THE IMPACT OF INFLATION ON THE BALANCE OF PAYMENT IN NIGERIA

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ABSTRACT

The paper evaluated the impact of inflation on the balance of payment in Nigeria. Data were obtained from the CBN statistical bulletin for the period 1981-2012 and analyzed using the ordinary least square regression method and E-view computer software. From the result of the analysis it was established that inflation had no significant and negative impact on balance of payment in Nigeria. It was also found that unemployment had no significant impact and positive impact on the balance of payment in Nigeria. It was recommended that the government should embark on efficient and effective expenditure switching policy or devaluation of Nigeria Currency (Naira), as devaluation of the country's currency will make exports cheaper and imports more expensive, thus, leading to a favourable balance payments position in the country. It was also recommended that government should make better use of direct controls and effective capital movement adjustment and the government should control and manage inflationary pressure efficiently.

Keywords; Inflation, balance of payment, CBN, Unemployment, and balance of payment.

Introduction

The maintenance of price stability is one of the macroeconomic challenges facing the Nigerian government throughout our economic history. This elusive factor is known and referred to as inflation in our economic history and this is defined by economists as a continuous rise in prices.

By definition, inflation is a persistent and appreciable rise in the general level of prices (Jhingan, 2002). Not every rise in the price level is termed inflation. Therefore, for a rise in the general price level to be considered inflation, such a rise must be constant, enduring and sustained. The rise in the price should affect almost every commodity and should not be temporal. But Demberg and McDougall are more explicit referring to inflation as a continuous rise in prices as measured by an index such as the Consumer Price Index (CPI) or by the implicit price deflator for Gross National Product (Jhingan 2002). In an inflationary economy, it is difficult for the national currency to act as medium of exchange and a store of value without having an adverse effect on income distribution, output and employment (CBN, 1984). Inflation is characterized by a fall in the value of the country's currency and a rise in her exchange rate with other Nation's currencies. This is quite obvious in the case of the value of the Naira (N), which was N1 to $1 (one US Dollar) in 1981, average of N100 to $1 in year 2000 (Okeke, 2000) and over N128 to $1 in 2003. This decline in the value of the Naira coincides with the period of inflationary growth in Nigeria, and is an unwholesome development that has led to a drastic decline in the living standard of the average Nigerian. To measure inflation are three approaches. These are the Gross National Product (GNP) implicit deflator, the Consumer Price Index (CPI) and the wholesome or producer price index (WPI or PPI). The period to period changes in these two latter
Inflation rates in Nigeria as it is easily and currently available on set of apparent in Nigeria from the onset of domestic inflation. Inflation was propelled in the 1960s through the "cheap money policy" adopted by the government to stimulate development after Independence. Interest rates were lowered and targeted at the preferred sectors of the economy, and was meant to facilitate the implementation of the First National Development Plan and subsequently the prosecution of the civil war. This led to rapid monetary expansion with the narrow and broad measures of money stock (M1 and M2 respectively) rising at annual rates of 29.7% (1961) and 44% (1969). Consequently, inflation increased from 6.4% (1961) to 12.1% (1969). The oil boom era of the 1970s was characterized by fiscal dominance and severe macroeconomic mis-balances as the period witnessed a sharp increase of government revenue in foreign exchange from oil exports. In 1971, the revenue rose from six hundred and three million naira (N603.0M) to Ten billion, four hundred and thirty three million, one hundred thousand naira (N10,433.3 M) with a share in the total revenue of 52.46% (1971 and 88.89% (Suleiman, 1998). Reluctantly, the government injected massive private and public expenditure into the economy through the enormous post war reconstruction of the early 1970s and expenditures on the Gigantic capital, embarked upon by all the governments under the third National Development Plan (Suleiman 1998). This increased the entire currency in circulation with businessmen calling and withdrawing money from the banks. As a result, the annual growth rate in money supply escalated from 56.6% to 91.3% in January and April 1975 (CBN, 1982).

Nigeria economy has undergone strains and stresses in their balance of payment since the collapse of the oil boom in early 1980's. During that time, Nigeria export was mainly crude oil which grew steadily from 1975 and reached a peak in 1980, the import grew faster, bringing about a growth deficit in the visible trade balance. Also the production and consumption patterns that emerged from, the era of the oil boom could not be sustained in the face of declining export or foreign exchange and inflation resulted from the heavy borrowing by the civilian administration, this made the balance of payment, capital account balance to reduce to degree of deficit which leads to low external reserve. Furthermore inflation is generally used to describe a situation of rapid persistence and unacceptable increase in general price level in any economy which brings about decrease in the value of currency. Also Lerner (1949) describe inflation as an excess of demand over supply. Again Solow (1970) sees inflation as going on when one needs more and more money to buy some representative bundle of goods and services meaning that inflation is a part of the adjustment process between two equilibrium. However it is not every rise in price that is being regarded as inflation but a persistent rise in aggregate price of goods and services; this is because price may rise to support a higher level of aggregate welfare.

The main reason for allowing inflation is because it allows for substantial redistribution of income and wealth from savers to borrowers that is from those who cannot protect themselves from the rise in the price of what they buy by raising the price of what they sell to those who can afford. High inflation hamper growth and development of an economy as it discourage savings and investment.

One of the causes of balance of payment problems is domestic inflation. Inflation create no problem for the balance of payment if all competitors are also inflating prices at the same rate since it is relative prices that matters in international trade as domestic trade if however, one country’s price level is rising faster than the levels of competitors countries, imports will rise more than the levels of export and this will lead to balance of payment problem. The policy decision is support a fixed exchange rate rather than allow the rate to be determined in free market, so as to eliminate fluctuation in the balance of payment rate. However, the Udoji Committee which doubled the basic minimum wage in the public sector in 1975 represented a climax in inflationary tendencies that led to the widespread strikes and unrest in the private sector on which the Udoji recommendations were not binding. This cost push factor further crippled productivity and enhanced inflation as the increased money supply and increased aggregate demand was not matched by an increased productivity.

The resultant structural rigidities hampering productivity, especially agricultural productivity led to the appointment of an Anti-Inflation Task Force in 1975 to recommend the liberalization of imports that resulted in the massive inflow of food, raw materials and other consumer goods.

Furthermore the hosting of FESTAC in 1977 help in compounding the problem of macroeconomic
stability whereas the accelerated growth in money supply and aggregate demand between 1970 and 1974 was attributed to monetization of crude oil exports earnings through Government spending, the main expansionary factor in 1975 to 1979 was the explosive growth in bank credit, especially to the government sector.

Consequently, inflation rates increased from 13.8% in 1970 to 33.9% in 1975 but fell to 11.8% in 1979. This fall was due to the direct credit allocation policy by government productive investments to generate output and employment growth. Again, the imposition of special deposits, especially on import demand helped to contain the growth in aggregate demand (CBN, 2001).

From the foregoing, over the years, inflation is one of the most crucial macroeconomic problems in Nigeria, hence the need for a greater attention to it. Given the major distortions caused by it in the economic growth of the country and the living standard of the citizenry, various administrations in Nigeria in the past and present had adopted various measures to deal with inflation in the country without achieving the desired goal -long-term solution. Therefore, the research work intends to make a critical assessment of the impact of inflation on balance of payment in Nigeria if the necessary condition upon which a lasting solution to inflation can be found in Nigeria.

Statement Of Problem
Inflation, unemployment and maintenance of stable balance of payment are all basic macro-economic problems facing every government in the world today.
Inflation causes uncertainty about future prices, thereby affecting the decision on expenditure, savings and investment and causes misallocation of resources. High inflation equally boosts growth and development policies of the policy makers. Our concern on unemployment is based on the fact that high unemployment leads to loss of output and reduction in aggregate income, it increases inequality since the unemployed loose more than the employed. Prolonged unemployment can cause misery, social unrest, loss of confidence and hopelessness for the unemployed;

Nigeria’s balance of payment have continued to show deteriorating trends. The cause of this deterioration includes, the import syndrome, mounting external indebtedness, hostile International environment, over dependence on crude petroleum etc, there is a link among these variables, which after time leave government confused and defected. This is because low unemployment is associated with a rapid rate of inflation; similarly high unemployment implies self-labor markets and consequent inability to push up wages. Consumers income and spending and also depressed and demand condition for rapid inflation are therefore unfavorable. Therefore, there is a tradeoff between the rate of inflation and unemployment. Price stability can only occur at the cost of high unemployment rate and low unemployment rate can only occur at the cost of inflation.

However, the Nigerian economy does not reflect this so called tradeoff. This is because experience has shown that rising inflation also leads to increase in unemployment rate, despite the monetary and physical policies by the authorities in Nigeria.

OBJECTIVE OF THE STUDY
1) To establish the impact of inflation on balance of payment in Nigeria.
2) To establish the impact of unemployment on balance of payment in Nigeria.

EMPIRICAL LITERATURE
Lucas (1973) investigates the unemployment-inflation trade off across countries and find out that, in general prediction of the theory are not entirely inconsistent with the data. Lucas study has been extended by other authors, Alberro (1981) and Kormendi and Meguire (1984) with less than clear cut result.
in General countries experiencing extremely volatile demand import tend to support the Lucas thesis. However, as Artfield et al (1985) note Lucas test and its extension are subject to measurement errors and misspecification problems, quite apart from not testing for structural neutrality. It is posited that inadequate public revenue in the face of rapidly expanding public service especially in provision of social Infrastructure led to deficit financing with inflationary consequences. The short coming has arisen among others, for the low level of development, the underdeveloped nature of institutions for mobilizing saving both private and public sectors.
Here empirical literature on the relationship between economic growth, unemployment and inflation were reviewed. Stock and Watson (1999) used the conventional Phillips curve (unemployment rate) to investigate forecasts of U.S. inflation at the 12-month horizon. These authors focused on three questions. First, has the
U.S. Phillips curve been stable? If not, what are the implications of the instability for forecasting future inflation? Second, would an alternative Phillips curve provide better forecasts of inflation than unemployment rate Phillips curve? Third, how do inflation forecasts from Phillips curve stack up against time series forecasts made using interest rate, money, and other series? They found that inflation forecasts produced by Phillips curve generally had been more accurate than forecasts based on other macroeconomic variables, including interest rates, money and commodity prices but relying on it to the exclusion of other forecasts was a mistake. Forecasting relations based on other measures of aggregate activity could perform as well or better than those based on unemployment, and combining these forecasts would produce optimal forecasts. Williams and Adedeji (2004) examined price dynamics in the Dominican Republic by exploring the joint effects of distortions in the money and traded-goods markets on inflation, holding other potential influences constant. They captured the remarkable macroeconomic stability and growth for period 1991 to 2002. Using a parsimonious and empirically stable error-correction model, they found that the major determinants of inflation were changes in monetary aggregates, real output, foreign inflation, and the exchange rate. However, there was an incomplete pass-through of depreciation from the exchange rate to inflation. They also established a long-run relationship in the money and traded-goods markets, observing that inflation was influenced only by disequilibrium in the money market. Popovic (2009) conducted a research on inflation and unemployment in the EU: comparative analysis of Phillips regularity through correlation analysis of unemployment and inflation in EU for the 1998-2007 periods and was found that the simple linear correlation coefficient between them is negative. They concluded that the relation between unemployment and inflation is moderate and inverse (negative). This shows that inflation in Nigeria is too much extent a monetary phenomenon. They find empirical support in context of the money-price-output hypothesis for Nigerian economy. M2 appears to have a strong causal effect on the real output as well as prices. Fakhri (2011) conducted research on the relationship between inflation and economic growth in Azerbaijan, he used Threshold model and found that there is a nonlinear relationship between inflation and economic growth with the threshold level of 13%. Chang-Shuai Li and ZI-Juan Liu (2012) conducted a study on the relationship among Chinese unemployment rate, economic growth and inflation; they employed Granger causality test, unit root, cointegration, VAR and VEC model. The study revealed that unemployment impacted negatively on growth while inflation impacted positively on growth in China. The study also revealed no causation between unemployment and inflation, but there is causation between unemployment and growth, while two-way causation existed between inflation and growth. Aminu and Anono (2012) conducted a study on the relationship between unemployment and inflation. They used OLS, ADF for unit root, Granger causality, Johansen cointegration, ARCH and GARCH techniques. The study revealed negative relationship between unemployment and inflation and no causation between unemployment and inflation; though they found that there is long-run relationship between the two phenomena in Nigeria. Aminu and Anono (2012) investigated the effect of inflation on economic growth and development in Nigeria. They employed OLS, ADF and Granger causality and found that there is a positive correlation between inflation and economic growth in Nigeria, though the results revealed that the coefficient of inflation is not statistically significant, but is consistency with the theoretical expectation, causation runs from GDP to inflation implying that inflation does not Granger cause GDP but GDP does. Bakere (2012) conducted a study on stabilization policy, unemployment crises and economic growth in Nigeria. He used OLS and found that the nexus between inflation, unemployment and economic growth in Nigeria were negative. Rafindadi (2012) conducted a study on the relationship between output and unemployment dynamics in Nigeria; he used OLS and Threshold model and found a negative nonlinear relationship between output and unemployment.

Using Okun's law "each percentage point of cyclical unemployment is associated with a loss equal to 2% of full-employment output; if full-employment output is $10 trillion, each percentage point of unemployment sustained for one year costs $200 billion".

Discussion of findings and conclusion.
FINDING NO 1: Inflation rate has a negative impact on balance of payment in Nigeria.
This finding is shown by the negative coefficient of inflation rate, -213.9975. This indicates that a unit change in inflation rate, leads to -213.9975 decreases in balance of payment. Therefore as inflation rate increases, balance of payment decreases. This finding is also in accordance with our a priori expectation which is based on economic theory that the inflation rate is expected to have a negative relationship with balance of payment in Nigeria.
FINDING NO 2: Inflation rate does not have significant impact on balance of payments in Nigeria.
This finding is shown by t-probability value of the balance of payments which is 0.9945 and which is greater than 5%, our chosen level of significance. This implies that the inflation rate has no real impact on balance of payment in Nigeria.

FINDING NO3: Unemployment rate has as positive impact on balance of payment in Nigeria. This finding is shown by the positive coefficient of the unemployment rate, 123579.0. This indicates that for a unit change in manufacturing output, about 123579.0 of the change will be transmitted private savings. This finding is not in accordance with our a priori expectation that real interest rate is expected to have negative impact on balance of payment in Nigeria. Thus, this finding indicates that as unemployment rate increases, there will be increase in the balance of payment. This is because as result of high unemployment rate, there will be low purchasing power which will discourage the rate at which people demand for foreign goods and services.

FINDING NO4: Unemployment rate does not have a significant impact on balance of payment in Nigeria. This finding is shown by the t-probability of the unemployment rate which is 0.5092 and which is greater than 5%, of our chosen level of significance. This implies that the unemployment rate does not have real impact on the balance of payment in Nigerian. Thus, the impact is a chance event. As a result of this, there is urgent need for the government to seek for a way of reducing the rate of unemployment so as to enhance the balance of payment. This can be done through government capital and recurrent expenditure.

Recommendations

The paper therefore recommends the following based on various studies and statistical interpretations of findings.

It was recommended that the government should embark on efficient and effective expenditure switching policy or devaluation of Nigeria Currency (Naira), as devaluation of the country's currency will make exports cheaper and imports more expensive, thus, leading to a favourable balance payments position in the country. Government should make better use of direct controls and effective capital movement adjustment. And finally, that government should control and manage inflationary pressure efficiently.

REFERENCES


