Fiscal Policy Measures and Balance of Payments in Nigeria

Dennis Brown E* and Joseph Bidemi O

1Department of Agricultural and Applied Economics/Extension, Rivers State University of Science and Technology, Port Harcourt, Nigeria
2Department of Economics, Nnamdi Azikiwe University Awka, Nigeria

Abstract

The paper investigates fiscal policy measures and balance of payments in Nigeria. The main objective of this study is to examine the extent to which fiscal policy measures have influenced the BOP position in Nigeria during the period under study. The study utilized aggregate annual data from 1980 to 2012. The data was analyzed with the co-integration/ECM method. The major findings are: the test for stationary using Augmented Dickey Fuller (ADF) showed that all the variables were not stationary in levels but were stationary in first difference. The Johansen-Juselius co-integration techniques were employed in testing for long run equilibrium relationship among the variables and the results indicated that co-integrating relationship was found among the variables. The parsimonious ECM result reveals that about 80% of the systematic variation in the dependent variable (BOP) is explained by the three independent variables which are Government Expenditure (GXP) and Government Tax Revenue (GTR) and Government Debt (GTD). Furthermore, the result revealed that government tax revenue has positive and significant effect on BOP in Nigeria, while government expenditure and debt have negative and significant impact on BOP in Nigeria based on the magnitude and the level of significance of the coefficient and p-value. The result also reveals that there is long run relationship between fiscal policy and BOP, as evidenced by the ECM. From the result so far, it is obvious that fiscal policy measures are effective in achieving a favorable balance of payments in Nigeria. The paper concluded that the success of fiscal policy in promoting favorable BOP depends on the level of public revenue available, the direction of public expenditure and its implementation. On the basis of the findings, we recommend amongst others that expansionary fiscal policy measures should be encouraged as they play vital role for the growth of the BOP in Nigeria. Also export promotion and import substitution strategies to increase the non-oil exports in order to achieve a favorable BOP in order to achieve a favorable BOP.

Keywords: BOP; Expansionary; ECM; Fiscal policy

Introduction

One of the major macroeconomic goals of any economy of the world is to use macroeconomic policies to maintain a healthy balance of payment position in order to safe guard the external value of national currency. There are two major tools of macroeconomic policies: monetary and fiscal policies. They are otherwise known as economic stabilization or demand management policy and are used to reduce variations in aggregate spending which are important causes of fluctuations in economic activity [1,2]. Of great concern in this study is the fiscal policy. It refers to changes in government expenditures, taxes, or both. Fiscal policy is expansionary if government expenditures are increased and/or taxes reduced while fiscal policy is contractionary if government expenditures reduced and/or taxes increased.

The importance of the external sector lies in the fact that every nation engages in trade and payments and the external sector performance measures the performance of an economy with respect to the rest of the world. In the light of this, the International Monetary Fund (IMF) gives both financial assistance and policy advice to countries that have experienced chronic balance of payments problem. The record of the monetary value of this trade between a country and the rest of the world is termed balance of payments [3]. Thus, balance of payment is an accounting statement that summarizes the economic transactions between residents of the home Country and residence of all other countries.

Fiscal policy as a tool for macro-economic management according to Akpapan is a purposeful use of government revenue (mainly from taxes) and expenditure to manipulate the level of economic activities in a country. It can also be referred to as part of government policy relating to the raising of revenue through taxation and other means and choosing on the level and pattern of expenditure for the purpose of manipulating economic activities or achieving some needed macro-economic goals [4,5]. These macro-economic goals include increase in per-capita income, low unemployment rate, positive balance of payments (BOP) position and price stability. The achievement of these goals will definitely lead to economic growth.

An examination of the Nigerian’s profile shows that the pressure on the balance of payments persisted in the first half of 1994. An overall deficit amounting to ₦7,275.6 million was recorded in the BOP compared with ₦3, 876.8 million in the deficit which substantially outweighed the surplus recorded in the current account. As in the previous year, the overall deficit was financed through the deferment of debt service obligations estimated at ₦24, 906.4 million ($1,138 million) falling during the reviewed period. As a result of this development, external debt fell from ₦29,093 million ($1,329.3 million) at the end of December 1993 to ₦26, 722.8 million ($1,222 million) at the end of December 1994 [6]. However, the situation worsened again in 2008 as a result of the global economic meltdown and falling oil prices.

The continual imbalances in the external sector of the Nigerian economy seemingly suggest that government needs more to be done

*Corresponding author: Dennis Brown E, Department of Agricultural and Applied Economics/Extension, Rivers State University of Science and Technology, Port Harcourt, Nigeria, Tel: 8037068750; E-mail: dennisewubare@yahoo.com

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so as to stimulate economic growth and development. Arising from above, this paper looked at the extent to which fiscal policy measures have influenced the BOP position in Nigeria during the period of 1980 -2002. In particular, the goals of this study are to ascertain the level to which government tax revenue, government debt and government expenditure has influence on the BOP in Nigeria.

**Literature Review**

The theoretical literatures abound on the relative effectiveness of fiscal policy in managing the economy. These theories are mixed. Examples of such theories can be traced back to the Mundell-Fleming model [7,8]. The Mundell-Fleming model, which is an open-economy version of the IS-LM model, posits that an increase in budget deficit increases consumer spending as it increases disposable income and hence, financial wealth. This increases import since expenditure increases on not only domestically produced goods but also on imported goods. However, an increase in the demand for import depreciates the exchange rate since it increases the demand for foreign currency. The depreciation of the exchange rate increases export. Since both import and export increase, the net effect on the trade balance is ambiguous.

According to the Keynes an absorption theory, an increase in budget deficit increases domestic absorption and import increases. Thus, the current account goes into deficit, from an initial equilibrium position. This is in contrast to the prediction of the Mundell-Fleming model, which predicts inconclusive effect [9].

According to the Ricardoian Equivalence hypothesis [10], shifts between taxes and budget deficits have no effect on real interest rate, investment and hence the current account. Thus, there is no link between budget deficit and external sector performance. The Ricardoian equivalence considers consumers to be forward looking. They therefore save any increase in expenditure made by the government so that they pay their expected future taxes when government eventually taxes them. This implies that deficit and taxes are equivalent in their effect on consumption, investment and hence current account. Thus, the Ricardoian equivalence implies that fiscal deficit has no effect on the external sector.

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The empirical studies on fiscal policy measures and the economy came to light when the United States experienced both trade deficit and budget deficit in the 1980s. The evidence has focused mostly on fiscal deficit and the trade balance or the current account. The methodology used includes the estimation of single equation using the Ordinary Least Squares (OLS), Two Stage Least Squares (2SLS), Vector Auto regression (VAR), Cointegration Technique, Macro econometric Modeling Approach and Granger Causality test.

Somnia et al. examined the relationship between the current account deficit and budget deficit in Pakistan over the period of 1971 to 2008 in order to test the validity of the Keynes an stance, which states that there exists positive and significant relationship between the said variables [11]. Their studies use Autoregressive Distributed Lag (ARDL) approach with Augmented Dickey- Fuller (ADF) Error Correction Method (ECM) and Toda-Yamamoto Multivariate Granger Causality Tests. Variables like budget deficit, current account deficit, GDP, exchange rate and interest rate were used to explain the inter-relationship. Their results submitted that there was indeed a long run relationship among the variables in the model and a stable long run relationship between budget deficit and current account deficit. This indicates that current account deficit is more sensitive to budget deficit and interest rate. Moreover, they asserted that when economic activities in the country increases, investment also increases which put upward pressure on interest rate; because of high interest rate, inflow of foreign capital which deteriorate the trade balance. With increase in economic activities, demand for imports also increases and leads to merchandise trade deficit in the economy. Also, the results suggested that a downward pressure in the magnitude of exchange rate and interest rate leads to worsening current account deficit. The results of T-Y tests of Granger Casualty show that there is a bidirectional casualty between budget deficit and trade deficit. The long run coefficients of control variables: GDP, exchange rate and interest rate appeared to be significant and the most significant variable is budget deficit. In Pakistan, trade deficit is showing varying trend, mostly increased deficit while budget deficit is reducing. The basic reason behind increased deficit can only be daily increasing oil prices which has not only increased cost of production but also freight charges. This dishearts the trade balance. Therefore, any policy measures to reduce the budget deficit in Pakistan could as well assist in reducing the Pakistan current account deficit that will ultimately leads to sustainable economic growth. So, it was suggested that the government should curtail its non-productive expenditures in order to reduce its budget deficit.

Egwaiikhide investigated the effect of budget deficit on the current account balance in Nigeria covering the period from 1973 to 1993 using Ordinary Least Square (OLS) regression model and Simulation model [12]. This econometric model captures the principal interactions between budgetary developments, money supply, price level, domestic absorption and the current account balance. Quantitative evidence suggested that budget policy developments affect the current account balance in Nigeria. There is also the finding that there exists a strong relationship between the budget deficit and the current account balance in Nigeria. In particular, dynamic simulation experiments was used to show that budget deficit, engendered by increased expenditure, leads to a deterioration of the current account, whether it is financed through central bank credit or external borrowing. He therefore asserted that budget discipline is necessary for the achievement of external balance in Nigeria.

Hashemzadeh and Wilson examined the dynamics of current account and budget deficits in selected countries like the Middle East and North Africa countries [13]. Their studies used causality Test and Vector Auto Regression (VAR) Impulse Response Function and Variance Decomposition techniques. Their goal was to discover the extent to which prediction errors in the trade deficit can explain the forecast errors in the budget deficit existing in Egypt, Iran, Jordan, Kuwait, Morocco, Oman, Syria, Turkey and Yemen from 1977 to 2003. Their results reported that with the exception of Morocco and Yemen, budget balance does not appear to be a significant predictor of current account balance. In Oman, the trade balance was predicted by the budget deficit (lagged by one period). They asserted that although...
deficit financing tend to simulate the flow of imports in an expanding economy, it may not pose a serious problem when the economy is in recession. Their research work also demonstrated that the twin deficit proposition is not universally supported. If anything, the incidence of twin deficits appears to be country specific. Also, the correlation between the two deficits is both complex and ambiguous. They also asserted that the dynamic relationship between the two deficits is subject to change depending on the underlying tax system, trade patterns and barriers, the exchange rate and a complex host of internal and international forces that help to shape a country’s economic status in the global setting. Attiya empirically investigated the effects of fiscal policy (or government budget deficit shocks) on the current account and the other macroeconomic variable such as real output, interest rate and exchange rate in Pakistan over the period 1960-2009 [14]. The analysis is performed through the structural Vector Autoregressive (VAR) approach. The exogenous fiscal policy shocks were identified after controlling the business cycle effects on fiscal balances. In contrast to the predictions of the most theoretical models, the results suggested that an expansionary fiscal policy shock (or a government budget deficit shock) improves the current account and depreciates the exchange rate. The private saving rises initially then fall and the investment falls contributory to the current account improvement while the exchange rate depreciates. The twin divergence of fiscal balances and current account balances is also explained by the prevalence of output shocks. Output shocks that are more than fiscal shocks appear to drive the current account movements and its movements with the fiscal balance. The interesting, and somewhat different result of this study is that, while most economic theories suggested that a fiscal expansion should be associated with a worsening of the current account and an initial appreciation of the real exchange rate, the empirical results suggested the opposite i.e. fiscal expansion is associated with an improvement of the current account and exchange rate depreciation. The current account improvement occurs even after the researchers control for the effects of the business cycle when an economic expansion improves the fiscal balance but worsens the current account. Therefore, even exogenous fiscal shocks seem to be associated with an improvement of the current account. This dynamics seems to be explained by a combination of factors such as, a fall (increase) in investment driven by crowding-out (crowding-in) caused by changes in real interest rates following fiscal shocks and movement in private savings can account for the paradoxical negative correlation between exogenous fiscal shocks and the current account.

Ali analysed the empirical relationship between fiscal policies and the current account, using panel regressions and panel VARs for 124 countries over 1985-2007 [15]. The analysis distinguishes between advanced, emerging and low-income countries; between oil exporters and non-oil exporters; between more open and less open economies; and between country-years with large output gaps and those where the gap was smaller. A battery of panel regressions (with individual country fixed effects) using annual data suggests a positive, significant, and robust association between fiscal balances and current account balances. This is intuitive given that oil price shocks typically induce large movements in public sector balances (through oil revenues) and the current account (through oil exports) in oil exporting countries. The results from the estimation are robust to controlling for GDP per capita, financial openness, and trade openness. The estimated impact of fiscal policy on the current account is somewhat stronger in emerging and developing economies than it is for advanced economies, though the difference is not significantly different. A possible interpretation is that, in emerging and developing economies, public spending tends to include the purchase of foreign made investment goods, and is thus more likely to spill over into imports than is the case in advanced economies. The association between fiscal policy and the current account is significantly affected by the level of the output gap. When output is above its potential, a fiscal expansion is more likely to result in additional imports; instead, when output is below potential, the additional demand stemming from a fiscal expansion is more likely to be met by increased production of domestic goods and services, rather than through imports. Private consumption typically collapses much more than government consumption, thus driving an improving current account, while fiscal balances deteriorate. Finally, splitting the sample between economies that are above and below the median with respect to openness to international trade, the relationship between fiscal policy and the current account is significantly stronger in economies that are more open to international trade than in less open economies. In economies more open to international trade, it is natural for a greater share of the additional demand stemming from a fiscal expansion to be met through imports. Using panel VARs, the empirical findings suggest that a fiscal expansion generally leads to a worsening in the current account balance, though the duration of the impact depends on the country sample. In a simple analysis of episodes of large adjustment in the current account and fiscal policy, it was found that the association between fiscal policy and the emergence or unwinding of large external imbalances is limited. The association between fiscal policy and the current account has also been found to be at least as strong in emerging and low-income economies as in advanced economies and significantly stronger in country-years where output is above potential than in cases where output is below potential.

Zaidi in his research study the effect of savings, investment and fiscal deficits on the current account deficits of some developing countries explored the Granger causality tests to investigate the relationships between each of these macroeconomic variables and the current account deficit [16,17]. Test results demonstrate that annual changes in both domestic investment and savings cause changes in the current account balance. Evidence of causal relationship between the current account balance and investment behaviour, an indication that foreign exchange constraint may have inhibited the volume of investment, was found for some of the countries in the sample. His study also examined the relationship between fiscal deficit and the current account balance. This was conducted using cross-sectional time-series data drawn from 12 developing countries. Although the estimated results showed a direct association between these variables, the causality tests conducted for some countries were diverse. Bi-directional causality exists between fiscal deficits and the current account deficits for South Korea and the Philippines, but a unidirectional causality (from the current account deficit to budget deficit) was the case for Thailand and Greece. As for Brazil, the result showed that the two variables are statistically for the period between 1972 and 1980.

Ram, using cross country regressions found that while growth in general is positively correlated with rate of change in total public expenditure, it is negatively correlated with the level of such expenditure [18].

Mansur examined the impact of budget deficit on the current account balance in Philippines which covered the period between 1970 and 1982. The study used a structural model (containing price, revenue, import, income and private sector absorption equations, with relevant identities) explaining the inter-relationships between fiscal expansion and the current account balance, on the one hand, and
government fiscal operations, domestic credit and money supply, on the other hand. Simulation results demonstrated that enlarged budget deficits (resulting from increased government expenditure) financed from both bank credit and external borrowing led to a deterioration of the current account. Thus, it was proposed that the achievement of a sustained balance of payments position in the Philippines required fiscal restraint.

Ogbole, Amadi and Isaac examined fiscal policy and economic growth in Nigeria: A granger-causality analysis. Granger causality test was employed to test for causal relationship between these variables [19]. The result of the analysis shows the existence of causal relationship between them with a unidirectional causality running from GE to GDP, which is in line with an a priori expectation. We conclude that in the period under study, fiscal operations in Nigeria, to some extent, caused some economic growth in the country, though the precise extent is subject of further study.

Adeoye examined the effects of fiscal policy on growth of the Nigerian economy (1970-2002) [20]. The result showed that capital expenditure as a ratio of GDP (used as proxy for public investment) exerted a negative impact on output growth by having a crowding-out effect on private investment. Thus from the foregoing empirical studies it may be inferred that the relationship between FP and EG may be either negative or positive depending on varying prevailing economic factors in the economics in question. However, our point of departure in this study is to investigate specifically the existence of causal relationship between FP and EG and the direction of causality, not merely establishing a correlation between them.

Despite several studies on fiscal policies, Adeoye observed that “the debate on the usefulness of fiscal policy as a tool for promoting growth and development remains inconclusive, given the conflicting results of current research” [20]. He opined that while the studies of Thornton, Lin and Liu indicated a net positive effect, those of Baily and Feldstein indicated a negative net effect.

Methodology

This study adopts the Cointegration/ECM test as the main statistical tool. The time series data (1980-2012) used was obtained from the Central Bank of Nigeria Statistical Bulletin of various issues from the 1980s to 2012. The model was constructed for the Nigerian economy. The constructed model has balance of payments (BOP) as the dependent variable while government expenditure (GXP), government tax revenue (GTR) and government debt (GTD) are the independent variables. All the variables mentioned above are in Million Nigerian Naira ($N$) (Appendix).

The unit root test in Table 1 above shows that the time series could not attain stationarity at ordinary level. Therefore, the variable was differenced once to attain stationarity and all the four time series were stationary at first difference. Given the existence of co-integrating equations, the econometrics model adopted is stated thus;

\[
Y_t = \alpha_0 + \alpha_1GXP_t + \alpha_2GTR_t + \alpha_3GTD_t + \epsilon_t
\]

(1.1)

On the apriori, it is expected that; \(\alpha_1 > 0\) and \(\alpha_2, \alpha_3 > 0\).

Moreover, the study employs the cointegration/ECM methods to examine the causal effects of the variables specified in the model. The unit root test via the ADF test precedes the cointegration and ECM test in order to test for stationarity of the variables. The unit root model is presented thus:

\[
\Delta Y_t = \alpha Y_{t-1} + \sum_{i=1}^{m} \delta_i \Delta Y_{t-i} + \epsilon_t
\]

(1.2) for levels

\[
\Delta \Delta Y_t = \alpha \Delta Y_{t-1} + \sum_{i=1}^{m} \delta_i \Delta \Delta Y_{t-i} + \epsilon_t
\]

(1.3) for first difference

\[
\Delta Y_t \text{ is the first difference of the series, } m \text{ is the number of lags and } t \text{ is the time.}
\]

Therefore, assuming the integration of order I(1) and cointegration between the levels of BOP (Yt), government expenditure (GXP), government tax revenue (GTRt), and government debt (GTDt). The following ECM, according to Engel, Johansen and Granger (1987), are formulated:

\[
Y_t = \delta_0 + \delta_1GXP_t + \delta_2GTR_t + \delta_3GTD_t + \epsilon_{t-1}
\]

(1.4)

From equation 1.1, \(\Delta\) indicates difference operator, Y represents the dependent variable, t implies time, \(\delta_0\) is the intercept and ECMt-1 is the error correction mechanism obtained from the long-run cointegration regression. While \(\delta_1, \delta_2, \delta_3\) are the coefficients of explanatory variables. The short run which is inevitable to achieve the long run equilibrium can be provided by the causal relationship between the variables [16].

Results and Discussion

The research examined fiscal policy and balance of payments in Nigeria during the period 1980-2012. An econometric model was constructed for the Nigerian economy. The constructed model has balance of payments (BOP) as the dependent variable while government expenditure (GXP), government tax revenue (GTR) and government debt (GTD) are the independent variables. All the variables mentioned above are in Million Naira ($N$) (Appendix).

The unit root test reported in Table 1 above shows that the time series could not attain stationarity at ordinary level. Therefore, the variable was differenced once to attain stationarity and all the four time series were stationary at first difference (ADF test statistic was greater than their theoretical values order one). Meaning that they were integrated of order one.

Max-eigenvalue test indicates 3 cointegrating eqn(s) at the 0.05 level * denotes rejection of the hypothesis at the 0.05 level **MacKinnon-Haug-Michelis p-values.

From the Table 2 above, there are three co-integrating equations at 5% level of significance. This is strong evidence from the unit root test conducted, where we observed that four variables were stationary at first difference. Given the existence of co-integrating equations, the requirement for fitting in an error correction model is satisfied.

Error correction model (ECM)

Error correction model (ECM) is a means of integrating the short-run behavior of an economic variable with its long-run behavior [21].

<table>
<thead>
<tr>
<th>Variables</th>
<th>ADF Test</th>
<th>Critical Value</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1% critical</td>
<td>5% critical</td>
</tr>
<tr>
<td>BOP</td>
<td>-7.699375</td>
<td>-3.6661</td>
</tr>
<tr>
<td>LOG(GXP)</td>
<td>-5.093031</td>
<td>-3.6661</td>
</tr>
<tr>
<td>LOG(GTR)</td>
<td>-4.626309</td>
<td>-3.6661</td>
</tr>
<tr>
<td>LOG(GTD)</td>
<td>-4.618280</td>
<td>-3.6661</td>
</tr>
</tbody>
</table>

Source: Researcher’s Computation

Table 1: Unit Root Test for Stationarity (Augmented Dickey Fuller).
The table below shows an inference error correction test conducted:

The result of the estimated parsimonious error correction model in Table 3 above shows that the coefficient of determination is 0.802. Thus, 80 percent systematic variation in BOP is explained by government expenditure, government tax revenue and government debt. Also, the overall model is significant at 5 percent level of significance as shown by the F-statistic of 12.776. Meaning that we accept the alternative hypothesis which states that there is a significant relationship between fiscal policy and balance of payments in Nigeria during the period of study. The coefficient of ECM is rightly signed (that is negative) and statistically significant at 5 percent significance level. Meaning that the short run dynamic has been adjusted to long run equilibrium. The Durbin Watson value of approximately 2.0, suggests a lesser level of autocorrelation. Meaning that the model is fit for policy recommendation.

Meanwhile, for the lag periods, all the variables were statistically significant at 5 percent level. The coefficient of the lag two period of government expenditure (GXP) was wrongly signed but statistically significant at 5 percent level. This implies that increase in government expenditure will not cause a favorable BOP position but will impact significantly on the BOP position in the Nigerian economy during the period of study.

The coefficient of the current and lag one forms of the government tax revenue (GTR) was rightly signed and statistically significant at 5 percent level. This suggests that in the current and lag one period, government tax revenue will only impact significantly on BOP in Nigeria. But the coefficient of the lag one form of the government debt (GTD) was rightly signed and statistically significant at 5 percent level. Meaning that increase in government debt (domestic and foreign) has a greater implication on the balance of payments of the Nigerian economy over the studied period.

Conclusion

The study focuses on the impact of fiscal policy on BOP in Nigeria. The BOP is seen as an indicator of growth in the developmental processes of the economy. The study adopted the co-integration/error correction model on a time series data from 1980 to 2012. The study regressed fiscal policy proxied by productive government expenditure, government tax revenue and government debt on balance of payments. The regression long run result reveals that about 80% of the systematic variation in the dependent variable is explained by the three independent variables such as Government Expenditure (GXP) and Government Tax Revenue (GTR) and Government Debt (GTD). The F-statistic is significant at the 5% level showing that there is a linear relationship between the BOP and the three independent variables. The result revealed that government expenditure has significant effect on BOP in Nigeria, while government tax revenue and debt have negative and significant impact on BOP in Nigeria based on the magnitude and the level of significance of the coefficient and p-value. The result also reveals that there is long run relationship between fiscal policy and BOP, as evidenced by the ECM.

From the discussion so far, it is obvious that fiscal policy measures are effective in achieving a favorable balance of payments in Nigeria. The researchers concluded that the success of fiscal policy in promoting favorable BOP depends on the level of public revenue available, the direction of public expenditure and its implementation.

On the basis of the findings of the study, the following recommendations amongst others were proffered towards enhancing impact of fiscal policy on BOP in Nigeria; Expansionary policies on fiscal policy measures should be encouraged as they play vital role for the growth of the BOP in Nigeria. Government economic policies should be on diversification of the economy to enhance the performance of manufacturing sector, so as to create more employment opportunities, because it may be a more effective way of reducing the level of unemployment and increasing the growth of the economy and hence the BOP. Export promotion and import substitution strategies to increase the non-oil exports in order to achieve a favorable BOP in order to achieve a favorable BOP. Fiscal policy should be given more priority attention towards the BOP by increasing the level of budget implementation, which will enhance aggregate spending in the economy. Feasibility studies should be carried out before either external or domestic debt is obtained to ascertain the economic advantage/disadvantage of such loans.

References