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## Impact of Monetary and Fiscal Policies in Combating Inflation in Nigeria (1984-2014)

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### **Abstract:**

*The study investigated impact of monetary and fiscal policies in combating inflation in Nigeria from 1984 to 2014. Ex-post facto research design was adopted for the study. Data used for the study were obtained from secondary source mainly from Central Bank of Nigeria statistical bulletin. Two main econometrics analysis were used for the study: ordinary least square method to study the relationship between monetary policy, fiscal policy and inflation, while Johanson Juselius Co-integration Test was used to study the long run equilibrium among the variables.*

*The study concluded that probability of each variable shows that they are statistically significant which means monetary and fiscal policies are both effective in tackling inflation in Nigeria. The study recommends that there should be proper co-ordination between monetary and fiscal policies as this will enhance discipline in government spending, and at the same time, will reduce inflationary pressure.*

**Keywords:** Fiscal policy, monetary policy, inflation, consumer price index, reserve requirements

### **1. Introduction**

Monetary and fiscal policies are measures that governments adopt using specific instruments to control, stimulate, structure or restructure their economies so as to attain the desired objectives which may include: control of inflation, employment generation, adjustment in the balance of payments, mobilization of savings. Others are increased output in the industrial, agricultural or other sectors of the economy.

Monetary policy has to do with the financial markets and constitutes measures taken by government and monetary authorities to control money supply in a way that certain objectives could be achieved. It involves the control of the price and availability of credit. Monetary policy can be used as a tool for the attainment of higher levels of output and employment. Fiscal policy on the other hand, has to do with taxes and government expenditures. Governments used fiscal policies to influence spending and economic activity by changing the levels and content of taxation, government spending and public debts. Some aspects of fiscal policy therefore relate to actions affecting government spending, while some others have bearing on revenue (Ezeugoh, 1987).

The goal of attaining sustainable economic growth and development has pre-occupied policy makers in the world. Sustainable economic growth and development is undoubtedly one of the most challenging development issues in the third world countries today. The two major economic policies often use to stabilize any economy of the world are monetary and fiscal policies and their cardinal tools are money supply and government expenditure (Asogu, 1998).

Today, monetary and fiscal policies are both commonly accorded prominent roles in the pursuit of macroeconomic stabilization in developing countries, but the relative importance of these policies has been a serious argument between the Keynesian and the Monetarists (Kareem, Afolabi, Raheem & Bashir (2013).

The monetarists believe that monetary policy exerts greater impact on economic activity, while the Keynesians believe that fiscal policy rather than the monetary policy exerts greater influence on economic activity (Ajisafe & Folorunsho, 2002). Policy makers have tried to adopt appropriate policies that can combat inflation and ensure price stability.

Inflation occurs when there is a general and continuous rise in the price of goods and services in the economy. During inflationary periods, opportunity cost of holding money is increased causing inefficient use of real resources in transactions. Therefore, inflation weakens the purchasing power of money and sinks the standard of living of the citizenry. While it is not arguable that monetary authority has formulated various policy measures as an attempt to curbing inflationary menace, the effectiveness of policy pursuit to curb inflationary environments is questionable as economies, particularly developing one still experience challenges (Gbadebo & Mohammed, 2015).

The problem of inflation in Nigeria has been confronted in a variety of ways by the government using different macroeconomic policies. The government introduced several measures e.g. National Development, Structural Adjustment Programme (SAP), guided deregulation to mention but few to combat this problem. Despite all the measures, inflation still persists in the country. Moreover, the issue of monetary and fiscal policy has one of its objectives of tracking the problem of inflation. The government and the Central Bank of Nigeria applied all measures to control it, yet every effort seems to be insufficient. Discussion in this paper will therefore focus on impact of monetary and fiscal policies in combating inflation in Nigeria from 1984 to 2014.

## 2. Literature Review

Literatures relevant to this study will be reviewed conceptually, theoretically and empirically.

### 2.1. Conceptual Review

#### 2.1.1. Inflation

Owolabi and Arulogun (2014) defined inflation as a situation when money income is falling. Also, inflation refers to a continuing rise in prices as measured by an index such as consumer price index (CPI) or by the implicit deflation for gross national production. Some researchers advocated that inflation can lead to uncertainty about the future profitability investment project. Hence, this leads to more conservative investment strategies than would otherwise be the case ultimately leading to lower level of investment and economic growth.

Khan (2002) concurs inflation may also reduce a country's international competitiveness, by making its exports relatively more expensive, thus, impacting negatively on the balance of payments. Inflation has unrelentingly been moving upward in Nigeria because of the years of neglects of the social infrastructures and general mismanagement of the economy.

According to Khan (2002), inflation is double-digit and surplus naira in circulation, scarcity of food, and fuel are part of the problems.

According to Folorunsho and Abiola (2000), they established from their study that inflation in Nigeria could be caused by the level of income, money supply, and public sector balance. The results also indicated that in the long-run, exchange rate, money supply, income and fiscal balance determine the inflation spiral in Nigeria. Their study therefore concludes that a reduction in fiscal deficits, an increase in domestic production and a stable exchange rate should be pursued as means of controlling inflation in Nigeria.

#### 2.1.2. Monetary Policy

According to Mordi (2008), the term monetary policy refers to a blend of measures designed by the central bank to regulate the value, supply and cost of money consistent with the absorptive capacity of the economy or the expected level of economic activity without necessarily generating undue pressure on domestic prices and exchange rates. The objectives of monetary policy can vary from one country to the other, but are generally of two variants. The first focuses on single objective of price stability, while the second perspective has multiple objectives of achieving not only price stability but other macroeconomic goals. The need to regulate money supply is based on the general consensus that the quantity of money supply and the general price level are highly related and if not regulated, could result in undesirable effects such as rising inflation.

In achieving monetary policy objectives, there are two types of monetary policy the central bank use, they are: the expansionary monetary policy and the contractionary monetary policy. Expansionary monetary policy is a set of action by the monetary authority to increase money supply in the economy. It is conventionally used to stimulate economic activity in a recession. Contractionary monetary policy on the other hand, seeks to reduce the level of money supply in the economy. It is conventionally used to reduce inflationary pressures in the economy.

#### 2.1.3. Fiscal Policy

Fiscal policy is the deliberate changes in the level of government expenditure, taxes and other revenue and borrowing in order to achieve such national goals or objective as price stability, full employment, economic growth and balance of payments equilibrium (Idowu, 2010). The stance of fiscal policy could be neutral, which implies a balanced budget where government spending is equal to tax revenue; expansionary where a government raises its spending or reduces taxation, or a combination of the two: or contractionary, when government spending is reduced either through higher taxation or reduced spending (Idowu, 2010).

During period of recession, government is supposed to carryout expansionary fiscal policy to take the economy out of recession and to put the economy on the part of growth and sustainable development. During the period of inflation, government is supposed to curtail its expenditure and taxes in order to check inflationary tendencies. This can control the economy trend and stabilizes the economy (Ackley, 2003).

Dwivedi (2006) identifies the following roles of fiscal policy as increasing the rate of investment. Fiscal policy is aimed at improving the rate of investment in both private and public sectors of the economy. Fiscal policy can be used to check actual consumption and raising savings ratio. It can also be used to discourage some investments while encouraging some that can stimulate the rate of growth.

## 2.2. Theoretical Review

### 2.2.1. Monetarist Theory

This school began in 1940s with Milton Friedman. Instead of rejecting macro-measurements and macro-models of the economy, the monetarist school embraced the techniques of treating the entire economy as having supply and demand equilibrium. However, because of Irving Fisher's equation of exchange, they regarded inflation as solely being due to the variations in the money supply, rather than as being a consequence of aggregate demand. They argued that the "crowding out" effects discussed by the monetarist would hobble or deprive fiscal policy of its positive effect. Instead, the focus should be on monetary policy, which was considered ineffective by early Keynesians.

Monetarism had an ideological as well as practical appeal: monetary policy does not at least on the surface, imply as much government intervention in the economy as other measures.

According to Iyaji, Success and Success (2012), the monetarist or Neo-Fisherian approach to inflation, they seek to ascribe observed rates of inflation in different countries to the respective growth rates of money supply per unit of the national product. This school of thought believes that inflation is mainly a monetary phenomenon. However, this may not be totally true of the Nigerian situation as there are other factors responsible for inflation in the country. The economic and financial review of the CBN (2011) argued that inflation in Nigeria moves with a lag with fluctuation in money supply. Thus, between 1970 and 1981, peaks in growth of broad money were associated with double digits inflation and that since 1984 to date (2020), the rate of inflation has grown faster than that of growth in money supply. This trend suggests that although growth in money supply may be significant in explaining inflation in Nigeria, it is not the only factor. Additionally, the monetarists argument was advanced by Friedman. He stated that changes in money supply have been seen to cause changes in price. It follows therefore, that an increase in money supply is likely to cause an increase in prices and hence, inflation (Friedman,1971).

### 2.2.2. Keynesian

Keynesian economics also called Keynesianism and Keynesian theory is a macroeconomic theory based on the ideas of 20<sup>th</sup> century British economist John Maynard Keynes. Keynesian economics argued that private sector decisions sometimes lead to insufficient macroeconomics outcomes and therefore advocates active policy responses by the public sector, including monetary policy actions by the Central Bank and Fiscal policy actions by the government to stabilize output over the business cycles. Keynes argued that the solution to the Great Depression was to stimulate the economy through some combination of two approaches: a reduction in interest rates and government investment in infrastructure. Investment by government injects income, which results in more spending in the general economy, which in turn stimulates more production and investment involving still more income and spending.

Keynes theory suggested that active government policy could be effective in managing the economy. Rather than seeing unbalanced government budgets as wrong, Keynes advocated what has been called counter cyclical fiscal policies, that is policies which acted against the tide of the business cycle, deficit spending when a nation's economy suffers from recession or when recovery is long-delayed and unemployment is persistently high and the suppression of inflation in boom times by either increasing taxes or cutting back on government outlays. They argued that governments should solve problems in the short run rather than waiting for market forces to do it in the long run.

Keynesianism does not consist solely of deficit spending. Keynesianism recommends countercyclical policies to smooth out fluctuation in the business cycle. An example of a countercyclical policy is raising taxes to cool the economy and to prevent inflation when there is abundant demand-side growth, and engaging in deficit spending on labour-intensive infrastructure projects to stimulate employment and stabilize wages during economic downturns.

### 2.2.3. Classical Theory of Demand

According to classical view on monetary policy, money is a veil. It is neutral in its effect in the economic growth. It simply affects the price level. An increase in the supply of money leads to an increase in the price level, but the real level income, the rate of interest and the level of real economic activity remains unaffected. In terms of quantity theory of money, the main function of money in classical system is that money is to act as a medium of exchange. It also helps to determine the general price level at which goods and services will be exchanged.

Irving Fisher (1932) in his quantity theory of money opined that the short run monetary control was directed by interest rates which were regarded as a main channel of the firms operating cost. Also, the risk in commodity price would lead to an increase in the firm's profits followed by increase in business investment, demand deposit, loan demand and money stock which lead to greater increase in community prices, investment and profit (Anochie & Erasmus, 2015).

The relationship between money and price level can be explained algebraically as:

$$MV=PT$$

Where:

M-exogenous variable (the supply of money)

V-Velocity of circulation

P-Level of prices

T-The volume of transactions

T is believed to measure output and as such, is often substituted for Y (national income). The above equation must hold ( $MV=PY$ ), that is, the rate of expenditure must equal the value of output. However, they argued that unwarranted increases in the money supply that manifests in inflation.

### 2.3. Empirical Review

In the developed countries, various research work has been conducted to study the impact of monetary policy and fiscal policy in combating inflation such as Rukelj (2009) investigates the interactions of fiscal policy, monetary policy and economic activity in Croatia. His study shows that fiscal and monetary policies move in the opposite direction i.e. they have been used as substitutes: fiscal shocks have a predominantly negative impact on narrow money, while monetary shocks produce negative effects on government expenditure.

Serbanoiu (2012) shows that in Romania, positive government expenditure shocks lead to an increase in output, decline in private consumption and investment (Crowding-out effect), initial rise in inflation and temporary decline in interest rate.

Jane, Gordan and Dragan (2013) investigated the macroeconomic effects of monetary and fiscal policies in three (3) south eastern economies; Croatia, Macedonia and Bulgaria. They employed recursive vector Auto regressions in order to study the inter linkages among fiscal policy, monetary policy and economic activity based on quarterly data. They obtained that fiscal policy exerts limited influence on inflation and monetary policy effects on inflation are rather modest.

In the developing countries, several studies have been carried out. Akinni Fesi (1984) showed that government deficit expenditure among other factors had a strong influence in explaining inflation in the country. He established that increase in government expenditure financed by monetization of oil revenue and credit from the banking system was responsible for expansion of money supply which in turn, with a lag in-effect contributed immensely to inflationary tendencies.

Ajisafe and Folorunsho (2002) in their study found out that monetary policy rather than fiscal policy exerts a great influence on economic activity in Nigeria. They therefore observed that the emphasis of government fiscal actions on the economy has led to a greater distortion of the Nigerian economy.

According to Ndiyo and Udah (2003), they found out that government policy requires a mixture of both fiscal and monetary policy instruments to stabilize an economy because none of these single instruments can cure all the problems in an economy.

## 3. Methodology

Research design adopted for this study is *ex-post facto*. For the purpose of conducting this study, secondary data was used to explain impact of monetary and fiscal policies in combating inflation in Nigeria for the period 1984-2014. Data were gathered from the statistical bulletin issued by the Central Bank of Nigeria for the period of the study.

For the purpose of carrying out this study, data analysis used include econometrics analysis. Two main econometrics analysis used include Ordinary Least Square method to study the relationship between monetary policy, fiscal policy and inflation while Johanson Juselius Co-integration Test was used to study the long run equilibrium among the variables. However, it should be noted that when using time series data analysis, these data are subject to the problem of spurious regression if the data are non-stationary and this could lead to an unreliable result. In order to avoid spurious regression, unit root test (Augmented Dickey fuller test) will be conducted in order to determine if the time series data are stationary.

### 3.1. Model Specification

The model used for investigating the impact of monetary and fiscal policies in combating inflation in Nigeria in this study followed that of Isiaka, Abdulraheem and Mustapha (2011) on "the impact of monetary and fiscal policies on the level of economic activities in Nigeria". The variables used in this study are based on the variables used by the above authors which include:

Federal government capital expenditure-FCE

Tax-T

Money Supply-MS

Treasury Bills-TB

Reserve Requirement-RR

Consumer Price Index-CPI

### 3.2. Econometric Model

$$CPI = \beta_0 + \beta_1 MS + \beta_2 TB + \beta_3 RR + \beta_4 T + \beta_5 FCE + \mu$$

Where:

The parameter estimates are  $\beta_1, \beta_2, \beta_3$  while  $\beta_0$  is the parameter constant  $\mu$ -Error term

The above model was used in analyzing the effectiveness of each policy in combating inflation.

## 4. Data Analysis, Results and Discussion of Findings

### 4.1. Unit Root Tests Results

Variable in the model were subjected to a stationary test as part of the necessary diagnostic check and pre-condition to run the vector error correction model to avoid spurious regression result. It is only when economic variables are either stationary or corrected and made stationary that they are suitable for economic analysis, forecasting and making policy decisions.

Variables	Augmented Dickey Fuller		Equation Specification	Order of Integration
	5% (ADF) statistics	ADF at first difference		
CPI	-3.574244	0.0343	Intercept	I(1)
MS2	-1.953381	0.0002	Intercept	I(1)
TB	-1.952910	0.0461	Intercept	I(1)
RR	-1.952910	0.0042	Intercept	I(1)
TAX	-2.976263	<b>0.0306</b>	Intercept	I(1)
FCE	-3.595026	0.0218	Intercept	I(1)

Table 1: Unit Root Test Result

Source: Researchers' Computation 2019

The results of the unit root tests conducted using the ADF statistics shown above reveals that the variables: consumer price index, money supply, treasury bill, reserve requirement, tax and federal government expenditure were made stationary at their first difference. With their p-values all below 5% significant level.

#### 4.2. Cointegration Test

The unit root test confirmed that the series are integrated thus satisfying the initial assumption for co-integration analysis. Lag length were selected to be three using information criteria and satisfied the mathematical stability condition. The results of the maximal Eigen value and trace test statistics for the two models are presented in table 2 and 3.

The p-values at 5% and 10% level of significant indicate that the hypothesis of no co-integration among the variables can be rejected for Nigeria. Both Trace test and Maximum Eigenvalue test found one co-integrating relationship at 5% significant level. Since the variables are co-integrated, it is concluded that there exists a long-run equilibrium relationship between the variables.

Hypothesized		Trace	0.05	
No of CE(s)	Eigen value	Statistic	Critical value	Probability
None	0.922181	184.8654	95.75366	0.0000
At most 1	0.789482	110.8176	69.81889	0.0000
At most 2	0.686964	65.63025	47.85613	0.0005
At most 3	0.530739	31.94861	29.79707	0.0278
At most 4	0.289970	10.00734	15.49471	0.2802
At most 5	0.002629	0.076328	3.841466	0.7823

Table 2: Result of Johansen Co-integration Test Base on Trace Statistic

Source: Researchers' computation using E-views, 2019

Hypothesized		Max-Eigen	0.05	
No of CE(s)	Eigen value	Statistic	Critical value	Probability
None	0.922181	74.04786	40.07757	0.0000
At most 1	0.789482	45.18735	33.87687	0.0015
At most 2	0.686964	33.68163	27.58434	0.0073
At most 3	0.530739	21.94127	21.13162	0.0384
At most 4	0.289970	9.931010	14.26460	0.2165
At most 5	0.002629	0.076328	3.841466	0.7823

Table 3: Result of the Johansen Co-Integration Test on Maximum Eigen

Source: Researchers' Computation Using E-Views 2019

#### Regression Analysis

Equation:  $CPI=5.1174+0.0059M2+0.04131TB-0.02043RR$ 

Variables	Co-efficient	R-squared	T-statistics	Prob	AIC
Money supply	0.0059	0.9722	8.1440**	0.0000	7.0536
Treasury bills	0.04131	0.9772	6.5417**	0.0000	7.0536
Reserve requirement	-0.02043	0.9722	-5.5411**	0.0000	7.0536

Table 4: Summary Result (Monetary Policy) of the Ordinary Least Square

Regression Model on Consumer Price Index

Source: Researchers' Computation 2019

Where \*\* Represents Significance Level of 5%

The regression equation in table 4 shows that the explanatory variable MS is positively related to the dependent variable which means an increase in the supply of money in the economy without a corresponding increase in the goods and services will in turn cause inflation in the economy. In summary, this means more money chasing fewer volume of

goods and services. Treasury bills also has a positive relationship with inflation which is the dependent variable and this means that when government buys treasury bills from the public they (government) pump money into the economy through purchase of securities which automatically increase the volume of money supply in the economy thereby causing inflation. This contractionary method is best used during boom. However, reserve requirement has a negative relationship with inflation. This when the CBN increase the percentage of the total holdings of the deposit money bank that must be kept with the CBN, which makes the deposit money bank have lesser amount to give to the public in terms of loans, overdrafts, this reduces the volume of money in circulation and this in turn reduces inflation in the economy and vice versa. That a 1% change in MS<sub>2</sub>, TB with RR held constant will lead to 0.005924 changes in CPI. Similarly, a 1% change in TB, MS<sub>2</sub>, with RR held constant will result to a 0.041308 change in CPI. And a 1% change in RR, TB, with MS<sub>2</sub> held constant will result to a -0.020426 change in CPI.

Furthermore, the coefficient of correlation R-squared=0.972289 shows that there is a high correlation between the explanatory variables and the dependent variables while the coefficient of determination Adjusted R-squared =0.969210 shows that the explanatory variables MS<sub>2</sub>, TB and RR have been able to explain 96.9%, variation in CPI. The other 4.0% in CPI is due to other factors not considered in the model, such as the propensity of the nationals to import, illegal activities like money Laundering to mention but a few.

Therefore, from the above regression analysis money supply and Treasury bills has a positive statistically significant impact in combating inflation while reserve requirement has a negative statistically significant impact in combating inflation in Nigeria.

The Durbin-Watson value 0.495739 shows that there are not serial correlations, though the coefficients of the explanatory variables are significantly small.

Equation 2:  $CPI = 14.21840 - 0.1187T + 0.0698FCE$

Variables	Co-efficient	R-squared	T-statistics	Probability	AIC
Tax	-0.1187	0.79	-0.4520	0.6547	9.0118
Federal Capital Expenditure	0.0698	0.79	9.6015**	0.0000	9.0118

*Table 5: Result Summary (Fiscal Policy) of the Ordinary Least Square Regression Model on Consumer Price Index*

*Source: Researchers' Computation, 2019*

*Where \*\* Represents Significance Level Of 5%*

The result of the analysis above shows that there is a negative relationship between Tax and CPI. When government increase the tax rate of each citizens, the citizens will have low purchasing power resulting to a decrease in the volume of money supply in circulation which will in turn reduce inflation in the country. Also, a decrease in Tax will lead to an increase in CPI. There is also a positive relationship between FCE and CPI. When government increases their expenditure without an immediate increase in the volume of goods and services in the country this results to an increase in inflation. This implies that increase in FCE will lead to an increase in CPI and vice versa. Though there is a positive and negative correlation between the dependent and independent variables under consideration, the coefficient (i.e. the rate of change in CPI resulting from change in Tax and FCE) is significantly small, -0.118783 and 0.069838 respectively. These small coefficients could be attributed to the fact that Tax do not really depend on consumer price index. The calculated value of the t-ratios (FCE) shows that the coefficients of the independent variables are statistically significant while the calculated value of the t-ratios (Tax) shows that the coefficients of the independent variable are not statistically significant.

The value of the R<sup>2</sup>=0.790541 shows that Tax and FCE accounted for 79.1% variation in CPI while the remaining 20.9% variation on consumer price index could be attributed to other factors not considered in the model. Accounting for the increase in the independent variables with the adjusted or corrected R<sup>2</sup>=0.775580 means that in fact the two explanatory variables Tax and FCE have explained in reality 77% variation in Consumer Price Index (CPI) under periods considered.

Testing the significance of the two explanatory variables simultaneously, the value of the F-test statistic  $F(2u) = 52.83$  shows that they are statistically significant as both 95% and 99% levels of confidence. The value of Durbin-Watson (DW) 1.000208 shows that there is presence of autocorrelation in the data collected.

In conclusion, the probability of each variable shows that they are all statistically significant and which means monetary policy and fiscal policy are both effective in tackling inflation in Nigeria.

## 5. Conclusion

The main objective of this study is to establish the impact of fiscal and monetary policies in combating inflation in Nigeria. Ordinary Least Square method was used to establish a simple relationship between the variables under study. Based on this study, Money supply, Treasury Bills, Reserve requirement, Tax and Federal government capital expenditure are the monetary and fiscal policy variables that can be appropriately manipulated to control inflation in Nigeria.

In the light of this, it is suggested that the Central Bank Nigeria's guidelines for banks should be strictly followed and the Central Bank should be given absolute control devoid of political interference so that the monetary policy can be well coordinated to achieve the desired macroeconomics objectives.

In conclusion, the probability of each variable shows that they are all statistically significant and which means monetary and fiscal policies are both effective in tackling inflation in Nigeria.

## 6. Recommendations

In the light of findings discussed above and the conclusion reached, the following recommendations are made:

- There should be proper coordination between monetary and fiscal policies. Proper and efficient coordination between monetary and fiscal policies enhance discipline in government spending; hence the large proportion of budget deficit financed subsequently by banks result in inflationary situation.
- The monetary and fiscal authorities should design monetary and fiscal policy instruments contingent to our socio-political environment, such as designing policies that will induce activities in the private sector which is in line with Obrimah (2015). His findings indicate that in spite of the observed dichotomies in the effects of activities within the private sector on inflation and exchange rates, it shows that activities within the private sector have induced lower inflation levels in Nigeria via price substitution strategies facilitated by import-related activities and not necessarily copied from other developed economy, hence, monetary authority is recognized to be potent tool in controlling inflation in Nigeria.
- It is equally realized that effective and successful implementation of monetary and fiscal policies depend on the health of the banking institutions. For the above policy to work, there is a need for a sound banking system. This can only be achieved if the monetary and fiscal authorities provide adequate framework for banks to operate. This would in no small way enhance the efficiency of monetary and fiscal policies as it is through the banking system that monetary and fiscal policies work efficiently.
- Emphasis should also be placed on money supply; hence it has much influence in controlling inflationary pressure in Nigeria. It is imperative on the side of government not to arbitrarily change money supply, since the growth rate of money induce inflation. Government should ensure that money supply is just sufficient to stimulate non-inflationary sustainable economic growth. More so, private individual should be encouraged to imbibe banking habits. Excess money outside the banking system not only reduces the lending strength of the banks but have negative effect on the economy.

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