

Financial Liberalization, Exchange Rates and Demand for Money in Developing Economies: The Case of Nigeria, Ghana and Gambia

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Abstract : This paper examines effect of financial liberalization on the stability of the demand for money function and its implication for exchange rate behaviour of three African countries. As the demand for money function is regarded as one of the two main building blocks of most exchange rate determination models, the other being purchasing power parity, its stability is required for the monetary models of exchange rate determination to hold. To what extent has the liberalisation policy of these countries, for instance liberalised interest rate, affected the demand for money function and what has been the consequence on the validity and relevance of floating exchange rate models? The study adopts the Autoregressive Instrumental Package (AIV) of multiple regression technique and followed the Almon Polynomial procedure with zero-end constraint. Data for the period 1986 to 2011 were drawn from three developing countries of Africa, namely: Gambia, Ghana and Nigeria, which did not only start the liberalization and floating system almost at the same period but share similar and diverse economic and financial structures. Its findings show that the demand for money was a stable function of income and interest rate at home and abroad. Other factors such as exchange rate and foreign interest rate exerted some significant effect on domestic money demand. The short-run and long-run elasticity with respect to income, interest rates, expected inflation rate and exchange rate expectation are not greater than zero. This evidence conforms to some extent to the expected behaviour of the domestic money function and underscores its ability to serve as good building block or assumption of the monetary model of exchange rate determination. This will, therefore, assist appropriate monetary authorities in the design and implementation of further financial liberalization policy packages in developing countries.

Keywords : financial liberalisation, exchange rates, demand for money, developing economies

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