dynamics of Oil Price and Exchange Rate: What Can We Learn from China and India? The paper tried to examine the variability of global oil and foreign exchange markets and spillover between them. The study considers currencies/paper monies of two major oil-importing countries (India and China) from

January 1, 2013 to October 31, 2019. However, the paper above has tried in conducting descriptive statistical analysis and Generalized Autoregressive Hetrocedansticity (GARCH) model for econometric analysis.

Apere (2017) empirically investigated the co-relationship between oil price fluctuations and inflation in Nigeria using quarterly data from the period 1980:1 to 2015:4. Vector autoregressive econometric model was adopted in analyzing the data for this research with the analysis carried out; the Lag length selection, VAR stability tests, VAR LM test for serial correlation, the Impulse Response Functions(IRFs) and the Forecast Error Variance Decomposition(VDCs). The study depicted that the response of inflation to oil price change is that as prices of oil fall, then inflation decrease also and stable as well as a positive price of oil results in a stable negative inflation rate, hence the relationship between inflation and oil price fluctuation is negative through the following variables: Crude Oil Price (COP), Inflation Rate (INFL) and Exchange Rate (EXCHR).

### 3. Methodology

The Secondary data was used for the purpose of this study. The study used annually time-series data on oil price and some selected macroeconomic variables. Secondary data covered the macroeconomic variables yearly transactions for 42 years (1981 – 2022) for each macroeconomic variable which was obtained from National Bureau of Statistics (NBS) and Central Bank of Nigeria (CBN). The oil price is the Brent

crude oil price also obtained from the US Energy Information Administration (EIA). The data collection was focused on the following variables: exchange rate, inflation rate, oil revenue and government expenditure which are the selected macroeconomic variables.

### 3.1 Model Specification

The specification of VAR model is as follows:

$$Y_t = C + \sum_{i=1}^p \Phi_i Y_{t-i} + u_t \text{-----} 3$$

**Where:**  $Y_t$  is a column vector of four (4) variables or  $Y_t = (y_{it} - - Y_{ct})$ , is a  $(4 \times 1)$  vector of the variables, therefore  $Y_t = (\text{Oil price Increase, oil Price Decrease, Maximum Oil Price and structural Equation of Oil Price})$  modeled in terms of her past values.  $\Phi_i$  are  $k \times k$  matrix with coefficients to be estimated or  $\Phi_i$  are  $(4 \times 4)$  is a matrix of coefficients (Exchange Rate, Inflation Rate, Government Expenditure and Oil Revenue),  $C$  is a  $k \times 1$  vector with constants and  $\epsilon_t$  is a vector of white noise processes, that is  $U_t = (U_{it} - - U_{kt})$  is a  $(4 \times 1)$  of  $K$ -dimension white noise with zero means that is  $E(U_t) = 0$ . Where the covariance matrix  $\Omega$  is assumed to be positive definite and  $p$  is the order of autoregression. The study was relied on variance decompositions and impulse-response functions to evaluate the nature of interactions among the variables.

**Where:**

$$Y_t = \begin{pmatrix} \text{OIL\_PRICE}_t, & \text{EXCH\_RATE}_t, \\ \text{INFL\_RATE}_t & \text{OIL\_REVENUE}_t, \\ \text{GOVT\_EXP}_t \end{pmatrix} \text{-----} 4$$

$\text{OIL\_PRICE}_t = \text{Oil Price}$

$\text{EXCH\_RATE}_t = \text{Exchange Rate of the Naira}$

$\text{INFL\_RATE}_t = \text{Inflation Rate}$

$\text{OIL\_REVENUE}_t = \text{Oil Revenue}$

$\text{GOVT\_EXP}_t = \text{Government Expenditure}$

't' = Time Period.

$et$  = Error Term assumption to be normally distributed with zero mean and constant variance.

$C$  =  $k \times 1$  vector of constants

$\Sigma$  = Summation of exogenous variables at time 't'

$Y_{t-i}$  = Lag of endogenous variables.

$U_t = N_1 - N_5$  are the impulse, innovations or shocks

$\Phi_i = \alpha_1 - \alpha_5$  Parameter to be estimated

It should be noted that estimated results of the VAR model such as (1) are more easily interpreted in its moving average representation, from which we may generate variance decomposition (VDC) and impulse response functions (IRFs).

The model of Apere (2017) was modified on the fact that Apere used three variables, while this study considers five variables that can be impacted by the oil price shocks.

The model is therefore specified in a matrix form as follows:

This equation can be expanded as by applying the Choleski decomposition results in a recursively identified structural VAR model:

$$Y_t = \begin{Bmatrix} \Delta OILPMN \\ \Delta OILPMX \end{Bmatrix} = \begin{Bmatrix} \Delta EXCR_{t-1} & \Delta INFR_{t-1} & \Delta OILR_{t-1} & \Delta GEXP_{t-1} \\ \Delta EXCR_{t-1} & \Delta INFR_{t-1} & \Delta OILR_{t-1} & \Delta GEXP_{t-1} \end{Bmatrix} \begin{Bmatrix} \varepsilon_{t-1}^{MN} \\ \varepsilon_{t-1}^{MX} \end{Bmatrix}$$

$\Delta OILPS \quad \Delta EXCR_{t-1} \quad \Delta INFR_{t-1} \quad \Delta OILR_{t-1} \quad \Delta GEXP_{t-1} \quad \varepsilon_{t-1}^{ST}$

**Where:**

$Y_t$  = is a column vector of observation at 't' of all the variables in model, i.e.

$Y = (OIL\_PRICE_t, EXCH\_RATE_t, INFL\_RATE_t, OIL\_REVENUE_t, GOVT\_EXP_t)$

$\Delta OILPMN$  = Minimum Oil Price,

$\Delta OILPMX$  = Maximum Oil Price,

$\Delta OILPST$  = Structural Equation of Oil Price Shock

This study is conducted by modifying and adopting the work of Apere (2017) in the field of social sciences after slight modifications in his model. The model of Apere (2017) was modified on the fact that Apere used three variables (crude oil price, inflation Rate, and real exchange rate) by using VAR model in quarterly time series data from 1980:1 to 2015:4 in his study

titled “ Crude Oil Fluctuation and Inflation in Nigeria”. The modifications, however, affect the period and study variables, that is, this study considers annual time series data from 1981 to 2022 with oil price and the selected macroeconomic variables (exchange rate, oil revenue, inflation and government expenditure) in carrying out the study.

## 4. Results and Discussions of Findings

### 4.1 Tests for Stationarity Results

**Table 1 Unit Root Tests**

| Variables      | Levels (5%) | Critical Values (5%) | 1 <sup>st</sup> difference (5%) | Orde 1 |
|----------------|-------------|----------------------|---------------------------------|--------|
| Loil_price     | -2.379      | -3.527               | -6.235                          | I(1)   |
| Exchang_rate   | -0.068      | -3.527               | -4.777                          | I(1)   |
| Inflation_rate | -3.096      | -3.553               | -5.744                          | I(1)   |
| Loil_revenue   | -0.544      | -3.527               | -5.564                          | I(1)   |
| Lgovt_expend   | -0.403      | -3.530               | -7.970                          | I(1)   |

**Source:** Computed by Researcher using E-Views 9 (2024)

In order to establish the stationarity of the data set, the ADF statistics was used. This

was necessary because time series data are generally believed to be non-stationary and

the nonstationarity implies the existence of unit root in the data which often give rise to the occurrence of spurious regressions (Bello, 2022). The ADF statistics in Table 1 shows that all the variables are non-stationary at level of 5% critical values. Consequently, the levels in the series will generate spurious results if used for information. The table also shows order of integration for oil price and selected macroeconomic variables that

the variables are to be integrated of order one, with the maximum lag is 9 and lag length is for all the variables, but the inflation rate has to be changed to 12 maximum lag in order to be integrated of order one so as to fit in VAR model for the study, then all the variables are now at first difference indicating that the series are not stationary at their level forms ( $p$ -value > 0.05).

#### 4.2 Johansen Cointegration Test

**Table 2 Johansen Cointegration Results**

| Null Hypotheses | Trace Statistics | C.V (5%) | Max- Eigen statistics | C.V (5%) | Variables    |
|-----------------|------------------|----------|-----------------------|----------|--------------|
| $r = 0^*$       | 108.631          | 88.804   | 43.976                | 38.331   | Loil_price   |
| $r \leq 1^*$    | 64.654           | 63.876   | 23.980                | 32.118   | Exch_rate    |
| $r \leq 2$      | 40.674           | 42.915   | 20.135                | 25.823   | Infl_rate    |
| $r \leq 3$      | 20.539           | 25.872   | 10.949                | 19.387   | Loil_revenue |
| $r \leq 4$      | 9.590            | 12.517   | 9.590                 | 12.517   | Lgovt_exp    |

Trace test indicates 2 cointegrating eqn(s) at the 0.05 level

Max-eigenvalue test indicates 1 cointegrating eqn(s) at the 0.05 level

\* denotes rejection of the hypothesis at the 0.05 level

\*\*MacKinnon-Haug-Michelis (1999) p-values

**Source:** Computed by Researcher using E-Views 9 (2024)

However, since all variables are integrated of the same order, Johansen cointegration test is performed and results are in Table 2. The result showed that the trace value exceeded the critical value and there are one cointegrating equation(s) at the 5 per cent significance level, while max eigenvalue indicates none cointegrating equation. As may be observed from the table, the trace

statistic indicates the presence of cointegrating vector. From these results, the study concludes that there must be a unique cointegrating vector governing the long-run relationship among the variables. The study then proceeds to estimate a VAR on first difference for the oil price and selected macroeconomic variables in the following section.

### 4.3 Optimal Lag Structure

**Table 3 VAR Lag Order Selection Criteria**

| Lag | LogL      | LR        | FPE       | AIC       | SC        | HQ        |
|-----|-----------|-----------|-----------|-----------|-----------|-----------|
| 0   | -449.2017 | NA        | 62574.64  | 25.23343  | 25.45336  | 25.31019  |
| 1   | -264.6954 | 307.5106  | 9.009453  | 16.37197  | 17.69156* | 16.83254  |
| 2   | -230.0134 | 48.16936  | 5.728753  | 15.83408  | 18.25334  | 16.67847  |
| 3   | -209.5569 | 22.72954  | 9.301906  | 16.08649  | 19.60542  | 17.31469  |
| 4   | -153.0071 | 47.12482* | 2.680525  | 14.33373  | 18.95232  | 15.94574  |
| 5   | -106.2063 | 26.00044  | 2.301843* | 13.12257* | 18.84083  | 15.11840* |

\* indicates lag order selected by the criterion

LR: sequential modified LR test statistic (each test at 5% level)

FPE: Final prediction error

AIC: Akaike information criterion

SC: Schwarz information criterion

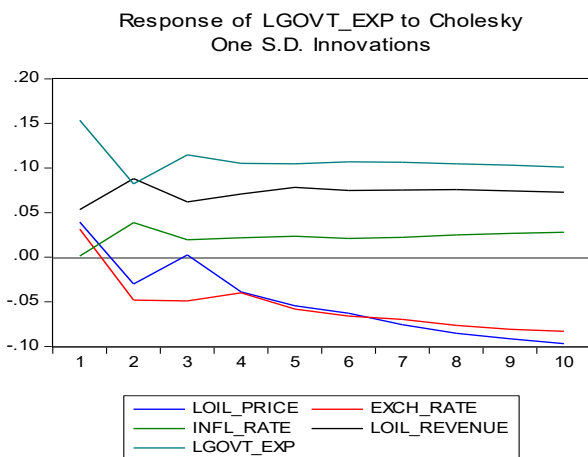
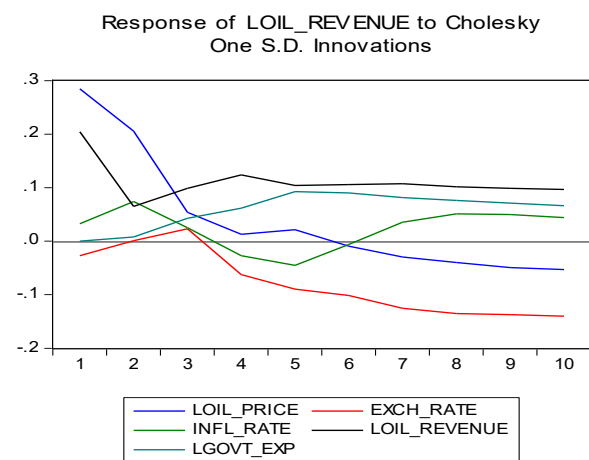
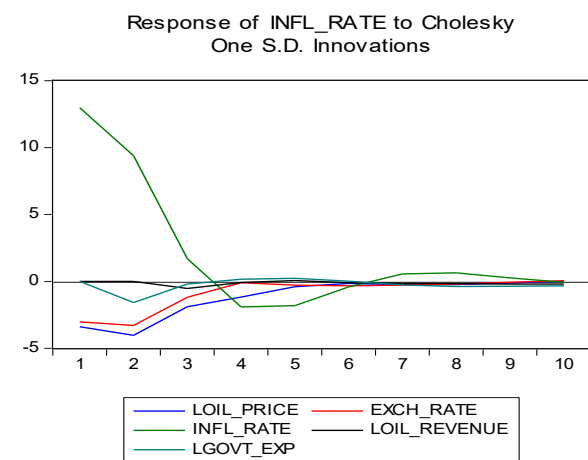
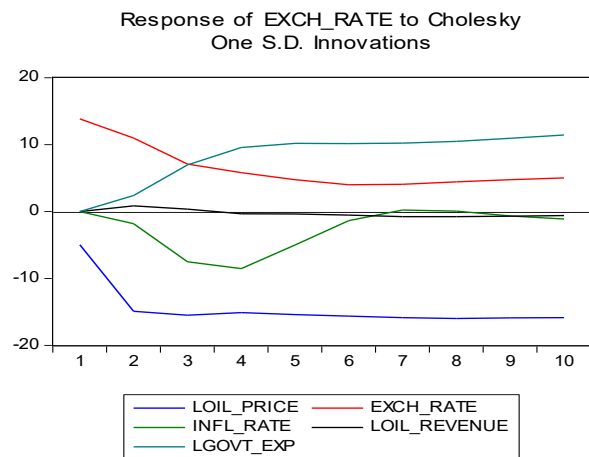
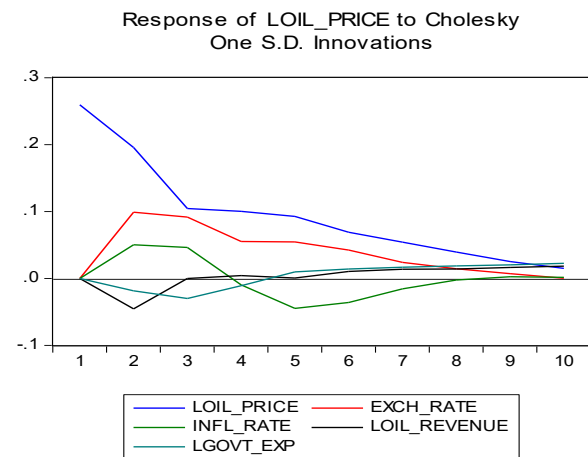
HQ: Hannan-Quinn information criterion

**Source:** Computed by Researcher using E-Views 9 (2024)

The result in Table 3 shows the maximum lag length determination estimated via the lag order selection criteria. The result shows that the optimum lag is lag five (5) since most of the criteria – FPE, AIC, and HQ showed the fifth lag to be the optimum lag length the VAR (5) model was estimated.

### 4.4 Impulse response functions for Oil price and Selected Macroeconomic Variables

An impulse response function depicts the effect of a one-time shock to one of the innovations/shocks on current and future values of the endogenous variables. It is also showed the responses of macroeconomic variables due to oil price shocks in Nigeria.



**Source:** Computed by researcher using E-Views 9 (2024)

### **Figure 1 Impulse Response Functions**

The figure 1 shows combined graph of responses of macroeconomic variables to oil price shocks which examines the long run dynamic interactions among these variables, the research generates impulse-response functions from the estimated VAR. From the second graph, the study shows the response of exchange rate to Cholesky oil price shocks as when the oil price falls within the negative region of a graph, from -5 to -15 and did not up to it reaches 10 period on horizontal line, then the response of exchange rate starts coming down from 15 to 5 on Y-axis and did not die up to it reaches 10 period on horizontal line (X-axis); indicating that the oil price and exchange rate are moving on the different directions, that is, as oil price raises, leads to depreciation of exchange rate since since Nigeria is both an importig and exporting nation, importing refined oil products and other products from the rest of the world dur to her incapacitated refineries.

However, the response of inflation due to oil price shocks from third graph is as oil price starts rising from -5 on Y-axis up to 0 level on X-axis and did not die until it reaches

period 10 on X-axis, thereby leading to a fall of inflation rate from 15 on Y-axis to negative region and it starts rising to positive region and did not die until period 10 on X-axis; meaning that as oil price falling slowly leads to rapid falling of inflation since the money supply falls which leads to fall in demand on consumption and investment desicions of households and firms under the periods of study.

From the fouth graph, however, as oil price starts coming down up to negative region on Y-axis and did not die until it reaches period 10 on X-axis, while the oil revenue responds by coming down frm Y-axis and keeps maintainig the constant or straight line up to period 10 on X-axis, which depicts that as an oil price falls at global oil market leads to a fall on Nigeria's oil-GDP and oil revenue that has a multiplier effect on govnrnmt expenditure and annual budget implementation in the country as we can see from graph fifth where by the curves or plots of oil price, oil revenue and government expenditure are moving in the same direction within the positive region and did not die until it reaches period 10.

**Table 4 Impulse Response Functions (IRFs)**

| Horizon(Annually) | LOIL_PRICE | EXCH_RATE | INFL_RATE | LOIL_REVENUE | LGOVT_EXP |
|-------------------|------------|-----------|-----------|--------------|-----------|
| 1                 | 0.259      | 13.847    | 12.966    | 0.204        | 0.153     |
| 2                 | 0.195      | 10.959    | 9.389     | 0.065        | 0.082     |
| 3                 | 0.104      | 7.088     | 1.678     | 0.098        | 0.114     |
| 4                 | 0.100      | 5.813     | -1.921    | 0.123        | 0.105     |
| 5                 | 0.092      | 4.757     | -1.809    | 0.104        | 0.104     |
| 6                 | 0.068      | 3.995     | -0.422    | 0.105        | 0.106     |
| 7                 | 0.054      | 4.056     | 0.544     | 0.107        | 0.106     |
| 8                 | 0.039      | 4.415     | 0.628     | 0.101        | 0.104     |
| 9                 | 0.025      | 4.746     | 0.250     | 0.098        | 0.103     |
| 10                | 0.015      | 5.010     | -0.066    | 0.096        | 0.100     |

Cholesky Ordering: LOIL\_PRICE, EXCH\_RATE, INFL\_RATE, LOIL\_REVENUE, LGOVT\_EXP

**Source:** Compued by Researcher using E-Views 9 (2024)

The Table 4 shows the reaction of exchange rate (Exch\_rate) due to shocks in oil price (Loil\_price) present for a short time period, but after that it stabilizes at 13.847% but started ups and downs to less than 4% at 6<sup>th</sup> year. Also, for inflation rate (Infl\_rate) response to shocks in oil price (Loil\_price) begins at 12.966% at first year and negatively started coming down to the 4<sup>th</sup> year period at -1.921% keeps fluctuating down to -0.066% after 10<sup>th</sup> year which is insignificant. However, for Oil revenue (Loil\_revenue) response to shocks in oil price (Loil\_price) starts from the first year at 0.204% to downward at 0.096% for the final year (10<sup>th</sup> year). In addition, for Government expenditure (Lgovt\_exp) response to shocks in oil price (Loil\_price) starts at 0.153%

from first year to downwards sloping as a result of its shocks down to 0.1% after 10-year horizons. In this case, the impact is positive, which means that the shock in one variable makes positive reaction to the other one.

#### **4.5 Variance Decompositions of Oil Price and Selected Macroeconomic Variables**

While an impulse response functions depict the changes of a shock to one endogenous variable on to the selected variables in the VAR, Variance Decompositions separate the variation an endogenous variable into the component shocks to the VAR. Thus, the Variance Decompositions provide the information on the relative importance of each random innovation in affecting the variable in the VAR.

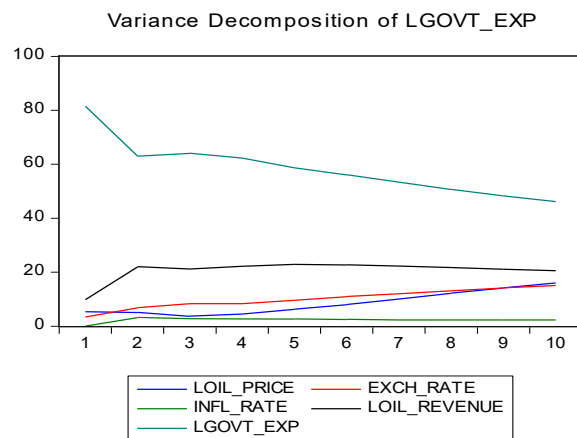
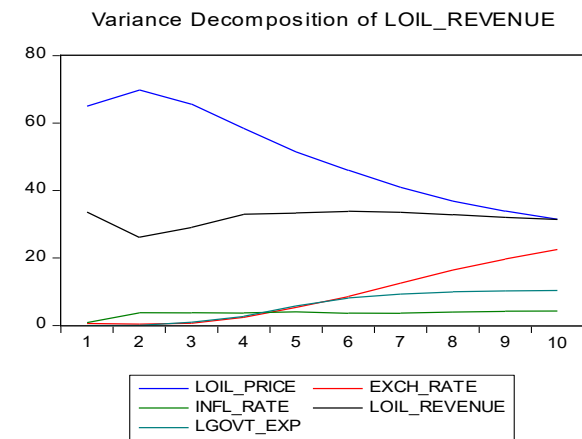
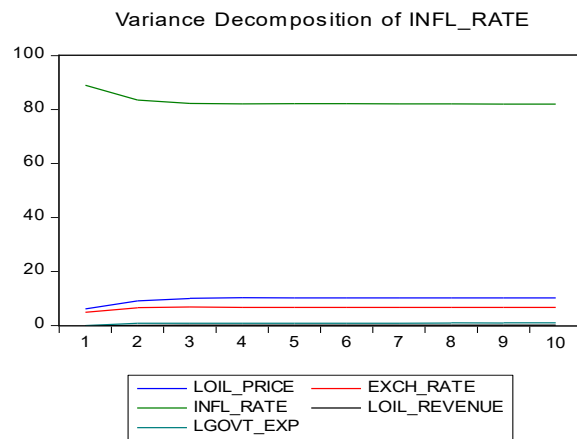
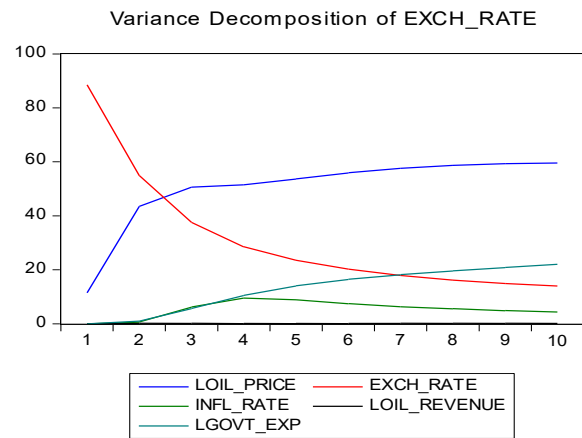
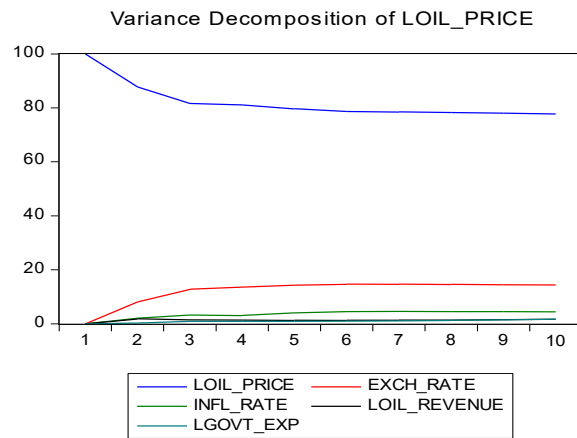
**Table 5 Variance Decompositions for LOIL\_PRICE and Macroeconomic Variables**

| Horizon<br>(Annually) | S.E.  | LOIL_PRICE | EXCH_RATE | INFL_RATE | LOIL_REVENUE | LGOVT_EXP |
|-----------------------|-------|------------|-----------|-----------|--------------|-----------|
| 1                     | 0.259 | 100.000    | 88.500    | 88.992    | 33.589       | 81.442    |
| 2                     | 0.346 | 87.744     | 54.831    | 83.542    | 26.097       | 62.966    |
| 3                     | 0.377 | 81.627     | 37.527    | 82.268    | 29.038       | 64.019    |
| 4                     | 0.394 | 81.102     | 28.464    | 82.103    | 32.922       | 62.289    |
| 5                     | 0.411 | 79.614     | 23.520    | 82.208    | 33.314       | 58.718    |
| 6                     | 0.421 | 78.647     | 20.251    | 82.180    | 33.774       | 56.021    |
| 7                     | 0.426 | 78.441     | 17.903    | 82.136    | 33.577       | 53.363    |
| 8                     | 0.429 | 78.302     | 16.196    | 82.085    | 32.819       | 50.662    |
| 9                     | 0.430 | 78.068     | 14.934    | 82.037    | 32.068       | 48.268    |
| 10                    | 0.432 | 77.747     | 13.966    | 81.997    | 31.391       | 46.136    |

**Source:** Computed by Researcher using E-Views 9 (2024)

Initially in Table 5, at 1-year horizon, all forecast error variances in LOIL\_PRICE are explained by their own innovations at 100 per cent, while all the explanatory variables of macroeconomic variables started from 0 per cent. The decrease in price of oil was about 59.59% and 4.34% of EXCH\_RATE forecast error VDC is explained by the LOIL\_PRICE and INFL\_RATE respectively. However, LOIL\_PRICE and EXCH\_RATE contribute 10.2% and 6.7% for the variation in the forecast error of

INFL\_RATE due to rise in oil price respectively. From the result in Table 5 shows that the variations in the forecast error of LOIL\_REVENUE after 10 years as results of contributions by LOIL\_PRICE and LGOVT\_EXP to 31.46% and 10.36% due to maximum oil price shocks respectively; It can also see from Table 5 for LGOVT\_REVENUE, where LOIL\_PRICE and LOIL\_REVENUE contribute 15.99% and 20.51% for the variations in the forecast error respectively.



Computed by researcher using E-Views 9 (2024)

### **Figure 2 variance Decompositions (VDCs)**

The figure 2 of VDC was used as an alternative method to examine the effect oil price shocks on selected macroeconomic variables (exchange rate, inflation rate, government expenditure and oil revenue). It depicted the forecast error variance for any variable in a system is explained by innovations to each variable, over a series of time horizons. Normally, own variable shocks try to explain most of the error variance, although the shock would also influence other variables in the system. In this case, the VDC validate the significant role played by LOIL\_PRICE in accounting for shocks in these macroeconomic variables namely: EXCH\_RATE, INFL\_RATE, LOIL\_REVENUE, and LGOVT\_EXP. It is also showed the results of shocks of macroeconomic variables due to oil price shocks under the study period in Nigeria.

However, from the second graph in figure 2 above shows the shocks as oil price tends to increase from 10 to 60 levels then the exchange rate tends to have a downward sloping from 90 to 10 rate which indicates an inverse relationship between oil price and exchange rate. From the third graph of variance decompositions forecast error depicts that the shocks of inflation rate to oil price is very wide as oil price maintains less than 10 forecast error then inflation rate remains on 90 forecast error did not die till it reaches period 10. The fourth graph, however, shows that as oil price tends to have downward sloping from about 70 to 40 on horizontal line and did not die till it reaches period 10, then the oil revenue tends to have a shocks from 35 to 30 and starts moving upward slowly up to 40 and did not

die till at period 10. Lastly, the innovations of government expenditure shows that there is a fall in government spending from about 80 to 50 due to fall in oil price at global oil market to less than 20 and did not die till it reaches period 10 on horizontal line.

### **5. Conclusion and Recommendations**

From the research findings, the study is carried out to investigate whether or not a response exists among oil price shocks and selected macroeconomic variables and to examine the various of oil price shocks with the implications on the Nigerian economy; and hence the study adopts the VAR model with Impulse Response Functions (IRFs) and Variance Decompositions (VDCs) to measure the shocks and responsiveness of both global oil price and some selected macroeconomic variables. It therefore, affirmed that the response of exchange rate to oil price shocks has an inverse relationship between oil price and exchange rate, indicating that the oil price and exchange rate are moving on the different directions, that is, as oil price raises, leads to depreciation of exchange rate since Nigeria is both an importig and exporting nation, importing refined oil products and other products from the rest of the world dur to her incapacitated refineries. Furthermore, the response of inflation rate, oil revenue and government expenditure to oil price shocks are positive but insignificant; meaning that as oil price falling slowly leads to rapid falling of inflation since the money supply falls which leads to fall in demand on consumption and investment desicions of households and firms as well as a fall on Nigeria's oil-GDP and oil revenue that has a

multiplier effect on government expenditure and annual budget implementation in the country under the periods of the study.

However, based on the results, the following were recommended: first, efforts geared towards developing the oil sector locally by making its refineries are operating at full capacity so as to reduce so more depending on foreign currency (US Dollar over Naira) so as to make an appreciation of exchange rate, controlling inflation, rise in oil revenue and oil GDP to complement government expenditure in Nigeria. Second, to assist federal government and CBN in achieving lower inflation and stable exchange rate towards economic growth targets, and diversification of economy should be formulated and implemented by Nigerian government.

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