

Analysis of the Relationship between Fiscal Deficits and External Sector Performance in Nigeria

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Abstract

The study examined the effects of and the causation between fiscal deficits and the external sector performance of Nigeria between 1961 and 2011. Data collected from various issues of Central Bank bulletin were analyzed by a bi-variate granger causality technique and the error correlation modeling techniques. Results showed a long run relationship among the variables. There also existed a bi-directional causality between budget deficit and external sector performance in the long run while a one – way causation existed from external sector performance to budget deficit in the short run with no feedback from fiscal deficit. Results also showed that fiscal deficit did not significantly affect external sector performance in the short run. Furthermore, the cross correlation coefficient indicated that fiscal deficits would lead to long run deterioration in external reserves accumulation and exchange rate. The study therefore recommends a minimization of the current size of fiscal deficits in order to avoid the long run negative effect on the external sector.

Key words: fiscal deficit, real exchange rate, external reserves.

1.0 Introduction

In the past decades there had been contention among development economists, policy makers regarding the impact of fiscal deficit and external sector performance among developed, developing and underdeveloped economies. The argument has been on the linkage in form of causality between fiscal deficit and external sector performance. Although some authors, policy makers and economists at large believe that the relationship between the aforementioned phenomenon is in an indirect form. (Korsu, 2007). However, the above notion is traceable to the era of the early classical economists who advocated the canon of surplus which is an offshoot of the laissez-faire philosophy. This was an era of minimal or complete absence of government intervention in economic activities of the state. However, with increasing quest for development, the failure of the market cum the abandonment of the laissez-faire philosophy and the rise of the Keynesian economics, the principle of surplus completely abandoned. It was discovered that there is no way a nation would develop without some level of deficit financing.

In recent times, rising fiscal deficit has been a common feature in the less developed countries. According to Ariyo (1993), this development is a consequence of the increased demand of the populace and the desire to enhance economic growth and development. The gap occurs due to the many problems that have bedeviled the revenue generation system in the country.

A rundown on the revenue and expenditure profile of the Federal government shows a wide gap between revenue and expenditure since 1970 up to date. Though the magnitude of deficit has been fluctuating, on the average it has been increasing. The magnitude is highest between 1990 and 2009. Ariyo and Raheem (1990) showed that rising fiscal deficit has been a common characteristic of the Nigerian fiscal system and that there have been no identifiable and justifiable macroeconomic objectives for such. Moreover Ariyo (1993) reported that fiscal deficit in Nigeria has become unsustainable since 1980.

According to CBN (2000), the deficits over the years were financed through external and internal borrowing plus draw-down on reserves. Prior to the 1970s, deficits were majorly financed through domestic sources. As from the 1970s, 87.1% of total deficits was financed by the banking sector and by the end of the 90s, the proportion rose to 94% of total deficits out of which the CBN provided 87.1%. The reliance on the banking sector over the years have impacted negatively on macroeconomic variables such as money supply, inflation, real growth rate, balance of payments and exchange rate.

From the writings of Lord Keynes and other post classical economists, a certain level of fiscal deficit is essential in the development process given the low level of savings and consequently low investment. However, it has been observed that the level, magnitude and method of financing fiscal deficits in Nigeria have produced and perpetuated macroeconomic imbalance (Nnanna et al., 2003). Consequently, the nation has experienced monetary expansion, high inflationary pressures, exchange rate depreciation, and deterioration in the balance of payments, sluggish and negative growth rates, high interest rates, financial sector distress, unemployment and a host of other similar problems.

The culminating effect of the above has been a decline in the growth of GDP, external reserves and accelerated inflation. According to Nnanna et al (2003), the period between 1981 and 2000, a high percentage of

fiscal deficits was financed by massive injections of funds by the banking sector especially the CBN into the economy. Between 1981 and 1990, the banking sector financed about 60.71% of total deficit. The situation became worse between 1991 and 2001 when 94.1% of total deficit was financed by the banking sector with CBN providing 87% of the finance. The percentage financed by the non-bank public has also been in the increase. It rose from 2.8% in 1991 to 33.1% in 1992 and by 199 it was as high as 44.9%.

From the scenario presented above, the following questions beg for answers

1. Given the presence of fiscal deficits and poor external sector performance, is there any causal relationship between fiscal deficits and external sector performance?
2. How does a fiscal deficit translate into poor external sector performance?

The answers to the questions above are of relevance to policy maker and possess immense policy implication for a developing nation such as Nigeria. This paper therefore attempts an evaluation of fiscal deficit and its effects on external sector performance in Nigeria.

Hence the remaining part of this part of this paper is structured under the following sections. Sections two showcase the relevant literature review and theoretical foundation. Sections three highlight the methodology of the study while section four presents the empirical analysis and discussion. Sections five concludes and proffer necessary policy recommendations.

2.0 LITERATURE REVIEW

The way and manner fiscal deficits are financed goes a long to determine its macro economic effects. Generally, fiscal deficits are majorly financed by seigniorage, domestic debt and external debts. Each method of financing fiscal deficits when excessively used creates certain macroeconomic imbalance. Seigniorage raises money supply consequently leading to inflation and depression of aggregate demand. Moreover, increased domestic debt results in high interest rates leading to decrease in private investment and consumption. Also expansion in external borrowing generates current account deficit, appreciation of real exchange rate and balance of payment disequilibrium.

Examining the transmission mechanism between fiscal deficit and external sector performance, Korsu (2007) asserted that fiscal deficit does not have direct effects on external sector performance. Fiscal deficit impact directly on money supply. An increase in fiscal deficit increases money supply when such is financed through seigniorage. Increase in money supply increases the price level leading to appreciation of exchange rates and deterioration of the balance of payments. Hence, fiscal deficits have indirect effects on real exchange rate, trade balance and overall balance of payment which are the indices of external sector performance.

From the pre- 1980s economic literatures, fiscal deficit was assumed to have no specific effect on external sector performance. For instance the open – economy version of the IJ-LM model by Fleming (1962) and Mundell (1963) showed that fiscal deficit increases consumer spending leading to increase in import demand depreciates the exchange rate which on the other hand increases in the demand for import. Subsequently, increase in import demand depreciates the exchange rate which on the other hand increase export. The situation here is that such an economy will experience increases in both import and export. Hence the net effect of fiscal deficit on trade balance is indeterminate. Similarly, according to the Recardian Equivalence hypothesis (Korsu, 2007), fiscal deficit has no effect on the external sector. However, Keynesian absorption theory stipulated that fiscal deficit will lead to deficit in the current account.

There has been no consensus as to the effect of fiscal deficit on the external sector performance. For example, studies by Piersanti (2000), Volker (1984), Laney (1986), Khalid (1996), Solocha (1988) and Saleh (2003) showed that external performance is negatively correlated with fiscal deficits. On the other hand, Khalid and Guan (1999), Zaid (1985), Evans (1988) and Bachman (1992) found no correlation between fiscal deficit and external sector performance indexed by current account deficit. Rodriquez's (1989) hypothesis showed that an increase in fiscal deficit affects real exchange rate as it implies a decline in consumer spending. If the public sector has a higher propensity than the private sector to spend on imports that on domestic goods, a shift to more public and less private spending implies increased demand for imports and a corresponding depreciation of real exchange rate. According to Williams and Klaus (1993), tests of this hypothesis showed split results for sampled developing countries. For Argentina, Cote d'ivoire, Morocco and Zimbabwe higher government spending leads to appreciation of real exchange rate while the reverse was the case for Chile, Columbia and Mexico. Their study also established that fiscal deficits spilled over into external account deficit leading to depreciation of real exchange rate. Their findings corroborated the findings of Khan and Lizondo (1987).

Korsu (2007) examined the effect of fiscal deficit on external sector performance in Sierra-leone. His study employed three stage least square (3 SLS) and simulation techniques. His study showed that fiscal deficit has negative implication for external sector performance in Sierra-leone. The findings of this study confirmed with the findings of Tcholate (2005), Egwaikhide (1995), Abell (1990), Kearney and Monadjemi (1990), Fapojuwo and Ojiojo (1945) and Olopoenia (1991).

Given that the effects of fiscal deficits flow indirectly to external sector through its direct effect on money supply and price, it is necessary to examine few literatures on the effects of fiscal deficit on money and price level. Study by Omoke and Oruta (2010) showed that a one percent increase in the share of fiscal deficit in GDP leads to an increase of about 0.94 percent increase in money supply growth rate. The study also revealed that money supply causes fiscal deficit implying that the level of money supply in the economy will determine whether there has been or there will be fiscal deficit. Moreover, a bi-directional feedback/causality existed between inflation and fiscal deficit.

There have been many studies on the possibility of a causal relationship between fiscal deficit and the general price level. Some studies indicated fiscal deficit as a major cause of inflation while others found no causal relationship of whatever kind. According to the findings of Thorn and Dastgheib (2003), fiscal deficits financed through money finance have resulted into high inflation levels and over burdening of the private sector for Yugoslavia and some Latin American countries. An examination of fiscal deficit and macroeconomic performance in some developing countries, William and Klaus (1993) came up with the following findings:

- money financing of fiscal deficits leads to higher inflation while debt financing leads to higher real interest rates.
- fiscal deficits spilled over into external deficits leading to appreciation of the real exchange rate,
- the fiscal deficits and growth are self-reinforcing in that good fiscal management preserves access to foreign lending and avoids the crowding out of private investment. On the other hand, growth stabilizes the budget and improves fiscal position. The study strongly recommended that a policy of low and stable fiscal deficits is necessary for a vicious cycle of growth and good fiscal management.

This study differs from previous works in Nigerian experience in the following areas

- Previous studies on the Nigerian external sector emphasized the effects of fiscal deficit on trade balance and current account while the effect on exchange rate and balance of payment was ignored
- Moreover, the study covered more years than the previous studies on this topic.

Research Methodology

Specifically, this study addresses two important issues: the causal nexus between fiscal deficit and external sector performance; and the impact of fiscal deficit on external sector performance in Nigeria. To this end, two models are specified:

Model on Causality

To examine the causal nexus between fiscal deficit and external sector performance, a bi-variate granger causality technique is utilized. The appropriate specification of the model (that is, whether in VAR or VECM) depends on the status of the unit roots of the variables of interest and also on the existence of co-integration between the variables. If the variables are not co-integrated, then a VAR model of the form below is utilized.

$$Y_t = \sum_{i=1}^n \alpha_{11} Y_{t-i} + \sum_{i=1}^n \alpha_{12} X_{t-i} + u_{1t} \dots \dots \dots (1)$$

$$X_t = \sum_{i=1}^n \alpha_{21} Y_{t-i} + \sum_{i=1}^n \alpha_{22} X_{t-i} + u_{2t} \dots \dots \dots (2)$$

Where Y_t refers to fiscal deficit and X_t refers to external sector performance. On the other hand, if the variables are co-integrated then, the VAR model must include an error correction term. Engel-Granger (1987) cautioned that the Granger causality test, which is conducted in the first differences of variables through a vector auto-regression (VAR), is misleading in the presence of co-integration. Therefore, an inclusion of an additional variable to the VAR system, such as the error correction term would help capture the long run relationship among the variables. Consequently, an augmented form of causality test involving the error correction term is specified in a bi-variate pth order vector error-correction model (VECM) as in (Ferda, 2007):

$$\begin{bmatrix} \Delta Y_t \\ \Delta X_t \end{bmatrix} = \begin{bmatrix} \varphi_{10} \\ \varphi_{20} \end{bmatrix} + \sum_{i=1}^p \begin{bmatrix} \alpha_{11} & \alpha_{12} \\ \alpha_{21} & \alpha_{22} \end{bmatrix} \begin{bmatrix} \Delta Y_{t-i} \\ \Delta X_{t-i} \end{bmatrix} + \begin{bmatrix} \lambda_1 \\ \lambda_2 \end{bmatrix} [ECT_{h,t-1}] + \begin{bmatrix} u_{1t} \\ u_{2t} \end{bmatrix} \dots \dots \dots (3)$$

where $ECT_{h,t-1}$ is the error correction term, the residual from the h th co-integration equation lagged one period.

Model on the Impact of Fiscal Deficit on External Sector Performance.

To estimate the effect of fiscal deficit on external sector performance, and also taking into cognizance other vital explanatory variables capable of influencing external sector performance, a simplified model is utilized:

$$ESP_t = \alpha + \delta_1 FD_t + \delta_2 DBT_t + \delta_3 EXT_t + \delta_4 OPNX_t + \delta_5 REG_t + \varepsilon_t \dots \dots \dots (4)$$

In addition to estimating the long run relationship above, the study also attempts to examine the short run

relationship between the variables by specifying the short run error correction model below:

$$\Delta ESP_t = \alpha_0 + \sum_{i=1}^n \delta_1 \Delta ESP_{t-i} + \sum_{i=1}^n \delta_2 \Delta FD_{t-i} + \sum_{i=1}^n \alpha_3 \Delta DBT_{t-i} + \sum_{i=1}^n \alpha_4 \Delta EXT_{t-i} + \sum_{i=1}^n \alpha_5 \Delta OPNX_{t-i} + \sum_{i=1}^n \alpha_6 \Delta REG_{t-i} + \psi ECT_{t-1} + \mu_t \dots\dots\dots(5)$$

The ECT_{t-1} is the error correction term of the short run equation.

Data Description, Measurement and Sources

This study covered the period of 51 years (1961 - 2011). The dependent variable of this study that is, external sector performance (ESP) would be measured by external reserves; fiscal deficit (FD) is measured by overall surplus(+)/deficit(-) of the federal government; debt (DBT) is measured by total debt which is the summation of domestic and external debt; exchange rate (EXT) is measured by the annual Naira/Dollars (₦/\$) official exchange rate; trade openness (OPNX) is measured as the ratio of non-oil import plus non-oil export to real gross domestic product; and real economic growth (REG) is measured by the real gross domestic product. All the data were sourced from the Central Bank of Nigeria (CBN) Statistical Bulletin, Vol. (22), December, 2011.

Empirical Result

Unit Root Test

The stationarity test of the variables was carried out using the Philip-Perron test. As observed on table 1, all the variables were non-stationary in their level form, thus leading to the testing of the variables at first differences, which revealed that all the variables were stationary at first difference, that is, the variables were integrated of order one I(1).

Table 1. Unit Root Test

Phillip-Perron (PP) Test			
Variables	Level	1 st Difference	Remarks
<i>BD</i>	0.9701	-5.6895*	I(1)
<i>LDBT</i>	-1.5301	-5.3417*	I(1)
<i>EXT</i>	0.7998	-6.4263*	I(1)
<i>LEXTRE</i>	-1.2085	-7.5467*	I(1)
<i>LREG</i>	-1.1813	-6.4211*	I(1)
<i>OPNX</i>	7.6130	-7.2188*	I(1)

Note: * implies one per cent significance level.

Consequent to the stationarity test, this study proceeded to examine the existence of cointegration among the variables via Johansen co-integration test. As noted on table 2 below, it was observed that the null hypothesis of no co-integration, for $r=0$ were rejected by the trace and maximum eigen-value statistics, because their statistics values were greater than their critical values. However, the null hypothesis of no co-integration at $r \leq 1$ could not be rejected by the trace and maximum eigen-value statistics because their statistics values were less than the critical value. Thus, based on the trace and maximum eigen-value statistics there is only one cointegration equation among the variables, implying a possible existence of a long run relationship among the variables.

Table 2. Summary of the Cointegration Estimate

Trace Test				Maximum Eigen value Test			
Null	alternative	Statistics	95% critical values	Null	alternative	Statistics	95% critical values
$r=0$	$r \geq 1$	109.186	95.754	$r=0$	$r=1$	56.261	40.078
$r \leq 1$	$r \geq 2$	52.925	69.819	$r \leq 1$	$r=2$	20.012	33.877
$r \leq 2$	$r \geq 3$	32.913	47.856	$r \leq 2$	$r=3$	15.915	27.584
$r \leq 3$	$r \geq 4$	16.998	29.797	$r \leq 3$	$r=4$	8.751	21.132

Causality Estimate

Based on the stationary and cointegration estimates, the causal nexus between budget deficit and external sector performance is examined equation (3), that is, the Vector Error Correction (VEC) causality equation. The result of the VEC causality estimate is presented on table 3 and from the table it is observed that the error correction term (*ECT*) for cointegrating equation with budget deficit (*BD*) as dependent variable was significant at one per cent, implying the existence of long run causality from external sector performance (*ΔEXTRE*) to budget deficit (*BD*). The error correction term had the expected negative sign (-0.4013), indicating a backward movement from short run disequilibrium toward long run equilibrium. Akin to the long run causality estimate, the short run causality result with budget deficit as dependent variable also showed evidence of causation from external sector performance to budget deficit.

With respect to the nature of causation from budget deficit to external sector performance, it was revealed that the error correction term for co-integrating equation was significant at five per cent, implying the existence of a long run causation from budget deficit to external sector performance. The error correction term had the expected negative sign (-0.0065), indicating a backward movement at a very sluggish pace from short run disequilibrium toward long run equilibrium. In contrast, the short run causality estimate revealed no evidence of causation from budget deficit to external sector performance. The import from the VEC estimate indicates the existence of a bi-directional causality between budget deficit and external sector performance in long run while in the short run a one-way causation exist from external sector performance to budget deficit with no feedback from budget deficit to external sector performance.

Table 3: VEC Causality Estimate

Independent Variables	Dependent Variables	
	<i>ABD</i>	<i>ΔEXTRE</i>
<i>ABD</i>	-	0.0040 [0.7931]
<i>ΔEXTRE</i>	18.1099 [4.0922]	-
<i>ECT</i>	-0.4013 [-6.4619]*	-0.0065 [-2.5757]**

Regression Estimate between Budget Deficit and External Sector Performance

Long Run Estimate

Owing to the existence of cointegration among the variables, the long run regression estimate is presented below. It is observed from the long run regression estimate that budget deficit (*BD*), debt (*DBT*), exchange rate (*EXT*) and trade openness (*OPNX*) had insignificant impact on external sector performance (*EXTRE*). In contrast, real economic growth (*REG*) had a very significant impact on external sector performance. The implication of this with respect to the variable of interest is that the budget deficit had not affected the performance of the external sector of the Nigerian economy over the period of study. The strong influence of real economic growth on external performance can be attributed to the increased growth experienced in economy in recent year, especially the performance of the oil sector in term of increase in production and exportation of crude oil to the international community due the increase international oil price.

Long Run Estimate

$$LY_t = 0.025 + 1.20E-06BD_t - 0.150LDBT_t + 0.008EXT_t + 0.783LREG_t + 0.268OPNX_t + \varepsilon_t$$

$$t: \quad [1.373] \quad [-1.119] \quad [1.289] \quad [3.852]^* \quad [1.614]$$

$$SE: \quad (8.76E-07) \quad (0.134) \quad (0.006) \quad (0.203) \quad (0.166)$$

Note: * implies one per cent significance level.

4.5 Dynamic Error Correction Model

Consequent to the co-integration estimate reported on table 2, this study proceeded to examine the dynamic short run relationship between fiscal deficit and external sector performance in Nigeria as specified in equation (5). Before, estimating equation (5), the stationarity property of the residual from the long run estimate was examined via the Augmented Dickey Fuller test (ADF) and the Phillip-Perron test. The result as presented in table 4 below, revealed that the residual is integrated of order one at one per cent significant level.

Table 4: Residual Stationarity Test

Variable	Augmented Dickey Fuller Test	Phillip-Perron Test	Order of Integration
Resid	-3.8150*	-3.8150*	I(0)

Note: * implies one per cent significance level.

Following the residual stationarity test, we over parameterized the first differenced form of the variables in equation (5) and used the Schwarz Information Criteria to guide the parsimonious reduction of the model. This helps to identify the main dynamic pattern in the model and to ensure that the dynamics of the model have not been constrained by inappropriate lag length specification (Amassoma et al, 2011; 2013).

With respect to the parsimonious regression estimate capturing the short run analysis, it is observed from table 5 that the coefficient of the error-term for the short run model is both statistically significant at one per cent and negative. The coefficient estimate of the error correction term of -0.46 implied that the model corrects its short run disequilibrium by about 46 per cent speed of adjustment in order to return to the long run equilibrium.

The coefficients of the first and third lagged values of external reserves (proxy for external sector performance) were positive and significant at five per cent while the coefficient of the first lagged value of budget deficit was negative and insignificant at five per cent. Also, the coefficients of current and third lagged values of exchange rate were negative and insignificant while the coefficient of the second lagged value of exchange rate was found to be positive and significant. Further, the coefficients of the second lagged value of debt and the first lagged value of real gross domestic product was observed to be negative and insignificant while the coefficients of second lagged value of real gross domestic product and current value of trade openness were observed to be negative and very significant.

With respect to the variable of interest, it was discovered that budget deficit had no significant effect on external sector performance of the Nigerian economy in the short run, rather it was the past performance of the external sector, past values of exchange rate, real economic growth (proxy by real gross domestic product), and past values of trade openness that significant influenced the external sector performance of the Nigerian economy.

The appropriateness of the short run model is verified by carrying out various diagnostic tests on the residual of the short run model; namely the histogram and normality, the serial correlation LM, Breusch-Pagan-Godfrey and the ARCH LM tests. The Jarque-Bera statistic from the histogram and normality test was observed to be insignificant (see appendix), implying that the residual from the error correction model is normally distributed. More so, the serial correlation, Breusch-Pagan-Godfrey and ARCH LM tests confirmed that there is no serial correlation in the residuals of the short run regression estimate (see appendix). This is because the F-statistics of these tests were insignificant. The implication of the above is that there are no lagged forecast variances in the conditional variance equation. In other words, the errors are conditionally normally distributed, and can be used for inference. Thus, the model could be considered to be reasonably specified based on the results of the above tests.

Table 5: Parsimonious Short Run Regression Estimate

Variables	Coefficient	Std. Error	t-Statistics	Probability
<i>C</i>	0.5114	0.1556	3.2862	0.0023
<i>ECM(-1)</i>	-0.4553	0.1378	-3.3039	0.0022
<i>ΔLEXTRE(-1)</i>	0.4039	0.1682	2.4008	0.0218
<i>ΔLEXTRE(-3)</i>	0.3585	0.1400	2.5616	0.0149
<i>ΔBD(-1)</i>	-1.8E-06	9.7E-07	-1.8293	0.0759
<i>ΔEXT</i>	-0.0164	0.0081	-2.0130	0.0519
<i>ΔEXT(-2)</i>	0.0224	0.0107	2.0808	0.0448
<i>ΔEXT(-3)</i>	-0.0139	0.0087	-1.6021	0.1181
<i>ΔLDEBT(-2)</i>	-0.7950	0.4543	-1.7499	0.0889
<i>ΔLREG(-1)</i>	-0.4705	0.2868	-1.6570	0.1065
<i>ΔLREG(-2)</i>	-0.8315	0.2868	-2.8995	0.0064
<i>ΔOPNX</i>	-0.9444	0.2725	-3.4656	0.0014
<i>R-square</i>	0.5127	<i>F-Statistic</i>		3.3475
<i>D.W. Stat</i>	1.84	<i>Prob. (F-Statistic)</i>		0.0031

Appendix

Fig A1: Histogram-Normality Test

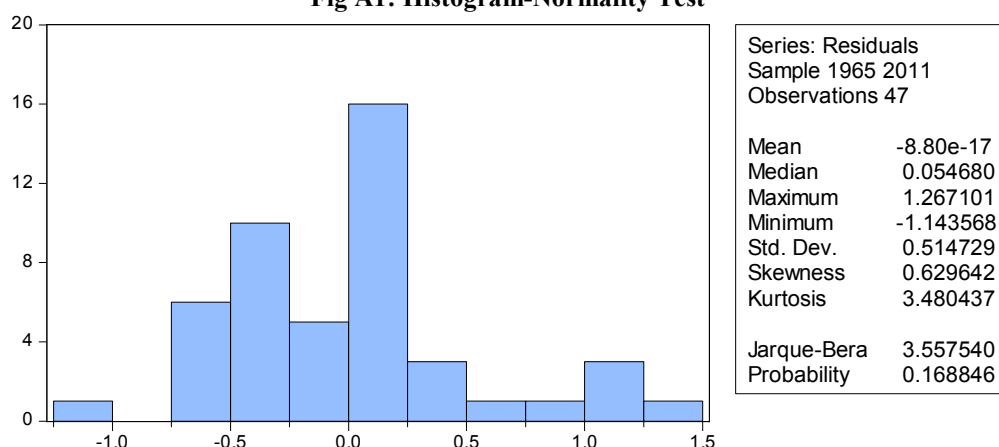


Table A1: Diagnostic Tests

Tests	F-statistic	P-value
Breusch-Godfrey Serial Correlation LM Test	0.7467	0.6621
Heteroskedasticity Test: Breusch-Pagan-Godfrey	0.5123	0.8819
Heteroskedasticity Test: ARCH	0.1024	0.7505

SUMMARY, CONCLUSION AND RECOMMENDATION.

The study examined the relationship between fiscal deficits and external sector performance in Nigeria between 1961 and 2019. Data in relevant variables were obtained from various issues of the Central bank statistical bulletin.

The study employed a bi-variate granger causality technique to analyze the nexus between fiscal deficit and external sector performance while error correction modeling technique was used to analyze the effect of fiscal deficit on the external sector performance. Data treatment involved the use of unit root and co-integration tests.

Results showed that all variables were non stationary in their level from and that all the variables were stationary at first differences that is, the variables were integrated of order 1 (1)

The trace and maximum eigen – value statistics showed only one cointegration equation among the variables implying a possible existence of a long run relationship among the variables. The VEC causality estimate showed the existence of a bi-directional causality between budget deficit and external sector performance in the long run while in the short run a one way causation existed from external sector performance to budget deficit with no feedback from budget deficit to external sector performance.

Hence, in the short run, there was no evidence of causation from budget deficit to external sector performance.

The long run res analysis on the effect of budget deficit on external sector rate and made openness has statistical insignificant effect on external sector performance. On the other hand, real economic growth had a very significant effect on external sector performance. Hence, budget deficit did not significantly affect external sector performance of the Nigerian economy over the period of study.

Moreover, analysis of the dynamic short run relationship between fiscal deficit and external sector performance showed that budget deficit has no significant influence on external sector performance in the short run. Variables of significance influence were past values of exchange rate, real economic growth and past performance of the external sector. The analysis of the cross correlation between Budget deficits and External sector variables namely external reserves and exchange rate showed that fiscal deficits unsened external competitiveness of the economy. The cross correlation coefficient of 0.56 implies that increase in fiscal deficits will lead to long run deterioration in external reserve accumulation and depreciation in exchange rate. This study therefore recommends that fiscal deficits should be minimized in order to avoid the negative implication on external sector in the long run.

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