British Journal of Multidisciplinary and Advanced Studies:
Business and Management Sciences 4(1),37-50, 2023
Print ISSN: 2517-276X
Online ISSN: 2517-2778
Website: https://bjmas.org/index.php/bjmas/index
Published by European Centre for Research Training and Development UK

Foreign Exchange Management and Economic Growth Nexus: The Role of Institutional Quality in Nigeria

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DOI: https://doi.org/10.37745/bjmas.2022.0104 Published: 28th January 2023

Citation: Opuala – Charles S., and Orji J.O. (2023) Foreign Exchange Management and Economic Growth Nexus: The Role of Institutional Quality in Nigeria, *British Journal of Multidisciplinary and Advanced Studies*: Business and Management Sciences 4(1),37-50

ABSTRACT: *The quality of governance depends largely on the role of government institutions through their regulatory and policy making functions; as it empowers private sector driven growth and macro managed domestic currency value. The study focused on Foreign Exchange Management and Economic Growth Nexus: The Role of Institutional Quality in Nigeria. Method of Fully Modified Ordinary Least Squares (FMOLS) was used to study the effect of Institutional quality to Nominal effective exchange rate on Economic growth from 1996 to 2021.Institutional quality functioned as the moderator. The finding showed a significant but inverse relationship between nominal effective exchange rate and economic growth due to decline in institutional quality. Also, the coefficient of interactive term suggests a complimentary effect exist between nominal effective exchange rate and institutional quality in building strong economy. Recommended that, regulatory authorities should work in synergy to develop strategies to regulate and encourage private sector participation in economic growth.*

KEYWORDS: Exchange rate management, governance, productivity, institutional quality

INTRODUCTION

The goal of nations to strengthen its institution by allowing it a sense of independence while, maintaining a reasonably check and balances is fundamental to achieving quality in its statutory functions. Institutional quality is associated with policies implemented by domestic institutions to establish legal and cultural rules under which socio-economic activities occur Wang et al (2021). Specifically, institutional quality manifests in the clear form of government effectiveness, which captures perception of quality of public and civil services, and the degree of their independence from political pressure, the quality of policy formulation and implementation, and the credibility of government commitment to such policies Opuala-Charles and Orji in WDI (2022).It follows that, the role of institutional quality in development of the financial sector with specific focus on exchange rate management is one of such factors with great influence on the

pace of economic growth Anthony-Orji et al (2019). Apart from known determinants of economic growth such as consumption spending, investment spending, government spending and net exports, other exogenous influences such as the regulatory quality, quality of governance, political stability and institutional effectiveness significantly impact growth potentials Abaidoo et al; Opuala- Charles and Orji (2022). Good governance, stable political climate and effective institutions, for instance, provide the needed support in creating enabling environment critical for productive sector to thrive; and its attainment is possible through effective exchange rate management.

The macroeconomic goal of improved productivity and stable foreign exchange rate could be achieved with a functional government policy through a strong institutional framework. Hence, developing a functional productive exports sector, attracts capital flow as well as building robust financial system basically for revenue generation, and external trade facilitation remained unarguably pertinent to the actualization of fundamental objective of macroeconomic stability Fapetu & Oloyede (2014). Functionality of productive sub sector is strong with an efficient financial system; which captures strong financial and other linkages institutions that promotes sound financial policies meant to liberalize capital flow across national borders, introduce innovative strategies in foreign exchange intervention and drive growth.

Moreover, the volume of foreign trade transaction has a positive correlation with roles play by institutional quality to motivate foreign investors to bring into the domestic market their capital as well as incentivize domestic investors to pull out investment resources from idle hoarde to fuel growth prospects. Whereas, lack of quality governance, political instability, weak institution and man-made blockages have adversely impacted on our capital flow, productivity, and Naira exchange value. Scholarly finding traces lack of political system and institutional reforms as having obvious tendencies of retarding capital flow, pointing out political stability and transparent democratic process as a critical to heightening investors' confidence Ewubare and Ozigbu (2017). Scientific study also has shown that low institutional quality tends to increase investment difficulties. Though, many scholars have argued that the host country's institution has a significant impact on foreign direct investment Asiedu (2006). In sum, the quality of institutions in any given economy underlines the extent of foreign direct investment, foreign portfolio investment, domestic currency status and gross domestic product.

However, foreign exchange management is described as a technique that involves the generation and disbursement of foreign exchange resources so as to reduce destabilizing short-term capital flows Fapetu and Oloyede (2013). That implies, effective control of availability, cost and volume of foreign currencies in exchange of the domestic counterpart in international trade and finance. Therefore, the foreign exchange management performance is significantly progressed through effective exchange rate policy thrust by institutions of government. And, in pursuant of improved gross domestic products, favourable trade policies must be implemented to liberalized foreign capital flow in the recipient economy hence, stabilizing foreign exchange and growth. The management of foreign exchange generally results from the fluctuations of exchange rates at

which units of domestic country's currencies are weighed against another in international trade and finance Oleka, Sabina & Mgbodile (2014).

Nigerian foreign exchange management has been a tough one, given the myriad policy based challenges, administrative lacunars and institutional inefficiency that appeared in the form of: administrative inflexibility in banks for buying foreign exchange, inconsistent foreign exchange rate policies, devaluation of naira due to weak export based and rising imports, money laundering, and lack of institutional sovereignty as cardinal contributors to worsening state of Naira value as well as declining productivity. Although, efforts made to encourage exports and substitute imports during the regulated regime rather than yielding expected outcomes, resulted in continuum of foreign exchange depreciation. All the policy strategies meant to increase non-oil exports, further left the value of Naira in deplorable state of N 0.714/ $ 1USD in 1970 and ₦ 0.647/$ 1USD in 1980 and ₦ 0.894/$1USD in 1985, and 21.88/1$ in 1995, and 102.11/1$in 2000, and 141.5/1$ in 2005, and 156/1$ in 2010, and 267/1$ in 2015 and 426/1$ in 2022 respectively CBN in Gbosi (2020). In view of these stated problems, the study attempts to close a knowledge gap by studying relationship between Foreign Exchange Management and Economic Growth in Nigeria; using Institutional Quality as a moderator.

Research Hypothesis

The general study objective relied on examining the Foreign Exchange Management and Economic Growth Nexus: the role of Institutional Quality in Nigeria. Given, the character of the study variables interaction and scope; we intend to draw a conditional hypothesis in order to demonstrate whether or not the growth of productivity sector as a result of foreign exchange management is condition upon the degree of institutional quality in Nigeria during the review period. Therefore, Null hypotheses is presented below: -

$H0_1$: Changes in Institutional quality does not have conditional effect on gross domestic product and foreign exchange management in Nigeria.
$H0_2$: Institutional quality does not moderate the effect of exchange rate management on gross domestic product in Nigeria.
$H0_3$: Productivity does not change as a result of institutional quality and foreign exchange rate management interaction.
The above stated hypotheses will guide the study objective in empirical analysis section.

LITERATURE REVIEW

There exists paucity of empirically tested studies on strict subject matter under discourse. Although scholarly works supported other areas of studies including foreign exchange rate management and economic growth; other aspects include economic growth and institutional quality, leaving the role of institutional quality on foreign exchange rate management and economic growth little researched.

While the study attempts to shift a focus to incorporate exchange rate management in the picture of economic growth and institutional quality; is to close the knowledge gap and expand frontiers. It follows that, Nigerian case of exchange management and economic growth is spectacular to ascertain the role of government effectiveness as well as regulatory quality in Nigeria. Against this backdrop, scholarly works on related literature showed effect of exchange rate movements on economic growth in Nigeria as studied by Akpan and Atan (2011), using generalized method of moments to report finding. In their summary report, no evidence of strong direct relationship between changes in exchange rate and economic growth rather, Nigerian economic growth had been affected by different monetary variables other than exchange rate. In a similar study, Omojimite et al (2010) with the techniques of generalized method of moments (GMM) examined exchange rate reforms on trade performance in Nigeria. Findings showed that exchange rate reforms impact on non- oil exports through depreciation of Naira value. In another clime, Md. Fazlul (2021) studied the impact of exchange rate on economic growth of Bangladesh using ordinary least squares (OLS) technique. The findings showed that exchange rate and foreign direct investment significantly affect economic growth in a positive manner. Fabricio et al (2015) evaluated real exchange rate and economic growth using ordinary least squares (OLS) and generalized method of moments (GMM) jointly. Research findings revealed that countries that maintained a higher undervalued real effective exchange rate grow faster. While Melingui et al (2019) shifted focus on the study of institutional quality, exchange rate and public debt in the Franc Zone using OLS. Specifically, legal framework and corruption was employed as proxy for measuring institutional quality. The finding result showed while real effective exchange rate increased public debt of African countries of Franc Zone; reform through institutional quality reduced debt burden in French speaking African countries during the study period. In a little different but related study, Omoke and Opuala-Charles (2021) researched on the criticality of institutional quality on exploring economic growth and trade openness in Nigeria. Cobb-Douglas production function was applied as a baseline theory, and findings revealed that quality of governance reduces negative effect of import trade on economic growth in Nigeria during the period of study. Yu Zhuang et al (2021) concluded the empirical survey on nexus between macroeconomic dynamics and trade openness using institutional quality as a moderator variable. Through the techniques of fully modified ordinary least squares (FMOLS) and dynamic ordinary least squares (DOLS), result finding showed: institutional quality enhances relationship between foreign direct investment and technical innovation on trade openness in China.

METHODOLOGY

The study relied on quasi-experimental design as data for estimation was obtained from World Bank Development indicator and Central Bank of Nigeria Statistical bulletin. The theoretical framework of this study follows a modification of Yu Zhuang et al (2021) to explore the objective of testing the conditional hypothesis of exchange rate management and economic growth on institutional quality in Nigeria from 1996 to 2021.

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Baseline Equation Specification

$$LGDP_t = \propto_0 - \beta_1 LNEER_t + \beta_2 LISQ_t + \mathcal{E}_t \quad (3.1)$$

Moderating Equation Specification

$$LGDP_t = \propto_0 - \beta_1 LNEER_t + \beta_2 LISQ_t + \beta_3 (LNEER*LISQ_{t)} + \mathcal{E}_t \quad (3.2)$$

Whereas,

$$LGDP_t = \propto_0 - \beta_1 LNEER_t + \beta_2 (LINSQ.GE + LINSQ.RQ_t) + \beta_3 (LNEER*LINSQ_t) + \mathcal{E}_t \quad (3.3)$$

$\beta_1 < 0, \beta_2 > 0, \beta_3 > 0$

$\propto_0$ = Intercept term; β_1 = coefficient of 1st explanatory variable; β_2 = coefficient of 2nd explanatory variable (moderator); $_3$ = coefficient of interaction; and $\mathcal{E}_t$ = error term.

Where: $LGDP_t$ is the time series outcome variable of gross domestic product logged value; $LNEER_t$ is the time series logged value of nominal effective exchange rate proxy of exchange rate management (it functions as the explanatory variable); $LISQ_t$ is time series log value of institutional quality (it serves as the moderating variable),and $LNEER*ISTQ_t$ (functions as interaction variable). Also, $LINSQ.GE_t$ is the government effectiveness, measure of institutional quality; **LINSQ.RQ** is regulatory quality as a metrics for institutional quality.

Variables and Explanation

i. Gross Domestic Product (GDP) is the total of the gross value added by all resident producers in the economy, plus any product taxes and minus any subsidies not included in the product value. It is calculated without accounting for the depreciation of manufactured assets or the depletion and degradation of natural resources. This measures at purchaser's prices and in U.S dollar converted from domestic currencies using 2015 official exchange rates. Data obtained from World Bank Development Indicator.

ii. Nominal effective exchange rate (NEER) measures weighted average (unadjusted) rate at which one country's currency exchanges for a basket of multiple foreign currencies. The index is expressed in Nigeria 2010 =100 base year, and data series collected from Central Bank of Nigeria statistical bulletin

iii. Institutional Quality (ISQ) explains the quality of governance as measured by government effectiveness; regulatory quality; control of corruption; political stability and absence of violence; rule of law and accountability. Data obtained from World Bank Development Indicator.

iv. Government Effectiveness (GE) measures quality of public and civil services in a country, and the extent of the independence of government institutions from undue influences in formulation and implementation of credible policies. It is a measure of institutional quality.

v. Regulatory Quality (RQ) measures government ability to formulate and implement sound policies that enhance private sector growth led performance

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Estimation Technique

The augmented Dickey-Fuller (ADF) is the most commonly accepted method of testing for unit roots employed to test for stationarity of the variables of the output equation. Essentially, it rely on basic autoregressive unit root test to accommodate general ARMA(p, q) models with unknown orders and their test is referred to as the augmented Dickey-Fuller (ADF) test. The ADF results are presented in levels and first difference. This enables us to determine in comparative terms, the unit root among the time series and also to obtain more robust results. The ADF test is considered superior to the Dickey-Fuller (DF) test because it adjusts appropriately for the occurrence of serial correlation. If serial correlation exists in the DF test equation, that is, if the true model is not AR(1), then we can use AR(p) in order to get rid of the serial correlation according to the following equations;

$$\varphi_p(B)Y_t = \theta_0 + a_t \quad (3.4)$$

Where;

$\{a_t\} \sim WN(0, \delta_a^2)$ with $E(a_t^4) < \infty$ and $\varphi_p(B) = 1 - \varphi_1(B) - ... - \varphi_p(B)'$ may contain a unit root.

To test for unit root; we assume that: $\varphi_p(B) = (1-B)\varphi_{p-1}(B)$

Where;

$\varphi_{p-1}(B) = 1 - \varphi B - ... - \varphi_{p-1}B^{p-1}$ has unit roots lying outside the unit circle.

$$\varphi_{p-1}(B)(1-B)Y_t = \theta_0 + a_t \quad (3.5)$$

$$\varphi_{p-1}(B)\Delta Y_t = \theta_0 + a_t$$

$$\Delta Y_t - \sum_{j=1}^{p-1} \varphi_j \Delta Y_{t-j} = \theta_0 + a_t$$

Hence, testing for a unit root is equivalent to testing $\varphi = 1$ in the following model;

ADF test equation:

$$Y_t = \varphi Y_{t-1} + \sum_{j=1}^{p-1} \varphi_j \Delta Y_{t-j} + \theta_0 + a_t$$

(3.6)

For ADF Hypothesis, we have:

$H_0 : \varphi = 1$ $H_0 : \delta = 0$

$H_1 : |\varphi| < 1$ $H_1 : \delta < 1$

Reject H_0 if $t_{\varphi=1} < CV$ but reject H_0 if $t_{\delta=0} < CV$.

Empirical Analysis

The session discusses the result of estimate, diagnostics analysis and discussion of findings. This modelled the conditional effect of institutional quality on enhancing exchange rate management

and economic growth in Nigeria from 2006 to 2021. Specifically, the study proceeds with test of augmented Dickey Fuller unit root.

Table 4. Result of Unit root ADF statistic**

Variables	Levels test (ADF) stat.	Critical Value*	First diff. (ADF) stat	Critical Values*	Prob.	Order of Integration
LGDP	-2.259781	-3.144520	-5.578339	-3.119510	0.0008	I(2)
LNEER	-2.043710	-3.081002	-3.676446	-3.098896	0.0180	I(1)
LISQ	-1.374319	-3.259808	-16.61711	-3.519593	0.0000	I(1)
LNEER*LINSQ	-1.281027	-3.2598081	-10.08991	-3.519595	0.0003	I(1)

Source: Authors' Computation (2022).
ADF** = Augmented Dickey Fuller unit root test with constant* MacKinnon (1996) one-sided p-values. The ADF unit root in Table 4.0 showed level of stationarity of the time series variables @ critical value of 5 per cent, the ADF statistic yielded mixed order of integration. Justifying the potency of the variable series.

The result of augmented Dickey Fuller unit root test showed that, all the variables of our model were integrated after 1st difference except the log value of gross domestic product. This is a clear indication of reliability for hypothesis testing in time series analysis. Therefore, we proceed to test the hypothesis about the research objective.

Research Hypotheses Test for Study Objectives
From table 4.1, we formulate procedural method for testing hypothesis so as to ascertain whether or not research objective is specifically achieved.
Ho: $\propto_0 = \beta 1 = \beta 2 = \beta 3 = 0$ (collectively)

Decision Criteria
Reject Ho if / t- Statistic calc./ > tabulated t – Statistic at 0.05; otherwise, do not reject.
At α = 5% with k-1 degrees of freedom. Where k = number of regressors used in the regression and n = number of observations.
The summary result of t test is presented in Table 4.1 and evaluated based on critical t-score of two tail test.

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Table 4.1 Summary Results of Hypotheses Test **

Variables	t-Statistic Calculated	Critical Value*	Level of significance@ 0.05.	Decision
Constant	17.52618	2.13	Significance	Reject
LNEER	-2.736447	2.13	Significance	Reject
LISQ	-3.101565	2.13	Significance	Reject
LNEER*LINSQ	3.313387	2.13	Significance	Reject

Source: Authors' Computation (2022).

* t-Statistic tabulated using two-tail test @ $t_{0.05/2}$, k-1 d.f. [16-1=15].** refer to table 4.2 to see the t- statistics values.

Conclusion

Since the individual results in Table 4.1 showed absolute t- values of coefficients of 1st explanatory variable (LNEER), moderating variables (LINSQ) and Interactive term (LNEER*LINSQ) jointly exceeded critical t- value (2.13) at 5 per cent level of significance. We reject Ho and conclude Exchange rate management is statistically significant to influence economic growth in Nigeria as a result of institutional quality. With this understanding, we proceed to test for conditional hypotheses using Moderating Estimate result in Table 4.2.

Moderating Estimate Result

Dependent Variable: LGDP

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	30.54716	1.742945	17.52618	0.0000
LNEER	-0.952619	0.348123	-2.736447	0.0230
LINSQGE_LINSQRQ	-0.050821	0.016386	-3.101565	0.0127
LNEER_LINSQGE_LINSQRQ	0.010818	0.003265	3.313387	0.0090
R-squared	0.871114	Mean dependent var		26.21843
Adjusted R-squared	0.828151	S.D. dependent var		0.303816
S.E. of regression	0.125946	Akaike info criterion		-1.058269
Sum squared resid	0.142761	Schwarz criterion		-0.884438
Log likelihood	10.87875	Hannan-Quinn criter.		-1.093999
F-statistic	20.27629	Durbin-Watson stat		1.563859
Prob(F-statistic)	0.000242			

Source: Authors' Computation (2022).

The coefficient of determination (R^2) of 87 per cent showed model strong fit. Indicating 87 percent total changes in gross domestic product is jointly explained by the influences of nominal exchange rate and institutional quality; leaving 13 per cent to unobserved. Given, the influence of moderator and interactive term in the model, a positive serial correlation (1.56) was observed using Durbin Watson statistic.

However, the conditional hypothesis result of whether or not changes in institutional quality conditionally effect economic growth based on exchange rate management showed: economic growth decreases by about 95 per cent, on average, due to a unit increase in nominal exchange rate if government effectiveness and regulatory quality is jointly reduced by about 5 per cent. All other things been equal. In order words, if the quality of government policy performance to address private and public sector activities and growth prospects goes down; foreign exchange management and domestic productive value added will be worse off.

Move over, the second hypothesis test seeking to ascertain whether or not institutional quality does moderate the effect of exchange rate management on economic growth revealed: recall that, the 95 per cent reduction on economic growth is due to 5 per cent slack in institutional quality in Nigeria. By implication, the weak institutional quality in Nigeria significantly weakened the expected effect of Naira depreciation to improving quantity and quality of exportable (tradable) goods.

Finally, the effect of interaction is captured by third hypothesis requiring to ascertain whether or not economic growth does change due to combined effect of exchange rate and institutional quality. From the results in Table 4.2, the coefficient of joint influence of nominal effective exchange and institutional quality is 1 per cent, and statistically significant. Meaning, the moderating role of institutional quality is effective to showing the degree of exchange rate effect on economic growth in Nigeria. More so, the 1 per cent coefficient shows that, exchange rate and institutional quality have an additive effect on economic growth in Nigeria.

Diagnostics Check

Residual diagnosis and parameter stability check is crucial to ensure the model conform to expectation. Therefore, residual test on Heteroscedasticity with Breush-Pagan-Godfrey is presentedTest of heteroskedasticity seeks to ascertain whether or not variance of the errors from regression is dependent on the values of the explanatory variables. Hence, stating a null hypothesis (H0) based on the comparison of observed and theoretical postulations.

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Table 4.3 RESIDUAL DIAGNOSTICS

Heteroskedasticity Test: Breusch-Pagan-Godfrey

F-statistic	2.195186	Prob. F(3,9)	0.1583
Obs*R-squared	5.493050	Prob. Chi-Square(3)	0.1391
Scaled explained SS	1.868113	Prob. Chi-Square(3)	0.6002

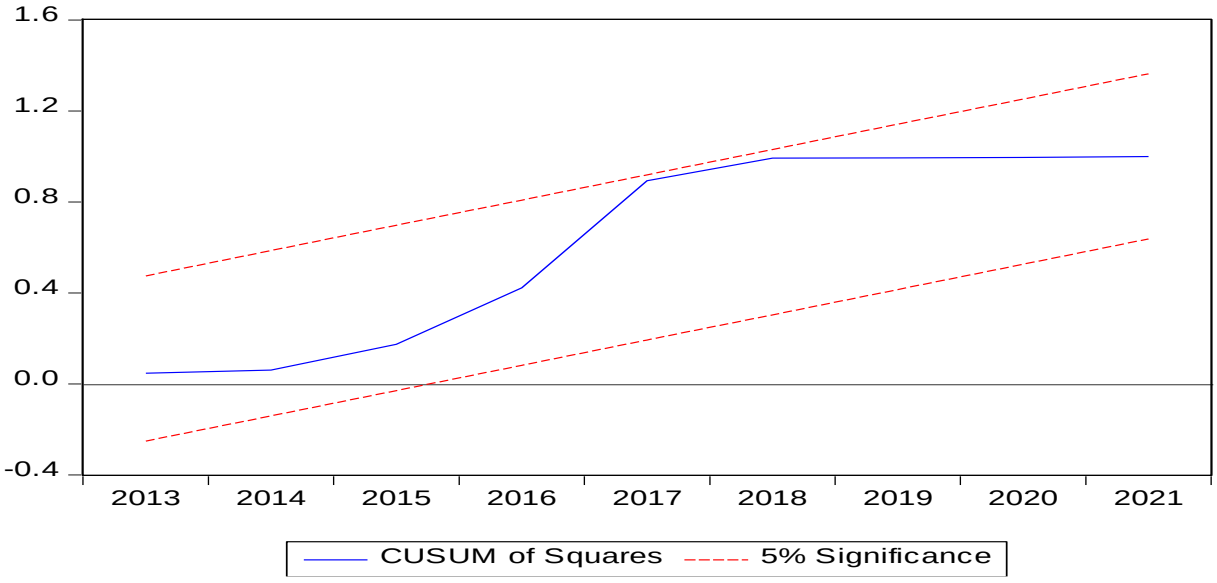
Source: Authors' Computation (2022).

From the Table 4.3, the probability of Observed R-square (0.1391) exceeds the conventional 0.05 level of significance. Thereby, accepting the alternative hypothesis that variance of error term are equal and independent of each other.

Stability Test

The stability of explanatory variables coefficient during the sample period is examined using cumulative squares of recursive residuals (CUSUM), and the result is graphically illustrated.

Fig 4.3a CUSUM plot for Stability Test



Source: Authors' Computation (2022).

The graphical analysis revealed the existence of parameter stability of the model reflecting the effect of institutional quality on exchange rate management and economic growth. Hence, the

stability property of CUSUM test method lies between dotted lines at 5 per cent level of significant.

FINDINGS AND DISCUSSION

The output of the research findings suggest that improvement in gross domestic value added in Nigeria is significantly dependent on the extent of government effectiveness in credible policy formulation and implementation. Foreign exchange management in Nigeria has not achieved its purpose of stronger Naira exchange due to weak regulatory posture of government institutions especially Central Bank of Nigeria and Federal Ministry of Finance in carry on their statutory roles of monetary and fiscal policies function. Also, the role of regulatory institutions to private sector led growth is weak, transcending to weak productive base, declining exports and high imports demand. Recall, economic growth decreases by about 95 per cent, on average, due to a unit increase in nominal exchange rate. By implication, currency appreciation decreases economic growth by a priori expectation, this is due to reduction of competiveness in global marketplace. But, government effective policy thrust can maximize the benefit of deprecation to boost tradable and non-tradable sectors.

Move over, the role of institutional quality in moderating the effect of exchange rate management on economic growth reflects the fluctuating tendencies of Nigerian Naira due to its continuous supply and scarcity of greenback use for imports of productive inputs and finished goods.
In sum, 1 per cent coefficient interactive term (nominal effective exchange and institutional quality) implies a complimentary effect. Meaning, Nigerian economic growth will significantly improve if strong exchange rate management policy is formulated and implemented.

Recommendations and Policy Suggestion

Given the Outcome of Research finding and discussion, the study makes the following recommendations:

- Nigerian government should strive to conduct bottom – up survey through a town hall meeting so as to identify the needs of the governed, and crystalized it with inclusive humane policy formulation.
- Public and civil services functions, operations and processes should be free from undue pressure from political elite, while, maintains a reasonable check and balances on each other.
- The regulatory authorities, especially Central bank of Nigeria and Federal Ministry of Finance should work harmoniously to develop synergistic strategies to regulate and encourage private sector participation in economic growth.

- Effective and credible exchange rate policy should be implemented so as to strengthen the value of Naira through strategic intervention, monetary policy recalibration and fiscal policy adjustment.
- People oriented Programmes should be developed to meaningfully engage unemployed labour force , reduce youth restiveness, insecurity so as to attract foreign investors.
- Government should ensure political and economic stability in order to attract foreign direct investment through multinational companies.

Acknowledgements I would like to thank my president, Dr. Silva Opuala-Charles for reading through the manuscript. Also, my sincere appreciation to the editor in chief and other anonymous reviewers for their time and effort. Not forgetting my family, colleagues and research team at Garden City Premier Business, Nigeria.

Funding This research is not funded by any organization, institution or person(s) other than the authors.

Availability of data Data and codes are available upon request. The data used for the analysis were sourced from Central Bank of Nigeria Statistical Bulletin (various issues), and World Bank Development Indicator

Declarations

Conflict of Interest The authors declare there exist no conflict of interest.

Ethical Approval No ethical approval was required for this study.

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