

Impact of Inflation and Monetary Policy Stabilization on Economic Growth Performance In Nigeria

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Abstract

Generally, both fiscal and monetary policies seek at achieving relative macroeconomic stability through maintaining stable prices or low and stable inflation. In the light of this, this study empirically investigates the impact of inflation and monetary policy on economic growth performance in Nigeria with the use of econometric technique - O L S method using time series data from CBN statistical bulletin from 1981-2008. The results revealed that although money supply is positively related to economic growth performance, but the result is however insignificant in the case of GDP growth rates on the choice of inflation rate has no significant impact on economic growth performance. This study reveals that monetary policy alone is incapable of controlling inflation. It should therefore be supplemented by fiscal measures, non monetary and non fiscal measures. Fiscal measures are highly effective for controlling government expenditure, personal consumption expenditure, and private & public investment. The study therefore recommends that the Central Bank of Nigeria needs to deal with monetary policy in a more transparent manner so as to address the issues of expectations as inflation exhibits a high degree of inertia.

Keywords: Monetary policy stabilisation; inflation; economic performance; Nigeria.

1. Introduction

In developed economies, such as united state and some core European countries, there is substantial evidence of the effectiveness of monetary policy innovations on real economic parameters (Rafiq and Mallick, 2008 and Bernake et al., 2005). However, for developing countries like Nigeria the evidence of the effectiveness of monetary policy is weak and requires deep understanding.

Monetary policy is a key component of any pro-growth strategy. The instruments of monetary policy are of two types: first, quantitative, general or indirect; and second, qualitative, selective or direct. The affect the level of aggregate demand through the supply of money, cost of money and availability of credit. Of the two types of instruments, the first category includes bank rate variations, open market operations and changing reserve requirements. They are meant to regulate the overall level of credit in the economy through commercial banks. The selective credit controls aim at controlling specific types of credit. They include changing margin requirements and regulation of consumer credit.

1.1 Policy on Bank Rate

The bank rate is the minimum lending rate of the central bank at which it rediscounts first class bills of exchange and government securities held by the commercial banks. The central bank raises bank rate on the emergence of inflationary pressures within the economy. Borrowing from the central bank becomes costly

and commercial banks borrow less from it. The commercial bank, in turn, raises their lending rates to the business community and borrowers borrow less from commercial banks. There is contraction of credit and prices are checked from the rising further. On the contrary, when prices are depressed, the central bank lowers the bank rate. It is cheap to borrow from the central bank on the part of commercial banks. The latter also lower their lending rates. Businessmen are encouraged to borrow more. Investment is encouraged. Output, employment, income and demand start rising and the downward movement of prices is checked.

1.2 Open Market Operation

Open market operations refer to sale and purchase of securities in the money market by the central bank. When prices are rising and there is need to control them, the central bank sells securities. The reserves of commercial banks are reduced and they are not in a position to lend more to the business community. Further investment is discouraged and the rise in prices is checked. Contrariwise, when recessionary forces start in the economy, the central bank buys securities. The reserves of commercial banks are raised. They lend more. Investment, output, employment, income and demand rise, and fall in price is checked.

1.3 Changes in Reserve Ratios

This weapon was suggested by Keynes in his treatise on money and the USA was the first to adopt it as a monetary device. Every bank is required by law to keep a certain percentage of its total deposits in the form of a reserve fund in its vaults and also a certain percentage with the central bank. When prices are rising, the central bank raises the reserve ratio. Banks are required to keep more with the central bank. Their reserves are reduced and they lend less. The volume of investment, output and employment are adversely affected. In the opposite case, when the reserve ratio is lowered, the reserves of commercial banks are raised. They lend more and the economic activity is favourably affected.

1.4 Policy on Interest Rate

A policy of high interest rate in an underdeveloped country also acts as an incentive to higher savings, develops banking habits and speeds up the monetization of the economy which are essential for capital formation and economic growth. A high interest rate policy is also anti-inflationary in nature, for it discourages borrowing and investment for speculative purposes, and in foreign currencies. Certain economists favour a low interest rate policy in such countries because high interest rate discourages investment.

1.5 Selective Credit Controls

Selective credit controls are used to influence specific types of credit for particular purposes. They usually take the form of changing margin requirements to control speculative activities within the economy. When there is brisk speculative activity in the economy or in particular sectors in certain commodities and prices start rising, the central bank raises the margin requirements on them. The results are that the borrowers are given less money in loans against specified securities.

One of the major objectives of monetary policy in Nigeria is price stability. But despite the various monetary regimes that have been adopted by the Central Bank of Nigeria over the years, inflation still remains a major threat to Nigeria's economic growth. Nigeria has experienced high volatility in inflation rates. The growth of money supply is correlated with the high inflation episodes because money growth was often in excess of real economic growth. However, preceding the growth in money supply, some factors reflecting the structural characteristics of the economy are observable. Some of these are supply shocks, arising from factors such as famine, currency devaluation and changes in terms of trade.

Inflation is a monster that threatens all economics because of its undesirable effects. The problem of inflation surely is not a new phenomenon. It has been a major problem in the country over the years.

Inflation is defined as a generalised increase in the level of price sustained over a long period in an economy. Inflation is a household word in many market oriented economics.

After an appreciable economic performance in the early 1970s, the Nigeria economy witnessed some anxious moment in the late 1970s to mid 1980s. Severe pressures built up in the economy mainly because of the expansionary fiscal policy of the federal government during these years. This was accompanied by high monetary expansion as the huge government deficit was financed largely by the Central Bank of Nigeria. This was exacerbated by the transfer of government sector deposits to the banks and the resultant increase in their free reserves with adverse consequences on the general price level. The inflationary pressure was further aggravated by high demand for imports of both intermediate inputs and consumer goods due to over valuation of the naira which made imports relatively cheaper than locally manufactured goods. In this case, the impediments to development may be referred to as cost. Economics theory, however, postulates that for the profit to be maximised, cost should be minimised. One of the main costs is inflation, which has turned into a canker worm eating deep into the nation's path of economic progress.

Undoubtedly one of the macroeconomic goals which the government strives to achieve is the maintenance of stable domestic price level. This goal is pursued in order to avoid cost of inflation or deflation and the uncertainty that follows where there is price instability. The effects of inflation on economic growth will be examined bearing in mind that a country (Nigeria for instance) will grow faster in real terms if inflation is reduced to a barest minimum. Perhaps it should be mentioned here that inflation is not incompatible with growth.

The primary functions of an economy whether socialist or capitalist is to satisfy the people's maximum wants. It must produce the consumer goods to make high standard of living for the people. Money is the means to achieve an end. Economic growth does not mean higher money income without being accompanied by higher real income. Economic growth means both quantitative and qualitative increase in the quantity of both the goods and services produced in the economy annually.

In short, growth means three things. Firstly, it implies an increase in the total physical or real output in the economy. Secondly, the composition and quality of goods and services produced due to growth should satisfy the consumer wants because in the ultimate analysis satisfaction of human wants is the end of all economic activities. Thirdly, economic growth should be achieved within the framework of economic freedom. Economic growth implies sustained increase in per capita real income.

1.6 Research Hypothesis

H₀: that monetary policy and inflation rate has no significant impact on economic growth performance in Nigeria.

H₁: that monetary policy and inflation rate has a significant impact on economic growth performance in Nigeria.

2. Literature Review

Monetary policy in an undeveloped country plays an important role in increasing the growth rate of the economy by influencing the cost and availability of credit, by controlling inflation and maintaining equilibrium in the balance of payments. So the principal objectives of monetary policy in such a country are to control credit for controlling inflation and to stabilise the price level, to stabilise the exchange rate, to achieve equilibrium in the balance of payments and to promote economic development.

Since its establishment in 1959, the Central Bank of Nigeria (CBN) has continued to play the traditional role expected of a central bank, which is the regulation of the stock of money in such a way as to promote the social welfare (Ajayi, 2000). This role is anchored on the use of monetary policy that is usually targeted towards the achievement of full-employment equilibrium, rapid economic growth, price stability, and external balance. Over the years, the major goals of monetary policy have often been the two later

objectives. Thus, inflation targeting and exchange rate policy have dominated CBN's monetary policy focus based on assumption that these are essential tools of achieving macroeconomic stability.

The economic environment that guided monetary policy before 1986 was characterized by the dominance of the oil sector, the expanding role of the public sector in the economy and over-dependence on the external sector. In order to maintain price stability and a healthy balance of payments position, monetary management depended on the use of direct monetary instruments such as credit ceilings, selective credit controls, administered interest and exchange rates, as well as the prescription of cash reserve requirements and special deposits. The use of market-based instruments was not feasible at that point because of the underdeveloped nature of the financial markets and the deliberate restraint on interest rates.

The most popular instrument of monetary policy was the issuance of credit rationing guidelines, which primarily set the rates of change for the components and aggregate commercial bank loans and advances to the private sector. The sectoral allocation of bank credit in CBN guidelines was to stimulate the productive sectors and thereby stem inflationary pressures. The fixing of interest rates at relatively low levels was done mainly to promote investment and growth. Occasionally, special deposits were imposed to reduce the amount of free reserves and credit-creating capacity of the banks. Minimum cash ratios were stipulated for the banks in the mid-1970s on the basis of their total deposit liabilities, but since such cash ratios were usually lower than those voluntarily maintained by the banks, they proved less effective as a restraint on their credit operations.

In general terms, monetary policy refers to 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. For most economies, the objectives of monetary policy include price stability, maintenance of balance of payments equilibrium, promotion of employment and output growth, and sustainable development (Folawewo, 2006). These objectives are necessary for the attainment of internal and external balance, and the promotion of long-run economic growth.

The importance of price stability derives from the harmful effects of price volatility, which undermines the ability of policy makers to achieve other laudable macroeconomic objectives. There is indeed a general consensus that domestic price fluctuation undermines the role of money as a store of value, and frustrates investments and growth. Empirical studies (Ajayi and Ojo, 2001; Fischer, 2002) on inflation, growth and productivity have confirmed the long-term inverse relationship between inflation and growth.

One of the major objectives of monetary policy in Nigeria is price stability. But despite the various monetary regimes that have been adopted by the Central Bank of Nigeria over the years, inflation still remains a major threat to Nigeria's economic growth. Nigeria has experienced high volatility in inflation rates. Since the early 1970's, there have been four major episodes of high inflation, in excess of 30 percent. The growth of money supply is correlated with the high inflation episodes because money growth was often in excess of real economic growth. However, preceding the growth in money supply, some factors reflecting the structural characteristics of the economy are observable. Some of these are supply shocks, arising from factors such as famine, currency devaluation and changes in terms of trade.

There is almost a universal consensus that macroeconomic stability, specifically defined as low inflation, is positively related to economic growth. Over the years the question of the existence and nature of the link between inflation and growth has been the subject of considerable interest and debate. Although the debate about the precise relationship between these two variables is still open, the continuing research on this issue has uncovered some important results. In particular, it is generally accepted that inflation has a negative effect on medium and long-term growth Bruno and Easterly, (2003). Inflation impedes efficient resource allocation by obscuring the signalling role of relative price changes, the most important guide to efficient economic decision-making Fischer (2002).

Inflation affects different people differently. When there is inflation, most prices are rising, but the rates of increase of individual prices differ much. The effect of inflation is explained on redistribution of income

and wealth, production, and on the society as a whole. Inflation redistributes income from wage earners and fixed income groups to profit recipients, and from creditors to debtors. On the other hand, when prices start rising production is encouraged. They invest more in the anticipation of higher profits in the future. This tends to increase employment, production and income, which is only possible up to the full employment level. Inflation adversely affects production after the level of full employment. The adverse effects production are; misallocation of resources, changes in the system of transaction, reduction in production, fall in quality, reduction in saving which is caused by increase in money needed for purchase of available goods and services, and corruption which spreads in every walk of life. All this reduces the efficiency of the economy.

3. Methodology and Model Specification

The data for this study are obtained from Central Bank of Nigeria (CBN) annually statistical bulletin from 1981-2008. The Econometric Ordinary Least Square (OLS) technique shall be employed in obtaining the numerical estimates of the coefficients in different equations.

Model 1

$$GDP = \alpha_0 + \beta_1 INF + \beta_2 M_2 + \beta_3 R + \mu$$

Where,

GDP = Gross Domestic Product

INF = Inflation Rate

M₂ = Broad money supply

R = Interest Rate

μ = Error Term

α₀ = Autonomous income

β₁, β₂, β₃ = Parameters.

Dependent Variable: LOG(GDP)

Method: Least Squares

Sample: 1971 2008

Included observations: 38

Variable	Coefficient	Std. Error	t-Statistic	Prob.
LOG(INFLATION)	-0.975229	0.350840	-2.779701	0.0088
LOG(M2)	1.102263	0.292267	3.771431	0.0006
LOG(R)	1.594836	0.405918	3.928958	0.0004
C	-2.832479	3.061533	-0.925183	0.3614
R-squared	0.787234	Mean dependent var	11.92077	
Adjusted R-squared	0.768460	S.D. dependent var	1.480916	
S.E. of regression	0.712596	F-statistic	41.93324	
Sum squared resid	17.26497	Prob(F-statistic)	0.000000	
Log likelihood	-38.93043			
Durbin-Watson stat	1.318002			

4 Interpretation of Results

$$\text{LOG Y} = (2.83) + (0.98) \text{ LOG INF} + 1.1 \text{ LOG M}_2 + 1.5 \text{ LOG R}$$

The equation shows a DOUBLE-LOG relationship between GDP, INF, R, and M_2 , the variables are logged because they do not have the same magnitude. One percent change in INF will induce a (-0.98) unit change in GDP, it shows that inflation has a negative relationship with economic growth (GDP). One percent change in M_2 will induce a 1.1 unit change in GDP; it shows that broad money supply has a positive relationship with economic growth. One percent change in R will induce a 1.59 unit change in GDP.

4.1 Hypothesis Testing

At 5% level of significance with a degree of freedom of 35(n-k), the tabulated value (T_{tab}) is 2.03, while the calculated value (T_{stat}) for the two variables (inflation rate and money supply) is -2.78 and 3.77 respectively. Since the calculated value is less than the tabulated value for inflation, it can be concluded that inflation rate has no significant impact on economic growth performance; therefore we do not reject H_0 . And the calculated value is greater than the tabulated value for money supply, it can be concluded that money supply has a significant impact on economic growth performance, therefore we reject H_0 .

4.2 MEASUREMENT OF GOODNESS OF FIT (R^2)

The coefficient of multiple determinations R^2 indicates that about 77 percent of the total variations in GDP are explained by the variations in all the explanatory variables used in our model.

4.2 Trends Analysis

(a) Figure 1 shows the trend analysis of Nigeria growth rate between the year 1971 and 2007. In it, Nigeria's economy has experienced different growth stages. The GDP growth rate recorded negative growth in the early 1980s (-2.7 in 1982, -7.1 in 1983 and -1.1 in 1984) after the outlier in 1981 with 550.53%. The growth rate increased steadily between 1985 and 1990 with 9.25% and 13.02% respectively, but fell sharply in 1986 and 1987 to 2.45% and -0.57%. 1990s witnessed an unstable growth. However, the growth rate has been relatively high since 2001 in a fluctuating manner, except in 1991 when a negative growth rate of -0.8% was recorded.

(b) Figure 2 shows the trend analysis of Nigeria growth between GDP and inflation. The trend analysis result shows that in the year 1972 inflation increased at the rate of 4.35% fell in 1985 to 1.07%. There was a sharp increase in 1988 to 61.02% and a sharp decrease in the year 1990 to 3.64%. The growth rate of inflation rose again to the highest in 1994 to 76.79% and a sharp decrease occurred in 1999 to 0.22% which happens to be the lowest. Increased after that and fluctuating till 2008 at 15.05%.

(c) Figure 3 shows the trend analysis of Nigeria growth rate between GDP and rate of interest. The interest rate growth rate experienced a consecutive 0% for 4 yrs and became negative in 1975 (-14.29), went back to 0% for 2 years. There was a sharp increase in 1978, 1982 to 16.67% and 32.26% respectively. It became negative in 1983 (-2.44%) and 1985 (-26.00%). It has been fluctuating since 1996 from positive to negative figures till 2008 when it became 1.88%.

(d) Figure 4 shows the trend analysis of Nigeria growth rate between GDP and M_2 . The growth rate of money supply was increasing at an increasing rate for the years of 1971-1975. It fell in 1976 and 1977 with 39.23% and 33.76% respectively. It had a sharp decrease in 1978, 1981, 1986, 1989, to 1.1%, 7.03%, 4.23%, 3.54% respectively. Ever since it has been fluctuating and by 2008 it became 57.79%.

5 Conclusion

Have used the multiple regression method to know and compare the contribution of money supply, interest rate, and inflation rate to GDP, making GDP the dependent variable, and money supply, interest rate and

inflation the independent variable. It has been seen that if there is an increase in money supply (m_2), there will be an increase in economic growth and a decrease in money supply (m_2) will lead to a decrease in economic growth (GDP). This is because there is positive relationship between money supply and GDP.

If there is an increase in interest rate, there will be a decrease in economic growth (GDP) and a reduction in interest rate will bring about an increase in GDP, because of the negative relationship between the two variables (i.e. interest rate and GDP).

On the other hand, when the quantity of money increases it reduces the rate of interest. A fall in interest rate would in turn increase investment which would raise aggregate demand. A rise in aggregate demand would first affect only output. Increase in M_2 will reduce interest rate that would in turn increase investment; output will be increased with high cost of input that would in turn increase the prices of the goods and services. People would be discouraged from saving and consumption will be increased, i.e. excess demand for goods and services since there is expectation of high price level (inflation), but economy growth would be increased due to increase in output that requires increase in input. But if there is excess of money supply, that results to increase in wages required by the workers that leads to increase in the price level, then inflation, thus increases economic growth with a low standard of living.

6 Recommendation

Money loses its value during inflation, people are discouraged from saving they want to buy all they need before the prices get higher than they can afford, this leads to things like black market, sellers buying at cheaper price and selling to consumers at current inflated prices, etc. This will cause scarcity of funds in the money market and reduces the level of investment in the economy. The resultant fall in the level of investment would mean a lower level of employment (rising unemployment and the recession have been the price that we've had to pay to get inflation down: that is a price well worth paying Norman Lamont (1942)) as well as shortage of goods and services in other words; the overall standard of living in the country would fall.

Monetary policy alone is incapable of controlling inflation. It should therefore be supplemented by fiscal measures, non monetary and non fiscal measures. Fiscal measures are highly effective for controlling government expenditure, personal consumption expenditure, and private and public investment. From the various monetary, fiscal and other measure used in studying and controlling inflation, it becomes clear that to control inflation, the government should adopt all measures simultaneously. Inflation is like a hydra-headed monster which should be fought by using all the weapons at the command of the government.

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Figure 1 showing trend analysis of Nigeria growth rate

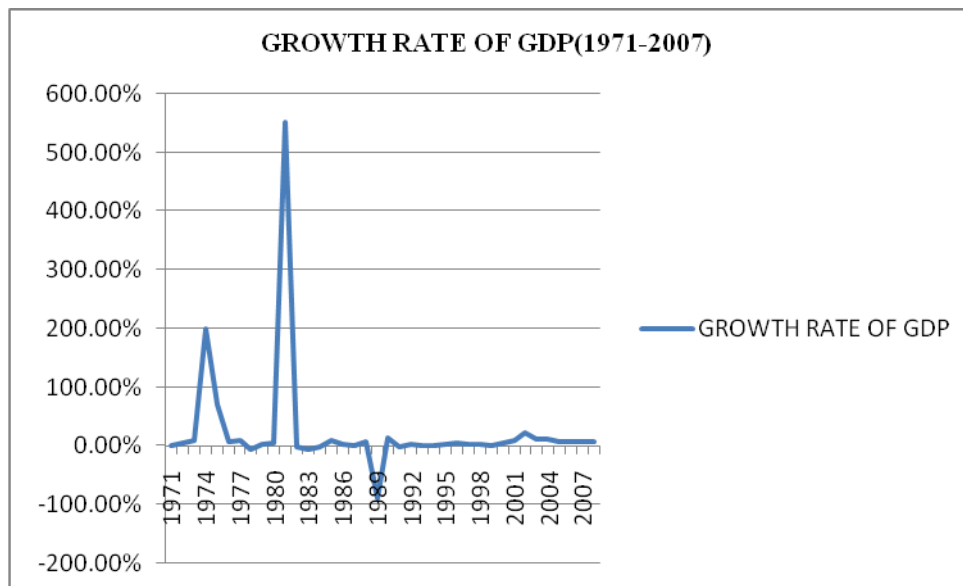


Figure 2 showing trend analysis between Nigeria GDP and Inflation

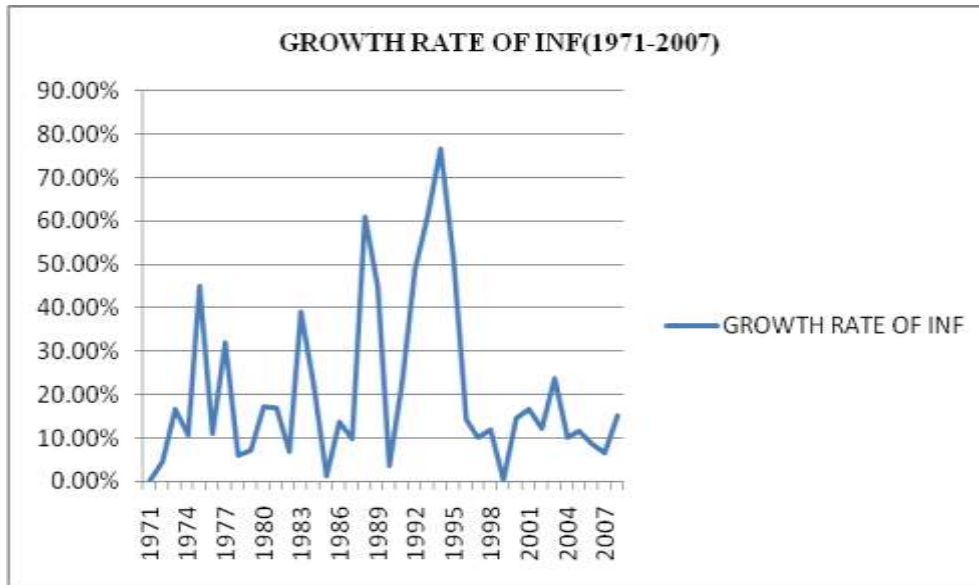


Figure 3 showing trend analysis between Nigeria GDP and Rate of Interest

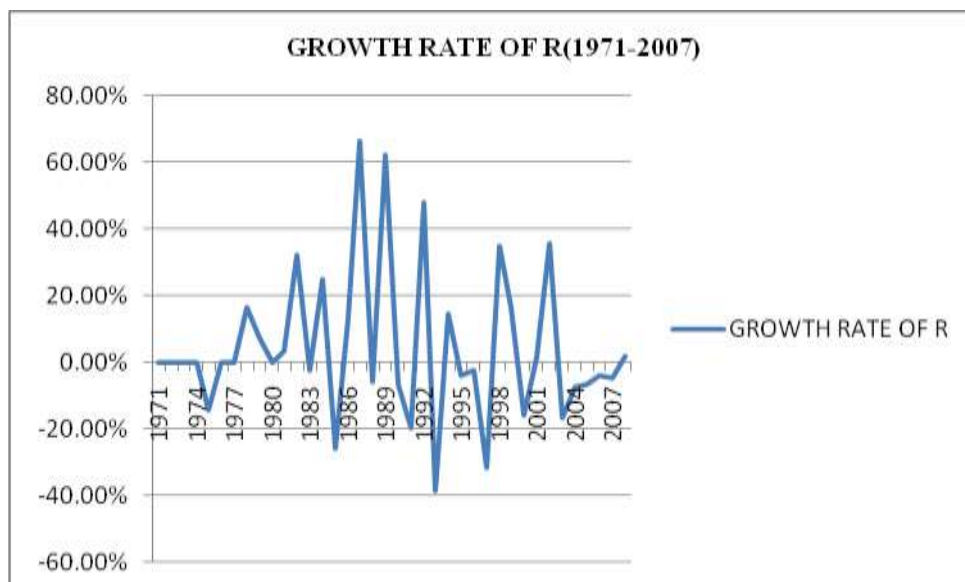
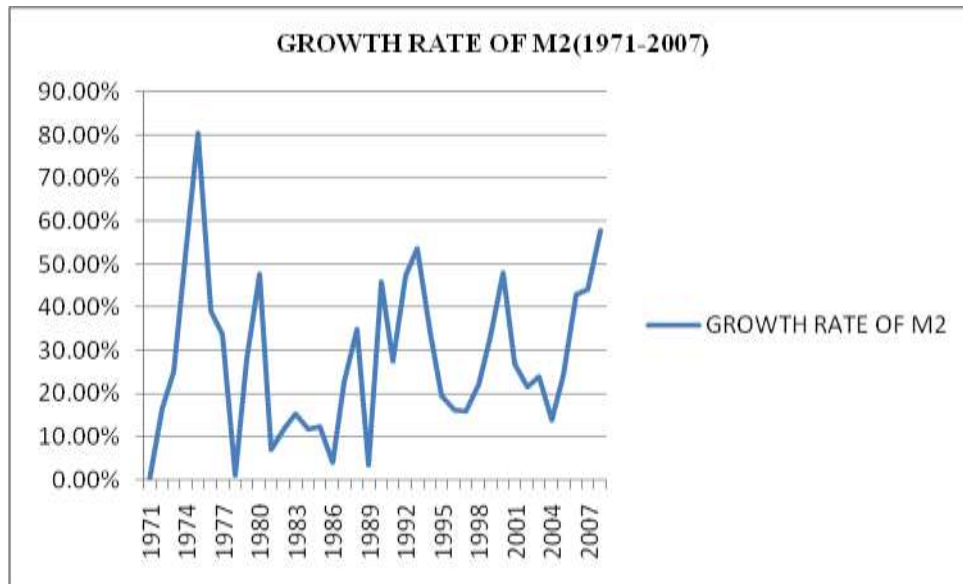


Figure 4 showing trend analysis between Nigeria GDP



APPENDIX: Showing Table of Analysis

YEAR	GDP	M2(X2)	INT	INF	GROWTH RATE OF GDP	GROWTH RATE OF INF	GROWTH RATE OF INT	GROWTH RATE OF M2
1971	4715.5	1041.8	7	0.23	0.00%	0.00%	0.00%	0.00%
1972	4892.8	1214.9	7	0.24	3.76%	4.35%	0.00%	16.62%
1973	5310	1522.5	7	0.28	8.53%	16.67%	0.00%	25.32%
1974	15919.7	2352.3	7	0.31	199.81%	10.71%	0.00%	54.50%
1975	27172	4241.2	6	0.45	70.68%	45.16%	-14.29%	80.30%

1976	29146.5	5905.1	6	0.5	7.27%	11.11%	0.00%	39.23%
1977	31520.3	7898.8	6	0.66	8.14%	32.00%	0.00%	33.76%
1978	29212.4	7985.4	7	0.7	-7.32%	6.06%	16.67%	1.10%
1979	29948	10224.6	7.5	0.75	2.52%	7.14%	7.14%	28.04%
1980	31546.8	15100	7.5	0.88	5.34%	17.33%	0.00%	47.68%
1981	205222.1	16161.7	7.75	1.03	550.53%	17.05%	3.33%	7.03%
1982	199685.3	18093.6	10.25	1.1	-2.70%	6.80%	32.26%	11.95%
1983	185598.1	20879.1	10	1.53	-7.05%	39.09%	-2.44%	15.39%
1984	183563	23370	12.5	1.87	-1.10%	22.22%	25.00%	11.93%
1985	201036.3	26277.6	9.25	1.89	9.52%	1.07%	-26.00%	12.44%
1986	205971.4	27389.8	10.5	2.15	2.45%	13.76%	13.51%	4.23%
1987	204806.5	33667.4	17.5	2.36	-0.57%	9.77%	66.67%	22.92%
1988	2198875.6	45446.9	16.5	3.8	973.64%	61.02%	-5.71%	34.99%
1989	236729.6	47055	26.8	5.5	-89.23%	44.74%	62.42%	3.54%
1990	267550	68662.5	25.05	5.7	13.02%	3.64%	-6.53%	45.92%

1991	265379.1	87499.8	20.1	7	-0.81%	22.81%	-19.76%	27.43%
1992	271365.5	129085.5	29.8	10.42	2.26%	48.86%	48.26%	47.53%
1993	274833.3	198479.2	18.32	16.8	1.28%	61.23%	-38.52%	53.76%
1994	275450.6	266944.9	21	29.7	0.22%	76.79%	14.63%	34.50%
1995	281407.4	318763.5	20.18	45.03	2.16%	51.62%	-3.90%	19.41%
1996	293745.4	370333.5	19.74	51.47	4.38%	14.30%	-2.18%	16.18%
1997	302022.5	429731.3	13.54	56.73	2.82%	10.22%	-31.41%	16.04%
1998	310890.1	525637.8	18.29	63.49	2.94%	11.92%	35.08%	22.32%
1999	312183.5	699733.7	21.32	63.63	0.42%	0.22%	16.57%	33.12%
2000	329178.7	1036079.5	17.98	72.87	5.44%	14.52%	-15.67%	48.07%
2001	356994.3	1315869.1	18.29	84.9	8.45%	16.51%	1.72%	27.00%
2002	433203.5	1599494.6	24.85	95.2	21.35%	12.13%	35.87%	21.55%
2003	477533	1985191.8	20.71	117.9	10.23%	23.84%	-16.66%	24.11%
2004	527576	2263587.9	19.18	129.7	10.48%	10.01%	-7.39%	14.02%
2005	561931.4	2814846.1	17.95	144.7	6.51%	11.57%	-6.41%	24.35%

2006	595821.6	4027901.7	17.26	157.1	6.03%	8.57%	-3.84%	43.09%
2007	634251.1	5809826.5	16.49	167.4	6.45%	6.56%	-4.46%	44.24%
2008	674889	9167067.6	16.8	192.6	6.41%	15.05%	1.88%	57.79%

Source: CBN Statistical Bulletin, Golden Jubilee Edition, December 2008 (Financial Statistics; 1971-2008, p. 202, 137, 45.)

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