

Impact of Monetary Policy on Price Stability in Nigeria

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Abstract

The study examined the effect of monetary policy on price stability in Nigeria. The objectives were to; examine the effects of money supply, interest rate, exchange rate on price stability. Exploratory research design was employed. Secondary data were extracted and used from CBN Bulletin. Ordinary least square of multiple regression statistical technique was adopted to establish the relationship between the variables. The study covered the period between 2007 to 2016. The analysis results revealed that there was a significant relationship between money supply and inflation, and there was no significant relationship between interest rate and inflation. Exchange rate significantly affects the level of inflation. The study recommended that more emphasis should be placed on money supply; hence, it has much influence in controlling inflationary pressure in Nigeria. Therefore, government should ensure that money supply is just sufficient to stimulate non-inflationary sustainable economic growth. Also, the Central Bank of Nigeria should advise banks to obtain clearance from the presidency through the Ministry of Finance before adjustment of exchange rate.

Keywords: *Monetary policy, Price stability, Money supply, Interest rate, Exchange rate*

1.0 Introduction

Monetary policy is a combination of measures designed to regulate the value, supply and cost of money in an economy, in consonance with the expected level of economic activity (Falawewo, 2003). The Central Bank of Nigeria (CBN) is saddled with the responsibility of ensuring price stability by implementing policies that enhance and sustain economic growth and appropriate change in the level of money supply. For many countries, the objectives of monetary policy are explicitly stated in the laws establishing their central banks, but generally, it is to achieve price stability, among other macro-economic objectives. The conduct of monetary policy solely relies on direct control measures which involves imposition of selective sartorial control credit ceiling, interest rate control, cash reserve requirement, exchange rate control and call for special deposits. Price instability is a reflection of pricing inflation and thus poses a threat on the economic progress of the nation (Nzotta, 2004). However, maintenance of price stability is often difficult to attain, at least in the short run, because of its apparent conflicts with other macro-economic objectives. This is in spite of the fact that the price stability is for every Nation and it as always been the core objectives of monetary policy framework. This is borne out of the perception that stability in prices of goods and services promotes economic growth and exist when there is sustainably low and stable inflation rate (Adeboye, 2014).

Price stability can assist to achieve maximum sustainable output growth and employment ultimately. In ensuring price stability, the Central Bank of Nigeria implements policies that guarantee sustained economic growth, through appropriately changing levels of money supply. The process of arriving at the CBN's monetary policy program entails an appraisal of developmental changes in the economy over a specific period and designing policy measures that would ensure price stability (Nzotta, 2004). This study therefore intends

to investigate the effect of monetary policy on price stability in Nigeria. Monetary policy through money supply, exchange rate, interest rate, affects prices in Nigeria. It has both positive and negative effect on the growth of Nigeria economy. The key problem facing CBN is how to curtail price instability in the face of macroeconomic problems. The imperative for this study is to investigate whether monetary policy can be used to redress this problem. The specific study objectives as;

- 1 To examine the effects of money supply on price stability
- 2 To ascertain the effect of exchange rate on price stability
- 3 To investigate the effect of interest rate on price stability

2.0 Theoretical framework and Literature review

The following theories are postulated on the impact of monetary policy in controlling inflation in Nigeria.

The monetarist theory

The monetarist theory states that the quantity of money is the main determinant of the price level or the value of money. Any change in the quantity of money produces an exactly proportionate change in the price level. If the quantity of money is doubled, the price level will also double and the value of money will be one half. On the other hand, if the quantity of money is reduced by one half, the price level will also be reduced by one half and the value of money will be twice. The quantity of money is traceable to Irving Fisher's famous equation of exchange

$MV = PQ$ Where; M = money stock, P = velocity of circulation of money, Q = velocity of transactions within the given Period.

The monetarists emphasize that any change in the quantity of money affects only the price level. This indicates that changes in the supply of money do not affect the real output of goods and services, but their values or the prices at which they are exchanged only. So, monetarist holds the view that increase in the quantity of money leads to increase in price.

Objectives of monetary policy

As in other economies, Anyanwu, Oyefusi, Oaikhenan and Diowo (1997) averred that monetary policy in Nigeria is aimed at moderating the inflation rate, promotion of growth, reducing pressures on the external sector, stabilizing the naira exchange rate and inducing increase in financial savings, investment and employment. However, due to conflicts in the attainment of these objectives, priorities are usually set in this direction. Thus, the ultimate targets of monetary policy are:

- 1) Sustained increase in output/growth
- 2) Price stability
- 3) Full employment
- 4) Sustainable balance of payments
- 5) Exchange rate stability.

These can be summed as economic stabilization (growth, price stability and full employment) and external balance (sustainable balance of payments and stable exchange rate). To attain the ultimate goals, policy makers identify variables that have stable, certain and strong relationship with the ultimate goals, which are referred to as proximate targets/goals. The conventional wisdom according to Anyanwu, Oyefuse, Oakhenan and Dimowo (1997), is that the terms of liquidity (or terms on credit and some measures of the quantity of liquidity) are possible proximate target variables. Commonly used target variables in Nigeria are;

- i) Interest rates

- ii) Money supply
- iii) Narrow money supply (M!) – currency plus demand deposits
- iv) Broad money supply (M2) M1 plus quasi-money (time and savings deposits)
- v) Domestic credit
- vi) High powered money or monetary base/resource money

Instrument of monetary policy used by the Central Bank of Nigeria (CBN)

Open market operation

The open market operations constitute a major instrument of monetary policy under the market-based system of monetary management. Essentially, open market operation is used by the monetary authorities to regulate the cost and availability of credit in the banking system and thus influence the level of money supply (Nzotta, 2004). Nnanna (2001) noted that the open market operations (OMO) entails the sale or purchase of eligible bills or securities in the open market by the CBN for the purpose of influencing deposit money, banks' reserve balances, the level of base money and consequently the overall level of monetary and financial conditions. The instruments traded include Treasury bill, treasury certificates and development stocks of not more than three years to maturity.

In the transaction, banks subscribing to the offer, through the discount houses, draw on their reserve balances at the CBN thereby reducing the overall liquidity of the banking system and the bank's ability to create money via credit. However, the use of open market operations (OMO) is geared towards achieving a substantial monetary tightening given the continued upward spiral in the inflation rate, the growing pressure on the naira exchange rate and the underlying growth of domestic liquidity arising from the CBN accommodation of the growth of fiscal deficit of the federal government.

Cash reserve requirement

The CBN complements the use of open market operation (OMO) with a reserve requirement. In this connection, the reserve requirement is an instrument for liquidity management and for prudential regulations. Nonetheless, a bank's ability to expand money supply through credit creation is always limited by the amount of the legal reserves. Thus, reserve requirements serve to limit the expansion of credit and money supply. The legal reserve requirements conceptually enable the Central Bank of Nigeria to manage the money supply by influencing the reserve base of banks. Here, if the reserve bases of banks are constrained through legal reserves (contraction in the reserve base) their ability to create money is also constrained (Iyaji, Success & Success, 2012).

Thus, movement in the legal reserves affects the reserve base of banks. There are basically two forms of reserve requirement, these are the cash reserve ratio (CRR) and the liquidity ratio (LR) while the former is defined as a proportion of total demand, savings and time deposits which banks are expected to keep as deposits with the CBN, the latter refers to the proportion of banks liquid assets to their total deposit liabilities.

Minimum rediscount rate (MRR)

The minimum rediscount rate (MRR) is the rate of interest charged by the central bank for rediscounting short bills (treasury bills, treasury certificates and eligible development stocks) for banks, especially when they are under pressure for short term fund (Nzotta, 2004).

However, Nnanna (2001) noted that the CBN discount window facilities were established strictly in line with the "lender of last resort" role that the bank is expected to play. Accordingly, it has continued to provide loans of short term nature to banks in need of liquidity. The essence is to achieve monetary stability enhance the liquidity of the banks and

foster public confidence in the banks. The facilities are collateralized by the borrowing institution's holding of government debt instruments and any other instrument approved by the CBN and subject to a maximum quota. As a tool of monetary policy, raising or lowering of all minimum rediscount rate (MRR) signals the intention of the monetary authorities to either contract or expand bank credit.

When the CBN finds that inflationary rates are going up in the economy, it may decide to raise the bank rate. Borrowing from the central bank becomes costly and thus banks usually respond by borrowing less from the CBN. With the upward movement of the rediscount rate, the banks in turn increase their lending rates to the borrowing public and thus enable the system to achieve a contraction in the volume of credit created, the money supply and inflationary rates.

On the other hand, if the CBN wants to reflate the economy following a depression, it may decide to lower the discount rate, borrowing becomes cheap. The banks respond by lowering the lending rates and thus creating more credit since the demand for credit would usually increase, especially in an interest sensitive economic system. Investments are increased and same to output, income and thus the movement of prices (Jhingan, 2007).

Moral suasion

This refers to the policy of the CBN, using its influence in the system, to persuade banks to restrain, moderate or channel their lending activities or allocate same in a particular manner (Nzotta, 2004). The CBN adopts this approach as a means of establishing two-way communication with the banks, thereby creating a better environment for the effectiveness of monetary policy

Monetary policy instrumentation

After the CBN's monetary policy proposals are approved by the President / Head of Stat, the relevant proposals are outlined in the form of a monetary policy circular for implementation by banks and other financial institutions. Penalties for malfeasance with specified guidelines are stipulated in the circular in order to monitor the activities of financial operations, the CBN conducts periodic and special examinations of books of all licensed banks which are also expected or required to submit regular/periodic returns on their operations to the CBN. Both the result of examination, the returns and current developments in the economy enables the CBN to evaluate the extent of compliance with the circular, the overall policy effects on the economy and hence the need or otherwise of policy revisions.

Exchange rate and inflation

The exchange rate is the price of foreign currency in terms of the domestic currency; like other prices in a market economy; it sends signals that affect consumption and investment decisions and therefore, influences both the composition and value of aggregate demand and supply. Exchange rate has a major role in monetary policy measures; its significance in monetary policy arises from its link to inflation, external competitiveness and balance of payments consideration. Exchange rate being a monetary instrument, its interaction with other monetary variables such as the money stock, interest rate and liquidity conditions is crucial to the achievement of macroeconomic stability.

Handa (2000) as quoted by Nyong (2001) had argued that exchange rate instability is a manifestation of economic volatility. The determinants of exchange rate include amongst others, economic fundamentals, such as the GDP, inflation, balance of payments, socio-political factors, macroeconomic shocks and speculative contagion. These drivers influence exchange rate dynamics through the demand for and supply of foreign exchange which can exert or ease the pressure on the market and cause the exchange rate to depreciate or

appreciate. However, a more depreciated exchange rate to increase competitiveness or to solve a balance of payments is usually done at the expense of higher inflation.

Nzekwe (2006) posits that pegging the exchange rate can lower inflation by inducing greater policy discipline and instilling greater confidence in the currency. He further averred that policy makers have long maintained that a pegged exchange rate can be an anti-inflationary tool. Two reasons are typically cited. A pegged exchange rate provides a highly visible commitment and thus raises the political costs of loose monetary and fiscal policies. To the extent that the peg is credible there is a stronger readiness to hold domestic currency; which reduces the inflationary consequences of a given expansion in the money supply. It is imperative to note that countries with pegged exchange rates have lower rates of growth in money supply and consequently inflation.

However, the monetary theories attempt to explain changes in exchange rates in terms of changes in the demand and supply of money between two countries. According to their theory, an increase in money supply causes the exchange rate to depreciate as a result of the induced inflationary pressures (Nyong, 2001).

3.0 Empirical literature

A large number of empirical studies have been done to estimate the impact of monetary policy on inflationary trends. Chimaobi and Igwe (2010) examine the real exchange rate overshooting and the output cost of bringing down inflation. They found that despite inflation sluggishness, core inflation can be reduced quickly by jumps in the price level induced by jumps in the exchange rate. Chaudhary and Ahmad (1995) assessed the long-run co-integration of inflation and some macroeconomic variables as money supply, and government budget deficit in Pakistan. Based on the monetarist and quantity theory approach to inflation and with a unit root test for stationarity, they observed that the domestic financing of budget, particularly from the banking system, is inflationary in the long-run. The results provided support for a positive relationship between money supply and inflation.

Akçay (1996) uses annual Turkish data to analyze the existence of a stable long-run relationship between budget deficits, money growth and inflation, and the results according to them was affirmative. Using the co-integrating vectors found in the study, they concluded that a significant impact of budget deficit on inflation cannot be refuted under the assumption of long-run monetary neutrality. However, when an unrestricted AR model was utilized on quarterly data corresponding to the post bond financing period, the results were suggestive of a weakened link from the other variables to inflation.

Kilindo (1997) attempted an experience of Tanzania's economic relationship between fiscal operations, money supply and inflation. Testing the structural model for the period of 1970-84, the evidence by the significant coefficients of the structural model and simulation results show a strong relationship between fiscal operation, money supply and inflation in Tanzania. Kibritcioglu (2002) consolidates the earlier work in Akçay (1996) by confirming the persistence of inflation in Turkey as a net result of sophisticated dynamic interaction of four group of explanatory factors of demand-side (monetary) shock, supply-side (or real) shocks, adjustment factors, and political processes. This means that an inflationary growth is a result of in-appropriation of various structural and economic factors. Engle and Granger (2008) explore the policy perspective of this concept they investigate the effects of an aggressive monetary policy on inflation persistence. Aggressive inflation policy includes the willingness to response to deviations from the inflation target. Using an adaptive learning framework under specific condition, their result shows that aggressive anti-inflation policies lower inflation persistence.

Akinboade (2004) explains the dynamics of inflation in South Africa and in their model which relates domestic inflation to a largely structural phenomenon in the money market, labour market and foreign exchange market conditions, suggests that there is a positive correlation between labour costs, broad money supply and domestic inflation such that, in the long-run, rising labour costs contribute significantly to inflation. In their view, an increase in the nominal interest rates, the effect of which is insignificant in the short-run will slightly reduce inflation in the long-run, while an increase in the broad money supply will contribute to domestic inflation in the long-run. Ocean (2007) analyzes that, the growth of money and inflation are closely related in the long-run, but that causality may run from inflation to money. The study adopted secondary source of data using multiple regression. He sees the ultimate cause of inflation as an inevitable consequence of heterogeneity in time preference rates between a government and households. This really seems to be a deviation from the conventional views that economic factors influenced inflation.

London (2008) provides empirical evidence on the relationship between money and inflation in Africa. Using both cross-section and time series econometric analysis, he showed that although, the simple monetarist inflation model appears to hold when tested in cross-section equations covering several countries and averaged over several years, the same is generally, not true for individual countries in time series analysis or cross-section studies. London's analysis strongly suggests that factors other than the rate of monetary expansion might have played an important role in determining short-run inflation trend in Africa. Therefore, the lesser role that are to be assigned to monetary factors over the short-run, the study urges greater flexibility in deploying policy instruments towards inflation target in African countries. Accordingly, he cautioned against the application of rule based on regional result in favour of those derived from country-specific findings.

Evans (2009) examined the possibility of a stable and predictable relationship to exist between inflation and the monetary policy instruments in Nigeria and Ghana. Using vector autoregressive models with some financial variables such as money supply, price, nominal exchange rates and interest rates, the result of the model shows that inflation is an inertial phenomenon in Nigeria and Ghana, and money innovations are not strong and statistically important in determining prices when compared with price shocks. That in the short-run, innovations in prices are mostly explained by their own shocks; the monetary policy instruments such as interest rates and exchange rates, have little or no effect on prices. The implication is that policy linkage between inflation and monetary policy instruments in Nigeria and Ghana is not strong and predictable in the short run (Chukwu, 2010).

McCallum and Nelson (2010) considered the relationship existing between monetary aggregates and inflation, and whether there is any substantial reason for modification of policy analysis. After affirming the Friedman's proposition that if a change in the quantity of (nominal) money were exogenously engineered by the monetary authority, the long-run effect would be a change in the price level (and other nominal variables) of the same proportion as the money stock, with no change resulting in the value of any real variable. They hold a contrasting view that, the monetarist proposition holds in a model economy if, and only if the model exhibits the property known as long-run "neutrality of money". They, therefore, challenged the view that has been widely expressed in the literature, both by critics and advocates of the use of money in monetary policy analysis.

Habibullah (2011) attempts to determine the long-run relationship between budget deficit and inflation in thirteen Asian developing countries, namely; Indonesia, Malaysia, the Philippines, Myanmar, Singapore, Thailand, India, South Korea, Pakistan, Sri Lanka,

Taiwan, Nepal and Bangladesh. Using annual data for the period 1950-1999, the Granger causality within the error-correction model (ECM) framework suggest that all variables involved (budget deficits, money supply and inflation) are integrated of order one. With existence of a long-run relationship between inflation and budget deficits, the study concludes that budget deficits are inflationary in Asian developing countries.

4.0 Research methodology

Secondary sources of data were used as the main method of data collection. The relevant data for this study have been obtained from the Central Bank of Nigeria (CBN) statistical bulletin. The data were collected on annual basis from 2007-2016. Ordinary least square of multiple regression statistical technique was employed to establish the relationship between dependent and independent variables. Based on this theoretical postulation, the study specified inflation as a linear function of money supply (MS), exchange rate (ER) and interest rate (IR). Inflation (INF) was used as the dependent variable.

$$INF = F(MS, ER, IR)$$

$$INF = b_0 + b_1MS + b_2ER + b_3IR + U$$

The theoretical expectations about the signs of the coefficients of the parameters are;

$$a_1 > 0, a_2 > 0, a_3 > 0$$

5.0 Analysis of data

The regression result of the impact of monetary policy in controlling inflation is Nigeria (1990-2016).

Regression result

Variable	Coefficient	Std. error	t-stat	Prob.
C	2.327873	0.337660	6.894123*	0.200
MS	3.481684	0.932634	3.733174**	0.0310
ER	0.972772	0.099138	9.812283**	0.0500
IR	-3.746307	1.657189	2.260667**	0.0210

$$R^2 = 0.705674, R^2(\text{adj}) = 0.632093, f\text{-stat.} = 9.5903, DW = 2.3485$$

* Significant at 1% level, ** significant at 5% level.

The estimated result as presented in Table 4.2 above is analyzed in terms of three criteria, namely; economic a priori criteria, statistical criteria and econometric criteria.

Economic a priori criteria

The empirical results show that all explanatory variables turned out with their correct expected signs, except interest rate. The estimated regression line has a positive intercept, represented by the constant term. This means that holding the explanatory variables constant, there will still be an increase in inflation by 2.32 percent. The positive sign of the coefficient of money supply shows a positive relationship with inflation, exchange rate with positive relationship with inflation while interest rate negative relationship with inflation.

Therefore 1 percent increase in money supply (3.48%), exchange rate (0.97%) will lead to an increase in inflation while 1 percent decrease in interest rate (-3.74%) will lead to a decrease in inflation.

Statistical criteria

The statistical test of significance of the parameter estimates is carried out using the t-statistic test. From the results obtained, two variables (money supply and exchange rate) were statistically significant. These variables were significant in influencing inflation. The high values of R-squared of 0.7056 and adjusted R-squared of 0.6320 showed that the estimated regression result has a good fit on the data. In particular, the adjusted R-squared of 0.6320

showed that about 63 percent of the systematic variation in the dependent variable has been explained by variations in the explanatory variables. The f-statistic value of 9.59 is reasonably high and showed the overall estimated regression model was statistically significant at the conventional 5 percent level of significance. This means that independent variables have joint effect on the dependent variable.

Econometric criteria

The Durbin-Waston statistic is employed here to test for the absence of autocorrelation in the model.

5.0 Findings

The major findings of the study include;

- i) There is a significant relationship between money supply and inflation in Nigeria.
- ii) Exchange rate significantly affects the level of inflation in Nigeria.
- iii) There is no significant relationship between interest rate and inflation in Nigeria.

6.0 Conclusion and Recommendations

It is a well-known fact that over the years, monetary policy has not made the desired impact on price stability in Nigeria. Nonetheless, a number of reasons have been advanced for why the performance of monetary policy over the years has been abysmal. These include lack of sufficient control of the financial institution, political interference and the inability of monetary authority to use monetary instrument.

However, based on this study, money supply, interest rate and exchange rate are the monetary policy variables that can be appropriately manipulated to control inflation in Nigeria. In the light of the findings, the following recommendations are made:

- 1) More emphasis should be placed on money supply, since it has much influence on inflationary pressure in Nigeria.
- 2) The prevalence of underground market (black market) in the exchange rate system has undermined the policy objective of controlling inflation. Therefore, Central Bank of Nigeria should advise banks to obtain clearance from the presidency through the Ministry of Finance before adjustment of exchange rate.

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