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INTRODUCTION TO ECONOMIC THEORY

DOMESTIC AGGREGATE DEMAND AND INFLATION.

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## Introduction

Aggregate demand is about the total amount of goods and services consumers, companies, governments, and foreign buyers wish to buy at different price levels for a particular period (Gregory & Taylor, 2020). Blanchard et al. (2021) stated that if inflation exists, it means prices are rising gradually in most markets, making our money less effective in purchasing goods and services. The concept of demand-pull inflation illustrates that economic theory considers it a crucial link between aggregate demand and inflation. According to Eichner (2023), when the economy already has low unemployment, additional demand leads to price increases and inflation. Therefore, controlling aggregate demand makes it easier to stop inflation or price changes.

The relationship between inflation and aggregate demand in Nigeria has significant implications for maintaining economic stability and informing policy decisions. In Nigeria, economic fluctuations are often triggered by shifts in government spending, interest rates, and unpredictable changes in the global oil market, which can significantly impact demand and inflation (Central Bank of Nigeria, 2022). The purpose of this essay is to carefully examine the ideas and examples of this interaction, with a focus on Nigeria and an analysis of current policies, and provide suggestions for improvement. The subsequent sections will examine each dimension, first explaining the underlying theory, then providing a detailed analysis of the data, and concluding with recommendations that support effective demand and inflation management in Nigeria.

## Theoretical Framework of Domestic Aggregate Demand

Aggregate demand (AD) constitutes the total planned spending on goods and services within an economy over a particular period, reflecting the relationship between the price level and the quantity of real GDP demanded (Auclert & Rognlie, 2018). Lau (2023) stated that there are four main sections: consumption (what people spend), investment (money businesses put into capital goods and inventories), government spending (what governments buy), and net exports (the gap between what is exported and imported). These components have a significant impact on the fluctuations of the economy. For example, Niemira (2024) explained that when people are more confident about making purchases, they tend to consume more, which boosts demand and supports economic growth. A decline in investment or government spending, resulting from tight budgets or rising interest rates, can reduce the amount of money people spend, potentially leading to a recession (Skott, 2020).

From a theoretical standpoint, Keynesian economic theory provides the fundamental framework for understanding aggregate demand, emphasizing its role as the primary driver of economic activity (Flaschel et al., 2021). According to Keynesians such as Hahn (2019) and Eichner (2023), economies often fail to utilize their workforce due to weak aggregate demand, and the government must increase spending and investment to counter this. For Jumayeva (2025), it is significantly different from classical theories, which assume that markets will consistently achieve full employment without significant external assistance. In practice, Keynesian economic thought has significantly influenced policy, particularly by advocating for actions such as fiscal stimulus following a downturn (Krugman, 2023). For example, the Nigerian government's expansionary fiscal policies during periods of economic stagnation highlight Keynesian principles in action, albeit with mixed results due to structural inefficiencies and governance challenges (Central Bank of Nigeria, 2022).

## Theories and Mechanisms Linking Aggregate Demand to Inflation

Deficit financing, according to Keynesian theory, helps revive the economy by amplifying its effects, particularly when demand is low due to a recession (Jumayeva, 2025). Gabaix (2020) believes that government deficits can increase aggregate demand by either increasing spending or lowering taxes, which allows households to retain more money. This process is expected to result in effective multiplication, so a unit of deficit spending should lead to greater total economic growth (Krugman, 2023). However, Palley et al. (2023) criticise Keynesian deficit financing, stating that it can cause long-term budget gaps and possibly lead to rising debt, which can cause inflation and make the fiscal situation unstable. According to Regil (2021) and Chidinma et al. (2022), the adoption of deficit financing, as recommended by Keynes, in Nigeria and other developing countries has varied and often led to larger deficits when the economy did not grow rapidly enough due to waste, governance flaws, and leaks.

Conversely, Barro (2019) proposed the Ricardian Equivalence hypothesis, arguing that government deficit spending does not affect aggregate demand as Keynes believed. For its part, Barro (2019) explains that as people realise there will be more taxes due to today’s deficits, they save instead of spending any extra money earned from government spending. Based on this hypothesis, it is uncertain that deficit spending boosts economic output. Still, Banday and Aneja (2019) argue that the aforementioned factors, consumer myopia, insufficient liquidity, and uncertainty about future taxes, limit the applicability of Ricardian Equivalence in everyday situations. In Nigeria, most observations suggest that Ricardian Equivalence is not applicable, as consumers tend to naturally spend the money provided by the government rather than saving it for future tax purposes (Isah et al., 2022).

Public choice theory also argues that when governments face budget deficits, politics plays a bigger role than economics (Mengiste, 2020). Self (2021) believes that politicians and bureaucrats sometimes choose to increase spending to gain the support of voters, stay in office longer, or help special interest groups, which might not be sustainable in the long run. According to this theory, continual deficits and rising debt are caused by politicians' self-serving motives, and it suggests that reform within institutions is needed to implement stricter budget rules (Agrawal et al., 2022). Many observations in Nigeria align with public choice theory, as electoral cycles have led to significant growth in public spending, substantial deficits, and an increased burden of public debt (Olujobi & Olujobi, 2020).

## Empirical Analysis of Aggregate Demand and Inflation in Nigeria

Historically, Nigeria’s economy has experienced significant fluctuations in demand and inflation, primarily due to its structural issues, changes in commodity prices, and government budgetary constraints (Okeke et al., 2022). Inflation typically rises when aggregate demand increases sharply, often occurring when the government increases its spending or commodity prices surge (Wuyah, 2020). According to the CBN (2025), Nigeria’s GDP increased during the oil price boom years of 2010-2013, alongside rising inflation, primarily due to higher fiscal policies, increased public spending, and growing consumer spending. Similarly, Andam et al.’s (2020) study highlights how economic recovery initiatives following the COVID-19 pandemic significantly boosted government spending, further exacerbating inflationary pressures within the economy.

An in-depth analysis of case studies reveals that changes in demand within Nigeria have historically led to inflation. An example of this is the inflation spike that occurred in 2016–2017, during which intense recessionary pressures and key fiscal policies aimed at helping the economy recover were implemented (Adaramola & Dada, 2020). Economic growth was hindered at this time by a significant decline in the value of the local currency, following a global drop in oil prices that raised the cost of imports and made domestic goods more expensive (NBS, 2025). After minimum wages increased in 2019, there was a higher demand because people earned more, which led to inflation since not enough was produced to meet the increased demand (Ibrahim & Aliero, 2020). Such examples underscore the delicate balance Nigerian policymakers face when managing demand-side interventions to stimulate economic growth without triggering excessive inflation.

Since managing both aggregate demand and inflation depends on the combination of fiscal and monetary policies, Nigeria’s economy becomes more complicated (Lau, 2023). Usually, Blanchard et al. (2021) posited that fiscal policy, which involves the actions a government takes regarding spending and borrowing, has a direct impact on aggregate demand. Infrastructure projects, subsidies, and social safety nets are often added to the budget to support the economy (CBN, 2022). However, they can sometimes lead to higher inflation if not implemented correctly or due to fraud. Much of the CBN’s (2025) attempts to stabilise the economy have depended on managing liquidity and inflation expectations through MPR and reserve ratios. Nevertheless, occasions when monetary and fiscal policies work at odds, such as borrowing more to finance government projects while keeping interest rates higher, can lead to less successful economic performance and ongoing inflation (Joel, 2021). Therefore, for management to be practical, fiscal and monetary authorities need to cooperate more to keep policies aligned and the economy stable.

## Critical Evaluation of Policy Responses in Managing Inflation via Aggregate Demand

The CBN frequently employs monetary policies to regulate spending in the economy and control inflation rates. The primary actions include setting the Monetary Policy Rate (MPR), managing cash reserves, and conducting open market operations (CBN, 2022). When monetary policy aims to lower inflation by increasing lending rates, it is sometimes less effective than planned, as various factors mitigate the impact of rate changes, including economic rigidity, weak transmission, and limited access to credit for all sectors (Wuyah, 2020). Persistent high inflation, together with shocks from abroad, a falling currency and restrictions on production, often make standard monetary actions ineffective, leading people to argue that over-relying on monetary policies does not solve the key underlying causes (Isah et al., 2022).

On the other hand, Imoudu et al. (2019) explained that Nigeria’s fiscal policy has taken the form of increasing expenditure during periods of low growth and reducing spending when government revenues increase, and its performance in managing inflation by addressing demand in the economy has not been consistent. For Okeke et al. (2022), sometimes, measures to invest more and stimulate economic growth using government funds have increased short-term employment and economic activity. However, they have often led to inflation, especially when budgets are mismanaged and poorly spent (NBS, 2022). Instead, cutting spending and raising taxes to fight inflation commonly slowed the economy, leading to increased unemployment and poverty (Chidinma et al., 2022). Even today, the main issues persist as the government’s unpredictable actions, a gap between financial and monetary policies, and weaknesses in the country’s structure, underscoring the need for robust, coordinated policy frameworks to achieve better short-term and long-term economic stability (Ibrahim & Aliero, 2020).

## Policy Recommendations and Fiscal Reform Strategies

Policy recommendations aimed at enhancing fiscal responsibility in Nigeria must include the implementation of transparent and enforceable fiscal rules. Through these rules, which may set limits on debt or government spending, nations can prevent their budgets from becoming unsustainable and debt from accumulating (Osinuga et al., 2024). Percy and Gloria (2024) explained that the government needs to diversify its revenue, as Nigeria remains vulnerable to fluctuations in oil prices. To become more financially stable, a country can broaden its use of non-commodity revenues, improve tax administration, and close gaps in tax enforcement, thereby increasing its independence from oil and unpredictable commodity prices (World Bank, 2023). When organisations ensure transparency and accountability by conducting regular audits, independent checks, and releasing financial information to the public, it enhances people’s trust. It encourages proper financial actions (Central Bank of Nigeria, 2022).

Furthermore, effective debt management and sustainability strategies are essential for maintaining fiscal stability (Rafindadi & Musa, 2019). Nigeria should establish comprehensive frameworks for debt management, emphasizing responsible borrowing and prioritizing low-interest, long-term loans (DMO, 2020). Policies that guarantee loans only to projects that bring economic gains are crucial for sustainable growth and ensuring debt repayment (Adegbie et al., 2022). Upgrading institutional frameworks requires supporting fiscal institutions, better organizing the Ministry of Finance (2025), the Central Bank of Nigeria (CBN) (2025), and the Debt Management Office (2025), and implementing adequate controls to monitor fiscal outcomes. By implementing these changes, there would be better control over spending, reduced misuse of public resources, and more efficient use of investments, ultimately making the country’s economy more stable in the long run (IMF, 2023; World Bank Group, 2024).

## Conclusion

Ultimately, this essay explored the relationship between domestic aggregate demand and inflation, highlighting that using measures to stimulate growth without negatively impacting prices is crucial for effective economic management. According to studies on Nigeria’s economy, it has been demonstrated that aggregate demand plays a significant role in determining inflation levels when the government borrows excessively and the economic system is inefficient. The analysis showed that maintaining inflation control requires a collaborative effort between fiscal and monetary policies, supported by a transparent government and prudent budgeting.

Essentially, the findings emphasise that handling aggregate demand should involve close consideration of stimulus effects to avoid causing unsustainable inflation. Moderate government spending, correct implementation of monetary policy, and a diverse mix of industries in the economy are necessary for sustained economic growth and stability. Next, attention needs to be given to analyzing how central banks and governments work together and how original tools can be used to address challenges arising from the outside and internal weaknesses. Furthermore, conducting studies on how demand changes for various sectors in Nigeria would help guide targeted inflation control and the formulation of more effective economic policies.

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