DEFICIT FINANCING AND ITS IMPLICATION ON PRIVATE SECTOR INVESTMENT: THE NIGERIAN EXPERIENCE

By Isah Imam Paiko

Department of Entrepreneurship and Business Technology,

Federal University of Technology, Minna.

ABSTRACT

Deficit financing is a recurrent decimal in Nigerian economy. Since independence, over 90% of Nigerians budgets are in deficit. Deficit financing seems to present a positive inflationary impact and a negative investment impact on developing economics particularly Nigeria. Usually when there is deficit, government fined ways of financing the deficit through borrowing from commercial banks or from non-banking public and through the issue of short-term bonds and monetary instruments. Prolong deficit financing have an overall negative impact on the economy by crowding out private investment. This paper examines the impact of government expenditures on private investment and also how the financing of budget deficit have not only affected the performance of private investment but also how it crowds out private investment in Nigeria. Secondary data from CBN statistical bulletin Bureau of statistics bulletin were used Econometric models were used in calculating the relative impact of deficit financing on private investment in Nigeria. The findings revealed a negative relationship between deficit financing and investment in the period under review i.e deficit financing in Nigeria crowds out private investment. The paper recommends that government should redirect it fiscal policy that would favor the private investor by discouraging high government expenditure and maintaining low fiscal deficit. Also, to avoid crowding out effect, it is recommended that deficit be financed through the capital market.

INTODUCTION

Deficit financing seems to present a negative impact on investment on developing economies especially Nigeria. When there is a budget deficit, government finds ways of financing the deficit through borrowing from commercial banks or from non-banking public and through the issue of short term bonds and monetary instrument. The use of these forms of deficit financing for the

pursuit of fiscal policies often leads to crowding out of private investment, inflation as well as future debt crisis.

The economic fundamental of fiscal policy is to affect a countercyclical policy so that booms and depressions during the course of business cycles are offset (Collins 1991). Thus fiscal policy is essentially used in fine-tuning the economy, this is why Keynes (1930) advocated deficit financing, (an injection into the economy to stimulate aggregate demand via multiplier effect) to effect a transition from mass unemployment to near full employment.

Thus, excessive and prolong deficit financing through the creation of high powered money may negate the attainment of macro - economic stability, which may in turn affect the level of desired investment in an economy and thereby stripe growth. Major determinant that is mostly directly affected by macro - economic policy is investment, both public and private (Word Bank 1993) such macro-economic policies involved the deliberate manipulation of policy instruments, such as monetary policy, government fiscal operations, exchange rate and trade policies, pricing and environmental policies for the purpose of achieving broad macro - economic of relative price stability, high level of employment, economic growth, equitable distribution of the national income and balance of payment equilibrium. These are macro - economic indicators upon which investor's confidence, expectation and decisions on whether to invest or not are based.

Macro economic variables could, therefore, be regarded as the economic fundamentals or preconditions that must be fulfilled without which investment cannot take place.

Deficit usually occurs as a result of government inability to match the fax revenue and expenditure. The deficit is financed either through borrowings (domestically or foreign) or use of foreign reserve to settle the deficit. By borrowing it means the government has to agree on the terms payments which usually are attached with strange regulations. Hence, this will perpetrate the deficit as more money will be spent by government on servicing the debt which creates more expenditure and deficit. Persistence of this many result to high and variable inflation, debt crisis, with crowding out of investment and growth and macro - economic imbalance in general.

High extension debt stock and debt burden have also been shown to have a dampening effect on investment mainly through the "debt overhang" effect, the crowding out effect and credit rationing.

The "debt overhang" effect refers to a situation in which a high debt burden discourages investment by the private sector since the new accumulated debt stock as a tax on future income and production.

The crowding out effect on the other hand, arises from the consideration that resources which called have been used for investment are often deviated to service foreign debt. Credit rationing refers to situation in which a highly indebted country is likely to face credit constraint in international capital market and this would lead to reduction investment.

MAIN OBJECTIVE

The focus of this study, therefore, is to examine the efficacy of the fiscal policies and the impact on the country's investment profile. This is with a view to using the benefits of hindsight to guide against pitfalls of the past in future, bearing in mind that investors confidence and expectation play significant roles in the decision to invest.

SPECIFIC OBJECTIVES

_ To evaluate how the financing of budget deficit has affected the performance of private investment in Nigeria.

_ To examine the impact of government expenditures on private investment.

_ To formulate econometric models and use it to calculate the relative impact of fiscal policy on private investment in Nigeria during the period under study.

_ To make policy recommendation.

LITERATURE REVIEW

Development models of public expenditure which primarily is the works of Musgrave (1974) and Rustow (1971) anchors on the fact that the countries of the world must pass through different stages before they could develop, and that these different stages requires varied proportion of Government spending to total investment in the economy will be large since most of her activities centre on capital formation bordering on roads, housing, telephone, education, health care, among others in preparation for takeoff in to the middle stage.

Many studies have been conducted on indirect effects of public deficits on private consumption and investment.

Komain (2007) examine the association between government expenditures and economic growth in Thailand by employing the Granger causality test, the result revealed that government expenditure and economic growth are not co-integrated. Furthermore, the result indicated a unidirectional relationship, as causality runs from government expenditures to growth.

Owoye,et.el (2007) investigated the relationships between government expenditure and economic growth for a group of 30 OECD countries during the period 1970-2005. The regression results showed the existence of a long-run relationship between government expenditure and economic growth. In addition they also observed a unidirectional causality from government expenditure to growth for 16 out of the countries, thus supporting the Keynesian hypothesis. However, causality runs from economic growth to government expenditure in 10 out of the countries, confirming the Wagner's law. Finally he found that the existence of feedback relationship between government expenditure and economic growth o0f four countries.

Cooray (2009) posited that increase in government expenditure contributes positively to economic growth.

Abdullah, (2000) explained that increased public expenditure leads to high economic growth through physical infrastructures.

Gregornu et.el (2007) in their work the impact of government expenditure on growth discovered that countries with large government expenditure tend to experience higher growth.

Liu,etel (2008) examined the casual relationship between GDP and public expenditure for the US data during the period 1947-2002. The causality results revealed that total government expenditure causes growth of GDP.

ts indicated that public expenditure raises the US economic growth. They concluded that judging from the causality test Keynesian hypothesis exerts more influence than the Wagner's law.

Erkin,(1988) examined the relationship between government expenditure and economic growth, by proposing a new frame work for New Zealand. The empirical results showed that higher government expenditure does not hurt consumption, but instead raises private investment that in turn accelerates economic growth.

Peters, (2003) studying sweeten examine the effects of government expenditure on economic growth during 1960-2001 period. The research also show positive relationship between two variables

Akpokodje (1998) using a time series data in order to avoid potentially spurious results emanating from non-stationarity of the data series. He tried to estimate long run relationship using standard ordinary least squares (OLS) techniques. The long run regression results indicated that a fiscal policy weakened by fiscal deficit has a strong and significant adverse impact on private investment in the long run. The result indicates that a percentage increase in fiscal deficit is capable of contracting private investment by as much as 61 percentage. This negative impact confirms the crowding out effect of government's fiscal deficit programme on private investment in Nigeria.

Akpokodje (1988) also observed that Government's monetary policy which insured credit to the private sector has a strong positive and significant impact on private investment. He found out that, in the long run, sectoral allocation of funds to the private sector is capable of inducing private investment. This implies that increase allocation of funds to the government to finance its expansionary fiscal policy programme at the expense of the private sector adversely affects investment in the private sector significantly.

According to Bamidele and Englama(1995) deficit financing is a veritable tool in macroeconomic management provided it is efficiently financed and productivity utilized on projects and programmes that could be self sustaining. However, excessive and prolong deficit

financing through the creation of high powered money negates the attainment of macroeconomic stability, which may in turn, curtail the level of desired investment in an economy and thereby stifle growth.

The World Bank (1996) cited studies by Fisher (1993) to demonstrate that the fastest growing countries in the world are those that maintain low inflation, low and manageable overall deficits, minimal price distortion's stable exchange rates, strong efficient and open economies with large trade shores, in contrast with those that exhibit long-run inflation rate in excess of 30 percent.

The report goes further to say that low growth rates and inflation rate are correlated with large overall budget deficit in parts because the financing was done mainly with Central Bank borrowings, as was the case in Nigeria (world Bank 1996). The same scenario has been observed among HPAE of South East Asia whose economies has been remarkably successful in creating and maintaining macroeconomic stability through manageable budget deficits, low inflation, maintenance of real effective exchange rate and keeping external debt under control which in turn, encourage private sector savings, investments, exports and growth.

Blejar and Khan (1984) conducted a study in Cote'Divoire, Thaialand and Argentina. Their findings revealed that public deficit have a negative effect on private investment in all the countries mentioned. However, the effect is stronger in Thailand but weak in cote'dIvore for Argentina, the study also found that deficit financing have a strong negative effect. And that public expenditure or consumption in the above countries crowds out private investment. The conclusion then is that budget deficit and government expenditure tend to crowd out private investment through domestic market in Argentina, cote'dIvore and Thailand.

Rama (1993) and solamano (1993) observed that public deficit could have indirect effect on private investment it real interest rates rise in response to higher domestic debt financing. Although, theories predict that real interest rate will have an ambiguous effects on private sector. Hence the study will examine the implication of deficit financing in Nigeria over given period of time (Ten years).

METHODOLOGY

The method used is the application of the regression analysis to evaluate the relationship between deficit financing and private sector investment. The basic procedure is this method includes models specification, estimation and evaluation and interpretation of the result. The data are secondary and were collected from CBN,World Bank, Bureau of Statistics publications for the period under study.

The model was estimated using the ordinary list square (OSL) technique and the estimate were obtained using econometric soft ware package system.

The general nature of the model was derived within the context of the theoretical link between investment and fiscal policy noted in literature. We formulate a regression model to assess the effect of deficit financing on private investment.

The equation used to estimate the relationship between deficit financing and private investment take the following forms.

$Y_t = F (S_1, S_2 S_3 S_4)$

Where

$Y_t = P_1$ (private investment)

S_1 = GM (government expenditure public sector borrowing from the commercial banking system).

$S_2 = D_B$ (budget deficit)

S_3 = XD external debt stock.

$S_4 = R_T$ (interest rate).

To verify the impact of fiscal policy on private investment, we hypothesis five functional relationships.

The first relationships measures, the effect of government expenditure on investment.

$P_1 = b_0 + b_1 Gm + U_t$ ------ (1) subject to the restriction

$\frac{\Delta Gm}{\Delta P1} > 0$

Where P_1 = private investment.

b_0 and b_1 = parameters of the equation

G_m = Government expenditure

U_t = the stochastic random error term.

The above restriction implies that a negative relationship is expected between government expenditure and private investment. In other words, we will expect the private investment to decrease when government expenditure increased.

The second relationship measures the effect of budget deficit financing on private investment

$P_1 = b_0 + b_2 D_B + U_t$ --------- (2) subject to the restriction

Where P1 = private Investment

b_0 and b_2 = Parameters of the function.

DB = Budget deficit.

Ut = the stochastic random error term.

The third relationship measures the effect of external debt stock on private investment

$P_1 = b_0 + b_3 + X D + U_t$ ---------- (3)

Subject to the restriction.

$$\frac{\Delta XD}{\Delta P1} > 0$$

Where P1 = Private Investment

b0 and b2 = Parameters of the function

XD = external debt stock

Ut = the stochastic random error term.

The above restriction implies that, there is an inverse relationship between external debt stock and private investment i.e. high external debt stock retards private investment. Therefore, the higher the external debt stock the less will be private investment (debt overhang hypothesis)

The fourth relationship measures the effect of interest rate on private investment.

$P_1 = b_0 + b_4 RT + Ut$ --------- (4) subject to the restriction

$$\frac{\Delta Rt}{\Delta P1} > 0$$

Where P_1 = Private invest,

B_0 and b_2 = Parameters of the function

Rt = interest.

Ut = stochastic random error term.

The above restriction implies that there is an inverse relationship between interest rate and private investment i.e. the higher the interest the lower will be the investment.

The fifth relationship which investigate the combine effect of all the explanatory variables on the private investment and from which the regression equation is derived can be presented in the form where

$P_1 = Y_t$, Gm = S_1, DB = S_2, S_3 = XD, S_4 = Rt.

$Y_t = b_0 + b_1S_1t + b_2S_2t + b_3S_3t + b_4S_4t + Ut$

Where, t = time, U = error term.

b_1, b_2, b_3, b_4, are the coefficients

All variables are as earlier defined

ANALYSIS OF THE REGRESSION RESULTS

The result of the empirical regression estimation for equation 1-4 were estimated using OLS regression calculation using the econometric view software package for the nominal variables for the data 1990 -2007 period.

1. Yt = 2.41030 – 0.767S1
   T cal = (2.81) (-2.345)
   S (B) =(0.34)
   R2 = 0.72 $\bar{R}2 = 0.70$
   F = statistics = 40.2
2. Yt = 1.789 — 0.653S2
   tcal = (4.231) (-1.922)
   S (B) = (0.030)
   R2 = 0.60, $\bar{R} = 0.59$.
   F-statistics = 50.6.

3. Yt = 1.782 — 0.434S3
   tcal = (6.25) (-2.34)
   S (B) = (0.310)
   R2 = 0.48, $\bar{R}2$ = 0.46
   F-statistics = 30.432.
4. Yt = 1.887 — 0.53S3
   tcal = (1.94) (-2.96)
   S (B) =(0.03)
   R2 = 0.70, $\bar{R}2$ = 0.68
   F-statistics = 30.432.
5. Yt = 6.427—1.806S1,—0.0746S2 —0.534S3 —0.0653S4
   tcal = (5.B) (-2.34) (-2.92) (-3.34) (-2.46)
   S (B) = 0.01
   R2 = 0.92, $\bar{R}2$ = 0.90
   F-statistics = 121.5
   D-W = 1.943

The mathematical specification give the tool for evaluating contribution of each of the variable in the composition of Deficit financing to private investment and the combined effect of all the explanatory variables on the private sector investment.

EVALUATION AND INTERPRETATION OF THE RESULTS.

In equation one, the size and sign of estimated coefficient was expected to be negative as theoretically expected. The coefficient is significant at both 10% and 5% level of significance. Indicating negative relationship between government expenditure and private investment assuring the mode of financing of the expenditure was through internal borrowing. The estimated equation fits the data almost perfectly as measured by R^2 indicating that 72% of the total variation in Y can be accounted for by change in S1. The F-statistics of 40.2 shows that the model is well specified.

Equation two explains the relationship between private investment and budget deficit financing. The negative value of the coefficient S_2 is as expected and is statistically significant at both levels of significance. Judging from the value of R^2 it can be concluded that the explanatory variables S_2 explain 60% of the systematic variation in the private investment during period studied. The F-value of 50.6 conforms the fitness of the equation as indicated by R^2.

A look at equation three shows a negative relationship between private investment and interest rate as theoretically expected. The explanatory variable accounted for about 48% of the variation

in private investment. This shows weak fit, however, the sign of the coefficient of the variable S_3 is correct and t-value is significant at both level of significance. The F-statistics of 60.5 shows the equation is well specified.

In equation four, negative value of the coefficient S_4 of the explanatory variable conforms to prior expectations. It shows that external debt stock S_4 is significant at both 5% and 10% level of significance. The R^2 shows that 70% of the variation in private investment is been explained by the explanatory variable. The t-value is significant. The F-statistics shows a good fit of the model.

Equation five investigates the combined effect of all the explanatory variables on the private investment. The prior expectations were that the size and signs of the estimated coefficient were expected to be negative. Therefore, the negative values of the coefficient of the explanatory variables conform to a priori expectations. In the light of empirical result above in equation five (5), all the four variables tested had significant influence on private investment in the period 1990 – 2008. The intercept coefficient (i.e. the constant) of 6.427 explains that change in private investment does not have anything to do with any of the variables S_1 S_2 S_3 and S_4.

The variables S_1 S_2 S_3 and S_4 are individually statistically significant, this is shown by the values t- calculated (2.34) (2.92) (2.81) and (2.46) for individual variables S_1, S_2, S_3, and S_4 respectively which is greater than 2. The signs of the coefficient of variables are correct and the t-values are significant at both 5% and 10% level of significance. This shows that each variables (S_1, S_2,S_3, and S_4) explains the variation in y. this implies that a relationship exist between each of the variables – private investment, government expenditure, budget deficit, lending rate and external debt stock. The negative of the coefficient for individual variables implies that there relationship with the dependent variable is inversely related judging from the value of R^2 it can then be concluded that the four(4) repressors in the equation explains 92% of the systematic variation in aggregate investment of the private sector during the period studied.

Then, the combined effect of S_1, S_2, S_3, and S_4 on Y is explained by F-statistics which is equally statistically significant indicating that there is a significant linear relationship between the four independent variables taken together and private investment.

The t-values are also significant. Also, the estimates are unbiased and consistent since the model does not suffer from either auto correlation or multicoltinearity. The D.W test of 1.943 conformed this assertion.

IMPLICATIONS:

From the analysis above, it is clear that government expenditure crowds out private investment by explaining above 92% of the total variation in private investment.

Budget deficit as investigated from the analysis also show a negative relationship with private investment which proves statistically significant at 5% and 10% level of significance. Deficit financing through commercial banks crowds out private investment through the rise in interest rate. This explains why the private sector is yet to develop.

Interest rate is an important variable in explaining variation in private investment. It coefficient show a negative value and statistically significant. Though the coefficient 0.534 is weak in explaining the effect of interest rate and private investment in Nigeria. This could attribute to the fact that most investment resources in Nigeria is from the informal sector of the economic.

Finally, the external debt stock coefficient was found to be negative and statistically significant. The implication of this is that the external debt stock and debt source affect investment many through the "debt overhang" effect, the "crowding out" effect and credit rationing.

It is permanent at this point to note that the two hypotheses earlier stated in this research work have been conformed, that:

i. There is negative correlation between government expenditure and private sector.
ii. That the budget deficit financing has a negative impact on private investment.

RECOMMENDATION AND CONCLUSION

Despite the lapses in Nigeria economic, the government expenditure, deficit financing and high external debt burden explain low investment profile in Nigeria, and government should redirect it fiscal policy that would favor the private investor by discouraging high government expenditure and maintaining low fiscal deficit.

Furthermore, in view of the nature of Nigeria economy epitomized by the problems hindering private investment like high government expenditure and deficit financing, the government should be prudence in it expenditure that has direct bearing on the private sector and that deficit could be finance through the capital market if well develop to avoid crowding out effect.

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APPENDICES

HOLDING OF FEDERAL GOVERNMENT DOMESTIC DEBTs OUTSTANDING

Years	CBN	Commercial Banks	Merchant Bank	Total Banking System	No. Bank – Public	Total
1990	56,564.1	8,917.3	358.3	65,839.7	18,255.9	84,095.6
1991	89,412.6	6,847.0	679.4	96,939.0	19,261.2	116,200.2
1992	122,028.3	5,881.2	1,027.0	128,936.5	32,963.7	161,900.2
1993	189,773.4	29,346.8	9,451.1	228,571.3	32,522.3	261,093.6
1994	159,661.6	39,184.2	8,644.8	207,490.6	51,869.8	259,360.4
1995	187,509.2	18,007.6	2,105.3	207,622.1	41,152.4	248,774.5
1996	247,461.2	40,026.3	5,080.5	292,568.0	51,106.1	343,674.1
1997	264,229.4	35,065.9	6,384.3	305,679.6	53,349.5	359,029.1
1998	435,131.7	49,540.1	4,574.4	489,246.2	48,244.7	537,490.9
1999	522,819.5	226,092.1	16,210.7	765,122.3	29,684.0	794,806.3
2000	713,932.6	132,681.7	9,310.7	855,925.0	42,329.0	898,254.0
2001	719,944.3	199,261.5	-	919,205.8	97,768.2	1,016,974.0
2002	519,770.8	460,229.5	-	980,000.3	186,000.4	1,166,000.7
2003	613,790.0	500,430.0	-	1,114,220.0	215,460.0	1,329,680.0
2004	403,461.7	669,070.2	-	1,072,531.9	297,793.2	1,370.325.1
2005	408,420.9	726,226.6	-	1,134,647.5	391,259.0	1,525,906.5
2006	335,534.7	882,850.9	-	1,218,385.6	534,873.4	1,753,259.0
2007	293,583.8	1,410,042.5	-	1,703,626.3	466,001.90	2,169,628.2

Source: Central Bank of Nigeria Statistical bulletin 2007.

FEDERAL GOVERNMENT DOMESTIC DEBT OUTSTANDING

YEARS	TOTAL
1990	84,093.1
1991	116,200.2
1992	161,900.2
1993	261,093.6
1994	259,360.9
1995	284,774.5
1996	343,674.1
1997	359,029.1
1998	537,490.9
1999	794,806.6
2000	898,253.9
2001	1,016,974.0
2002	1,166,000.7
2003	1,329,680.0
2004	1,370,325.2
2005	1,525,906.6
2006	1,553,259.0
2007	2,169,628.2

***Total includes Treasury Bills, Treasury Certificate, Treasury Bond, Development Stock, other bonds.**

Source: Central Bank of Nigeria Statistical Bulletin.2007

Table 1: SOME RELEVANT MACRO ECONOMIC INDICATORS

YEAR	DEFICIT % OF GDP	CAPACITY UTILISATION
1980	23.3	57.5
1981	27.7	55.5
1982	3.6	53.5
1983	9.3	47.8
1984	7.4	39.9
1985	7.2	12.7
1986	12.2	36.4
1987	5.5	42.0
1988	8.4	44.5
1989	6.7	42.4
1990	8.5	3.90
1991	11.0	32.4
1992	7.2	41.8
1993	15.3	37.2
1994	2.7	30.4
1995	0.5	44.8
1996	1.3	36.8
1997	- 0.2	34.4
1998	- 4.7	34.9
1999	- 8.4	36.0
2000	- 2.9	34.5

Source: Central Bank of Nigeria Statistical Bulletin and Central Bank of Nigeria Annual Report and Statement of Account, 2000.

Table 2: BANKING SYSTEM CREDIT TO THE ECONOMY (N'million)

YEAR	CREDIT TO PRIVATE SECTOR	CREDIT TO GOVERNMENT SECTOR	% OF GOVERNMENT
1980	7,190.3	3,596.6	33.3
1981	9,654.4	6,613.4	40.7
1982	11,371.5	10,555.3	47.9
1983	12,353.5	15,828.2	56.2
1984	12,942.2	18,199.6	58.2
1985	13,700.2	18,980.1	58.1
1986	17,365.0	19,455.3	52.8
1987	25,476.1	21,450.1	45.7
1988	29,773.6	45,591.0	76.0
1989	30,942.8	18,316.3	37.02
1990	36,631.0	30,345.5	45.3
1991	45,325.2	38,498.5	45.9
1992	61,020.3	80,715.5	56.9
1993	95,285.0	184,848.7	67.9
1994	122,273.3	228,349.4	65.1
1995	151,065.4	224,677.8	59.8
1996	223,240.5	117,560.0	34.5
1997	276,489.5	54,679.5	16.5
1998	352,359.5	133,929.0	27.5
1999	455,205.2	176,804.9	27.9
2000	596,001.5	(110,202.8)	(22.7)

Source: Central Bank of Nigeria Statistical Bulletin and F.O.S. Annual Abstract of Statistics of Account, 1998.

WEIGHTED AVERAGE DEPOSIT AND LENDING RATES OF DEPOSIT MONEY IN BANKS

YEAR	SAVINGS	PRIME	MAXIMUM
1990	18.80	25.50	27.70
1991	14.29	20.01	20.80
1992	16.10	29.80	31.20
1993	16.66	18.32	36.09
1994	13.50	21.00	21.00
1995	12.61	20.18	20.79
1996	11.69	19.74	20.86
1997	4.80	13.54	23.32
1998	5.49	18.29	21.34
1999	5.33	21.32	27.19
2000	5.29	17.98	21.55
2001	4.49	18.29	21.34
2002	4.15	24.85	30.19
2003	4.11	20.71	22.88
2004	4.19	19.18	20.82
2005	3.83	17.95	19.49
2006	3.13	16.89	18.70
2007	3.24	16.49	18.24

Source: Central Bank of Nigeria Statistical Bulletin.2008