

The Impact of Exchange Rate Fluctuation on the Economic Growth of Somalia

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Abstract

The purpose of this paper was to empirically investigate the impact of fluctuating exchange rates and inflation rates on the economic growth of Somalia. Due to Somalia's well-documented exchange rate fluctuations, it became imperative to investigate the impact that the exchange rate fluctuations have on the country's economic performance. In this study, secondary data was used which was obtained from the Central Bank of Somalia, World Bank, Statista, and International monetary fund. The scope of the data was from the years 2005-2020. The ordinary least square (OLS) correlation and multiple regression analysis were used by this paper in order to examine the influence of fluctuating currency exchange has on the economic growth of Somalia. According to the findings, the exchange rate shows a slight positive association with little statistical significance ($r = .184$; $p = .496$) with GDP growth, implying that changes in the exchange rate account for 1.84 percent of total GDP. In addition, the results indicate that the relationship between inflation rate and economic growth is a weak positive correlation with no significance statistically ($r = .205$; $p = .447$). The finding of this paper will aid Somalia and other comparable countries in improving their monetary policies in general; it might be utilized by Somalia's central bank as a roadmap for effective monetary policy.

Keywords: Economic growth, Exchange rate, Gross Domestic Product, Inflation rate, Somali Shilling and US Dollar.

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1. Introduction

Every nation has its money own currency for interior installments, and the need to utilize unfamiliar monetary standards emerges when a business or monetary relations are set up between organizations working inside the nation and organizations working outside of it. Companies importing goods from a foreign country with a different currency need to acquire the currency of that nation to pay for the cost of importing goods and services. This forces importing companies to enter the currency exchange market to exchange their currency with the desired currency. In truth, foreign currencies are required not only by businesses that deal internationally but also by anybody who travels outside of his home country and requires the currency of the country he wishes to visit, even if he is only a tourist who is obliged to conduct exchange transactions.

The exchange rate of one currency versus another is continually changing, which might result in various exchange rates in different financial hubs. Due to the disparity in pricing, exchange agents conduct price arbitrage activities across financial centers, then exchange purchasing in the low-cost financial center and reselling in the high-cost financial center. Exchange brokers profit from the spreads.

The Somalia shilling (SOS) is the country's official currency. The foreign currency market is free of regulatory monetary authority's interference. In the lack of a central bank or state-led monetary policy, Somalia's post-war rebound was accompanied by a tremendous need for liquidity. Somalia and its neighboring Somali-speaking territories utilize a variety of currencies. The Somali shilling and the Somaliland shilling are used by Somalis, however, they rely significantly on the US dollar for larger purchases or transactions (commerce, trade, salaries, and project spending by international institutions). (Hagmann & Stepputat, 2016)

However, over the past two decades, the Somali Shilling exchange rate against the US dollar and Euro currency becomes unstable. Somali shilling exchange rate varies among states due to poor central government. The nation's central bank failed to control the country's exchange rate system. (Yassin sheikh Ali et al., 2017)

As of December 2021, 1 US Dollar is equivalent to 24000 and 40,000 shilling in southern and northern parts of Somalia respectively. After the collapse of the Somali central government back in 1990, Somalia has been wracked by societal turmoil and violence. The breakdown of governmental infrastructure, which resulted in the informal sector controlling critical economic infrastructures, is one of the post-conflict legacies. Somalia's statistics system became rudimentary, making it difficult to get high-quality economic data for planning and programming purposes. Nonetheless, as indicated by increased economic activity in construction, financial services, and telecoms, public trust in the market is improved. The entrance of a large number of diaspora investors has also boosted economic activity, providing much-needed funds for investment. International remittances into developing nations have risen considerably since the 1990s, from \$30 billion in 1990 to \$325 billion in 2010.

Somalia has also had a similar trend, albeit one with a far larger scale and rate of expansion than other

emerging countries. The Somali diaspora remitted home roughly US\$1.3 billion per year in official remittances from 2015 to 2017, but unrecorded flows could be substantially higher. (Mohamed, 2020). For decades, many developing nations, particularly those in Sub-Saharan Africa, have had trade deficits. Somalia, in particular, is an excellent illustration of one of these nations with a trade imbalance. The country's reliance on imports of food, fuel, building materials, and manufactured products has resulted in a chronic trade imbalance. Livestock, bananas, skins, fish, charcoal, and scrap metals are the main exports. (Sheikh Ali et al., 2018)

However, over the past decade, Somalia is making considerable strides toward re-establishing its economy. Construction, agriculture, and telecommunications have all witnessed sustained expansion in recent years. Somalia's Federal Government initiated ambitious reforms to restore and enhance the country's institutional economic system. The changes include the enactment of essential laws such as the Public Financial Management Law, Company Law, and Revenue Law and the submission of the Customs Bill to Parliament. FGS vowed to continue to rebuild the economy by publishing fundamental rules and policies to aid in the execution of the laws that have been passed. (Central Bank of Somalia, 2018)

Drought, floods, locust invasions, and the COVID-19 outbreak are among the shocks that may afflict Somalia in 2019 and 2020. COVID-19 Conservation measures like travel bans and supply and value chain disruptions resulted in a 1.5 percent reduction in real GDP in 2020, compared to 2.9 percent in 2019. Reduced foreign direct investment as a result of investors staying away during the postponement of disputed elections, a decline in remittances as a result of the global crisis, and restrictions on livestock exports by Gulf countries have all impacted progress. (Miranville, 2020)

Dollarization and monetary fabrication have stifled financial sector expansion, leaving little opportunity for monetary policy. Annual inflation is predicted to fall to 4% in 2020, down from 4.7 percent in 2019. This is due to tax cuts on food essentials and increasing food availability. The Somali shilling was relatively stable between January and November 2020, decreasing by less than 1% as growing dollarization lowered the supply of counterfeit money. Exports are still lagging behind imports, resulting in a persistent trade imbalance.

Decreased net economic inflows and decreased exports are predicted to increase the current account deficit, which is expected to hit 12.8% in 2020. The COVID-19 crisis is believed to have increased poverty, as seen by the 4.4 percent decline in real per capita income. Somalia has been experiencing massive exchange rate fluctuation rate and loses its value immensely over US Dollar, EURO, and other neighboring country's currencies over the past four decades. Most of the researches done by scholars focus on the effects of external debt, FDI, and foreign aid on economic growth, thus the aim of this study is to empirically investigate the effect of impact of fluctuating currency exchange rate on Somalia's economic performance.

2. Literature Review

The aggregate and sectorial impact of exchange rate shocks in Australia have been studied. While economic theory predicts the general direction of collective reactions to exchange rate swings, the data quantify these responses. The findings show that the mining, manufacturing, personal services, and other business services industries are most vulnerable to currency fluctuations. (Manalo et al., 2015)

The impacts of exchange rate variations on real output, price level, and real value of aggregate demand components in Turkey have been examined and found out that the expected exchange rate appreciation has severe negative consequences, reducing real production growth and investment and export demand while rising price inflation. Despite a rise in export growth, unforeseen exchange rate variations have asymmetric impacts that underscore the relevance of unanticipated depreciation in limiting production growth and the development of private consumption and investment. (Kandil et al., 2007)

Between 1998:Q1 and 2019:Q3, the influence of exchange rate volatility on Turkey's economic development was examined. The influence of fluctuating currency exchange rate on economic development in Turkey was studied using an Autoregressive Distributed Lag (ARDL) Model. The ARDL model's estimation findings revealed real effective exchange rate volatility has a detrimental and statistically significant influence on Turkey's economic development, long-term coefficients show that export and investment have a considerable positive impact on real GDP, but import and exchange rate volatility have a significant negative impact. (Ozata, 2020)

In Egypt and Turkey, researchers compared the impact of exchange rate variations on real output, price levels, and the actual value of aggregate demand components. The study discovered that expected exchange rate appreciation has large negative consequences in Turkey, reducing real production growth and demand for investment and exports while increasing price inflation. Despite a rise in export growth, random variations in Turkey have asymmetric impacts that underline the relevance of unanticipated depreciation in reducing production growth and the growth of private consumption and investment. Egypt's export growth was hampered by the expected exchange rate rise. Because of the asymmetry, the overall effect of unforeseen exchange rate swings in Egypt reduces real production and consumption growth while increasing export growth. (Kandil & Nergiz Dincer, 2008)

In South Africa, the effect and responsiveness of employment to the real exchange rate and real economic

growth were assessed using the Vector Autoregressive (VAR) model and multivariate co-integration approaches. In the long run, employment responds favorably to economic growth and adversely to the real exchange rate, according to the findings of this study. In the short run, real economic growth and employment have a positive association, but employment and the real exchange rate have a negative relationship. (Chipeta et al., 2017)

In Mogadishu, the link between inflation and its impact on households was explored. The study's goals were to determine the association between purchasing power and household livelihood, analyze the relationship between market commodity prices and household influence, and explain the impact of economic conditions on households. The study discovered that Mogadishu, Somalia, has high inflation. Also, the majority of individuals are satisfied with their economic situation. As a result, inflation plays a critical role in lowering economic growth by supplying people with goods and services. The study's findings revealed that inflation and household in Mogadishu had a substantial association. (Malin, 2016)

In Somalia, the trade balance, money supply, and foreign debt all have a negative significant association with the exchange rate, however, the lack of government has a positive significant link. Since 1991, Somalia has lacked a strong central government. As a result, the exchange rate in Somalia has improved. That Somalia's central bank should undertake measures that enhance political circumstances, hence increasing the value of the Somali shilling. (Ibrahim & Nageye, 2017).

A simultaneous equation model and two, three-stage least square (2SLS and 3SLS) approaches are used to study the link between exchange rate and economic development in Pakistan. For the period 1976–2010, it was revealed that the exchange rate has a positive relationship with economic growth via export promotion incentives, raising investment volume, boosting FDI inflow, and supporting import substitution industries. Even though the exchange rate has a positive influence on economic growth, it cannot be used as a policy tool. (Aman et al., 2017)

Actual exchange rate variations and their impact on Australian output are investigated. According to the range of models examined, a temporary 10% depreciation of the exchange rate increases the level of GDP by 14–12% over one to two years; a permanent 10% real depreciation is estimated to increase the level of GDP by around 1% after two to three years, according to the range of models explored. (Manalo et al., 2015)

A new database was created to characterize the de facto Exchange Rate Regime (ERR) for 145 nations for the whole post-Bretton Woods period. The global variations in de facto ERRs through time, as well as the link between ERR and economic growth were explored using this new database. The study found out that at the highest degree of significance, intermediate ERR is found to be favorably associated with economic growth. In addition, the link changes by income level, and the choice of ERR appears to be more relevant in low-income nations than in high-income countries. (Frankel, 2019).

The impacts of exchange rate variations on Nigeria's economic growth are investigated in the research. Using annual data from 1986 to 2012, the study looked at the relationship between exchange rate and economic growth. The OLS method, the Johansson co-integration test and the error correction technique were all employed (ECM). According to the findings, there is no significant relationship between the exchange rate and Nigeria's economic performance. (Okorontah & Odoemena, 2016)

Another research looked into the effects of exchange rate fluctuations on specific economic sectors in Nigeria. The research looked at the Nigerian economy's agriculture (AGDP), manufacturing (MGDP), petroleum (PGDP), and service (SGDP) sectors. According to the findings, the exchange rate had no substantial influence on AGDP, MGDP, or SGDP. However, the exchange rate had a positive and large influence on PGDP. According to the report, Nigeria's economy should be diversified so that non-oil sectors may generate considerable foreign money. (Victor C et al., 2019)

The impact of real effective exchange rate volatility on economic development in Central and Eastern European nations was studied in research. The study examined the type and extent of such movements on growth using yearly data for fourteen CEE nations from 2002 to 2018. The empirical findings from panel data using fixed-effects modeling show that exchange rate volatility has a considerable negative impact on real economic growth. Alternative metrics of exchange rate volatility, such as standard deviation and z-score, tend to support the findings. To support economic growth, authorities should employ various measures to maintain the exchange rate stable. (Morina et al., 2020)

3.0 Methodology

In general, various macroeconomic metrics, such as GDP, export, import, exchange rate, and inflation, are used to determine economic growth. Thus to investigate the impact of fluctuating exchange rates on the economic growth of Somalia, secondary data will be obtained from different reliable sources. The data will be taken from several Central Bank of Somalia Bulletin editions. Secondary data will be employed in this study, and it will come from the Central Bank of Somalia's Statistical Bulletin on different topics, the World Bank, and the International Monetary Fund. The models in this study are based on yearly Somalia data on macroeconomic variables such as Gross Domestic Product (GDP), Exchange Rate (EXR), and Inflation Rate (IFR) for the years 2005 to 2020.

The ordinary least square (OLS) correlation and multiple regression analysis will be used in this study to

examine the influence of the exchange rate on the economic growth proxy of Gross Domestic Product (GDP).

3.1 Mode Specification

The following is a model that states that the Exchange Rate and Inflation Rate all have a substantial impact on economic growth (GDP):

$$GDP = f(EXR, IFR)$$

$$LN\text{GDP} = \beta_0 + \beta_1 LN\text{EXR} + \beta_2 LN\text{IFR}$$

LnGDP = Gross Domestic Product

LnEXR = Exchange Rate

LnIFR = Inflation Rate

β = intercept

$\beta_1 - \beta_2$ = Coefficient of the independent variables

All variables are expressed in natural logarithm form.

4.0 Data Analysis and Result Interpretation

Table 1: Descriptive table.

Descriptive Statistics					
	N	Minimum	Maximum	Mean	Std. Deviation
GDP Growth Rate	16	-1.50	3.50	2.2062	1.14395
Exchange Rate	16	19000.00	35000.00	26650.6250	4866.84927
Inflation Rate	16	3.82	18.00	11.0154	4.93015
Valid N (listwise)	16				

Table 1 shows that the lowest GDP growth rate is -1.50% and the highest GDP growth rate is 3.50%. During the studied period, the average GDP growth rate was 2.20%. This demonstrates that Somalia's GDP growth has averaged 2.20% over the past 16 years (2005-2020).

The nation's exchange rate had an average of 26650 during 2005-2020. The highest and lowest exchange rates were 35,000 and 19000, respectively. On the other hand, inflation rates varied at the lowest rates of 3.82% and 18% respectively. This study found out that the average inflation rate between the years 2005-2020 was 11%. During the study period of 2005 until 2020, as shown in the above table, it can be summarized that Somalia's GDP growth, exchange rate, and interest rate were average 2.20%, 26650, and 11% respectively.

Table 2: Correlation

Correlations				
		GDP Growth Rate	Exchange Rate	Inflation Rate
GDP Growth Rate	Pearson Correlation	1	.184	.205
	Sig. (2-tailed)		.496	.447
	N	16	16	16
Exchange Rate	Pearson Correlation	.184	1	.561*
	Sig. (2-tailed)	.496		.024
	N	16	16	16
Inflation Rate	Pearson Correlation	.205	.561*	1
	Sig. (2-tailed)	.447	.024	
	N	16	16	16

*. Correlation is significant at the 0.05 level (2-tailed).

Table 2 shows the correlation between GDP growth rate, exchange rate, and inflation rate. The result shows that the exchange rate has a very low positive relationship with no significance statistically ($r = .184$; $p = .496$) with GDP growth, which indicates that exchange rate changes account for 1.84 percent of total GDP. Furthermore, there is no significant relationship between the exchange rate and GDP growth as the p-value is .496 which is greater than .05. This result has similar findings to research done by Adeniran et al (2014), Ashar (2012), Akpan (2008), and Azeez et al (2012).

On the other hand, the relationship between inflation rate and GDP growth was found to be a low positive relationship with no significance statistically ($r = .205$; $p = .447$). This implies that inflation rate changes account for 2.05 percent of total GDP growth.

Besides, the study shows that there is a moderate positive correlation between inflation rate and exchange rate with $r = .561$ and statistically significant due to the p-value of .024. This means that an increase in the exchange rate will increase the inflation rate by 56.1%.

Table 3: Model summary

Model Summary

Model	R	R Square	Adjusted R Square	Std. The error of the Estimate
1	.221 ^a	.049	-.097	1.19838

a. Predictors: (Constant), Inflation Rate, Exchange Rate

The above model summary shows the r square which means how much in percentage all the independent variables explain change or variation in the dependent variable. The result shows an r-value of .221 which indicates the correlation between GDP growth and predictor variables; exchange rate and inflation rate. The r square is .49 which means that 4.9% change in GDP growth can be accounted for by exchange rate and inflation rate.

Table 4: Anova.

ANOVA^a

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	.960	2	.480	.334	.722 ^b
	Residual	18.670	13	1.436		
	Total	19.629	15			

a. Dependent Variable: GDP Growth Rate

b. Predictors: (Constant), Inflation Rate, Exchange Rate

Table 4 demonstrates the impact of exchange rate and inflation on GDP growth. The p-value equals .722. This result indicates that there is no significant impact of exchange rate and inflation rate on GDP growth.

Table 5: coefficient

Coefficients^a

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	1.197	1.749		.685	.506
1 Exchange Rate	0.000042	.000	.100	.308	.763
Inflation Rate	.034	.076	.149	.455	.657

a. Dependent Variable: GDP Growth Rate

The coefficient table shows that the dependent variable GDP growth is regressed on predicting variable exchange rates and inflation rates. The study found that the exchange rate does not significantly predict GDP growth, $F(2, 13) = .334, p = .722$, which indicates that the exchange rate does not have a significant role in shaping GDP growth ($b = .000042, p = .763$). On the other hand, the study indicates that the inflation rate does not significantly predict GDP growth, $F(2, 15) = .334, p = .722$, indicating that the inflation rate plays no role in GDP growth ($b = .034, p = .657$). These results show no significant effect of the exchange rate and inflation rate on GDP growth. Moreover, the $R^2 = .049$ depicts that the model explains 4.9% of the variance in GDP growth.

5.0 Conclusion and Recommendation

The fluctuation of the Somali shilling has become something that every Somali is accustomed to. The main reason for the fluctuations in the exchange rate is that the Somali government does not control the exchange rate. This led me to investigate whether there is a link between the volatile exchange rate and the country's economic growth.

The objective of this paper was to examine the impact of fluctuating exchange rates and inflation rates on GDP growth in Somalia from 2005 till 2020. The finding of this paper depicts that exchange rates and inflation rates have a slight positive with no significant impact on the country's GDP growth during the study period. The exchange rate has a weak positive association with GDP growth, implying that changes in the exchange rate account for 1.84 percent of total GDP. Furthermore, because the p-value is 0.496, which is greater than 0.05, there is no significant association between the exchange rate and GDP growth. The findings of this study corroborate those of prior studies that developing countries have a better option of flexible exchange rate regimes than developed countries. Adeniran et al (2014), Ashar (2012), Akpan (2008), and Azeez et al (2014) all came to identical conclusions. Some scholars suggested that the exchange rate is positively associated with economic growth, while others argued that it is negatively related, based on empirical research. However, the study's empirical research revealed that the exchange rate is positively correlated with output growth.

Over the past decades, the Somali shilling lost its value, which paved the way for Somali businesses to turn to the dollar. Dollarization helped Somalia to curb inflation and protect businesses from currency instability as Somalia's economy massively depend on imports from foreign countries such as China, Turkey, Ethiopia, and UAE.

Somalia has a big trade deficit thus to maintain a surplus balance of trade, the government should stimulate export promotion initiatives. The researcher suggests other scholars should think about using many variables to

explain economic growth.

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