PRINT: ISSN 0971-8923 ONLINE: ISSN 2456-6756
JOURNAL OF SOCIAL SCIENCES
Interdisciplinary Reflection of Contemporary Society

PRINT: ISSN 0971-8923 ONLINE: ISSN 2456-6756
J. Soc. Sci., 12(2): 93-100 (2006)
DOI: 10.31901/24566756.2006/12.02.02

Monetary Policy and Macroeconomic Instability in Nigeria : A Rational Expectation Approach

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KEYWORDS Monetary policy; macroeconomic instability; rational expectation; Nigeria

ABSTRACT Generally, both fiscal and monetary policies seek at achieving relative macroeconomic stability. Based on countries' experience on the role of monetary policy in controlling economics instability, this study examines the efficacy of monetary policy in controlling inflation rate and exchange rate instability. The analysis performed is based on a rational expectation framework that incorporates the fiscal role of exchange rate. Using quarterly data spanning over 1980: 1 to 2000: 4, and applying time series test on the data used, the paper shows that the effort of monetary policy at influencing the finance of government fiscal deficit through the determination of the inflation-tax rate affects both the rate of inflation and the real exchange rate, thereby causing volatility in their rates. The paper reveals that inflation affects volatility of its own rate, as well as the rate of real exchange. The policy import of the paper is that monetary policy should be set in such a way that the objective it is to achieve is well defined.