

Relationship between fiscal policy and balance of payment on economic growth in Nigeria

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Abstract

This study investigates the relationship between fiscal policy and balance of payments on economic growth in Nigeria from 1984 to 2017. The method employed is Autoregressive Distributed Lag (ARDL) using variables such as government expenditure, balance of payments, unemployment, real exchange rate, inflation and economic growth. The study revealed that Nigeria absorb more than what the economy produce (that is, domestic expenditure and investment are greater than National income) which result to balance of payment (BOP) deficit arising from over population as compared to productive sector of the economy. The result also shows a positive and significant relationship between unemployment and economic growth. Government expenditure is negatively related to economic growth in short-run, however, in the long run it is positive through infrastructures; inflation is positive in short run while it is negative in the long run; Exchange rate reveal negative and significant relationship with economic growth. It is concluded that balance of payments deficit and over population it's a curse to the economy, it is recommended that Absorption and Devaluation of currency to improve export and deteriorate import through policy induced approach

Keywords: Gross Domestic Product, Balance of Payments, Government Expenditure

JEL classification: E62

1. Introduction

Economic growth, balance of payments, price stability, and employment creation are the most macroeconomic objectives of every state irrespective of economic status of developed, developing or underdeveloped economies (Reem, 2009). Rhohana, (2017) also shares idea on these objectives which are conflicting factor to one another in most economy. To maintain balance of payments equilibrium, Milthani (1994) stated that seeking the help of international monetary fund (IMF) that give pieces of advice to members on the appropriate measures to be used for balance of payments equilibrium

to be achieved in any country is highly paramount. Fiscal policy is highly recommended as Keynes, 1973 had rightly said that ‘as total demand is volatile and irregular, free market economy will frequently face with inefficiency in macroeconomic outcome in form of economic recession (when demand is poor) and inflation (when demand is appreciate). These can be mitigated by economic policy responds, in particular, monetary action by the apex bank of the country and fiscal policy action by the state which can result in balance of payments unfavorable. The expenditure by the government (fiscal policy) in manufacturing and industrial sector reduced the tension of over reliance on imported goods, this help to advance BOP equilibrium through government intervention (Alexander, 1952). For economic growth to be achieved in an economy, fiscal policy and balance of payment has a vital role to play.

Over decades in Nigeria ranging from her year of independence till date, the economy is still faced with problem of over dependent on foreign products for sustenance and survival despite the numerous natural resources endowment in the economy (Bhim, 2017), thus, makes the economy to be operating unfavorable balance of payments. This is due to fiscal policy ineffectiveness in the economy as experienced during the oil boom era of 1970s where government expenditure (fiscal policy) was shifted to oil sector as a result of the huge revenue receipts received from the sector at that time (World Economic Watch, 2010). The effect of fiscal policy and balance of payments in Nigeria has been a problematic factor inhabiting economic growth since after independence (Hasemzadeh, 2004). The negligence of Agricultural sector due to inappropriate fiscal policy led the economy to be basic importer of food items and other major commodities in the country (Onoh, 2007). However, the failure of oil revenue as foreign exchange earnings caused the economy to experience a decline in gross domestic investment as percentage of GDP from 16.3% and 22.8% in 1970s and 1980s to 14% in 1988 and later increased to 18.2% in 1991 (Agiobenebo, 2000, & Gbosi, 2002). In the first quarter of 2011 the economy posted a surplus of NGN 2175.1 billion compared with NGN 253.3 billion deficit in the same year (World Bank, 2012). The economy balance of payment rose to 54.5% in export year-on-year till 57.3% increase on crude oil in first quarter of 2018 World Bank Report (2018), the fluctuations in all these despite the said effectiveness of the fiscal policy and the balance of payments deficits ignites this research work to examine the trend between fiscal policy (government expenditure and taxes) and balance of payments in Nigeria in checking the influence of fiscal policy on balance of payments in the country. However, the study seeks to fill the gap between deficit balance of payments and efficacy of fiscal policy to achieve economic growth in Nigeria with the aims of achieving how fiscal policy affect balance of payments on economic growth in Nigeria, the nature of relationship that exists between fiscal policy and balance of payments on economic growth of Nigeria. The study will be grouped into five sections, section one comprises of the introductions and aims of the study. Section two includes review of relevant literatures and theoretical framework, section three

contains the methodology used to achieve the research objectives, Section four is concern with data analysis of the empirical results. Lastly, section five includes summary conclusion and recommendation.

2. Literature Review

There are various empirical studies on the relationship between fiscal policy and balance of payments. Bo sodersten and Reed (1994) underpinned the idea of government using fiscal policy to correct the effect of balance of payments disequilibrium (Deficit) through the use of government expenditure and taxation in the economy; either by reducing expenditure and increase tax or increasing expenditure and reduce tax depending on the policy targeting. Mithani (1994) revealed that balance of payment is more harmful to a country's economic growth from his empirical analysis of Pakistan from 1984 to 2010.

Egwaikhide (1994) investigates the effect of fiscal policy on external balances (balance of payments) in Nigeria from 1973 to 1993, captured variables like inflation, money supply, domestic absorption government expenditure on fiscal budgetary policy and balance of payments with OLS and Simulation Approach. His result submitted that government expenditure influences balance of payments with a strong relationship. Thus, to attain external balance, fiscal discipline is necessary in the economy. The studies of effectiveness of fiscal policy and economic growth portray a positive relationship using ordinary least square method and co integration test. The study found a long run relationship between government expenditure and economic growth, such that an increase in government expenditure will lead to expansion in the economy (Ram,1986; Barro, 1991; Easterly & Rebelo,1993; Otani & Villanueva, 1990; Komain & Brahmarene, 2007; Rayan & Sharma,2008). On the contrary, other studies found a negative relationship between fiscal policy and economic growth (Abu-bader & Abu-qarn, 2003; & Ladua, 1986; Adeoye 2006). However, (Kormendi and Meguire, 1995) could not find any relationship using annual data from (1970-2007), the result shows that the effect of monetary policy is much stronger than the effect of fiscal policy in economic stabilization. In the same vein, (Olawunmi and Ayinla, 2007) estimates fiscal policy in achievement of sustainable economic growth using slow growth model and ordinary least square (OLS) method discovered that, fiscal policy has no impact on sustainable economic growth in Nigeria. Ogbale, Amadi, and Essi (2011) investigate the impact of fiscal policy on economic growth in Nigeria from 1970 to 2006. Their findings show that there is a difference in effectiveness of fiscal policy and economic growth. Onwanchukwu, (2015) examined the impact of fiscal policy in unemployment and inflation on economic growth in Nigeria from 1985 to 2010 using Ordinary Least Square (OLS) technique, findings revealed that unemployment does not significantly impact economic growth in the country while inflation impact significantly on economic growth in Nigeria.

Muhammad (2014) study the effect of inflation and employment on economic growth of Pakistan from 1980 to 2010 using ARDL, the study observed that inflation differs

from economy to economy his findings revealed that there exists a positive relationship between inflation and economic growth. Akpansung (1998) examined the applicability of monetary approach to balance of payment in Nigeria from 1960 to 1995 using two stage least (2SLS) with relevance monetary variables, he summated that balance of payment has a negative relationship with economic growth.

3. Methodology

This study adopted the Absorption Theory propounded by Alexander (1952). The theory state that if a country has deficit in her balance of payments, it means that people are “absorbing” more than they produce. This explains the rate of employment of factors of production in the economy which make the domestic expenditure on consumption and investment to be greater than national income of the country absorbing. However, if a country is having balance of payment surplus it means that the people are “absorbing” less than what the produce. Domestic expenditure on consumption and investment is less than the national income of the country, which indicates full utilization of factor resource in the economy. Thus, balance of payments is explained as the difference between national income of the country and her level of domestic expenditure. The theory can be explained in the following form:

$$Y = C + I_d + G + X - M \dots\dots\dots 1$$

Where Y represents the national income of the country, C is the consumption expenditure I_d is the domestic investment, G is the autonomous government expenditure, X is the export of the country, where M is the import. Thus, the summation of $(C + I_d + G)$ is the total absorption represented as ‘A’ and the balance of payments $(X-M)$ represented as ‘B’. Thus, the equation became

$$Y = A + B \dots\dots\dots 2$$

$$B = Y - A \dots\dots\dots 3$$

Which means that balance of payments on current account is the difference between Y and A. balance of payments can be improved by either increasing domestic income or reduce the absorption. First it increases export and reduce imports, therefore, fostering economic growth through the national income. The marginal income generated will further increase income through multiplier effect. This will lead to an upswing in domestic expenditure. Thus, the net effect is

$$\Delta B = \Delta Y - \Delta A \dots\dots\dots 4$$

The total absorption ΔA depends on the marginal propensity to absorb when there is depreciation. This is express as ‘a’

$$\text{Devaluation also directly affect absorption through changes in income represented as D. therefore, } \Delta A = a\Delta Y + \Delta D \dots\dots\dots 5$$

Put equation 4 into 3, we have

$$\Delta B = \Delta Y - a\Delta Y - \Delta D \dots\dots\dots 6$$

The equation point towards three factors which explain the effect of devaluation of currency on the balance of payments of a nation, these are the marginal propensity to absorb (a), secondly, ΔY and changes in direct absorption. It may be observed that since 'a' is the marginal propensity to absorb, (1-a) is the propensity to save. These factors in turn, are disturbed by the likelihood of unemployment and full employment of resource of the country.

3.1 Estimation Procedure

There are many tests for establishing the stationary or otherwise of a series. Unit root can be tested using: Dickey-Fuller (DF) test, Augmented Dickey-Fuller (ADF) test, Phillips-Perron test and Kwiatkowski et al. test.

The Augmented Dickey-Fuller (ADF) (1979) regression tests for the existence of unit root Y_t .

The extension of DF test (Augmented Dickey-Fuller test, ADF) allows for possibility that the error term is autocorrelated. The ADF test refers to the t statistics of coefficient on the following regression:

$$\text{Case 1: no constant no trend: } \Delta Y_t = \gamma Y_{t-1} + \sum_{i=1}^k \beta_i \Delta Y_{t-i} + \varepsilon_t \dots\dots\dots \text{equation 1}$$

$$\text{Case 2: with constant but no trend: } \Delta Y_t = \alpha + \gamma Y_{t-1} + \sum_{i=1}^k \beta_i \Delta Y_{t-i} + \varepsilon_t \text{ equation 2}$$

$$\text{Case 3: with constant and trend: } \Delta Y_t = \alpha + \lambda t + \gamma Y_{t-1} + \sum_{i=1}^k \beta_i \Delta Y_{t-i} + \varepsilon_t \text{ equation 3}$$

The model specification is based on the theoretical argument in the literature review. Therefore, the empirical model follows Alexander (1952) though with a slight modification. The adoption of the model is because it gives the inside association of the dependent and independent variables. The model can be express in the following linear form

$$GDP_t = \beta_0 + \beta_1 GEX_t + \beta_2 BOP_t + \beta_3 UNEM_t + \beta_4 EXCH_t + \beta_5 INF_t + \mu_t \dots\dots\dots 7$$

| | | |
|---|---|------------------------------------|
| GDP | = | real gross domestic product |
| GEX | = | government total expenditure |
| $UNEM$ | = | unemployment rate |
| $EXCH$ | = | exchange rate |
| BOP | = | balance of payments |
| INF | = | inflation |
| μ | = | disturbance term (white noise) |
| t | = | represents time period. |
| β_0 | = | parameter constant/ intercept |
| $\beta_1, \beta_2, \beta_3, \beta_4, \beta_5$ | = | coefficient or parameter estimates |

3.2 Autoregressive Distributed Lag Model (ARDL)

The study utilizes the newly proposed ARDL bounds testing approach originally introduced by Pesaran and Shin (1999) and later extended by Pesaran, Shin and Smith (2001) to examine the co-integration relationship between GDP and its various determinants of fiscal policy and balance of payments. The test has a numerous advantage over the various co-integration tests. First, unlike other conventional co-integration techniques, the ARDL bounds testing approach does not impose the restrictive assumption that all the variables under study must be integrated of the same order. In other words, the ARDL approach can be applied to test the existence of a relationship between variables regardless of whether the underlying regressors are integrated of order one I(1) and order zero I(0). Another advantage of the ARDL technique is that it generally provides unbiased estimates of the long-run model and valid t -statistics – even when some of the regressors are endogenous (Odhiambo, 2008; 2011). Again, while other co-integration techniques are sensitive to the size of the sample, where the critical value on their estimation is based on a large sample from 500 and above, the ARDL test is suitable even when the sample size is small given the critical value of small sample size by Narayan (2005). Thus, the ARDL test has superior small sample properties compared to the Johansen and Juselius (1990) co-integration test.

Following Pesaran et al. (2001); Narayan (2005), the study estimates the robust Autoregressive Distributed Lag (ARDL) model. The bounds testing approach is employed to test the existence of a cointegration relationship amongst the variables.

The ARDL(p, q_1, q_2, \dots, q_k) model specification is given as follows;

$$\Phi(L, p)yt = \sum_{i=1}^k \beta_i(x_i) Lq_i + \delta wt + ut \quad i=1 \dots \dots \dots 8$$

where

$$\Phi(L, p) = 1 - \Phi_1 L - \Phi_2 L^2 - \dots - \Phi_p L^p$$

$$\beta(L, q) = 1 - \beta_1 GEX - \beta_2 BOP - \beta_3 UNEM - \beta_4 EXCH - \beta_5 INF, \text{ for } i=1, 2, 3, 4, 5 \quad ut \sim iid(0; \delta)$$

L is a lag operator such that $Lyt = Xt$, $Lyt = yt - 1$, and a $s \times 1$ vector of deterministic variables such as the intercept term, time trends, seasonal dummies, or exogenous variables with the fixed lags. $P=0, 1, 2, 3, 4, 5$ $q=0, 1, 2, 3, 4, \dots, m$, $i=1, 2, 3, 4, 5$: namely a total of $(m+1)$ different ARDL models.

The maximum lag order, m , is chosen by the user. Sample period, $t = m+1, m+2, \dots, n$.

3.3 Long and short Run Elasticity Estimates

The long run coefficients are estimated to find the elasticity of the determinants of gross domestic product based on the equation specified underneath.

$$GDP_t = \beta_0 + \beta_1 GEX_{t-1} + \beta_2 BOP_{t-1} + \beta_3 UNEM_{t-1} + \beta_4 EXCH_{t-1} + \beta_5 INF_{t-1} + \mu_t \dots \dots \dots 9$$

Here, the variables are as earlier explained. The study estimates the long run equation based on the existence of co-integration using lag length automatically selected by Akaike information criteria.

The error correction term is included in the analysis of the short run elasticity of the model in order to find the speed of adjustment. The parameter of the error term shows how quickly variables converge to equilibrium. The error-correction term is calculated from the long run co-integrating vector and it should have a statistically significant coefficient with a negative sign. Once the model has been estimated, Pesaran and Shin (1999) suggest applying the cumulative sum of recursive residuals (CUSUM) tests proposed by Brown et al, (1975) to assess the parameter stability.

3.4 Sources of Data

The data employed in this study are secondary data which were obtained from the World Bank data, Central Bank of Nigeria statistical bulletin and Bureau of statistic from 1984 to 2017 using annual time series data.

4. Data Presentation, Analysis and Discussion of Result

4.1 Unit Root Test

Table 1 Unit Root Test (ADF)

| Variable | Constant without trend | | Constant with trend | |
|----------|------------------------|----------------------------|---------------------|----------------------------|
| | Level | 1 st Difference | Level | 1 st Difference |
| LGDP | -3.069** | -4.611*** | -0.012 | -5.169*** |
| LGEX | -3.195** | -0.696 | -1.256 | -14.375*** |
| BOP | -2.790* | -6.081*** | -3.161 | -6.028*** |
| UNEM | -1.292 | -7.804*** | -3.065 | -7.718*** |
| INF | -2.119 | -4.638*** | -4.722*** | -4.968*** |
| EXCH | -2.602 | -4.803*** | -2.223 | -5.344*** |

*Note: ***, ** and * represent significance level at 1%, 5% and 10% respectively. The figures are the t-statistics for testing the null hypothesis that the series has unit root. The lag length is determined automatically based on Schwarz information criteria. The critical values for intercept without trend are -4.284580, -3.562882 and -3.215267 whereas, for intercept with trend the values are -3.661661, -2.960411 and -2.619160 for 1%, 5% and 10% respectively.*

Following the result of Table 1, it can be seen that all the variables pass the unit root test of ADF at 1st difference and some at LEVEL with co integration order of 1(0) and 1(1). Thus, the null hypothesis of non-stationary is rejected at 1st difference and accepts the alternative hypothesis of stationary. This evidenced the use of the data for further use in analyzing the relationship between fiscal and balance of payments on Nigerian economy.

Table: 2: The result of ARDL Bound Test for co integration

| Bound Test To Co integration | | | |
|--------------------------------|-----------------------------------|-----------------------------------|--|
| F (LGEX BOP, UNEM, LEXCH, INF) | | | |
| Optimal lag structure | | ARDL (2, 1, 1, 2, 1, 1,) | |
| F-statistic | 14.66481 | | |
| Significant level | critical value {Lower bound 1(0)} | critical value {upper bound 1(1)} | |
| 10% | 2.08 | 3 | |
| 5% | 2.39 | 3.38 | |
| 2.5% | 2.7 | 3.73 | |
| 1% | 3.06 | 4.15 | |

The value of F-statistic figures test for null hypothesis that there is no co integration among the variables used. To demonstrate the co integration relationship among gross domestic product (LGDP) and its determinants, an overall significant F-test for the null hypothesis of no co integration relation was analyzed. The result of the F-test for co integration test is = 14.66481 which is higher than 1% upper bound critical value of ARDL co integration. This implies that there is long run relationship among the variables employed in the analysis.

4.2 Long Run Results

Table 3: Longrun Regression Result

| Dependent variable (LGDP) | | | |
|---|-------------|----------------|-----------------------|
| EC= LGDP-(1.6216*LGEX-0.0008*BOP+0.024*UNEM-0.8334*LEXCH-0.0163*INF+0.9018) | | | |
| Variable | Coefficient | standard error | t-statistic (p-value) |
| LGEX | 1.621601 | 0.118347 | 3.70208 (0.0000) *** |
| BOP | -0.00804 | 0.004990 | -0.161216 (0.8737) |
| UNEM | 0.024107 | 0.008021 | 3.005365 (0.0076) *** |
| LEXCH | -0.833396 | 0.145024 | -5.746594(0.0000) *** |
| INF | -0.016327 | 0.004555 | -3.584316(0.0021) *** |
| C | 0.901762 | 0.288786 | 3.122603 (0.0059) *** |

Note: *, **, *** represent 10% 5% and 1% significant level respectively.

Table 4: ARDL Short Run Analysis

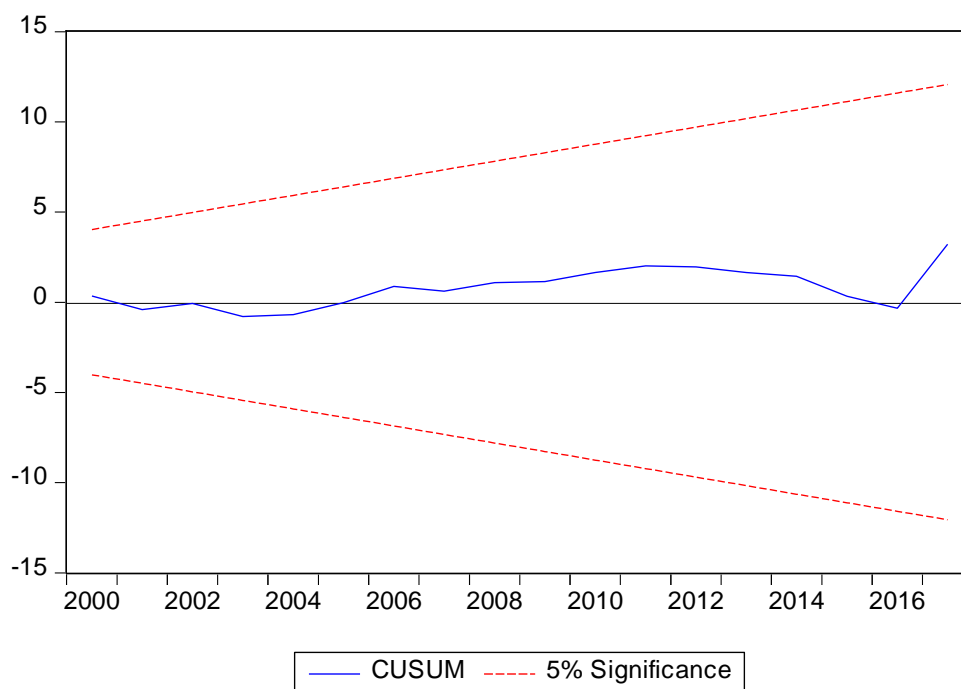
| Variable | coefficient | standard error | t-statistic | (p-value) |
|------------------------|-------------|----------------|-------------|-----------|
| $\Delta(\text{LGEX})$ | -0.381878 | 0.222339 | -5.627196 | 0.0006*** |
| $\Delta(\text{BOP})$ | -0.003778 | 0.001992 | -1.896212 | 0.0741 |
| $\Delta(\text{UNEM})$ | 0.007599 | 0.004092 | 1.857095 | 0.0797 |
| $\Delta(\text{INF})$ | 0.003003 | 0.001194 | 2.515117 | 0.0216 |
| $\Delta(\text{LEXCH})$ | 0.292676 | 0.065678 | 4.456194 | 0.0003*** |
| $\text{Cointeq}(-1)^*$ | 0.613943 | 0.052477 | 11.69921 | 0.0000 |

Notes: P values: significance *10%; **5%; ***1%.

From table 3, the long run result shows that government expenditure (LGEX) is positive and significant at 1% which implies that an increase in government expenditure will increase economic growth by 1.62% through capital expenditure in the economy. balance of payment deficit is negative and not significant in long run while it is also negative but significant in short run it implies that an increase in balance of payment deficit will reduce economic growth by 0.08% in the short run this ensure the consistency of Mithani (1964) who says BOP deficit is more harmful to a country's economic growth.. Unemployment is positive and significant at 1% both in short run and long run relationship which may be attributed to impact of informal sector contribution to the outputs of the economy which renders the effect of unemployment in the nation meaningless, though not as expected. Inflation is negative and significant at 1% in long run showing an increase in the general price level in the country will reduce the growth of the economy by 0.01% This finding is in line with Muhammad (2014) who investigated the effect of inflation on economic growth in Pakistan from 1980 to 2010 using ARDL, he noted that inflation varied from economy to economy but most studies found a positive relationship between inflation and economic growth. Exchange rate is also negative and significant in long run which implies that an appreciation of exchange rate reduces economic growth in Nigeria

4.3 Stability Test

The stability test is used through cumulative sum of recursive plot to check for the stability of the model coefficient. The stability of CUSUM test through the plot of residual will be stable if the line of the residual lies within the boundary of the graph at 0.05 level of significant.



The result of stability test revealed that the model is stable through its CUSUM analysis. As indicated by the CUSUM analysis, the blue line is within the boundary which implies that at 5% level of significant the model is stable in investigating the relationship between fiscal policy an balance of payment in Nigeria under the period of study.

5. Conclusion and Recommendations

The study examines the relationship between fiscal policy and balance of payments in Nigeria. Empirical analysis of government expenditure, unemployment, inflation and exchange rate as factor inducing balance of payments equilibrium on national economy, using available data, was considered; which previously has not been found in recent literatures.

The study found a (significant) positive relationship between unemployment and economic growth showing that an increase per unit of unemployment will increase economic growth by 1.8 units, which explains that the prevalence of unemployment increase growth potentials. World Bank estimate were adopted in measuring unemployment. For most of the period covered (1984-2017), the estimate of balance of payments is negative, signifying that the country absorb more than it produce and residence periodically import goods and services from abroad. Similarly, exchange rate and inflation was identifies as consequence of economic growth and balance of payments disequilibrium. However, some of the variables was found to be positive and significant in short run and a negative coefficient in the long run such as exchange

rate and inflation while government expenditure shown to be positive and significant in the long run. Balance of payments is negative both in short run and long run analysis of ARDL, unemployment is positive both in short run and in the long run with a significant value.

Following the result from the research work above, it is recommended that for Nigerian economy to grow by considering the aspect of fiscal policy and balance of payments, the following points are recommended for policy makers to look into in order for the ugly situation facing this great country with enormous mineral deposit and human capacity to be resolve in the economy.

- i. Capital investment should be given more priority by both the government and private sector with full liberalization of the economy to encourage foreigners for more investment. This will help to reduce unemployment rate facing the economy and the productivity of the nation will increase.
- ii. Import substitution industries should be built through corporate bodies to ensure competition in the production of goods and services, while government should play a regulatory role to ensure regular supply and availability of products in the economy through proper implementation of fiscal policy to reduce the rate of importation of unnecessary goods into the country which often result the economy to operate disequilibrium balance of payments.
- iii. Problem of unemployment in the economy could be solved if fiscal policy could be effectively implemented. The problem of unemployment in Nigeria gear the economy to deficit balance of payments since those that could have been used for the production of imported goods are unemployed, the national output also get falls below the desired level of output in the production of basic consumer and capital goods. This revolved round the economy to caused high rate of poverty in the

The relationship between fiscal policy and balance of payments in Nigeria was investigated using five independent variables such as government expenditure (GEX), balance of payments (BOP), unemployment (UNEM) inflation (INF) and exchange rate (EXCH) with gross domestic product (GDP) as the dependent variable with 34years as the scope of the study. Therefore, other researchers are advice to increase the scope of the study, more variables to see the effectiveness of the relationship. The research uses ARDL, its advice for other researchers is to employ other econometric technique to evaluate the relationship.

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