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Terms of Trade, Institutional Quality and Exchange Rate Volatility in the Economic Community of West African States

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Abstract

In this study, we examine the relationship between terms of trade and exchange rate volatility in the ECOWAS bloc taking into account the existential role of institutions. We focus on 15 countries in the ECOWAS bloc for the past 21 year (i.e., 2000-2021). Using the Panel Autoregressive Distributed Lag Model (PARDL), we estimate the short, long-run parameters and the error-correction mechanism to show the relationship between the exchange rate and the other variables. We find terms of trade and institutional quality mostly exert significant negative impact on exchange rate returns in the long run whiles financial development, external debt and debts services have mixed results. The general imbalances of the term of trade in the sub-region causes the destabilization of currencies and as a result, reduces aggregate GDP and eventually sinks economic development. Therefore, strong institutions are needed to produce counterproductive policy response to stabilize exchange rates movements.

Keywords: West Africa, exchange rate, institutional quality, term of trade, financial development.

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