DEFICIT FINANCING AND MONETARY POLICY IN NIGERIA: AN IMPACT

Soile, I. O. And M. S. Ogunmuyiwa

Abstract

The impact of budget deficit on various sectors of an economy depends largely on the method of creating as well as the means of financing such deficits. While many studies have argued that debt financing has very different effects from tax financing, others maintained that the method of financing is largely irrelevant. In this paper, we investigated the impact of deficit financing on monetary aggregates using Nigeria is annual data for the period of 1970 - 2000. The result revealed that deficit financing through monetary expansion generates increase in price levels while government debt and fiscal deficit have negative effects on price levels.

Introduction

The objectives of monetary policy are almost similar to that of fiscal policy. However, the government through its fiscal operations influence on the economic health of the country and most times, problems arise from the fiscal deficit of government, which hamper the achievement of some monetary policy objectives. For instance, when the fiscal operations of the government results in a deficit, the mode of financing such budgetary gap has implications for economic performance, especially in the areas of resource utilization in the private sector as well as on macro economic stability and growth. Most times, when the financing is sourced from the non-bank public, the action will lead to a reduction in aggregate demand as household's disposable income is shared between consumption expenditure and investment in government securities. Although, this mode of financing has an obvious advantage of being less inflationary than monetary financing, it might likely lead to the "crowding out" of productive private sector investment. On the other hand, financing deficit through borrowing from the Central Bank constitutes a fresh injection of money into the economy, which directly affects the monetary base and the expansion in money supply.

In Nigeria, as in most developing economies fiscal adjustments involving a conscious reduction in fiscal deficits are generally regarded as a major element of policies to achieve monetary restraint. Infact, the need to curb excessive growth in monetary expansion and pressure on excess demand arising from large fiscal deficits was the focal point of government fiscal policy under the economic policy reforms in the mid eighties.

There is no doubt that several authors have explored contending issues in fiscal deficits on a number of countries (see Olopoenia, (1991). Ariyo, (1993); Ogun and Adinkiju, (1995); and Egwaikhide, (1995). This particular effort however departs from previous studies on fiscal deficit in that, it allows for the analysis of the impact of deficit financing on money supply, interest rate and other macroeconomic variables in the context of monetary control and linkages. The monetary dimension of the investigation appears more relevant to the balancing of both fiscal and monetary policy.

The rest of the paper is divided into four sections. The next section presents a profile of deficit financing in Nigeria. A short review of some relevant literature is constrained in section 3 while data are analysed and results interpreted in section 4. Section 5 offers some concluding remarks.

Deficit Financing In Nigeria

Deficit financing became a serious issue of economic interest around 1980 when fiscal deficits rose from $4427.9m in 1975 to £41,975.2m in 1980 (Table 1). Prior to this time, deficits and its financing were not considered as a major threat to monetary management for two reasons. First, government was generating huge revenue from the sales of the crude oil enough to execute her economic programme. Second, the rapid inflow' of foreign exchange earnings, largely from improved petroleum prices as well as the tempo in the construction and service sub-sectors, helped to sustain the GDP growth rate at reasonably high levels. For instance the rate of growth of GDP averaged about 8.8% between 1970 and 1974. the deficits between 1975 and 1980 were as a result

of the weakened oil market (due to fall in prices and glut in supply) and the inability of the government to cut back on its expenditures.

As public sector expenditure continued to expand further without due regard to the steady decline in revenue, the outcome was the build up of large fiscal and external deficits. Attempts to bridge the budgetary gap by government resulted in huge borrowing from the banking system, especially from the CBN, while the financing of foreign deficits led to the constant draw down of external reserves and apparent adverse effect on balance of payments position. With the persistent increase in total expenditure relative to the retained revenue of the federal government, the proportion of deficit as a measure of GDP rose from 3.9% in 1960 to an average of 7.5% between 1981 and 1986 (see Tablel)

One of the main objectives of the Structural Adjustment Programme (SAP) introduced in 1986, was the adoption of tight fiscal and monetary policies to reduce inflationary pressure, rationalize public expenditure, including revenue diversification and public investment polices. However, owing to declining oil revenue and the indebtedness of government (most of which are falling due), it became obvious that the available resource would not meet government fiscal needs. Consequently, government resolve to maintain a lower budgetary deficit of 3.5% of GDP in order to ensure judicious public expenditure in line with revenue constraint. In the said 1986, government recorded a deficit of $48,254.3m, representing 11.3% of GDP. Government deficits increased to $435,755.2m and ^4107,735.3% in 1991 and 1993 respectively. These figures represent 11% and 15.5% of GDP in their respective years. Between 1904 and 2000 government deficits as a percentage of GDP fluctuated greatly with 1.9%, 9.1%, 13.4% and 7.4% in 1994, 1998 and 2000 respectively.

Table 1: Fiscal Deficits And Macro Economic Performance Indicators (1970-2000)

	1970	1973	1976	1979	1982	1985	1988	1991	1994	1997	2000
GDP(Normally N'b)	5.20	10 9	27.3	43.15	51.71	72.35	145.24	324.01	914.94	2356.60	2612.04
Fiscal Deficit	7.55	1.66	10.9	14.61	61.04	30.39	121.60	357.55	702.70	370.49	421.33
Deficit as% of GDP	8.7	1.5	4.0	3.4	11.8	42.0	8.4	1 1.0	7.7	6.4	7.4
Extra Dept (ED)	1.75	10.99	27.29	43.15	51.71	72.36	145.24	324.01	914.94	2.356.74	3.167.10
Domestic Dept (DD)	111	1.06	2.63	7.23	15.01	27.90	47.03	116.20	259.3	243.67	261.30
ED as (%) GDP	3.4	2.5	1.4	3.7	17.1	23.9	92 2	101.2	70.9	26 6	121.25
DD as % as DD	18.7	9.7	9.6	15.5	28.7	3.6	32.4	35.9	28.3	14 6	1 1.7

Sources: (1) CBN's Statistical Bulletin
(2) African Development Indictors

On ways and manners of financing the deficits, government has used both internal and external sources especially, through foreign loans, reserves depletion and borrowing from bank and - "n-bank public. Between 1975 and 1978, domestic money market accounted for an average of of funds used in financing' government expenditure, with CBN accounting, for 87.6% of the ^ red it to the federal government. Until the late 70s, Nigeria did not borrow from external sources. On. The average, about 27.5%) of the deficit in 1972, 1976, 1978 and 1780 was financed from *oreign loans while in 1992 about 30% of the deficit was financed from external sources (see Table2). The trend of heavy reliance on finance from internal sources continued for most part of the 90s. with CBN credit accounting for a major portion of the funds that were mobilized from internal jcjrces. Infact, during the SAP era (1986 - 1994) domestic borrowing especially from CBN Kcrimted for an average of 76.8% of finances used in meeting the fiscal deficit of government.

The effect of persistent borrowing from CBN over the years to finance deficits cannot be undermined particularly on the growth rate of public debt. For instance, domestic debt outstanding r::e35ed from $428.4b in 1986 to $4161.96b in 1992 and stood at $4343.7 in 1997 while external.

debt outstanding rose from $45 1.7b in 1982 to ^4914.96b in 1994 and stood at N3 167.16b in 2000. The upward trend of external debt continued in the 90s reflecting the depreciation of the Naira and increased debt service payments. The debt service ratio on outstanding external debt between 1970^ and 1982 averaged 2.3% , but in 1991 stood at 29%.

The use of taxes to finance government deficit is not a common feature in Nigeria partly as result of the underdeveloped tax system and partly due to the relatively poor state of the earning capacity of the Nigerian workers.

Table 2: Fisca Deficits And Mot e of Financing In Nigeria (1970 -2000)

	1970	1973	1976	1979	1982	1985	1988	1991	1994	1979	^ II H'
Deficit (over all)	455.1	166.1	1,090.8	1761.7	6,104,2	3,039.7	12,160,9	35,755.2	70,270.8	37,048.4	
Finances:											
Foreign (Net)	1.0	48.9	24.5	383.8	263,5	1045.9	1,918.7	2972.6	8,390,8	7825.4	
Domestic (Net)	227.4	60.5	1041.3	729.0	3,402.0	571.2	8,361.8	32,112.4	60,247,6	(143,189.5)	
Banking System:	165.6	28.5	620.0	101,6	3,989.2	785.6	8,902.4	31,107.1	40,900.1	(153.143.2)	
CBN	45.0	28.1	1,460.0	(1211,0)	2.989.2	(567.6)	7,473.7	18,430 8	41,253.0	(52,288.4)	
Non Bank public	61.8	32.0	421.3	627,4	412.8	214.4	2,259,4	1,005.3	19,357.5	9,953.7	1,11
Other Funds	226.7	(275.5)	25.0	(2:554.5)	2,438.6	1422.6	1,880.4	670 2	1,632.2	98,314.7	* • "

Sources:

(1) CBN’s Statistical Bulletin
(2) African Development Indictors.

Previous Studies

As earlier mentioned, considerable efforts have been made to analyse the dynamics of government deficit in LDCs particularly in Nigeria. Past works ranged from causes and effects of fiscal deficits [see Usman (1995), Egwaikhide (19991; 1996), Ariyo (1996) to the implications of its various form of its financing (see Ojo (1992), Roe (1990) and Egwaikhide (1995).]

Roe's (1990) findings pointed to the fact that the severe and persistent public sector financing problem in Africa had a clean and obvious connection to the external finance and debt problems. His submission was that African governments generally have not succeeded in bringing deficits down to manageable or easily financeable levels as revenue had continued to decline relatively to GDP while total expenditure remained stubbornly at around 31% of GDP. Baro (1974) examined whether fiscal deficits have resulted in more expansionary monetary policy due to monetization of debt and found no systematic relationship between fiscal deficits and expected money growth.

Egwaikhide (1991) examines the determinant of government expenditure and fiscal deficits in Nigeria. He found that the growth of budget deficit had been due to factors such as government expenditure growth, revenue instability and inflation. In a later study, Egwaikhide (1995) investigated the effects of budget deficit on the nation’s current accounts and observed a positive relationship between the two variables. Blinder (1982) used the changed in bank reserves relative to GNP as a proxy for monetary growth and allowed for the possibility that the extent to which deficits are monetized depends on the prevailing inflation rates. He found that monetary policy is slightly more expansionary when deficits are higher but that monetization of the deficit varies inversely with the rate of inflation. Fiani, (1991) established a contrary evidence from the perceived wisdom that large deficit or its monetization foster inflation using Morocco’s inflation performance. He however cautioned that Morocco has relied more on inflation tax. Ojo (1992) showed that the magnitude and pattern of government fiscal operations have been identified as a major source of ineffective monetary control in Nigeria. Similarly Ojo and Okunrounmu (1992) found that increasing level of fiscal spending as well as the level and mode of financing the fiscal deficits has resulted to macroeconomic instability and frequent rise in the public debt, with adverse effect on monetary base and money supply over the years.

Oilier studies that have sound supports for the positive relationship between deficits and monetary growth include Hamburger and Zwick (1981), Niksanen (1978), Osakwe (1983) and Sowa (1991).

Methodology and Empirical Analysis

From the proceeding sections, we have observed that there exists a causal link between different measures of fiscal deficits and price level (inflation). The Study therefore presents a simple specification of the fiscal deficit and price level functions adapted from previous works.

Following Oyejide (1972), Kilindo (1997), Egw'aikhide et al (1994) and Fiani (1991). price level can be expressed as a linear function of change in Money supply (MS). Domestic Credit. Budget Deficit (BD) and monetization of deficit or Government Debt (GD) Hence, the linear equation below.

$$\mathbf{P = a + a,\ MS + a_2\ DC + a\ 3\ BD + aj\ CD + uj} \qquad (1)$$

Similarly. Fiscal Deficits (FD) can be expressed as a positive function of government expenditure to GDP ratio (GE) Interest rate (R) as well as investment (INV), Gross National Expenditure (GNE), Government Consumption Spending (GCE), Private Consumption Spending (PCE) and Money Supply Growth (MSD) i.e.

$$\mathbf{FD = b_{„} + b,\ GE + b_2\ INV = b_3R + b_4\ GNE + b,\ GCE + b_6\ PCE + b_7\ MSG + u_2}$$

The annual data sourced from the African development indictors (year 2001) and the CBN's Economic and financial indicators (early 2000) were fitted into the two equations above through the Ordinary Least Square (OLS) regression technique. The equations were estimated in log-linear form as the linear version failed to perforin to expectations. Lagged values were introduced to capture the slow response to changes in explanatory variables, but did not improve the fit of the equations. The results are presented below with t-values in parenthesis.

1. p =26.67 + 0.02MS + 8.65DC - 1.04BD + 4.94GD

-2 (2.72) (0.95) (-1.46) (|.%)

R = 0.665; D. W = 2.58

FD = 2.80-0.16GE-0.01 INV+ 0.43r-29 GNE+ 8.13GCE+ 1.2DCE + 0.15 MSG

(1.48) (-1.88) (3.30) (-2.43) (1.94) (2.05) (1.45)

-2

R = 0.594 D. W. = 2.436

Generally, both equations have good fit with an adjusted R^2 of about 67% and 60% respectively. Many of the estimated co-efficient have the right signs and are significant at conventional levels. The evidence from the results indicates that price level has been moving along with moment in the various measure of fiscal deficits, except the traditional fiscal deficit (BD) which is not significant even at 10% level.

The policy implication of this is that both debt and monetary financing of deficits in Nigeria are usually accompanied with rises in price level (inflation). In addition, increasing fiscal deficits within a reasonable limit has the potential of raising government expenditure, consumption (private and public), money supply growth and interest rate while the excessive growth of fiscal deficits leads to sharp increases in consumption and interest rate which are inimical to investment and economic growth.

conclusion

The general conclusion of the study is tilt fiscal deficit and its financing in Nigeria has led to higher consumption and interest rate, monetary growth, private and public consumption, government expenditures growth, but lower investment and aggregate demand. We therefore opine that a device ^ for moderate increases in fiscal deficit (within the acceptable 3% of GDP) should be pursued while a better co-ordination between monetary and fiscal policy should be encouraged such that borrowing would at all times be consistent with the objectives of monetary policy as well as over all

macroeconomic objectives of the government. In addition, there is need to brace up the country's tax system to meet the revenue challenges of a growing economy like Nigeria.

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