The Impact of External Reserves and Investment on the Wealth of Nigerians

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Abstract
External reserves constitute an integral part of the wealth of the nation such that the lack of it brings worry to most nations and can limit the ability of the country to make foreign currency denominated payments and limits its spending abroad. With the continual increase in the price of crude petroleum in the world markets, Nigeria has been enjoying increases in the external reserves position in the international markets. However, the paradox is that the poverty level in Nigeria contradicts the country's immense wealth and external reserves. Therefore, the objectives of this paper are basically two. One, is to find out if Nigerians are better off in the process of accumulation of the external reserves, and if the wealth of the nation is impacting their lives, and second, what best opportunity to apply this funds to enable Nigerians share in and benefit from the external reserves. To achieve these, two regressions were used for the measurements. A single regression of Two Stage Least Squares method (TSLS) was adopted in order to solve the problem of simultaneity bias which violates the assumptions of classical regression. The result showed that the investment or Gross Fixed Capital Formation is significant and more important in the wealth of Nigerians than in the external reserves. Thus the paper recommended that public investment be undertaken to improve the quality of life of Nigerians and their wealth in the process.

Introduction

Most nations of the world are covertly or overtly concerned with the total stock of the external assets they hold at any one time as the world tend to compare the stock of assets available to the nation from whatever it has with the standard of life. The significance of external reserves in the nation's economy stem from the fact that it represents what is immediately available to the nation to meet external obligation without having to resort to borrowing and acceptance of aid. External reserves constitute an integral part of the wealth of the nation such that the lack of it brings worry to most nations and can limit the ability of the country to make foreign currency denominated payments and limits its spending abroad. Of recent, the external reserves of the nation have come into focus, following superlative performance of monoculture product of the country in the international markets. With the continual increase in the price of crude petroleum in the world markets, Nigeria has been enjoying a boom in its external reserves position in the international markets as price hit all time high of $99.00 (amidst increases in the nations exportable quota). The nation's reserves reached an amount of $52 billion as at October 2007, after Nigeria settled monstrous and annihilating debt owed to London and Paris club of creditors. The improvement of the asset led to the appointment of the external assets managers to invest the resources and to earn rates of return commensurate with the market on them.

The appointment of external managers, apart from meeting the management of reserves as its common today, was also to help achieve the internationalization of the operations of Nigerian banks through integration via the joint management process. The Central Bank of Nigeria, being a national fiduciary and as a regulator, finds it difficult to operate freely in a market where banking institutions operate. As at today, Nigerian banks have not recorded any benefit after their names were used to collect and receive the funds by the overseas banks and this has prompted the banks to continue to source capital to meet the benchmark placed by the Central Bank of Nigeria for the management of the funds.

Given the formula used for revenue allocation in Nigeria, much of the funds so aggregated over the years are being disbursed regularly by the Central bank after strident calls by the elected officials of the nation, who in the name of developing their respective areas have continued to request for the sharing of the reserves. For the government it has provided some level of liquidity and has helped in executing some developmental projects (legislators have been calling for funds to develop their constituencies!), but it is also apposite to mention that much has been lost to wastage, outright theft and corrupt practices.

In the present circumstance, the ideas people entertain are that the nations is worth so much in dollars externally and this resources continue to flow in through the increase in the prices of this wasting and irreplaceable asset, but has not been translated into development or growth in the nation (Ojo, 2007). Neither is the Nigerian anywhere better off perceivably by this increase in the assets nor does the present circumstances portend a likely improvement in the lives of the ordinary Nigerians, which then invokes fear and trepidation in the hearts of Nigerians if things will ever improve.

The objectives of this paper are basically two. One, as the title suggest to find out if Nigerians are better off in the process of accumulation of the external reserves, and therefore if the wealth of the nation is impacting their lives, and second, what best opportunity to apply this funds to enable Nigerians share in and benefit from the external reserves. To do this, a simple hypothesis that the Nigerian has not benefited from the continuous increase of the external reserves is proposed in the null form. For this purpose, the paper is structured into five sections comprising of the present part as introduction, a theoretical underpinning of external reserves and wealth components, the methodology adopted to perform this tasks, observations and recommendations in that order.

2. Review of Literature and Theoretical Framework
External Reserves

External reserves are regarded as assets of a nation through the Monetary Authority of the country. The assets are held in stocks, currencies or other financial instruments that allow one country to settle amounts owed to other countries (Reserve Bank of South Africa, 2005). In this way, it may include gold as this was and is still the prime commodity money in use throughout the world. It equally consists of gold, SDRs, foreign currencies, and other liquid assets held by a central bank (Aremu *et al*, 2006). The main function of the external reserves is the backing up the domestic currency Other functions include the following, according to Nugee (2002), as a tool of exchange rate or monetary policy, servicing foreign currency liabilities and debt obligations, source of funds to pay for government expenditure overseas, defense against emergencies or disasters and investment fund. Therefore, external reserves are assets held externally by the Central bank that is convertible and available for use to meet stated and official needs of the government of the day. The recent accumulation of the external reserves by some Central Banks of today stems from financial mercantilism (Aizenman, 2006) of the Asian tigers that encourage the continuous production of goods by inducing the industries coupled with all manners of policies for export market. (China is stocking or *hoarding* $1,430,000 million as at October 2007). This practice is believed to have started from the experience of the contagion that rocked the four Asian countries in the late nineties from which the countries lost heavy amounts of foreign exchange to capital flight.

In this wise, China was accused of stockpiling reserves, and so do some of the emerging economies, including Nigeria. The issue raises the question of optimal level reserves required to run an open economy and hence the Calvo/Guidott rule of three months import requirements may be insufficient to meet national needs when other factors like debt and foreign investment especially of the portfolio stock have been introduced to the scenario. Accumulating external reserves *can* help in dealing with issues that could lead to capital flight by ensuring confidence. Reddy (Governor of Reserve Bank of India), believes that there are many hidden benefits in holding large stocks of foreign reserves though there are costs which generally offset the benefits (2006). The international rating agencies attach higher weights to large reserves which include:

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maintaining confidence in monetary and exchange rate policies; enhancing the capacity to intervene in foreign exchange markets; limiting external vulnerability so as to absorb shocks during times of crisis; providing confidence to the markets that external obligations can always be met; and reducing volatility. The need to maintain large reserves is also positively proved in Adetiloye (2007) where it was found out that the keeping large foreign exchange has impacted positively on the volatility of the exchange rate. The asset belongs to the monetary authority who has exchanged the foreign reserves for local currency for those who brought in the foreign currency in the first place. But then the monetary authority is a statutory corporation created by the State to perform the functions that could lead to market chaos if allowed to be performed by competing firms

Balance of Payments

A record of economic transactions between one country and the rest of the world which the International Monetary Fund (2006) defines as, the flow and not stock of financial assets and liabilities complied on a specific date. Economic transactions in this case are those that affect the capital or financial and current accounts of the balance of payment. The third part of the BOP may show the International Reserve Position. The mastery of the national accounting process and workings of the Balance of Payments (BOP) enables the understanding of linkages between economies of the world. The management of the two sections of the accounts has to do with controls and restrictions or the opening up of the accounts. The IMF was quoted to have said that it may teach or advise the opening of current account but completely unsure of capital accounts (Eichengreen, 2000). With an open or liberalized current account, the country tends to purchase from overseas at the rate of exchange dictated by the position of the BOP (high exchange rates when the BOP is in deficits and low rates when the BOP is in surplus), while with the capital account no assurance can be given because of the flows that cannot be fully followed as some inflow would be hot money and others for direct investment. The *above the line* and *below the line* elements of the BOP ensures that the current account mirrors the expenditure pattern of the country, which consequently affects the position of the capital account. Since more than current account transaction is reflected in the capital account, the capital account becomes the focus of transfers between the country and the rest of the world. The trading position of the country is revealed by the buoyancy or otherwise of the BOP. Changes in the BOP reflect the trading and investment position of the country, with the following notation:

$$BOP = CA + KA + E\&O - \Delta FXR = 0,$$

where the BOP is $= 0$ and CA, KA, E&O and ΔFXR represent current account, capital account, errors and omissions, and changes in the foreign reserve position respectively. The BOP seldom balances and the statistical discrepancy is introduced into it to bring out a balance. The inclusion of the internal sector, according to Jhinghan (2003, 1053) brings about this equation

$$S+T = C+I+G + (X-M)$$

where C is consumption expenditure, S domestic saving, T tax receipts, I investments expenditure and G Government expenditure,

$$C + S + T \text{ is GNI or National Income (Y)}$$

with the first term being *absorption* and below as:

$Y = C + I + G + (X - M)$.

In equation form: $BOP - Y = C - I + G + (X - M)$

which represents the relationship between the BOP and national income.

National Income Accounting Process

This is a method and process adopted in the measurement of production and income in a country (Britannica Encyclopedia, 2005). It is the monetary measurement of the total goods and services produced in a country in a particular year. There are three known methods of accounting for the income of the nation namely: the product, income and expenditure methods. The commonly used method of the three is the product or output in the economy. In spite of the difficulties encountered in the measurement of the national income, this is usually undertaken to enable the development policy makers know areas of focus for the nation.

Apart from the problems faced in accurate measurement, the GDP (an invention of Simon Kuznets during the WW II) and GNI are not easily arrived at. Equally NNP which recognizes subsidies, taxes and depreciation is an important measure of national wealth (Fraumeni, 1997). For a nation that produces a wasting mineral, Nigeria's crude petroleum has been the major contributor to the national wealth. A new national statistic, GO (Gross Output), is now added to the national figures by some other nations of the world, in order to correct for the shortcomings of the GDP measure (Skousen, 2001) and is defined as intermediate II output plus GDP (final output only), where Intermediate Input (II) represents the sale of all products of natural resources in manufacturing and wholesale markets. GDP represents the value in the final retail market.

Heal (2004), exhaustively discusses the wasting nature of mineral resources and that as a curse, the producers are often aggravated with economic, social and political problems that makes it imperative to consider their accounts as producing an overestimation of what they are really worth, because conventional income accounting does not give room for possible depletion of the asset. The need for sustainability of the national welfare is important to be sure that what has been claimed continues. For Nigeria to be sure that there are less malpractices in the upstream sector of the petroleum industry and to maximize the benefits in full, she must take charge of many things being done at present by the foreign oil companies, given the importance of the resource to the economy (International Herald Tribune, 2007).

In the process of national income accounting the following variables used are:

Expenditure is a control measure to vary the level of output in an economy, by inducing production and engaging the government in expansionary budgetary policies and to induce increases in aggregate demand, the highly correlated nature of expenditure and income makes it possible to influence one by the other, but the banks' introduction of assets acquisition schemes

Selected Human Development Indicators for Selected Years

Parameters	1985	1990	2000	2001	2002	2003	2004	2005	2006
Phone subscribers per 100	0.28	0.31	0.47	0.78	1.76	3.00	7.37	14.01	23.5
Internet users per 100	-	-	0.06	0.09	0.32	0.56	1.28	3.54	5.53
Roads, paved (% of total)	-	30.00	-	-	-	-	15.0		
Adolescent fertility rate per 1000	-	-	158.31	-	153.26	-	-	136.66	131.1
Births attended by skilled officers	-	33.00	-	-	-	36.3	-	-	
Improved sanitation facilities	17.00	54.00	35	35	36	45	53	62	62
Improved water source as % of population	-	51.00	52	-	-	-	53	-	-
Income share by lowest 20%	-	49.00	49	-	-	48	-	-	-
Malnutrition prevalence	-	35.1	-	-	-	27.20	-	-	-
Poverty headcount ratio National Poverty Line	43.00	-	-	-	-	-	-	-	-
Primary completion rate	-	-	-	-	-	72.42	71.28	-	-

Source: World Bank (2007)

Consumption, a measure of development of a nation, it is also the total goods and services produced per time. It is a measure of the level of income and goods and services available to the population. The term connotes the ability of the man to make purchases for personal use and has become a source of concern as it is now seen to be undermining the resource base and exacerbating inequalities both domestically and worldwide. This is causing the dynamics of consumption-poverty-inequality and environment nexus to accelerate (UNDP, 1998). Therefore, major consumption in the economy is done by the rich and the middle class.

The major contributor to the external reserves - the export of crude petroleum - belongs to Nigeria and Nigerians and therefore is a national wealth. The political economy of Nigeria does not allow higher than 13% revenue to meet derivation purposes which when received by the benefitting states, can be invested in growth inducing sectors of their economies but this is not so. The issue of oil derivation and sharing is a contentious issue outside the scope of this work. While non-oil producing areas have been encouraged to produce more for export purposes through the provision of export incentives by NEXIM and other agencies, there seem to be little

achieved on this side. The tendency to look at, and see the CBN's assets as that of the nation is compelling because it is statutorily owned and controlled, but it is a going concern that should exists not to depend on the government but to be self sustaining and therefore participate in the financial system, as it is a financial fiduciary (Broz, 1998) though should nor pursue profit. Then the reserves belong to those on whose behalf the CBN is holding it, and may belong to it where it has paid Naira worth for it. In this way, the CBN is seen as an *advanced* Bureau de Change!

3. Methodology and Results

The method adopted to find out the impact of the external reserve involves the use of the ordinary least square method to know the relationship that exists in the wealth of Nigerians as to the stocks of external reserves held by the CBN. The general model in form of regression using the OLS method is employed to investigate the impacts of the accumulation of the reserve on the wealth of Nigerians. There are two regressions involved to do the measurements. A single regression of Two Stage Least Squares method is adopted in order to solve the problem of simultaneity bias which violates on the assumptions of classical regression. The instrumental variable of external reserves will be used. In the process variables that are instrumental to the regression are specified in the regression equation 2

One measures the impact of the external reserves on national wealth using per capital GDP and thus we propose

$$PerCapGDP = f(Inv + exterrese) \dots\dots\dots\dots\dots\dots\dots\dots\dots (1)$$

Where exterese is taken to represent the external sector of the economy
A second regression is proposed to test and investigate the relationship of the external reserves to the wealth and the general living standards of the Nigerian

$$exterrese = f(consumption + curaccbal) \dots\dots\dots\dots\dots\dots\dots\dots\dots (2)$$

where *currenccbal* represent current account balance of the BOP or X-M

The impact of the external reserve on per capital GDP of the country becomes sharply clear as the results show. This is expected. The components of the GDP include a section of the BOP which captures the external sector. The adjusted R^2 of .986 and adjusted R of .969 is high showing that only .14 of the causes in the improvement of the GDP cannot be accounted for by the equation 1. A comparison of the impact of GFCF and external reserves show clearly that the GCFC is more important in the per capital Gross capital formation process than external reserves. The results show that GFCF has higher positive unstandardized coefficients than external reserves 0.010 to 0.080 though both significant at 10%. The coefficients correlation between the two variables show a negative of 1.000 to − 0.937 indicative of near perfect negative relationship

between the two. In essence the gross capital formation increases by expenditure of public resources, including the reserves. An earlier performed regression results show that the Durbin Watson statistics is well tolerated at 1.978. The collinearity statistics of VIF (variance inflation factor) and tolerance show 34.723 and 0.029 respectively for external reserves and 20.996 and 0.048 for capital formation in the economy as vector for increase of production. F statistics in this case is 277.922. The importance of the GFCF is further exemplified the fact that it is significant beyond 1% levels. However the negative correlation that exists between the two variables can be explained in form of the expenditure that the country makes to increase the capital stock in the economy through public sector investment. Since investment is highly significant in the per capita income we conclude that the external reserves have not contributed the wealth of Nigerians (Data is provided in the appendix).

4. Recommendations

Based on the data and results, the capital formation of the country has grown slowly while the external reserves have increased over the same period. The Human Development Indicators (World Bank, 2007) earlier shows the level of the value of life commanded by Nigerians and the rate of growth of these indicators do not match the growth rate of the external reserves. This being so, the country should be making public investment to increase the capital formation process to increase value of life. In the process, the values of investment made should be the actual value delivered as corruption has become a kind of tax on the economy. This needs to be done noting fully that major supplier of foreign reserves in the economy has been petroleum which is a exhaustible resource. Areas of investment that should be of utmost concern for the economy are the infrastructure, education (to increase human capital both in quality and quantity), potable water, energy and health provision and the improvement of social amenities. Encouragement needs to be given to investors to invest more in the economy to increase capital stock from the private sector. This would act as impetus for both domestic and foreign investors. In actual fact, the investment process should be a partnership between the private and the public where the public makes autonomous investment which definitely would induce the other type of investment to the benefit of Nigerians of all hues. One consideration that is outside the topic but important however is the control of inflation in the process of making public expenditure to increase per capital GDP. Ingenious ways of controlling the challenge might be careful management by various means which include direct overseas expenditure (not advisable) securitizations of debt that would so accrue careful injection of foreign proceeds and sterilization measures.

Conclusions

This paper has looked at the impact of external reserve in the wealth of Nigerians. The wealth of Nigerians has not been evenly distributed as the Gini coefficient shows, but has used the Human Development Indicators as proxy for the wealth of Nigerians. Since the HDI can

only increase or improve through investment, this paper concludes that the government should make further investment to improve the standard of living of the people (population) which has also been found to be increasing in leaps. The improvement in the investment climate should be done in order not to increase the level of inflation in the economy but induce other investment from the private sector. The data analyzed proves that increasing the GFCF can increase the wealth of Nigerians more than the accumulation of external reserves.

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Data Employed in the Regressions

Year	Per Cap	GDP	External Res	Consumption	Investment
1970	169.4	5,203.7	104.6		
1971	121.1	6,570.7	132.3		
1972	157.5	7,208.3	191.6		
1973	189.7	10,990.7	241.0		
1974	259.8	18,298.3	3,112.5		
1975	282.6	21,558.8	3,380.1		
1976	358.8	27,297.5	3,057.6		
1977	345.6	32,747.3	2,521.0		
1978	339.6	36,083.6	1,249.1		
1979	426.6	43,150.8	3,043.2		
1980	469.0	50,848.6	5,445.6		
1981	510.6	102,686.8	2,424.8	34,563.1	12,215.0
1982	481.6	110,029.8	1,026.5	36,297.3	10,922.0
1983	329.7	119,117.1	781.7	41,060.2	8,135.0
1984	295.2	125,074.8	1,143.8	47,430.2	5,417.0
1985	325.8	144,724.1	1,641.1	53,331.1	5,573.0
1986	500.0	143,623.9	3,587.4	55,934.6	7,323.0
1987	1,128.0	203,037.1	4,643.3	79,628.3	10,661.1
1988	1,201.5	275,198.2	3,272.7	113,013.3	12,383.7
1989	2,005.0	403,762.9	13,457.1	136,569.7	18,414.1
1990	2,512.0	497,351.3	34,953.1	169,309.2	30,626.8
1991	2,900.7	574,282.1	44,249.6	218,692.8	35,423.9
1992	5,899.3	909,754.2	13,992.5	396,156.5	58,640.3

1993	4,795.7	1,132,181.2	67,245.6	529,623.6	80,948.1
1994	5,124.6	1,457,129.7	30,455.9	686,989.8	85,021.9
1995	21,951.0	2,991,941.7	40,333.2	1,517,235.9	114,476.3
1996	26,910.0	4,135,813.6	174,309.9	2,331,306.8	172,105.7
1997	27,042.0	4,300,209.0	262,198.5	2,401,595.9	205,553.2
1998	24,050.0	4,101,028.3	226,702.4	2,712,511.3	192,984.4
1999	27,966.9	4,799,966.0	546,873.1	2,089,505.3	175,735.8
2000	39,039.0	6,850,228.8	1,090,148.0	2,331,878.2	268,894.5
2001	44,488.5	7,055,331.0	1,181,652.0	4,225,976.9	371,897.9
2002	45,669.5	7,984,385.3	1,013,514.0	5,805,085.0	438,114.9
2003	59,819.6	10,136,364.0	1,065,093.0	4,979,560.0	429,230.0
2004	74,480.0	11,673,602.2	2,252,644.0	5,372,560.0	456,970.0
2005	98,587.2	N	3,835,433.0	N	

Sources: CBN (2007) Statistical Bulletin (N'm)

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Results Summary

PerCapGDP	Dependent		Multiple R.	0.986
Exterresse	Predictor		R Square	0.972
Investment	Predicator		Adjusted R	0.969
Currenabal	Instrumental		Durbin Watson	1.978
Consumption	Instrumental			

Coefficient Correlations

			Extreserv	Investment
Equation 1	Correlations	Extreserv	1.000	-.937
		Investment	-.937	1.000

Coefficients

		Unstandardized Coefficients		Beta	t	Sig.
		B	Std. Error			
Equation 1	(Constant)	-186.519	1219.271		-.153	.880
	Extreserv	.010	.004	.338	2.705	.016
	Investment	.080	.014	.676	5.614	.000