**CHAPTER ONE**

**INTRODUCTION**

**1.1 Background to the Study**

Countries have been known to develop through the accumulation of savings that have been profitably invested to yield returns and increase production in different sectors of the economy. Such investments could be social or soft in outlook (housing, health and education), while others are infrastructural or hard (transport, power and water), and yet others are purely economic, which the private sector undertakes for private capital accumulation. This has made monetary authorities promote the domestic savings within the economy, since it seems that the primary source of finance for investment is savings. Such accumulated capital has been allowed to freely flow from their countries to others over the years and this has been on for centuries. Such capital flows however became quite pronounced during the nineteenth century, especially during the upheavals in Europe, between the countries and continents of the Northern Hemisphere. At that time, capital moved from those countries of Europe to the Americas in search of higher returns (Cardoso and Dornbush, 1989).

Following a retreat to nationalism and redirection of resources to winning the two world wars, capital flows between countries resumed after the World War increasing gradually to the level it has assumed in recent times. The process of financial globalization, and some other factors, from which every economic unit attempts to maximize returns, seems to have accentuated this trend as capital flows and movement became more fluid and pronounced after Second World War, especially from the 1960s. The trend of movements from the countries of the North to the South existed up to the early 1970s but has been later replaced with a South to North trend. While capital flows within the Western world seemed to have been continuous overtime, the case of capital flows out of the Less Developed Countries to the Western world became noticeable from the early 1980s. Since then, these unusual flows have become a source of concern because of the macroeconomic challenges facing these countries, and as a result of the paucity of much needed capital to develop and promote growth in these countries. This unusual flows of capital from poor to rich countries is termed capital flight

Capital flight specifically refers to the movement of money from investments in one country to another in order to avoid country-specific risks (such as hyperinflation, political turmoil and anticipated depreciation or devaluation of the currency), or in search of higher yield. Capital flight has become an issue in recent times in the Nigerian financial environment such that three national dailies (*The Guardian, Daily Vanguard* and *The Sun*) ran editorials on it between April 11th and 20th 2010. Flights of capital in Nigeria manifest themselves in many ways, among which is the country’s loss of an estimated sum of $95 million (₦655.46 million at $1/₦145.00) as payments to counterparties outside the country over the last twenty years (between 1986 – 2006) due to lack of indigenous technology (see - *The Guardian* editorial of 8th of February, 2007. Empirical studies of the Nigeria situation reveal that a total nominal sum of $107 billion of Nigerian assets was reported to have flown out of the country according to Lawanson (2007) for the period of 1970 to 2001, while Collier *et al* (2003) estimates capital flight out of Nigeria to be about $75 billion for the period of 1970 - 2000. These two figures are far from being close, because of the numerous reasons and different estimates of capital flight, the fact that capital flight continued unabated and the different estimation methods adopted by each of the studies.

Trillions of US$ (dollars) move around the world in response to the stimuli of return and safety (IMF, 2006). The International Monetary Fund further reports that offshore held assets amounted to some $11.6 trillion and income from such assets was $866 billion as at year end 2005. As a result of this, about $255 billion is lost in tax revenue regularly by countries suffering from capital flight – being a proof of the effect and the challenge of capital flight. The IMF has expressed concern over this issue: "....in light of the conventional wisdom suggesting that capital normally flows from capital-rich (developed) and mature markets to capital-scarce (developing), emerging markets".

An estimate of capital flight at this period is important in order to know the relationship existing between it and domestic investment in Nigeria. While many studies have been done on the topic, very few of these studies have been undertaken in relation to investment by Nigerians themselves. The studies of Ajayi (1990) which covered the period between 1970 and 1989 need a revisit. The studies of Onwudoukit (2001) did not provide any estimate and that of Lawanson (2007), was basically on capital flight with no relation to any other economic variable. These studies provided estimates to show the impact of trade misinvoicing or trade faking. The producer price compounded figures for trade misinvoicing were put at $316,888 million ($316.9 billion) and $436,092.3 million ($436 billion) by Morgan Trust and World Bank respectively as at 2001 using the residual methods. These figures are at variance with Collier’s, and need some clarifications. However, none of these studies empirically studied capital flight with its impacts on investment in the domestic economy.

The uses to which capital in flight are deployed are many, and became noticeable when developing countries’ holdings of earning assets in form of Certificate of Deposits (CDs), real estate or negotiable bonds became significant and could no longer be ignored (Cardoso and Dornbush, 1989). Nigeria, a country with a large poor population is classed among the developing countries of the world, though she earns much foreign exchange from crude oil exports, she is still in need of capital to develop, maintain and upgrade her infrastructure. Nevertheless, the country has been faced with continuous outflow of capital, which has made some scholars conclude *a priori* that the country is facing capital flight challenges.

Capital flight studies are so important to emerging financial markets that it has become difficult to have a uniform definition or estimates because of peculiarities of each country. Each study finds a definition for its country of study. While it can result from an immediate and spontaneous reaction to the changes in the economic circumstances of a country, it can also be a continuous challenge. The components of the capital fleeing the country need to be fully analyzed, their routes need to be known and the legitimacy or otherwise of these routes, as well as their residency status and the methods adopted for it.

For these reasons, there are many definitions and estimations, which are included in the works of Cuddington (1986), Morgan Trust and Banking Company (1987), Cumby and Levich (1987) to Lessard and Williamson (1987). Each of the definitions has its own peculiar way of measuring or estimating capital flight and the various components that make it. Each of these definitions is not exactly like any other one. This is one reason researchers in this area would calculate many figures to form a band that suggests that, capital flight for a specific country, is between one estimate and the other.

Since the methods adopted for capital flight appear to be discrete and assisted by domestic and foreign financial institutions through which these funds leave, the degree of openness and transparency of such transactions are limited. This has made the topic even more interesting, and discussions unending, especially against the backdrop of lack of capital resources for various investment needs in the economy. Walters (2002) describes capital flight and other flows as follows: “International flows of direct and portfolio investments under ordinary circumstances are rarely associated with the capital flight phenomenon. ‘....r*ather, it is when capital transfers by residents conflict with political objectives that the term ‘flight’ comes into general usage*.” This description becomes instructive in the light of macroeconomic changes in Nigeria in the past seven to ten years (2000 – 2007). Walters describes capital movements as activities involving:

1. Transfers via the usual international payments mechanisms, regular bank transfers are easiest, cheapest and legal.
2. Transfer of physical currency by the bearer (smuggling) is more costly, and for many countries illegal.
3. Transfer of cash into collectibles or precious metals, which are then transferred across borders.
4. Money laundering, the cross-border purchase of assets that are then managed in a way that hide the movement of money and its owners, and
5. False invoicing in international trade transactions.

Meanwhile, within the domestic economy, the importance of investment has been realised by successive administrations long time ago, especially of foreign direct investment. This has made many successive governments to do *something* about the encouragement of its inflow. Various governments have encouraged inflow of foreign investment through policies enunciations rather than concrete steps to implement policies formulated and establish a culture of encouraging domestic investments by residents as a way of life. Various administrations have employed public image-makers to polish Nigeria’s image, with the heads of government travelling around the world to canvass for foreign investors. In addition, various laws have been enacted to establish institutions and special units (such as Nigeria Investment Promotion Council) to foster economic and investment growth, among many others that have been done to encourage investments but to no avail.

Investment in the domestic economy by indigenous investors has been low because of the preference to invest outside the economy. There are various reasons for this preference. Successive governments’ efforts to improve and encourage domestic investment by indigenous investors have not yielded the desired results; but have showed deeper interest in the encouragement of inflows of Foreign Direct investment (FDI) into the economy. While the advantages of FDI in terms of its additions in form of entrepreneurial possibilities, advantages, marketing and managerial expertise that come with it cannot be overlooked, the failures of domestic investment promotions is disturbing and cannot encourage economic growth and development. However, the promotion of Foreign Direct Investment inflows to the detriment of domestic investment is inappropriate since charity should begin at home. Meanwhile, the encouragement of domestic investment in the face of various daunting risks has proved to be impossible and has been unsuccessful.

Domestic investment is only possible with aggregated domestic savings which itself is a function of the level of income. However, the rate of investment *vis a vis* growth has proved to be negligible. Uchendu (1993) found that there is a positive but low correlation between savings and investment in Nigeria. The Nigeria financial environment records low savings resulting from low income; low income itself is as a result of low investment which can only generate low savings – thereby forming a vicious circle. Given that the available domestic resources are the only sources of investment, then the rate of investment committed would be low. However, other sources of investment, such as foreign inflows of capital can be used to supplement domestic investment.

# 1.2 Statement of the Problem

Capital flight reduces domestically available investible capital. Domestic investment is expected to have a negative correlation with capital flight. Given that inflows of Foreign Direct Investment (FDI) should complement domestic capital, capital flight has constituted a problem. Domestic investment of either autonomous or induced type was not considered in earlier studies in relation to capital flight. In spite of governments’ continuous campaigns for foreign investors to invest in the domestic economy, capital flight has continued unabated. This raises a concern on the effect of capital flight on domestic investment. Where previous studies were done on capital flight, they were not specific on Nigeria. Investments that lead to increase in capital formation for the economy and act as the foundation for infrastructure or framework for the development of the country cannot be made in the face of inadequate capital.

Capital flight being a challenge to domestic investment is exacerbated by the process of financial globalisation that enables capital to move freely between countries. Since capital seeks the best avenue where it can earn the highest return given a level of assumed risks, the domestic investment environment has not been clement enough for investment. Financial globalisation, in some cases, has rendered some national governments’ monetary policies ineffective. Since financial globalisation connotes the liberalisation of the capital account, it enables capital to move in and out of the domestic economy with reduced level of restrictions. Emerging economies that have been forced to open up their economies have faced episodes of capital flight as results of financial globalisation induced crises. Countries that that liberalise their capital accounts are more prone to financial crashes or at least financial volatility because of the multifarious impacts of unrestricted capital flows involving them. Studies of financial globalisation induced volatility and flights of capital have generally left Nigeria out even where less prominent countries like Namibia were empirically investigated. Financial globalisation is expected to impact negatively against capital flight as a result of inflow of capital into the economy. This is expected to boost domestic income and lead to financial and real development. But its effects in those countries have not been so productive but have rather brought market failures.

Capital flight has been caused partly by lack of confidence by domestic investors in the economy and has encouraged domestically generated capital to flee from the economy. While foreign capital that has been invested in the economy can leave after some time if the investors’ objectives are achieved, domestically generated capital flowing offshore should generate and report returns. However, a situation that encourages domestically generated capital to find solace and investment grounds abroad leave much to be desired. The concern here is that the level of autonomous investment that should be undertaken suffers because capital has relocated out of the economy. Given the level of infrastructural deficit (the main situate of autonomous investment) facing the country, the required capital to construct, replace and rehabilitate infrastructure is either not domestically available or would be sourced at some expense. A second issue on resident capital is that per capita income goes down as capital flees. This reduces per capita income productivity. The scenarios generate macroeconomic challenges for policymakers as to how to retain resident capital in the economy in the face of competing real rates of return in developed and mature financial markets.

The study of capital flight and aggregated financial savings in the investment process is important since a cycle has been established between income, savings and investment. The loss of investment that happens when capital flight occurs means equally that some savings are lost to the economy. Research on capital flight seems not have reached this point of discourse. Since income is also a strong determinant of savings, the impacts of this scenario on financial savings under the golden rule level of capital in conditions of capital outflows and flight is also a financial concern. The golden rule level of capital is defined as a steady state with the highest level of consumption that benevolent policymakers should achieve for individual’s well being. With this, the rate of investment is detrimentally affected especially under increased domestic consumption propelled by population increases. This ultimately affects further capital formation. The role and the impact of the exchange rate is in the process is exemplified by the understanding that capital in the domestic economy has alternative uses in capital formation

**1.3** **Objectives of the Study**

The major objective of this study is to analyse the impact of capital flight on the Nigerian domestic investment in a financially globalising world, with the aim of finding out if capital flight can increase through financial globalisation and thereby reduce domestic investment in the process. The specific objectives are:

1. To examine the relationship between capital flight and domestic investment, and sum up the challenges posed by capital flight to domestic investment during the period of financial globalization in Nigeria.
2. To evaluate the impact of capital flight on financial savings since it is the primary source of financing investment.
3. To find out the type of capital flight and estimates that is more significant and therefore relevant to Nigeria.
4. To investigate the role of the nominal exchange rate and its impact in encouraging capital outflows and domestic investment in the economy.

**1.4 Research Questions**

To achieve the earlier stated objectives, the following research questions become pertinent:

1. What is the existing relationship between domestic investment and capital flight in Nigeria?
2. Given that capital flight and outflows have continued as proved by earlier studies, how has this affected domestic savings that drive investment
3. With the export performance in the period from 2000 to 2007, especially of the petroleum sector and prices of other commodities that resulted in a seemingly buoyant accumulation of external reserves. What has happened to capital fight?
4. What is the impact of the incidence of capital flight in the era of financial globalisation indicated by a high level of openness and capital account liberalisation?
5. With the uneven level of development between the different countries of the world, and especially the developed countries and Nigeria, how can Nigeria limit further capital leakage out of the economy when the return-risk dimensions in investment paradigm are taken into account?
6. What is the role of the exchange rate in the capital flight process, given that the flotation of the currency has been on since 1986 when the currency has been on managed float?
7. With continuous flights of domestic capital from the economy, how has domestic investment in Nigeria fared within the current financial globalisation period?

**1.5 Statement of Hypotheses**

1. H0: Capital flight has not significantly affected domestic financial savings in Nigeria.
2. H0: Risk in the macroeconomic conditions of the country does not have a long run relationship with capital flight out of the economy.
3. H0: There is no significant relationship between the process of financial globalization and capital flight out of the country.
4. H0: Capital flight in the Nigerian economy does not have a significant relationship with domestic investment.

**1.6 Significance of the Study**

Given the fact that capital flight is an established phenomenon in the Nigerian economy (Ajayi 1992, Onwuodokit 2000, Collier *et al* 2003 and Lawanson 2007), the understanding of its major negative impact on investment in Nigeria is important. The need to empirically investigate the relationship that exists between capital flight and investment cannot be overemphasised. Various studies have always concluded *a* *priori* that capital flight brings about the lack of investible funds in the economy and pushes the country to seek external resources to meet developmental needs (Ajayi, 2000). The implications arising from this would bring about a decision that would enable resident capital to be profitably invested in the economy rather than having to seek alternative investment outlets outside. This area has not been addressed by any previous study on Nigeria, though some studies have been done on other countries. It is believed that this study bridges this gap.

Financial globalisation has become an observable fact following the liberalisation of most countries’ capital accounts and especially the floating of the exchange rates. This study investigates the impact of the financial globalisation process on capital flight in Nigeria. Nigeria had to implement the floatation of the Naira as part of the cross-conditionality of the International Monetary Fund to secure support for its Structural Adjustment Programme (SAP) in 1985/1986. Also, this study enables the understanding of the impact of the adoption of a floating exchange rate regime on capital flight and empirically tests if the process has had negative or positive impact on capital flight in Nigeria. In the process, the determinants of the financial globalisation and the current status of Nigeria can be easily understood.

The study brings out the effect of accumulation of reserves on capital flight out of Nigeria. Also the use of the reserves over the years can be fully understood, and the possible more productive ways to direct the reserves in future years. For instance, the external reserves of Nigeria which have gone up to about $60 billion in 2007 had dropped to less than $30 billion dollars as at December 2010.

## The literature is replete with the various estimates and definitions of capital flight. Though all point to the same direction that capital is lost to the economy suffering from capital flight, the peculiar definition that best fits the Nigerian type of flight can be fully understood as a result of this study. The study brings to light the many estimates or definitions most relevant to Nigeria. This will avail policymakers the opportunity to direct efforts at how to eliminate the challenge in the most effective way possible

Nigeria is presently overwhelmed with the infrastructural deficit that has impeded the development of the country and its transformation into an industrial economy. In addition, the economy has constantly lost resources to capital flights over the years. The study will help bring policy makers back to the issues that need to be addressed in order to attract further capital inflows in FDI and retain resident capital domestically and thereby reduce capital flight out of Nigeria.

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It is arguable if capital flight has increased the depletion of external reserves which seem to the hallmark of emerging economies among which Nigeria has been classed of recent. The external reserves of the country steadily increased through accumulation and good performance of the commodity sector of the economy especially petroleum from 2004. The ostensible reason for the maintenance of high level of reserve was for liquidity and as measure to attract FDI. In spite of seeming progress of this classification by Goldman Sachs (2003), capital flight has continued unabated especially without the attraction of corresponding quantum of foreign investment and capital into the economy. In spite of the view of some studies that that capital flight should not result from high level of reserves as it should increase the confidence level of the foreign direct investor, the reverse has been the case. Nigerian external reserve has been high at over $60 billion as at 2007 but has steadily reduced to about $33 billion by December 2010 without corresponding increase of FDI inflows.

Different definitions exist for capital flight by different studies using different estimates. The three commonest definitions are those of the World Bank (essentially from Cuddington), Dooley and Morgan Trust Banking Company which all came out in 1986. Though the different estimates point to the fact that capital flight estimates are country-specific, it nevertheless require that attention be paid to a specific definition that may allow the country to deal with the problem using the particular and the most significant estimates. The most significant determinants can then be used to unravel the main issues that need to be focused on in the search for the solution to the problem of capital flight in Nigeria. Noteworthy also is the fact that the literature has also began to make a distinction between illegal and legal capital fight.

## 1.7 Scope of the Study

This study is centred on Nigeria and there is no comparison with the estimates of capital flight and its incidence with those of the Latin American (LATAM) countries, and a number of emerging economies of the world among those of South East Asia. Capital flows occur from countries to countries throughout the world and can become a concern when the flow becomes heavy and is enough to disrupt the financial system. When the quantum of capital flows is continuous, it becomes capital flight as capital flees either to safety or to secrecy. As a result, of this, nearly all countries are involved in the capital flows management attempting to avoid heavy flows that degenerate into capital flight. Cursory references may be made. However, this is done to investigate if the case of Nigeria is significantly different. Data from 1970 – 2007 are to be used in the study. The period covers both pre-globalisation and globalisation years. Also attempt is made to find the long run relationship for these periods in the analysis.

## 1.8 Outline of the Study

The study is arranged in five chapters. Following after this chapter (chapter one) is the review of extant literature on the main concepts. Definitions of capital flight and its various dimensions, concepts of open macroeconomics and capital account liberalisation area are discussed before concepts of domestic investment and financial globalisation. These concepts are narrowed down to Nigeria with available empirical studies. In addition, the empirical literature that pertains to Nigeria is reviewed. The importance of net errors and omissions as used in the Balance of Payments are discussed. The influence of the international banking and offshore financial markets especially within the context of the ECOWAS and Nigeria banking institutions are also discussed. The impact of illegally acquired wealth from corruption by public officials and private agents, which leads to capital flight, is also put in perspective. The causes and routes of capital flight in Nigeria are reviewed. The chapter will also review the scenarios of capital flight around the world and its impacts on such other flows as foreign debt and aid.

Chapter three presents the theoretical framework, research methodology adopted and the *raison d'être* for each method. This consists of explanation of data sources, details of the data transformation and model specification adopted in this study. The choice of secondary sources of data and its transformation are explained. Chapter four presents all the results, starting with the stationarity tests. The regression estimates, interpretation of results and the discussions of other findings that are of interest in the study are also included. Finally, chapter five summarises the study and recommendations are made and subsequently conclusion is drawn.

### CHAPTER TWO

### REVIEW OF LITERATURE

**2.0 INTRODUCTION**

Capital flights and its movement among countries are important economic issues that countries have to grapple with in the development process because of the importance investment assumes in the domestic economy. The issues of capital movement is known to be heavily politicised (Walters, 2002). Since capital, in the development process passes through investment in the economy to increase income and induce other investments, its importance cannot be overemphasised. When capital leakage occurs in an economy, much resource and opportunity for growth is lost. The processes of such movement are eased by the spate of globalisations sweeping through countries. Globalisation itself has been held to enable efficient allocation of capital within the world economy. Flows and flights of capital occur to move capital from one economy to another and therefore have serious economic and financial implications in the countries suffering and benefitting from them. This scenario is compounded by the country’s need for investment capital domestically.

This chapter reviews important literature to this study in terms of capital flight and investment issues juxtaposed with episodes financial globalisation sweeping across the countries The fluidity of capital in those countries that have lost substantial amount of capital to flights of capital before now and without the current episodes of financial globalisation underscores the importance of investment in domestic economy that has been lost. Investment done by private firms and non-public firms are the most hit by the lack or paucity of investible funds that result from the episodes of capital flight, which causes the economy to lose substantially in the long run. Episodes of loss of confidence in the financial system and the economy can be debilitating often which can lead to a contagion in a financially integrated region. Capital flight continually produces new estimates as more researches are done on the phenomenon. Issues that were considered less important before suddenly become significant due to dynamics in the economics of countries.

**2.1 CAPITAL FLIGHT**

**2.1.1 CONCEPTUAL AND DEFINITIONAL ISSUES IN CAPITAL FLIGHT**

The various definitions of capital flight came up when capital flight became topical in the 1980s, following the series of sovereign debt defaults by Latin American countries, especially by Mexico and Argentina. This prompted the World Governing Financial Institutions (WGFI) to begin both academic and professional studies and researches on the subject. Of the three WGFI, the International Monetary Fund (IMF) has been at the forefront of research on the topic and has given proactive advice to countries perceived to be suffering this plague as to what to do to control the problem.

Capital flows from developed countries should not be much of concern but can be if it bothers on the capital movement from capital scarce countries to countries with abundant capital. Capital outflows measured against the Gross Domestic Product or income must be less than percentage growth for it to be insignificant. The outflow of capital becomes capital flight when the GDP increases at a lower rate than capital outflow. Flows of capital will continue around the world as long as countries trade with one another. The treatment of capital flight has moved from the old methods of examining the Errors and Omissions and other sections of BOP to national factors and particularly on resident capital issues (Schneider, 2003). The capital flight episodes can be country-specific and may not be fully generalized.

The countries and regions that have experienced capital flight have had varying degrees of capital flight resulting from among others, completely liberalized capital accounts, macroeconomic mismanagement, political factors and business and investment related reasons. Since capital flight figures are estimates, some of the capital adduced as capital flight may not be necessarily so, but errors in the recording process and unrecorded flows. While those countries that have experienced the flights of capital have been involved in some forms of political and economic crises or other, measurement of capital flight have also captured normal and regular flows as well.

The issues of foreign aid and debt induced capital flight and their implications in these countries become relevant. The impact of corruption and illegal movement of funds across countries on capital flight cannot be brushed aside in the current episodes as well. Collier *et al* (2003) considers one of the implications of capital flight as the brain drain that has compounded the woes of those countries as they lose out in the movement of human capital who are seeking better returns for their services across the countries of the world. The influence of war and other disruptive social-economic and political tendencies on capital flight in these countries cannot be treated in isolation. The impacts of transition and emerging economies where *spontaneous privatizations* have taken place in certain parts of the world resulting in capital flows and flight (such as in Russia) should also be considered. The influence of private banking and the activities of international financial institutions in capital flight which used to be strong have waned.

There are many definitions of capital flight, which has made it a very wide area for researchers and this has caused the material on it to be voluminous, with every researcher attempting to define or explain his or her own definition. The original definition of capital flight is rooted in political and economic uncertainty of the domestic economy (Kindleberger, 1937). To overcome the definitional problems of this subject, there is the need to look at the dimensions capital flight can assume and the process by which it can be carried out.

The foundation of capital flight is in economic, political as well as social risks. The economic dimension is founded on by the fact that as economic agents and entities have the freedom to choose in what form to hold their assets, so do they also have the freedom of choosing where to hold such assets, either in the domestic or foreign economy.

Cuddington (1986) defined capital flight as short-term speculative outflows out of a country. This is taken to mean outflows that would involve the acquisitions of assets overseas plus net errors and omissions in the balance of payment of the country. The error and omission figure is a strange element introduced into the balance of payments to cancel out any discrepancy, which could have arisen as result of some accounting reasons. Cuddington’s definition is synonymous with the term “hot money flows.” Hot money is capital looking for investment with guaranteed high returns, given an acceptable level of risk, wherever it can be found in the world, within a stipulated time frame (usually short) and quickly leaves as soon as this objective is achieved.. The definition recognizes that the non-bank private sector entities are involved in capital flight. Dooley (1986) believes that this form of capital in flight often responds faster to *expected* *returns* or risks factors and variations in the macroeconomic conditions affect such flows. The capital may be repatriated to its origin when the risk environment improves. This normally exposes the balance of payments to serious volatility. Basic risks capital flight has posed to resident capital are loss of income or outright capital losses as a result of exchange rate devaluation or depreciation.

A second definition of capital flight, by Khan and Ul Haque (1987) defines it as gross private short-term capital flows in addition to net errors and omissions in the country’s Balance of Payments. The two definitions above tend to agree. The basic difference between the two is the term ‘speculative’, while Khan and Ul Haque look at capital flight from the point of normal capital flows, Cuddington looks at it from the point of speculative flows. One of the important aspects of strategic financial management today is asset or portfolio diversification, which has its advantages. Should portfolio diversification out of the country be taken as capital in flight? This might be so if any of the following conditions do not exist:

(a) such investment is expressly legal

(b) diversification is investment and not speculation

(c) returns are received or reported at home.

Otherwise it becomes capital flight.

A third definition, by Morgan Guaranty Trust Company (1986) is "the reported and unreported acquisition of foreign assets by non-bank private sector and elements of the public sector." This definition attempts to estimate capital flight indirectly as the counterpart of net direct investment inflows in addition to increases in gross external debts minus outflows through current account deficits and less the acquisition of foreign assets by the banking institutions and the monetary authorities. This definition has been criticised by Cline (1986) on the basis that items not within the control of the authorities like the income from tourism, cross-border transactions and reinvested income (which are included) should be deducted from such estimates.

One usually acceptable definition sees capital flight as all private capital outflows from developing countries, be they short-term or long-term, portfolio or equity investments (Ajayi 1992) and (Oloyede, 2002). This definition considers simply all outflows of capital out of the developing economies irrespective of the purpose or by whom. This is perhaps one of the broadest definitions of the subject. With this definition, capital that leaves the economy for investment purposes changes character and finally return may be classed as capital in flight. The basis for this definition, Oloyede argues, is that developing countries, of which Nigeria is one, are capital poor and therefore should not have capital flowing out but staying, and that the country should be a net borrower in the development process, supplementing domestic resources with borrowed capital from abroad. The bottom line of the issue is that capital is lost to the country suffering from capital flight.

Capital flight has been referred to as the movement of money from investments in one country to another in order to avoid country-specific risks (such as hyperinflation, political turmoil and anticipated depreciation or devaluation of the currency), or in search of higher yield. It is seen in massive foreign capital outflows from a country, and reflected often of domestic currency instability. The outflows, when they occur, are large enough to affect a country's entire financial system.

The definitions are not all concerned with economic phenomena, but also political. Capital flight, which happens as result of macroeconomic changes and expectations, is linked to the changes in the value of assets and expected returns. However, some amounts of capital can flee due to political reasons, to which the above definition alludes. The political aspect of the topic is content-deep, as capital flight has been traced to people and politics of countries. Vu Le and Zak (2001) adopted the Morgan Guaranty Trust definition, while not attempting to define the phenomenon in spite of the thrust of their paper, agree that the causes are not all purely economic. In the current globalizing world, where capital movements through the capital account of the BOP is unhindered and unrestricted, a new definition for capital flight should consider the freedom of choice of the wealth holder to choose where to hold his investment and in whatever form. This is where portfolio theory of capital flight is founded.

Ayadi (2008) adopting the Error Correction Mechanism (VECM) in the Nigeria’s case, discovered that the revolving door, interest rate differentials and exchange rate are significant and agrees that the capital flight erodes the economy of critical financial and economic resources that could otherwise be deployed to financing growth and recommends the targeting and removal structural distortion from the Nigeria economy in order to abate capital flight.

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###### 2.2. CAUSES AND ROUTES OF CAPITAL FLIGHT.

Ajayi (2005), revisiting the issue and mentioned the various causes of capital flight in any economy as, varying risk perception, exchange rate misalignment, financial sector constraints and repression, fiscal deficits, weak institutions, macroeconomic policy distortions, corruption by political leaders, and extraordinary access to government funds among others. Each of these causes has its effects on the economy of the country where capital is fleeing. For instance, the risk perception goes with the theory of portfolio selection.

Exchange rate misalignment encourages the development of parallel market premium in the foreign exchange market and exposes the wealth holder to capital losses should devaluation or depreciation happen. Financial market repression regulates return to capital and does not allow the financial institutions to develop products and services that meet clients and customers needs, thus encouraging them to seek investment of their funds outside the shores of the country. Fiscal deficits and macroeconomic distortions in the economy encourage flights of capital because of their attendant effect on the instability of exchange rate they bring about. Corruption by political leaders and extra ordinary access to government funds lead to unwholesome transfer of funds overseas for the main purpose of escaping sanctions and seizures by government. (This is mainly attributed to management of the external sector, especially of the foreign exchange rate. Many countries have moved from fixed exchange rate to floating rate regime where the risks are borne by the market participants and not the monetary authorities).

Perhaps, a compelling hypothesis of capital flight is that of macroeconomic and financial instability in the system leading to lack of confidence. As residents’ confidence in the domestic assets as a means of earning income wanes, they begin to purchase foreign assets. Various African Ministers of Finance and the Central Bank Governors in their meeting in Ethiopia in 1991 cited macroeconomic instability as the major culprit responsible for capital flight. The proceedings, edited by Roe (1992), cite the following as major destabilising features in their various countries economies:

1. persistent negative real interest rate, which indicates that the rate of inflation is higher than interest rates payable on deposits,
2. overvalued foreign exchange rates which discouraged export of commodities and encouraged imports that invariably led to the use of exchange restrictions to control outflow of funds and thus led to fiscal volatility, and
3. The loss of confidence in the financial system, all in tandem.

The quantum of these actions led to capital flight in each of the countries. With supporting evidence from Brazil, it has been discovered that excessive use of exchange rate control can be damaging to the external sector as it depicts lack of confidence to foreign investors. Bhagwatti (1978), Krugman (1987), Nembhard (1996) and Mahon Jr., (1996) all justified the use of exchange controls as a controlling measure in case of serious outflow of capital from the domestic economy. This can only be used in the short-term. The use of exchange control was tested by Pinheiro (1997) and concludes that that Brazil’s capital flight estimates generally support his thesis that a functioning set of government’s interventionist policies (a government intervention in the foreign exchange market) which uses capital controls can help to curb capital flight. The major problem with this is its sustainability. For example, Brazilian capital flight increased significantly in the 1980s when government intervention policies began to break down.

The above issues on macroeconomic instability are linked to structural adjustment programs (SAP) of the IMF and debts being owed by the country. The origin of macroeconomic issues is often the nature of trade engaged in by the country leading to accumulation of trade debts. This induces the need to seek loan from the various sources where they can be obtained before they become odious and repayment becomes unsustainable.

In reviewing the volatility route of capital flight, the role of foreign aid in the arrangement is important. It has been asserted that aid can indeed lead to capital flight. Bluir and Hamnan (2003) believe that because of the volatility of aid, the increasing use of governance conditionality can lead to capital flight because of minor political events which can cause macroeconomic instability in the economy.

Another route that has been identified is the Dutch disease route, according to (Corden, 1984). This has to do with the appreciation of the real effective exchange rate (REER), which then affects the tradable sector and the exports of the economy detrimentally and in the process much more rsources than the economy can absorb is available per time. This will tend to shift available capital abroad for investment purposes. Bevan *et al,* (1999) believe that this is the main reason why the non-oil export and foreign private investment collapsed in Nigeria in the 1980s. Therefore, with no non-oil exports backing, exports values nose-dived in later years. When the export prices of oil collapsed, it consequently affected the Balance of Payments negatively. This is one of the arguments of resource curse as it affects Nigeria. Capital flight is expected to come in two fronts: here during oil boom years – through de-industrialization of the economy and high level of corruption – both good grounds for this phenomenon. Various cures have been prescribed for the disease.

As a tool of political oppression, rationing of available foreign exchange introduces bias to the allocation of this scarce resource during an import-licensing regime and can be seen as a tool of oppression of the government of the country by the opposition (Coronel, 2004). This is possible where distrust is pervasive between the government and firms owned by members of the opposition. This was prevalent in Latin American countries, especially in Venezuela. The test of this assertion is difficult but nonetheless important in order to know the extent and empirically test the reliability of the assertion. While studies of capital flight have been carried out, researchers have said little about the components or composition of gross flows that net off to constitute capital flight, as though they are of no consequence. The evidence here is that a number of countries have assets outside their shores and at the same time having a sizeable amount of foreign debt (Dooley *et al,* 1983). While capital flight, as a private concern flows in one direction, public capital flows in the other direction, occurring simultaneously (Eaton, 1989).

It may be wise to conclude, as in many of the studies that the incidence of capital flight is due to increase in the country risk that has to do with the nature of the country and governance problems. Examples abound in the classic case of Brazil as found in Pinheiro (1997), and many studies involving Collier (1999, 2000, 2002 and 2003). The country risks feature prominently in the Nigerian case.

## 2.3 CAPITAL FLIGHT AND CAPITAL FLOWS

The subject of capital flight is often included under the topic of capital flows while countries that have done some researches refer to it simply as capital flows, which makes it sounds less illegitimate and less unethical in development economics and international finance. The reasons for this treatment or compartmentalization is rooted in the economic importance and understanding of investment and portfolio diversification, especially as it concerns acquisition of assets overseas by residents of a country. There are two basic reasons why an entity may want to hold assets in foreign economy. Firstly, it protects the assets from a dwindling currency that normally happens where the local or domestic currency may be facing devaluation, or when depreciation of the currency is anticipated. In order to avoid this problem or the possibility of capital losses, the agent simply transfers such assets into a currency where some stability is assured – this is capital in flight.

Secondly, the exportation of capital from a country is seen as a means of diversifying assets, rather than holding one portfolio, spreading of investment is advised to the investor. This is seen in the light of investors investing resources outside the domestic economy, for diversification purposes. In this wise, the investor, who has diversified becomes a foreign investor who could now be a foreign direct or portfolio investor, with noticeable impact in the macroeconomic condition of the host country. The capital is lost to the home country but a gain to the host country. The challenge here is that factors that affect foreign private direct and portfolio investments must equally manipulate capital flight since both are included in capital flows. Before now, the traditional explanatory factors that have been held to be responsible for the behaviour of exchange rates movements, such as the impacts of international trade and cross border flows have declined somewhat, capital flows having increased in importance in the meanwhile (Moosa, 2004). This comes in a bundle and has been defined variously by WFGI in manners that suited their purposes.

The classifications of capital flows and flight can be nebulous is adequate line is not drawn between the two, namely when does capital flows become capital flight. The following can be considered as signposts of flight rather than flows:

1. The quantum of capital outflows relative to the financial system, especially M2 and macroeconomic growth variables,
2. Persistence and continuous nature of the flow which builds pressure on the domestic currency,
3. The ‘reverse’ flow consideration: that is capital flows that is not of the debt flowing from developing countries to developed countries.

**2.3.1 Public and Private Wealth or Capital**

The definitions of these two terms notwithstanding, there arises the need to distinguish private capital or wealth from public wealth or capital.Collier, Patillo and Hoeffler (2003 deals with capital flight and flows issues as it concerns capital and wealth on one hand and public and private on the other. Public wealth is the total stock of assets that is available to a particular nation at any point in time. The wealth of a nation here includes all that pertain to the nation in terms of investment goods and other publicly accumulated assets less liabilities. In other words, public wealth is common good available to all and every member of the community or society, but its direction and use is often controlled by the appointed representative or leaders of the people. Private wealth is the accumulation of the micro units in form of the individual or the firm in the society. This is equally a stock aggregated from flows of income. Private wealth is not available to the general populace and is controlled not by appointed leaders or representatives, but the holder or the owner. The holder directs or deploys it the way he or she chooses including investment in any country of choice. Public wealth is directed by the leaders and for the purpose of the people. Capital flight as private sector activity could only involve public capital if there is a leakage of public capital to the private sector. The table below shows capital flight per region per worker.

**Table 2.1**

##### Private Wealth and Its Composition by Region

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| |  |  | | --- | --- | | Region Public Wealth  per ($) per worker | Private wealth Private capital Capital flight Capital flight  per worker per worker per worker Ratio | | SS Africa 1271 | 1752 1069 683 0.39 | | L. America 6653 | 19631 17424 1936 0.10 | | South Asia 2135 | 2500 2425 75 0.03 | | East Asia 3878 | 10331 9711 620 0.06 | | Middle East 8693 | 6030 3678 2352 0.39 | |

**Source**: **Flight Capital as Portfolio Choice** (**Collier, Patillo and Hoeffler (2003)**

**2.3.2 Capital Flight and Wealth of a Country**

Capital flight reduces the welfare of the people of a country. The meaning of wealth is often associated with the stock of capital a person, business firm and a country holds. It is taken to be money, savings, investments or some other form of financial capital. Real wealth is not just about possessions because the word real depicts tangibility or visibility, which gives it form. Thus, wealth is defined not only in terms of financial investments but also in terms of tangible riches that can be seen as evidence of well being.

The wealth of a nation is measured in terms of its ability to produce and the stock of goods or infrastructure in place in the country. President John Fitzgerald Kennedy in 1963 defined wealth or the Gross National Product (GNP) of a country to include the air, other environmental and ecological factors surrounding national wealth and things that make life worthwhile. Webster’s Dictionary defines wealth as “asset in whatever form that has the capability of being used to produce more wealth.” This definition resembles the one for capital, which makes some people often want to substitute wealth for capital in today’s lexicon. Principally, the part of wealth taken out or withdrawn to be used to produce income is capital. Therefore, capital is that part of wealth engaged in production, while income or return is the gains made from capital invested.

Wealth is a stock, which differentiates from income that is regarded as a flow. The terms are generally measurable. Different types of capital exist as we noted in the first part of the chapter. The one often referred to most are financial and physical capital. Human capital and social capital exist as well, as they can be used to build more wealth. The Organisation for Economic Cooperation and Development (2001) defines social capital as relationships, networks and norms that facilitate the collective action and human capital as the knowledge, skills, competencies and other attributes of each individual that facilitate the creation of personal, social and economic well being.

The flights of capital reduce aggregate domestically available capital for either investment or consumption in the economy. It affects both the Gross National Product (GNP) as well as Gross Domestic Product (GDP) though unequally. The adverse effect is seen more significantly in domestic product aspect than the national product, since some capital may not be traceable after it leaves the shores of the economy.

**2.3.3 Capital Accumulation or Formation**

Capital accumulation or formation refers to the process of amassing or stocking of assets of value, the increase in wealth or the creation of further wealth. Capital formation can be differentiated from savings because accumulation deals with the increase in stock of investments and not necessarily all savings are invested. Investment can be in financial assets, human (capital) development, real assets that can be productive or unproductive. The increase in investment through non-financial assets has been held to increase value to the economy and the increase in the gross domestic product through further increase in employment.

The focus of investment in the accumulation process is increase in the total net fixed capital formation for the country, foreign direct investments and increase in household assets on annual basis. Over the years there has been continuous debate on growth theories and the function of capital in the process. Both Keynesians and Neo classicalists have disagreed on the function of capital in the process of growth. Thus from Solow (1956), Kaldor (1957) and through to Sraffa (1960), there are deluge of agreements and disagreements on the issue. Sraffa and Robinson were of the Cambridge school while Samuelson and Solow were of the MIT. These sustained the exogenous growth model. The model was an extension of the Harrod-Domar growth model with the inclusion of productivity and growth. The essence of all these is to explain the significance of capital accumulation in the economic growth and development process. These economists agreed with the H-O theory on capital mobility and its impacts in the growth process.

Of recent, there has been a dissenting view that capital accumulation has nothing to do with economic growth or development according to Easterly and Levine (2001). Before this study, the widely accepted view was that capital and its accumulation affects and influences growth. Easterly and Levine insists that the process of growth was not necessarily fuelled by capital accumulation, but by some specific endogenous variables in each of those countries. They made the following observations:

1. Residual or other factors rather than capital accumulation are responsible for the growth in income and growth differences across countries.
2. Income diverges over the long run.
3. Factor accumulation is persistent while growth is not persistent and the growth path of countries exhibit remarkable differences across continents.
4. Economic activity is highly concentrated with resources flowing into the richest areas.
5. National policies are closely associated with long run growth rates

In spite of all of these, why does capital still flow from one country to another?

The answer is not farfetched from the possible real returns from investments and its safety in different sectors of the economies of countries where growth and development is induced and encouraged. The factors that encourage the flows of capital from one economy to another are rooted in the domestic policies of the country receiving such investment or capital. The argument that capital formation and accumulation are the main causes of development that, the receiving countries have received cannot hold true, because it is not capital formation or accumulation that drives growth. Nevertheless, capital is attracted to the best environment where it can be profitably invested for real returns with little attendant risks. In order words, the environment to large extent determines if capital inflow or flight would occur or not. Therefore, it is possible that capital flight takes place because the environment is not conducive for capital to be stay and thrive.

**2.3.4 Portfolio Theory in Capital Flight**

One common reason for preference for overseas investment is the portfolio theory argument. Discussions on portfolio elicits high level of esotericism, when they tend to become dynamic, as static models and one country assumption can be easily understood and assimilated. The considerations of currency, real effective exchange rates, possibility of foreign or home bias, influences by the level of risks and real rates of return makes matters to be slightly complicated (Tille and Wincoop, 2007). However, the portfolio approach to international flows and flights of capital have been accepted as the most popular (Obstefeld, 2004). In the analyses of many of the flights of capital investigated, the portfolio approaches seem to have gained upper hand. The choice depends so much on the choice of investors who choose where to hold their wealth, either at home or overseas. The choice of either of these is influenced a lot by the risk and return trade off and other considerations.

Kraay and Ventura (2002, 2003) in their analyses, grouped the drivers of international portfolio flows into two namely: portfolio growth and portfolio reallocation models. The portfolio growth components are defined as increases in the national savings that lead to capital outflows which equals to the rise in national savings times portfolio share of foreign assets. The second one is active portfolio reallocation of wealth across assets. Capital outflows that relate to portfolio reallocation reflect a change in portfolio shares away from passive portfolio, since changes in assets price affect portfolio shares without any asset trade- a dimension known as passive portfolio management. The above scenario abandons the other relative factors that are involved in the inflow and outflow on the exchange rates and equity prices. An appreciable increase in the inflow of resources will undoubtedly affect the real effective exchange rate and the prices of the available equity stocks at home. This is the current position with our stock market and the relationship with the rate of exchange in its bubble days at about 2007 and 2008. This implies that the inflows of foreign portfolio funds into the capital market need to be monitored in order for it not to result in capital flight in the nearest future.

One the most statistically significant theory of capital flows is the portfolio choice argument. The argument has been seen in more than one way. So important is the portfolio approach that Lane and Millesi-Ferretti (2004) and Obstfeld (2004) have called for the continuous use of portfolio approach in the explanation of countries of open economy dynamics. Kouri (1976) and Dooley and Isard (1982) did not support the use of portfolio approach initially with microeconomic foundations as a result of lack of empiricism and because it was in its formation stages. The campaign nevertheless received caution earlier in Obstfeld and Rogoff (2002) as to where to draw the line in dynamic first order open economy before the current position. In Deveruox and Saito (2006), it was found that the existence of nominal bonds and the portfolio composition of net foreign assets is an essential element and a significant cause of capital flows between countries. When investors adjust their gross positions in each currency’s bonds, countries can achieve an optimally hedged change in their net foreign assets (or their capital account), thus facilitating international capital flows.

## 2.3.5 Risk and Uncertainty in Capital flight

Politics can affect asset distribution in an open economy, with politics being seen as an investment risk. Capital flight has been seen to arise as a result of risks, actual or imminent, especially when the risk of reduction in capital value or returns in the assets holdings is anticipated. In practical sense, capital flight is defined as the difference between total private capital outside the domestic economy and that part for which interest income is identified and reported. By the non-reporting of the returns, it can be said that such capital is lost to the country. Collier *et al* (2001 and 2002) have concluded that the incidence of capital flight anywhere in the world is in response to portfolio choice and risks.

The discussion on political risks is terse and more economic risks are assumed in the works of previous researchers. Cerra *et al* (2005) is of the contention that researchers have started directing attention to non-macroeconomic variables such as political risk factors. For instance, Gibson and Tsakalotos (1993) had earlier concluded that political risk and expected depreciation of the currency were significant determinants of capital flight in five European countries they studied. Similarly, Fatehi (1994) took it further by inferring that political instability often adversely influences inflow of Foreign Direct Investment into a country. Fatehi argues “whatever keeps foreign investors away from a politically volatile country should influence capital flight as well”. Also, Lensink, Hermes, and Murinde (1998) examined the relationship between political risk and capital flight for a number of developing countries.

Conclusively, Schneider (2003) defines capital flight as that part of the outflow of resident capital that is motivated by economic and political uncertainty. This implies that the political uncertainty will involve likely change of government or governmental policies as denoted by country instability and all forms of minor and major changes in the political arrangement in the country, which returns the argument back to Vu Le and Zak (2001). They concluded that no matter how capital flight is defined conceptually and (or) measured, political risk factors matter in the case where no other macroeconomic variables are taken into account. In all of these, no definition was provided for politically induced capital flight, which affects confidence in the economy of the country, Cerra *et al* (2005) concludes.

## 2.4 LEGAL AND ILLEGAL CAPITAL FLIGHT

Borrowings and debt acquisitions that become capital flows into a country through government and official sector have proved to be veritable sources of capital flights in Less Developed Countries (LDCs) as found out by Ajayi and Khan (2000). There was a drastic increase in the level African countries debt from $18 billion dollar in1975 to $220 billion in 1995. One of the ratios used to measure sustainability of debt, the GNP/Export ratio moved from 51 percent to 270 percent with South Africa and 300 percent without. Specifically, in the case of Nigeria, Ajayi believes that the debt problem arose because of the specific structural defects inherent in the economy, and goes on to show, after testing econometrically, that the most significant variables are nominal effective exchange rate (NEER) and the terms of trade (TOT).

The tests in Ajayi and Khan (2000) reveal that there are more capital flight episodes under the military than under the civilian administration, and more flight took place in the oil boom years than the lean years of oil sales. The study was not emphatic as to conclude that the military governments encouraged capital flight or not since the level of economic performance during these periods were not the same. These constituted the legal capital flights.

Cardoso and Dornbush (1989) first hinted at the possibility of illegal capital flight when they refer to the type of capital flight that took legal channels being dominated purely by profit motive, since capital flight is more of a private sector activity. Baker (1999) established the strongest link between capital flight and political corruption, when he divided capital flight into two: legal and illegal. The legal aspect of capital flight covers the movement of capital out of the economy, which involves the proper transfer of after-tax profits, which is documented as it passes through the borders and remains in the books of the entity from which it is transferred.

On the other hand, the illegal component is tax evading and therefore illegal from the country from which it originates and thereafter disappears. Of the $7.3 trillion assets under management by the offshore banks around the world for various purposes, among which is corruption, as at March 2001, about $500 billion of these assets is said to have emanated from transitional and developing economies into western bank accounts or some other offshore bank accounts. Baker (1999) insists that the motivation for the two forms differ as the legal capital flight flees to safety, while illegal capital flight flees to secrecy to transform or metamorphose. Legal capital flight that flees to safety might return after a return of the economic environment to a more clement situation, but little of illegal capital that flees to secrecy ever return. When it does return, it is as foreign direct investment, or as interest on principal loans and dividends on share capital: but it never fully returns.

The basic components of illegal capital flight are:

1. Corruption through government officials, which arises out of misappropriation or embezzlement of public resources, bribe resources and kick-backs received and paid into foreign bank accounts
2. Trade misinvoicing and transfer pricing and tax evasion to generate illegal returns.
3. Criminal money from the illegal trade in drugs, children and women, arms, counterfeit goods and other like activities.

The ease with which these types of capital moves around stems from elaborate tax havens, secret jurisdictions, shell banks, dummy corporations and fake foundations. Baker (2007) says that in the case of illegal capital flight it might be impossible to trace out a misinvoicing. This is because of possible agreement between the parties on the method of transfer right from onset. He illustrated with two perfect hypothetical examples. One of the reasons for the furtherance of underground economy is that corruption and other anti social vices are allowed and can thrive. The line of difference between money laundering and illegal capital flight is fuzzy, as money laundering is seen as movement of illegal proceeds (from terrorism, drug trafficking and the like) through the financial system to clean it of illegality and criminal trace.

The World Financial Governing Institutions seemed helpless in the scourge of illegal capital flight which was generally ignored until the shout by Baker. Kaufmann (2007) in a conference on Illicit Financial Flows organized by Global Financial Integrity Network agreed that reporting problems exist, but that the World Bank is looking at a way to attack them frontally. There are two general options: an upstream approach (anti-money laundering) or a downstream approach (recovery of stolen assets). He added that the World Bank intended to lecture the developing countries on the evils of financial corruption but it is the responsibility of rich countries to recover stolen resources stashed with them.

**Table** **2.2**

**Estimated Cross -Border Flows of Dirty Money US$ Billions (1999)**

|  |
| --- |
| **Illegal Financial Flows Globally From Developing and** |
| **Transitional Economies** |
| Corruption $30 to $50 $20 to $40 |
| Criminal $331 to$ 549 $169 to $238 |
| Commercial $700 to $1000 $350 to$ 500 |
| Total $1.061 to $11,599 $539 to $778 |

**Source**: **Capitalism’s Achilles Heels: Raymond Baker (1999) Page 169.**

Bakre (2002) also, mentioned the tax evading activities of the Multinationals or Transnationals as a serious cause of capital flight as Baker mentioned their role in this act through transfer pricing. The paper mentioned Halliburton- Oil servicing and Engineering Company Ltd, Shell International Petroleum and Chevron Nig Ltd. The Transnationals (TNCs) engaged in the transfer pricing activities are only interested in increasing sales turnover and not profits. The activities of the transnational companies in the area of transfer pricing can be measured if one is able to access their records from the overseas operations and the home consolidated accounts, but it is outside the scope of this study.

Corruption seems to have its foundation in poverty and attempts to escape from it. However, political corruption stem from funding of political parties (Walecki, 2006), which must be clearly seen as the heart of political finance and electioneering campaign costs. As a result of continuous noticeable outflow of resources outside the country, non-Governmental Organizations (NGOs) have used the term capital flight to campaign and advance their causes in various ways.

The effects of illegal capital flight have been the underestimation of flows of resources between countries in the following areas, according to Baker (2007),

1. **Foreign trade**: When imports and exports are falsely priced to shift capital out of the country, national accounts are underestimated and do not capture the elements of mispricing, this suggests that trade deficits and surpluses are wrongly measured.
2. **Capital outflows and Inflows**: The overpricing and under pricing are actually capital flows which is not seen in the national accounts.
3. **Gross Domestic Output or Product**: This is wrongly stated by both countries involved in mispricing of exports or imports.

**2.5 RISKS AND CORRUPTION**

**2.5.1 Macroeconomic Risks**

Risks generally concern the possibility of the expected return deviating from the actual. In simple terms, it means the probability of an unexpected outcome. There is a constellation of different types of risks in economics and finance numbering over fifty. All the risks in international banking and finance are grouped into two: namely sovereign risks and country risks. Sovereign risks address the freedom a country has to decide what it wants to do through the will of its people because it should be a popular decision by them. Such decision becomes a sovereign decision, which can only be altered by the people. The decision is exercisable by the government on behalf of the people. It is a counterparty risk that a court cannot adjudicate on since it is a people’s decision. Decisions, such as debt repudiation and other sovereign decisions can hardly be redressed by the counterparty, except it has the ability to impose and enforce sanctions. Country risks address the types of risks that come from the country’s institutions, circumstances and the failures that arise from their operational practices. This work addresses this area and not money laundering.

Risks in the process of capital flight involves the investor not being able to meet the target or expected return on his investment and the fear of capital loss occasioned by inflation, exchange rate depreciation or devaluation, interest rate misalignment (encouraging hot money flows), lack of foreign exchange, expropriation and other macroeconomic factors. In essence, the risks factors are concerned with economic phenomena that impact on the eventual value of investments at the end of the investors’ horizon. These risks are subsumed in the country risks group (Erb *et al* 1996). International Country Risk Guide (ICRG), a guide issued by an international consulting firm on countries around the world is an authoritative document in this area. Of these risks, the most common and perhaps biggest, however, is devaluation of the currency by the country. ICRG groups the risks international investors face under three main headings of political, economic and financial risks.

**2.5.2 Political Risks**

Political risks assess the political stability of a country. The main components of this are stability of the government, socio economic conditions, investment profile, internal and external conflicts. Corruption comes in as a major subcomponent, law and order, ethnic tensions and democratic accountability. All the variables of concern to Nigeria as a country, under economic risks are the GDP per head, real GDP growth rates, inflation rate and current account balance as a percentage of GDP and budget balance as percentage of GDP. The variables that are considered important under financial risks are exchange rate stability, net international liquidity position, current account balance, foreign debt and foreign debt service. While the list may not be exhaustive, the prevalent ones in the case of Nigeria are political instability, internal conflicts, threats of inflation, exchange rates instability and corruption and until very recently, foreign debts and international illiquidity. These make the country most unsuitable for foreign investment and encourage the flight of domestic capital. Where foreign investment is made, a high premium is paid to transfer such risks. Resident capital that has the opportunity of moving overseas is given the impetus to do so under these scenarios and is not likely to return until such risks are no longer subsisting. Erbe *et al* (1996) reports a negative correlation between country risks measures and country equity returns. This brings the portfolio choice theory of Collier *et al* (2003) and Lawanson (2007) into view.

**2.5.3 Corruption and Capital Flight**

Capital flight being one of the methods to transfer capital out of the economy has been fuelled more by corruption within the country than any other social malaise since corrupt elements in the country find it difficult to retain ill-gotten wealth in the domestic financial system. Corruption is a narrow concept and defined by the IMF (2003) as **the abuse of public authority or trust for private benefit**. The basis for capital flight by private entities and government functionaries is corruption which has been defined as ‘the abuse of public interest and the undermining of public confidence in the integrity of the rules, systems and institutions that promote the public interest’ (Baker, Christensen and Shaxson, 2008). According to Walter (2002) bribery is commonplace in many countries and is pervasive among public officials. Despite official laws banning bribery, the practice is sometimes an intrinsic part of a country’s cultural, political and economic system.

**Table 2.3**

**Nigeria’s Corruption Perception Index 1996 - 2009**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Year** | **Corruption Index** | **Rank (in the world)** | **No of countries surveyed** | **Rating weight (Probability)** |
| 1996 | 0.6 | 54 | 54 | 1 |
| 1997 | 1.76 | 52 | 52 | 1 |
| 1998 | 1.96 | 81 | 85 | 0.95 |
| 1999 | 1.6 | 98 | 99 | 0.99 |
| 2000 | 1.2 | 90 | 90 | 1 |
| 2001 | 1.0 | 90 | 91 | 0.99 |
| 2002 | 1.6 | 101 | 102 | 0.99 |
| 2003 | 1.4 | 132 | 133 | 0.99 |
| 2004 | 1.6 | 144 | 146 | 0.98 |
| 2005 | 1.9 | 154 | 158 | 0.97 |
| 2006 | 2.2 | 142 | 163 | 0.87 |
| 2007 | 2.2 | 147 | 180 | 0.81 |
| 2008 | 2.7 | 122 | 180 | 0.67 |
| 2009 | 2.5 | 130 | 180 | 0.72 |

**Source: Transparency International (Various Reports /Years)**

**NB: Column 5 is by Author and derived as: columns 3/4**

Corruption is an endemic problem and has a pervasive influence on country risk characteristics. The International Country Risk Group (ICRG) groups it under political risk and measures it as governance problem. It is often counted as a social ill and more tolerated in some countries than others. However, Quan and Rishi (2006) group it as economic risk indicating that it contributes to the investment risk in the economy. Data employed in the study was based on the Transparency index for the period between 1995 and 2001 for 45 developing countries. China and countries of the South East Asia seem to be the focus because Nigeria was missing. The study found out that holding other variables constant corruption does contribute to capital flight significantly. The paper recommends that advocating good governance by combating corruption makes a great deal of sense for countries aiming to curb capital flight.

The impact of corruption on domestic investment is seen in the additional costs that it adds to total cost of investment projects both of the private and public sectors. According to Vaclav Havel, the Czech President (2001) corruption “may either deter investment or render it less productive through its adverse impact on the risk and cost of doing business”. Political corruption is defined by Transparency International (TI) – as “the abuse of entrusted power by political leaders for private gain, with the objective of increasing power or wealth.” Political corruption it may be noted, need not involve money changing hands; it may take the form of “trading influence” or granting favours that “poison politics and threaten democracy. It sacrifices merit for mediocrity”. Corruption is essentially an issue of governance - touching on law and bureaucratic quality, government stability and civil liberties (Abbey, 2005)..

In these places, it is tolerated or simply overlooked. Its grouping in the political risks by the ICRG is instructive because it is an institutional problem. Most times, corruption in politics is taken to refer to money changing hands as it seems that the end result of all form of corruption is pecuniary gains. The Nigerian episodes of corruption depicting glaring departure from honesty (Diamond, 1993), are causing the country to draw negative attention to itself from the international investing community. Corruption has certainly emerged as the major impediment to economic and national development in contemporary Nigeria, affecting both the governed and the government (Bayart, *et al* 1997). While corruption distorts government expenditures, pillaging of States’ assets, bribery is common at the highest levels of government. It is almost the way of life of the people (Olu-Adeyemi, 2004). For the Nigerian civil servant, corruption has more than seventeen faces through which it manifests itself, but is more notorious for near impossibility to establish (Arene, 2001). The international corruption watchdog, Transparency International has consistently reported the high level of the corruption in the country, though rating has improved marginally of recent. As a result of the inability of corrupt elements to invest the ill gotten funds at home, they result to transferring such fund out of the country either for investment or safekeeping resulting in capital flight.

There are two national official watchdogs constituted to stop and stamp out acts incidental to illegal capital flight, especially the acts of corruption. The Economic and Financial Crimes Commission (EFCC) and the Independent Corrupt Practices Commission (ICPC) have been noted to make some efforts at performing assigned roles, though not without difficulties. The EFCC has been more visible than the ICPC. While the EFCC has the powers to arrest and prosecute, the powers of the ICPC’s are less obvious beyond normal prosecution using the regular courts and the already established executive arms to enforce its actions. Both were established to stop the acts of corruption and eradicate other financial crimes ranging from advance fee fraud to bunkering (the illegal lifting of crude oil). The EFCC, though very visible, cannot be said to have been successful, as it has been accused of becoming a tool in the hand of government to deal with political opponents. Its affiliation to INTERPOL and FIU has helped somewhat of recent to track slush and stolen funds resulting from capital flight

**2.5.4 IMF on Governance Issues and Corruption**

The WFGI have not been of much help in combating capital flight through corruption, neither have they been able to deal with the evil through their lending activities to countries since they have some advantage in handling the countries needing assistance at the point of borrowing. One way corruption can be stemmed in the public sector is the use of governance criteria to control and oversee the activities of government officials. Since 1996 IMF has been enjoined to promote good governance in every respect and all aspects of its operations, which include the rule of law.

The issue of governance comes directly under the surveillance function of the Fund. Measures, standards, codes and initiatives that are internationally accepted be should be implemented in governmental, financial and corporate sectors. It also has developed two transparency codes on the fiscal, financial and monetary policies transparency. The GDDS (General data dissemination system) and SDDS (special data dissemination standard) encourage timeliness, quality, and transparent data dissemination. The IMF has always included the following measures into its programs as conditionality for any country seeking assistance from it.

1. Price decontrol, liberalization of exchange rate and system, the creation for market-determined interest rates, and the abolition of direct allocation of credit using ad hoc non- financial measures. All these help curtail the fertile ground for rent seeking activities.
2. Fund’s technical assistance has helped in designing sound economic and public policy measures that ensure public sector accountability and transparency is put in place.

**2.5.5 Corruption Control and Freedom of Information (FOI) Law**

A major requirement to curb corruption is accountability and integrity on the part of the public official, but more importantly transparence in the conduct of public affairs. To ensure transparency, the media must be enabled to perform. A free press would ensure that the public officials maintain transparency by obtaining publicly valuable information without cost and making such information available to the public to enable the public assess the official. In this vein, it is believed that an elected official has little chance of escaping than unelected one. A democratic government in place would ensure that the officials are transparent in the conduct of public affairs. A free unbiased press is able to monitor the activities of public officials and divulge abuses of power (Brunnetti and Weder 2003). However Bac (2001), argues on the downside of FOI laws as the chances of knowing who to bribe when the need arises and possibility of reducing the quality of political class presenting themselves for election if their lives cannot be private anymore (Sutter, 2006). Moves have been made by the National Assembly to enact the semblance of FOI laws in Nigeria and these have hit the brick wall at least three times. The 6th National Assembly (2007- 2011) visited the process at least three times before successfully passing a heavily modified version of the bill on 23rd February 2011.

Some of the areas limited by the FOI bill were explained to be for national security and economic survival of the country. It is hoped that it will not be a lame-duck law passed to follow international trend like the untested Bankruptcy Act of 1999.

**2.5.6 Private Banking Services for Flight Capital**

The use financial incentives to lure foreign depositors have been mentioned previously as one of the significant causes of capital flight. The role of private banking and its impacts in flows of capital between countries is important now, especially in the case of illegal capital flight (Henry, 2006). Overseas banking institutions attract savings abroad by offering real returns and other financial inducements (especially deposit insurance) to investors and practically meeting every demand of the clients by offering private banking services. Vespiginani (2009) indicates that much of the capital flight in the LATAM countries wee as a result of financial inducement by deposit money banks from the developed financial markets especially the United States. This was the situation in Nigeria in the early 1980s (before Second Republic was truncated) when a DMB from Europe advertised personalised banking services in national dailies. The term "private" refers to the customer service being rendered on a more personal basis rather than in mass-market retail banking, usually via dedicated bank advisers. The provision of private and personal banking services has led banks to canvass and market top segments of the society that fall into this group, which invariably includes the rich and top civil and public servants and government functionaries. Much of the money sourced in this manner that end up in overseas bank accounts and other offshore financial centres come from corruptly acquired funds that cannot be invested within the economy.

Christensen (2009) alludes to the role being played by the developed countries by establishing offshore centres and other tax havens. Developed economies encourage their financial institutions to establish offshore centres to access capital from various sources around the world. The issues of capital flight and tax evasion, which have been largely ignored for so long, are moving to the centre stage. It is now possible to connect money laundering, corruption, financial market instability, rising inequality and poverty and tax havens are being identified as a common denominator in each of these problems (Murphy, 2007). Hudson (2004) says that the United States Government Departments actively encourage the establishment of the offshore centres by domestic banks (especially J P Morgan, Chase Manhattan and Citibank) where international investors invest in international currencies of those countries (exerting a pull pressure in the process to maintain or cause their value to appreciate). A number of countries in Africa are attempting to ‘compete’ with the developed countries by establishing such centres in their countries, especially within their Export Processing Zones (EPZ) to give it legitimacy.

Funds that came in were mainly from the persons who are involved in corrupt practices and operate black economy. The striking fact is that the most liquid persons are the people who operate illegitimate business and tax evaders who avoid having tangible property for obvious reasons. These funds were invested in various manners that may not be fully permitted in the onshore centres as a result of disclosure and reporting requirements.

**2. 6 INVESTMENT**

**2.6.1 Definitions of Investment**

Contemporary macroeconomic interest in investment and its functions tilts towards Foreign Direct Investment (FDI). Unlike the previous and immediate post-Keynesian era, there is paucity of current literature on domestic investment, which makes availability of empirical results difficult, though the understanding that investment as the key driver of business cycles and employment is still respected. That capital flight and outflows reduce the available investable capital in the economy is uncontroverted. Investment is first seen as savings, and then as postponed consumption. The Keynesians term investment as additions to capital, which works to increase the level of income and production, by increasing production and the purchase of capital goods (Jhingan, 2003). An investment is the purchase of goods that are not consumed today but are used in the future to create further capital (wealth). Investment can also be referred to as the production of capital goods (Heim, 2008). In finance, an investment is a monetary asset purchased with the idea that the asset will provide income in the future or appreciate and be sold at a higher price. Gross private domestic investment is the measure of investment used to compute GDP. This is an important component of GDP because it provides an indicator of the future productive capacity of the economy. It includes replacement purchases plus net additions to capital assets plus investments in inventories. [Net investment](http://en.wikipedia.org/wiki/Net_investment) is gross investment less depreciation.

Expected return in the future determines the level of investment that can be made in the current period. The expectation here refers to the interest rate, according to Heim (2007), the price of borrowed funds, which determines investment as the most important factor affecting the GDP. Investment in this form is an addition to real capital and capital stock in the economy. Investment, in finance, is the process of acquisition of financial assets (securities) for earning a return, (Stiglitz, 1993), which can be made domestically or abroad.

Other determinants of investments demand are the activities of the stock market (as measured by the stock market index), level of capacity utilization by firms, profitability of current investment which induces future investment, the level of depreciation allowance, the extent of government deficits and of course the exchange rate (Heim, 2008). Heim (2008) found out that that capacity utilization has no significance with government investment (which leads to crowding out or in of other investment) which is the most important variable of the eight Keynes hypothesized. In addition, investment can be seen as a function of the difference between the market value of the additional unit of capital and its replacement cost (Tobin, 1969), and can generally be divided into autonomous and induced investment which, according to Arrow (1968) can be considered reversible and irreversible. Autonomous investment is service based and not induced by demand as is not influenced by returns of factors of production while induced investment is largely profit motivated. Autonomous investment is in the purview of the public sector and therefore propelled by the government. In all of these definitions the uses of investment that leads to capital formation and increases in production capacity of the economy is the most stressed and significant (Malinvaud, 1982 and Snessens, 1987).

**2.6.2 Domestic Investment**

Domestic investment is investment made to increase the total capital stock in the domestic economy. This is done by acquiring further capital-producing assets and assets that can generate income within the domestic economy rather than abroad. Physical assets particularly add to the total capital stock. Boosting economic development requires higher rates of economic growth than savings can provide. However, it is the savings that capital flight and flows affect. The role of savings in the investment process is positive. Countries with higher propensity to save have greater savings at every level of income and interest leading to a higher equilibrium level of savings and eventually a lower equilibrium level of interest. Savings ordinarily is accumulated income and abstention from current expenditure. Part of the finance for investment is provided by the corporate sector, bank loans and households’ savings make up the other part. With this, savings is no longer a constraint to investment demand. The role of interest rate in the accumulation of volitional savings has somewhat reduced, as the rate is set in conjunction with other factors to achieve full employment and stable prices. The need to achieve and maintain internal and external balance is important for the Central Bank to consider the role of savings alone in the macro economy. Among the external balance parameters are the exchange rate, trade and capital flows. In the United States, capital flows have dwarfed trade flows many times over. If public sector investment is encouraged, it could crowd in other domestic investments, with the economy sustaining high growth rates in the process.

A World Bank study found that long-term relationship between savings and investment tend to be strong, (World Bank, 2007), though countries with the highest investment rates are not necessarily the ones with highest savings rates. This is the virtuous cycle that development policy makers ‘attempt to set in motion and encourage. While short term investment are highly encouraged by external sources of fund, long term investment are more domestically driven. This is one of the reasons why aid is less effective in the long run in the development process, since most go to palliatives. With lower rates of interest, asset values tend to be on the upward swing which invariably represents the discounted value of such assets thereby increasing the rate of acquisition and investment in such assets which increases aggregate demand. This produces increases in total supply and further aggregate demand. Investment therefore is not constrained by aggregate savings but more by domestic interest rates (Monetary Policy Rates) as set by the Central Bank who have other objectives apart from maintenance of low inflation in conjunction with increase in savings within the domestic economy (Moore, 2006). Therefore the new equation of investment is Investment = (Savings) + (newly created money available to Deposit Money Banks).

Savings and investments are interrelated as they influence each other in the economic process. Generally, sub-Saharan Africa has lagged behind in the saving rates among other regions of the world. While savings rates have doubled in south East Asian countries and increased in Latin America countries, it has stagnated in sub-Saharan Africa, according to Loayza, Schmidt-Hebbel and Serven (2000). Since savings, investment and economic growth are linked; unsatisfactory and poor performance of the one affects the other and could lead to stagnated growth, affecting the viability of the Balance of payment (Chete, 1999). Attempts at reducing expenditure have affected investment rates that led to poor and sluggish growth and eventually affecting savings performance (Khan and Villanueva, 1991).

One of the five ways of increasing savings domestically is the reduction in capital outflows out of a country (World Bank, 2007). The others are the control of demographic factors (population etc), reforming the tax sector, financial sector reforms and increasing investment opportunities. Of the five, the control of capital outflows may not easily achieved since it could be externally induced, while the others can be controlled within the domestic environment. Capital flight in the economy is then seen as both a cause and consequence of a country’s poor investment performance. Various units employ the capital flight process to transfer resources abroad through different means.

The role of taxation in the domestic savings is seen as endogenous and need to be managed proactively since taxes and subsidies are used to influence consumption and production. Distortionary taxation may encourage or discourage capital outflows and inflows when taxes are imposed on incoming income from abroad, which is not without difficulties (Razin and Sadka, 1989). Quantitative restrictions might be resorted to, to transfer capital abroad. Optimal taxation is consistent with aggregate production efficiency in a closed economy, but economies are no longer closed. The optimal allocation of domestic savings would ensure that the incentive to locate capital abroad is eliminated, if before tax rate of return on domestic capital (i.e. the marginal productivity of domestic capital) should be equated to the world rate of interest *ceteris paribus.*

According to Keynes, the difference between realized marginal efficiency of capital (MEC) and the rate of interest is the opportunity cost of investment. Theory assumes, as result of uncertainty, that expected returns on investment is volatile only for private investment. This theory relates investment to GDP. The accelerator is important to know why a slowdown in growth of the GDP can lead to negative growth in subsequent periods through a reduction in investment spending. Since the assumptions of the accelerator are restrictive, Jorgensen (1971) theorized that what determines the optimal level of investment stock depends on:

1. The level of output and the user cost of capital, which depends on the price of capital goods.
2. The real rate of interest
3. The depreciation rate

The deficiencies in the accelerator model relates to the inconsistencies of the assumptions of perfect competition and exogenous determination of output brought about the need for the application of Tobin’s Q theory which emphasizes the relationship between the increase in the value of the firm due to the installation of additional capital and its replacement cost. Q theory according to Nnanna *et al* (2004) has been criticized on various grounds among which are:

1. The marginal and average Q will systematically differ if firms enjoy economies of scale or market power or are unable to sell all they want.
2. The assumption of increasing installation cost is unrealistic
3. Cost of additions to an individual firm’s capital stock is likely to be proportional or even less than proportional to the volume of investment, because of the indivisibility of many investment projects and,
4. Disinvestment is more costly than positive investment as capital goods are often firm specific and so have less resale value.

From Arrow’s perspective, irreversible investments create a wedge between the cost of capital and its marginal contribution to profit under conditions of certainty and can be adversely affected by risk factors (Bertola and Caballero, 1990). Uncertainty of investment here means that the possibility of reducing future excess capacity cannot be without costs.

The basis of the discussion above can be seen in the provision of infrastructure in the economy with autonomous investment that is more government propelled and powered. With capital flight, investment that should be made to influence the level of demand in the economy is lost. When public capital is lost, it is through mismanagement and corruption. Equally, induced investment is determined by the level of potential demand in the economy. Capital lost to the country through private sources can be used to establish new process lines and facilities that would increase the aggregate demand in the economy. The fact that the financial system has further capital aids investment either through availability of credit or the lowering of its cost. This is important, that if capital lost to the economy were to stay, and much more money would simply be available. This is the greatest challenge of capital flight.

With the dual gap theory, it is plausible to accept that sufficient domestic savings might not be generated to allow the domestic economy to grow at an acceptable level since there is always the need for a foreign complement. Such complement only come in form of foreign exchange to augments excess of exports over imports *(X-M)* and borrowed capital as represented by *(S-I).* The requirements of the two gaps may be different over time, which depends on the seriousness of the needs in the economy (Salman, undated). Countries may prefer to trade off the opportunity cost of investment for import of capital goods to enable quicker capital formation, depending on choices. The role of domestic investment is germane to the retention of capital within the domestic economy as investment outside the economy in overseas investment indicates the preference of investors for external investment rather than domestic investment.

**2.6.3 Review of Empirical Studies on Investment**

Sub-optimal allocation of resources due to governance and political-economy situation of the country is partly responsible for the low rate of domestic investment in Nigeria according to Collins and Bosworth (2003) as cited in UNCTAD (2007). Though no statistics is available to support this, the above-mentioned factor is responsible for low Total Factor Productivity (TFP) growth. With Nigeria’s low level of savings and investment profile, Nwachkwu and Odigie (2009) recommend the increase in the production base of the economy in order to increase the two variables by encouraging the increase in funding for the diversification efforts away from oil. The use of National Economic Empowerment and Development Strategy (NEEDS) to improve the productive base of the economy is particularly mentioned. Specific sectors that should be of interest are the agricultural and Micro, Small and Medium Enterprises (MSMEs) scale sub-sector, to encourage savings and investments rates in the Nigerian economy.

The fact that real rates of interest are low in the country cannot be overemphasised, leading to abysmally low rate of real interest where it is not entirely negative, thereby discouraging savings altogether. The real rate of interest is important because the nominal rate cannot encourage savings because depositors face purchasing power risk overtime everywhere. Where this is overlooked as a result of regulation, the spread between interest rates on savings and lending becomes an issue that must be tackled, if investment and savings must be encouraged in the economy. The spread between deposit and lending rates have remained high ranging between 10% to 20%, depending on the bank [(The fairly older banks have a regime of lower interest rates than the younger banks) CBN, 2009)]. This is one of the reasons why most developed economies target the interest rate variable to influence their macroeconomic conditions in the medium to long term. This also helps to increase domestic investment. To encourage investment in long term assets (which increases the capital stock in the economy), the Small and Medium Scale Enterprises can be deepened as enunciated in the Financial System and Strategy 2020 document (Oyelaran–Oyeyinka, 2008). With its ability to propel a launch of the country from a service-based economy to real industrial output-country, producing for export as well as for domestic consumption, the unreformed sector can replicate the events in the banking and telecommunication sectors.

The problem of conditions of uncertainty is more serious in Nigeria as a developing country with yet to be perfect political, social-economic and legal system and institutions. The conditions of financial constraints which, can be binding has been exemplified by Stiglitz and Weiss (1981), stating that at the micro level, firms face binding financial constraints in domestic financial markets, because interest rates are subjected to endogenous credit rationing. Credit rationing affects the firm through the increase in the cost of credit and the opportunity cost of retained earnings and this distortion will discriminate against marginal borrowers as do incentives and subsidies.

Economic growth, which is the increase in the value of goods and services produced in an economy, is measured in a conventional way as the rate of increase in the real Gross Domestic Product after deflating it by the implicit deflator. The relationship between physical investment and GDP is considered the most important of the factors antecedent to growth (Levine and Renelt, 1992). Liquidity preference is one of the main reasons why an investor would prefer to invest in financial instruments rather than physical or real investment, some of which are irreversible. The law of diminishing returns ensures that the continuous additions of an input (for example, capital) relative to the others can lead to reduction in marginal growth or negative growth, and therefore there is the need to consider a place for labour or human capital. From the investment climate point, the attractiveness of the acquisition of foreign assets depends on the rate of return when adjusted for exchange rate, which when compared with the domestic return should be consistently higher. The considerable gap in the factor productivity between developed countries and Nigeria as a nation should normally equal higher exchange rate adjusted for rate of return on domestic investment.

A positive correlation has been established between investment and economic growth (Chenery and Strout 1966, and Iyoha 1998). Iyoha (1998) was able to use investment-income ratio with data between 1970-1994 to establish that a 10% per cent rise in investment in Nigeria income ratio will lead to a 3% rise in per capital Gross National Product in the short run and 26% in the long run. This led to the conclusion that the Gross National Product is highly investment elastic in Nigeria. Aggregate investment, comprising of both private and public investment, is needed for rapid growth and the development of the economy. The investment that discourages capital flight and retains capital within the economy is of interest here, given that the rate of investment affects the development of the economy positively. Investment in growth yielding sectors of the economy in the short run may be good but at a cost of real sector growth in the country. The investment made in the people and infrastructure is seen to be the best as it produces multiplier effect on the economy in the long run.

The attitude of Nigerian banks in the savings and investment analysis of Soyibo (1994) raises a great concern as the findings prove that the lack of interest in investment is basically for profit motive, and the income theory justifies their lending behaviour after the financial market deregulation of 1987. (The banks were forced to lend to specific sectors before this time.) Before this, Ojo (1976) had mentioned the unwillingness of the banks to aid and further investment by their lending activities. In addition, Soyibo shows that borrowers’ ability to repay was significant, followed by the profitability of the sector in their lending decisions. These were significant in the bankers’ lending decisions. Ability of the borrowers to repay, profitability of the sector of operation, previous experience of the, borrower in a similar project, borrower's contribution, returns to the bank and collateral offered were considered important in that order. Further investment waned as short-termism and preference for high returns and liquidity took over.

Low real interest rates are expected to encourage investment in the economy. Administratively pegged or heavily regulated interest rates regime does not allow for optimisation of savings resources within the banking system. Banks, under the sectoral allocation of credit were forced to invest their deposits in such sectors as desired by the government to boost the development of the economic sector. While Uchendu (1993) agrees that the low level interest encouraged direct private borrowing for investment purposes, this regime of interest rate has been blamed for retardation in the development of the financial system which encouraged capital flight in the process and poor loan discipline. Bogunjoko (1998) surmises that though financial savings increased this did not translate to investments. The subsequent latitude by financial institutions to determine the interest rates given some bounds have produced poor results. Reasons for this are not farfetched as banks avoided long term loans and became risk averse preferring short term loans with good liquidity prospects to development oriented projects and real investments.

Ige (2008) mentions the irreducible role of the government in the process of governance and public financial management. The government as a unit has not been helpful to domestic investment in the country and with the direction of its investments over the years. Where the government has made investment, it is in projects that do not crowd in other investments though the government may have borrowed from the financial system to commit to such investment. The government should invest in the value-adding sectors of the economy. The contention is that the government should provide necessary infrastructure for the enhancement of the life of the individual members of the society and encourage private entrepreneurship, which would then pave the way for venturing successfully into various production outlets.

Public sector spending has been held to contribute to investment in Nigeria, though exaggerated, and its effects much lower than acclaimed where elements of external finance have been involved (Akintoye and Olowolaju, 2008). Also, the investment profile of Nigeria seem to be following a cycle of ten years with the Vector Autoregressive technique adopted in the analysis by Akintoye and Olowolaju (2008). The paper recommends that policies intended to achieve increases in domestic investment and real output should be encouraged while efforts should be made to promote private domestic investment in the short, and long run.

The role of the exchange rate in the process of investment inflow has seen as major determinant in the inflow of external capital. Investors’ low values for the domestic currency *vis* a *vis* its reference currency could be a discouraging factor. Obadan (1994) tends to support this view with the recommendations for a freely floating exchange rate for the domestic currency. Uremadu (2008) recommends the reduction in exchange rate distortions and misalignments. This would most likely increase the inflow of foreign funds into the economy and increase capital formation through the increase in real investment in the industrial sector of the economy.

The trend assumed by investment in Nigeria reveals that the deposit money banks (DMBs) financed a lot of capital investment before 1976, amounting to an annual average of 37% and this dropped gradually until it reached the present level of 14.6 % for the period 1996 – 2000. The share of loans to the services sub-sector increased of recent from 0.3% in the seventies to 11 % in the nineties. Also, the classifications that have a figure of 43.3% comprise of other loans, excluding investment. It is however clear that the financial services is taking the driver seat according to theory, (Nnanna *et al*, 2004). According the CBN (2007), a larger portion of credit went to the miscellaneous sector, which has many variables and continues to increase with consumer credit made available by the banks. The mean credit to the agriculture sector was only 3% during this period. International trade received 2%. The productive sector of the economy (mining 9%, manufacturing 19% and agriculture) received a total credit of 31%.

**2.6.4 Sources and Determinants of Domestic Investment**

Sources of investment could be external or internal and private or public. Tella (1998) employing the Harrod-Dormar growth model adopted, the ratio of savings to capital-output ratio (i.e. Incremental Capital Output Ratio: ICOR) determines economic growth with the *g=s/r* where *g* is the economic growth rate, *s* the saving rate and *r* the ICOR of a given amount of capital. Though Moore (1998) believes that savings does not constrain investment, Tella with the Harrod Dormar model asserts that given a level of national income, the aggregate spending or consumption will in the long run affect savings, and the only way to encourage investments is to introduce policies that will encourage savings. The other source of funds is external finance which is savings of other economies that can enter the economy through loans, grants, direct and indirect foreign investment. Therefore, the main sources of investment in any economy narrow down to external and domestic savings.

Domestic sources of capital to finance investments in Nigeria have been empirically determined to be public and private. Units may finance investment requirements also by savings or borrowings. However, the immediate source of investment is savings (Nnanna, 2004). The other determinants include domestic consumption of fixed capital and transfers from the rest of the world. The public sector meets its investment needs via the collection of taxes and other non-tax income sources. The surplus goes to increase the capital stock in the economy which is investment. For the agents in the private sector when investment expenditure exceeds the available savings, the balance is made up by borrowing from financial institutions, which happens frequently.

The financial institutions that provide capital for investment in Nigeria today include Deposit Money Banks (DMBs), and Development Finance Institutions (DFIs). The list has been increased by the rapidly-expanding Pension Funds sub-sector that is accumulating funds at a high rate. The main semi-informal sources are the cooperatives that have been recognized to bridge the gap and purely informal sources through the *ajo, esusu, adashi* and its other variants. Total resources available in the informal sector cannot be correctly estimated, but has been ascertained to be considerable enough to sustain some meaningful long-term capital investment. Nevertheless, the amount that can be raised on the market is a serious constraint (Ojo, 2008) to long-term development.

Banks are major sources of private sector investment in most economies of the world. Whenever the government wants to borrow in those economies, they turn to the public via the issues of debt instruments such as development stocks, bonds and treasury bills, which is equally available to the financial institutions to invest in. For a myriad of reasons, governments in most developing countries borrow from the banking sector to meet their monetary, financial and short-term needs and objectives. These borrowings become a problem when they are rolled over, eventually causing illiquidity in the financial system. It is understandable, that the banks may prefer to lend to the government but this form of lending crowd out the few viable propositions that could have been made for the private sector investment.

The attitude of Nigerian banks has not been encouraging to the private domestic investors by the way and manner they conduct their lending operations. Soyibo (1994) catalogued the problem as problems that have not allowed savings to transmit to investments as, inadequate information about investment opportunities, unpredictability of the domestic economic environment, and lack of adequate infrastructure. The issue of infrastructure showed up as recommendation for improving the investment climate in Nigeria (Oyeranti 2003 and Oyelaran–Oyeyinka 2008). Unlike the banks in developed countries, Nigerian banks have done very little to encourage domestic investment, depending on the government to do this for the financial system. The Nigerian Stock Exchange (NSE) went on road shows and other promotional and public glitz to encourage investment in the market and created the investment awareness of the capital market. While the theory of income approach has been the main driver of the operations of the Nigeria banks, the asset approach to management is preferred as it helps banks to tailor their liabilities towards the particular balance sheet structure they desire.

The other major sources are external and constitute the accumulated savings of other countries, which is accessible through loans, grants and equity participation. External finance could come through capital market or Foreign Direct Investment. Supranational financial institutions have also provided funds for the purpose of investment in Nigeria. The International Development Association (IDA) African Development Bank (A*f*DB), United Nations Development Program (UNDP) and lately the European Union (EU) have influenced the direction of capital investments in Nigeria.

Findings on the methodology adopted are varied as some unexpected results came up become some variables were not correctly signed which was attributed to poor quality of investment in Nigeria. The study goes to show that investment in Nigeria does not deliver its value. The finance function shows that 1% change in domestic savings can bring about 4% change in availability of finance to underscore the importance of savings in the domestic economy. The investment function indicate that 0.41 decline in investment can result from 1.0% decline in exchange rate. Also significant is the private sector credit with 1% change leading to 2.59% change in investment. The production function indicates that, to achieve a 1.3% increase in production levels of the economy, Nigeria requires a 5% change in investment level. This shows the level quality of total factor productivity. To tackle the problem of inadequate investment in Nigeria, the following critical factors must be addressed: perverted interest rate structure (Ojo, 2007), exchange rate volatility, high inflation rate, macroeconomic and social political instability and foreign debt (this is beginning to rise now).

Privatisation of State Owned Enterprises is significant either in encouraging domestic investment by indigenous entrepreneurs or in partnership with foreign partners. Since most foreign investors prefer brown fields and cross-border mergers and acquisitions to greenfields and starting new projects, the impact of divestment process of government from the State Owned Enterprises (SOEs) is important. Soyibo, Olayiwola and Alayande (2003) in their study show that erstwhile SOEs increased their investment profile after being privatised. While in the services sector, employment became reduced as a result of privatisation, but had an additional investment capital – obviously to increase efficiency. The privatised SOEs in the manufacturing sector increased real investment obviously to increase production and boost profitability.

Generally, the privatisation programme of the Federal Government improved the quantum of investment, which resulted in greater profit taking by the firms. The paper recommended the continuation of deregulation, privatisation and commercialisation programmes in order to continue to encourage investment spending by privatised firms. Adegbite (2007a) finds a causal relationship between output and export, which can only be encouraged by further privatisation and investment. The companies also recorded higher operational efficiency and increase in employment level in the economy.

In addressing what are the main drivers of investment in United States, the model developed by Heim (2008) to deal with issue adopted a two stage least squares (2SLS) technique that was done in a stepwise manner to show the impact of each of the variables employed in the regression estimates. This produced remarkable results that show the impact of each of the variables in a progressive manner. The results depict clearly that the government expenditure (crowding out effect) was the most important determinant in the investment demand in the United States, accounting for 40% of the impact on investment demand, which proves the crowd out theorists right. The remaining variables are depreciation 20% (capital assets consumption) and acceleration rate (yearly change in the GDP) 20%.

**2.6.5 Measurements and Models**

The determinants of investment are much clearer with the empirical literature than when theoretical arguments are postulated on investment in many countries including Nigeria. Nnanna *et al* (2004), authoritatively posit that the main determinants are in two forms: the finance and investment model. The finance model was however employed in the regression estimates carried out. The investment model starts with Cobb-Douglas production function measures capital or investment in physical assets first. Then it was specified to include the distortions and accompanying shocks, constraints and exogenous shocks in the macro economy as follows:

*Y = f (A, K, L) = A, L*

Where *Y* represents output, *K* is the capital stock, L labour supply and A the total factor productivity

K *f (r psc ner Y):*

Where *r, psc, ner* and *Y* represent prime lending rate, (PLR), credit to the private sector, nominal exchange rate and national income respectively. The finance model of determinants of investment in Nigeria could be seen to be mainly from debt and non-debt sources that could be domestic or foreign with the following model

*PSC f (SAVS, INV*),

Where, *PSC, SAVS* and *INV* represent private sector credit, National Savings, and Investment respectively (Investment is divided into two parts namely *PUV* Public and Private Investment).

**2.6.6 Foreign Private Investment**

Capital flight is a phrase that is used when capital outflows in a country continues unabated. Little thought is given to the possibility that the flight of capital in one country results in investment in another. Just as the wealth-holders choose where to diversify their resources, foreign investors scout for places where their investment can be safe and yield adequate returns. The clamour by developing countries for foreign investment in their domestic economies often overlook the medium and long term effects of the immediate resulting inflows, where the investment do come. Developing countries like Nigeria often spend huge sums of money packaging themselves and engaging their officials in worldwide travels to sensitize investors to come and invest in their domestic economy, knowing that the immediate effect is positive to their countries and on the capital or financial account of the Balance of Payment. This inclination has led to the thinking that when a foreign investor comes into the economy to make investments, it is often lost on the indigenous people that such investment would yield returns and that there would be repatriation of the returns back to the home countries’ of the investor. If it is portfolio investment, such investment at some time in the future would be repatriated, either in full or part. This has not been given enough thought by policy makers and financial authorities of most developing countries.

The role of the domestic institutions is important in the attraction of foreign investments to the economy. The regulatory and controlling institutions such as Nigerian Investments and Promotion Commission (NIPC) and Central Bank are important in this regard, as they provide barometer to measure the seriousness of the country in attracting and sustaining foreign investment. While the Central Bank of Nigeria oversees the inflows mechanism, the NIPC oversees the window and direction of investment. With the plethora of provisions available in the NIPC’s guidelines as alluded to in Otokiti (2007), incentives such as full repatriation of dividends net of tax and non-expropriation of foreigners’ assets in the country are comforting, but with the legal framework and court’s tedious processes much cannot be expected by foreign investors in Nigeria. The role of the courts in enforcing common law provision in adjudication of cases is important, as it has been held to improve foreign investors’ confidence in the domestic law courts, (La Porta, Lopez-de-Silanes, Shleifer, and Vishny, 1998)

A love-hate relationship comes in where the indigenous people would welcome the foreign investor warmly at their arrival only to hate them later when they engage in continuous repatriation of profits and some other reasons later in the future. Of course, foreign direct investment is more reliable and desirable than foreign portfolio investment which is growth inducing and generally more beneficial to the economy of the country, especially when made to support the real sector. The resultant effect of the inflow has positive effect on the surplus in the Balance of Payment. The effect in the medium to long-term is often different as it would be time to repatriate profits or returns and principal in the case of FDI and portfolio investment, respectively. These in themselves are determined by a number of factors, which include openness of the economy, existence of market-determined interest rates, liberalized labour laws and the impartiality and the quick dispensation of justice by the legal institutions in the domestic economy (Yang e*t al*, 2000).

Hot money flows (taken as capital in flight) through foreign portfolio investment is seen to be more unstable and can induce financial crises and serious financial instability and with negative results for the economy because of the short horizon of the investors. It is also stated that investing in the equities of emerging market can produce above average returns by the institutional and hedge (pension) funds in developed economies who are always looking out for above average market returns (by at least 1.5% points), which can be protective when interest rates are down (Conover, *et al,* 2002). The issue here is that this is not resident capital and openness of the capital account should allow an easy flow of capital out of the economy. Of recent, the Nigerian Stock Exchange withstood the test of the international portfolio investors when they suddenly pulled out the sum of $3 billion worth of investments at the height of its bubble (Business Day, 2007). A more convincing argument on the portfolio effects of capital flows is found in the work of Collier *et al* (2003), who tested a number of countries in sub-Saharan Africa for capital flight and concluded that it is the portfolio responses of the residents that determine how, where, and when resources move between countries. As Transnational and Multinational Corporations (MNCs and TNCs) diversify by investing in facilities in other countries, capital movements result from these companies’ diversifications, as in this late Stephen Charles Kanitz quote:

“*When it is an American company that puts money abroad, it is called foreign investment and when an Argentinean company does the same it is called capital flight. Why is that when an American company puts 30% of its equity abroad it is called strategic diversification, but when a Bolivian puts only 4% abroad it is called “lack of confidence?” –* . The Wall Street Journal September 21, 1984.

The effect of capital flows between countries in the investment profile of the receiving country is considered as a measure of confidence, though the rate of long-term development it can engender has been disputed and cannot be fully measured. The ability of such capital flows to stimulate the long term growth in developing economies is in doubt (Mishra *et al,* 2001). Capital flows, when it is not *well* managed can lead to volatility in the domestic financial system. The share of private capital coming into developing countries has increased and the flows were taken as a causative factor to the attendant growth the countries recorded in their process of development. Studies have not shown emphatically if private capital flows drive growth. On the other hand, it is believed that domestic growth often drives capital flows and that private capital flows only reinforce the growth process. Capital flows have accentuated income differentials between countries.

Financial literature, agree that capital will move from where it is relatively surplus to where there is shortage because returns are higher where it is scarce than where it is surplus, and is expected to boost investment in the recipient countries (Summers, 2000). It is obvious that for the process of development through foreign inflow of capital to work, there will be well-developed physical infrastructure, well educated and skilled workforce, according to Lucas (1990), as these constitute favourable business environments that have encouraged earlier flows (Mody and Snrivasan, 1998). This is the reason why the capital flows to low income countries have not been substantial. This has been measured by the long-term developments recorded in these countries, only by the effects attributed to foreign direct investment and international bank lending. Portfolio investment on the other hand, has been seen to contribute to less development (Bosworth and Collins, 1999). The dual gap theory emphasizes investment and trade as the determinants that are germane and need to be managed in the economy in order to induce growth rates desired by the country that have significant natural resources to support it. A dollar increase in further investment achieves less impact than the earlier investment under diminishing return conditions over time.

The uses of capital flows are changing. Greenfields are no longer been favoured where foreign direct investment is involved, while cross-border mergers and acquisitions have been more common. The current emphasis is rather on portfolio investment with hedge funds holding sway.

However, most countries have recently built large foreign reserves, partly in response to the need for greater liquidity to ward off financial crises resulting from sudden flights of capital or to support a weak currency. In addition, while discussion has been on capital flight very little is said on portfolio diversification, which has suddenly increased the outflows of capital in recent times, as corporations become more internationalized in their operations and begin to expand their investment abroad.

On exploring capital flows to United States in the 1990s when it benefitted greatly, it was discovered that the progressive state of technology impacted on the economy and consequently caused capital to flow into the US. This was said to have led to the appreciation of the US$ which caused investors in the world to rebalance portfolios (Pennings and Tyers, 2007) and at that time the dollar consequently became a choice currency for many countries and international investors. In this way, the internal and growth policies of a country can have a positive effect on its external sector through foreign inflow of capital. It is equally common to have hot money flowing into a country for investment purposes, especially when the rates of exchange and interest are misaligned, which immediately leaves as soon as the basic objective has been achieved. There is also the possibility of borrowing in an economy to invest in another if there is interest rate misalignment between the country and a reference country. This is the main plank on which the uncovered interest rate arbitrage operates (Moosa, 2002). The practice of the Transnational corporations that originate from a home country to site a production facility in another country, produce goods and products meant for distribution and sale in another, but seek funds and finance in yet another country to do this is well noted (Aremu, 2005).

**2.6.7 International Capital Flows**

Capital flows across countries are typically classified in terms of maturity (short-term versus long-term) and whether the investment represent some form of control over the target investment or for the sole purpose of earning returns - (Portfolio versus direct):

1. **Short-term Capital Flows:** Short-term debt instruments (e.g., U.S. Treasury bill) have offered relatively appreciable real rates of return at low levels of risk for investor worldwide. Short-term capital tends to follow rise or fall in interest rates and it is highly speculative and unreliable. It forms to a large extent the hot money flowing around the world that is cashing in on the misalignment between interest and exchange rates in the presence and the use of capital controls, according to Dominiguez, Auguste, Kamil and Tesar (2004). Treasury bills, American, and Global Deposit Receipts (ADRs) provide internationally tradable investment instruments. It is not certain if Nigeria has been able to attract any of these, though two banks have ADRs selling outside Nigeria. Rates of interest payable on these instruments are generally less than rates of inflation. This discourages investors.
2. **Long-term Capital Flows:** Long-term capital flows play a significant role in the capital account of the BOP of many countries. Long-term capital is typically attracted to economic and business environments expected to provide significant long-run stability and economic growth. This is usually more reliable than short-term capital and can play an important role in the industrial growth of a nation. Though, this has recorded improvements in the Nigerian economy recently and its impacts incontrovertible, its effects on stifling out domestic investment and savings is well noted (Kayode and Oyeranti, 2002)
3. **Portfolio Investment:** A portfolio investment is a transaction in which securities are held purely as a financial investment, which can be liquidated depending on the investment horizon of the holder. This has been on the increase of recent due to the internationalisation of the capital market, but is seen as the major cause of hot flows that in itself causes capital flight and is currently been blamed for the downturn of the Nigerian Stock Exchange. The recent market bubbles aided the inflow of portfolio funds, which many overseas hedge funds took advantage of to make quick returns. Beaker, Harvey and Lundblad (2005) find that capital inflows benefits equity markets with above average financial development, better legal systems and better quality institutions, which mostly are still fledgling and nascent in most of the emerging markets of Africa.
4. **Direct Investment:** ForeignDirect Investment (FDI) is a transaction in which the investor has a controlling share or participates in the management of the firm. The cut-off level of ownership beyond which an investment is classified as direct investment varies across countries, and depends a lot on who is defining what foreign direct investment (FDI) is, but is usually around 10%. Nigeria has received a sizeable of this in recent past, but direction seems not to have gone into the real sector investment.

**2.6.8 Foreign Direct Investment (FDI) Inflows**

This refers to investment by multinational companies with headquarters in developed countries transferring funds (including reinvestment of profits), but also a whole package of physical capital, techniques and production, managerial, marketing expertise, products, advertising and business practices for maximum global profits- (Thirlwall, 1994). It is the net financing by an entity in a developed country, which has the objective of obtaining and retaining a lasting interest in an entity resident in a developing (another) country. For the Development Assistance Committee (DAC) of Organization for Economic Cooperation and Development (OECD), its definition allow for at least 10% ownership of the enterprises or equivalent in voting power or other means of control. It is also known as investment made to acquire a lasting interest in a foreign enterprise with the purpose of having an effective voice in its management - IMF. World Trading Organization (WTO) says FDI occurs when an investor based in one country (home country) acquires assets in another country (host country) with the intent to manage the asset. Therefore, FDI is a whole total of the following:

* New equity from the foreign country to the company in the host country.
* Re-invested profits earned from the company, and
* Long and short-term net loans from the foreign company to the host company...

Capital flight is an outflow and will be at variance with foreign direct investment. Among the many benefits of FDI is human resources development, which according to Ige and Odularu (2007) continually influences further inflow of capital. These scenarios can make the battle against capital flight frustrating since capital moves to where it can earn the most returns. On the other hand, portfolio investment involves the inflow of foreign capital into an economy in order to take advantage of the domestic financial market. This often happens when a misalignment of interest rates allows a return higher than what is commensurate with the level of risks to be undertaken possible. Portfolio investment could be in the money or capital market. More often, such investment is made in the domestic capital markets to take advantage of a bullish trend.

Capital flows in the direction of open countries that have prepared themselves for acceptance of foreign investment. With the debt crises of the 1980s and the International Monetary Fund urged debtor countries to dismantle controls, which coupled with imperfect liberalization of the current, and capital accounts, debtor countries opened up with little caution. This caused instantaneous growth in some countries but has actually left those countries worse off, because it had little influence on the welfare of the people. At the root of the capital flows is the sudden liberalization of the capital accounts which led to spontaneous inflow of foreign investment that were not invested in the long term assets, but assets yielding quick returns such as stocks and real estate. For some, the investments were made in currency speculation and bank lending such as in Thailand and the Philippines in the early 1990s. Bello (1998), reports that the root cause of capital flight that took place in the late 1990s in four Asian countries was the financial liberalization that encouraged a flood of short-term private flows. While capital continues to flow in the direction of countries adjudged best for FDI, the following has been noticed as Anderson (1998) has reported:

1. There is dominance of private capital throughout the world these days. Official funds no longer flow around, but private capital looking for possible maximum investment and returns. This position is partly due to the abuse foreign aid and assistance has suffered and as well as the official debts that was contracted but has flowed back into the Swiss bank accounts which have constituted some form of capital flight to these countries. For example, 85% of capital flows in 1996 were private in origin.
2. The emergence of short-term private investment flows as the faster of the foreign investments in the developing countries. While the IMF has been the main protagonist of the open economics, some countries not directly under the purview of debt or its supervision have bowed to external pressure to liberalize their capital accounts for the main purpose of attracting foreign investment of this sort. Between 1990 and 1996, the movement of portfolio equity flows into the South surged from $3.2 billion to $45.7 billion as a number of debtor countries followed the advice of the U.S., World Bank and the IMF (often as cross conditionality) to open their stock markets to foreign investors and deregulate their financial markets.
3. The emergence of ten countries that are being touted as beneficiaries of open macroeconomics through the instrumentality of foreign private investment have further helped the argument. Therefore, not all developing countries are benefiting from the capital flows that have come from the West or North. Of these ten countries, three were involved in the crises of the late 1990s that became a contagion in South East-Asia, sweeping the region and causing the loss of a third of the market capitalization of stock markets around the world

In summary, FDI has been held to increase the national stock of capital (especially through Greenfield investments) and produce investment spillovers through linkages among firms. Its drawbacks are among the fact that mergers and acquisition activities among the MNCs hardly increase the national stock of capital. It may also crowd out domestic investment if they raise productivity, especially with imported inputs. FDI may ease the constraints in the financial markets if they import capital rather than source funds from the local market. McMillan (2004) as cited in European Central Bank report of 2008 finds that the effect of capital importation by Transnationals (TNCs) or Multinationals (MNCs) is stronger in low-income countries than high-income countries.

Various incentives are available to induce foreign direct investment in any economy. According to UNCTAD (1996) eight fiscal incentives are possible for the foreign investor. They assist in reducing the cost of production via taxes, depreciation and duties. The incidences of the fiscal action are on profit, capital investment, labour, sales, value addition, export and import based. The Nigerian Investment Promotion Council uses only two: tax holiday for pioneer status companies and a reduced tax of 30 percent for companies in Nigeria (NIPC, 2004). For Nigeria, the main discouragements to foreign direct investment have been inadequate infrastructural facilities, lack of adequate monetary and fiscal incentives, inadequate and complex regulatory and legal framework, social and political instability and of course corruption (which raises the cost of doing business).

**2.7 CAPITAL FLIGHT, OPEN MACROECONOMICS AND BALANCE OF PAYMENTS**

As economies become more open to the international financial environment choices become more restricted. Literature has it that the trillema of open macroeconomics are issues that the government of a country must consider well before deciding which of these issues it chooses to control. Issues in the macroeconomic management of the country in the trillema are fixed or floating exchange rates regimes, restricted or liberalized capital account regime and monetary policy autonomy that can be a regulated or deregulated financial environment. The government of the country must abandon at least one of the three variables, as it cannot control the three simultaneously. In an economy that is opening up in accordance with Mundell-Flemming approach, the complete management of macroeconomic variables such as fixed exchange regime, capital mobility and domestic policy autonomy (in the regulation of interest rates, for example) constitute an ‘unholy trinity’ (Cohen, 1996). This leaves the government with the choice of managing the domestic variables more prudently to attract investment and discourage unnecessary out flows and capital flight.

**2.7.1 Openness of the Current Account**

The issue of openness of the sections of the BOP has always formed a major part of discussion on reforms advised to the developing countries facing one economic or financial crises or the other. The belief that the opening of the sections of the account can bring about the desired results have led to some countries opening their accounts too quickly without observing adequate safeguards in the process. This has been costly, caused mainly by unfair competition from more industrially advanced economies that are able to produce goods more cheaply and efficiently. These had led to losses in resources in terms of serious outflows of scarce foreign reserves of those countries. While the IMF has said that it had advised the opening of the current account of debtors and countries with which it has adjustment programs, it had not advised the opening of capital accounts at any time. Since the two accounts comprises of different economic transactions they are affected differently by liberalization. Eurodad (2006) has chosen to define the components of trade liberalization as lowering / rationalizing tariff systems within a regional economic area or trade zone, removing quantitative restrictions and allowing unrestricted quantity of trade, dismantling controls on flows of goods and services and simplification of tariff structures.

Openness of the current account refers to a situation in which the current account is allowed to record any transaction that should normally pass through it without any administrative or quantitative restrictions through the regulation of trade. The reference to the opening of current accounts is another euphemism for completely liberalized trade or free trade as promoted by the World Trade Organization (WTO). The current account is important in the process of accumulation of external reserves by the country, using the simple derivation of Exports – Imports *(X-M)* thereby increasing the country’s assets in other countries of the world and becoming a net creditor.

The current account represents the passage of real resources for exchange of value and is regarded as an important section of the BOP. Aizenman (2006) argues that the persistence of the current account has to do with both the need to accumulate or *hoard* reserves because of good performance of the export sector on one hand, and imbalances resulting from deficits on the other, and therefore the need to adjust for such persistence. If countries can not exactly match their imports with exports, then the need to make adjustment, which can be either in quantity or in price, must arise and the adjustment process must be easy or smooth. The paper was concerned with the degree to which higher international or external reserves/GDP ratios have been associated with greater capacity to smooth adjustment shocks overtime. The paper concludes finally, that developing countries are characterized by a faster current account adjustment than Organisation for Economic Cooperation and Development (OECD) countries; LATAM (Latin American countries) adjust faster than Asian emerging economies and exporter of natural resources (Nigeria is in this group) countries adjust faster than the exporters of manufactures. β was used to denote the speed of the adjustment to steady state level in the regression estimates as in Taylor (2002) and negative α came out for countries that are very sensitive and extremely volatile to external shocks. These are small economies. Basic factors that affect the persistence and the adjustment process for current accounts are:

Higher reserves, higher GDP growth and a lower share of commodities are associated with significant increase in the persistency of the current account when using a univariate regression.

Higher persistence is positively associated with higher IR/GDP, lower inflation, greater flexibility of the exchange rate and a higher share of manufacturing.

Discussion of the persistency of the current account cannot be concluded without raising the current practice of some emerging economies to accumulate foreign or external reserves. China has accumulated or *hoarded* external reserves in which it presently stocks an amount as high as $2,773,000 million and Nigeria with $40,900 million as at September 2009 (Wikipedia: accessed 16/11/2009). This is causing challenges in international financial markets and monetary circles in that China has refused to allow the Reminbi (domestic currency) to appreciate in order to stem the persistency of the current account and reduce the level of trade, though it is equally facing capital flight. One of the costs of maintaining high level of reserves is the quasi-fiscal cost the country faces in terms of lost opportunities. This is the current concern of the international financial community now especially in the face of an unstable dollar and shaky productivity level in the United States.

The current account is very important in that trade misinvoicing, which is one of the avenues of capital flight goes through this section of the BOP. Most emerging economies attempt to manage the account by restraining trade and misinvoicing through the control of imports. The role of inspectors has not been felt much in controlling the quality, quantity and price of imported or exported goods.

**2.7.2 Openness of the Capital Account**

This was initially referred to as Washington Consensus by Williamson (1990), who included it as a policy measure to be adopted by developing countries needing the assistance of the IMF. This was done in order to free the capital account from the control of the monetary authorities so that market forces would operate freely and allow firms in those countries to seek funds from world capital markets.

Nevertheless, the IMF has since denied this, when the wave of the uncoordinated capital accounts liberalization caused increased financial instability in those countries leading to a contagion in a number of them in the 1990s. This was the basis of the argument of Stiglitz (2002) who believes that the policy was made to favour the US and the UK. The UK has the Eurocurrency market domiciled in London where capital flight proceeds are normally round-tripped and invested and later borrowed, while the US has firms seeking foreign locations but could borrow from the domestic financial market.

**Table 2.4**

**Balance of Payments Crises and Capital Flight**

|  |  |  |  |
| --- | --- | --- | --- |
|  | **Credit** | **Debit** | **Capital Flight** |
| Current Account | Export of goods and services | Import of goods and services | Trade misinvoicing |
| Non Reserve Capital Account | Private export of assets (capital inflows) | Private import of assets (capital outflows) | Legal and Illegal transfers |
| Official Reserve settlements | Foreign CB net purchases of home assets (official capital inflows) | Home CB net purchases of foreign assets (official capital outflows) | Reduction in reserves and assets |

**Source: Adapted With Modification from King (2006)**

From the path-charting work of Epstein and Schorr (1992), the determinants of capital controls have always included an independent central bank that is largely free from the government’s control, majority government with democratic structures and sovereign power residing with the people. Others are balance of payments surplus over a consistent period, a stable exchange rate, and financial sector with some strength and resilience.

In most of the works of researchers, the determinants of the degree of openness of the capital account have always included variables listed above and have always been found to be significant. An interesting discovery in the work of Joyce and Noy (2008) was that corruption was found to be significant at 5% level of significance. This indicates that, as a corrupt government is likely to maintain control on the capital accounts, so would large and heavy government expenditure continue. Figures ascribed to the capital account are only official to the extent of records available. Where records are not available, the figures are transferred to the errors and omissions. It has been used to mean the ‘*suspense’* account figures to balance the resulting figures of the BOP

**2.7.3 Errors and Omissions**

One of the puzzles for most countries’ statisticians is the balancing entry of the Balance of Payments which Eggerstedt, Hall, and Van (1995) raised as a challenge is the error and omissions. This item balances up the Balance of Payment, when the figures do not agree. This is the case most of the time. The IMF (1993) explains it, as the practice, when all actual entries are totalled, the resulting net balance will almost inevitably show a net credit or a net debit. That balance is the result of errors and omissions. In the compilation of statements, the standard practice is to show separately an item for net errors and omissions. Also known as statistical discrepancy, it is intended to offset over-statements or understatements in a Balance of Payment.

The size does not provide an indication of overall accuracy of the BOP, as there could be compensating errors. Admittedly, the major source of errors and omissions in the BOP is the short-term capital movement that is often difficult to trace or fully recorded. This item permits clear recognition of the real creditor non-resident who is the owner of the claims on the economy and the real debtor non-resident who has external liabilities to the economy. Some of the errors would have offset one another and therefore the size of the figure does not necessarily provide a measure of accuracy of the BOP (Linde, 1999).

Large and negative variable items can be indicative of capital flight especially in the face of pending devaluation or anticipated depreciation and of uncontrolled outflows to bypass exchange controls. Equally, positive net errors and omissions can be indicative of proceeds from illicit activities flowing into the country. Common formal causes of errors and omissions, as Floria (2001) says are improper release of merchandise against documents, misdirected freight, improper selection of a carrier, delay, shipment which does not arrive in a timely manner, subrogation claims, counter claims, quota problems, failure to file claims timely and improper classification. All these are legitimate reasons why errors and omission is needed to balance up the BOP.

However, all the formal errors in the Errors and Omission of the BOP can be summarised into three basic groups, according to (Bloomberg, Forss and Karlsson, 2003). They are measurement errors that deal with valuation registration especially due to exchange rate fluctuations. Coverage errors which occur when business operations and operators are not fully registered (leading to shortfall in the number of business transactions) and *periodisation* or time errors which occur because of transactions being reported for a different period other than when they occur. Some illicit reasons have been adduced for the need to use this statistical discrepancy. These illegal transactions have only one entry where such transfers are legitimate. Others are deliberate attempts by some countries to portray their BOP in a particular light (Adegbite, 2007). It has been the main item under consideration by researchers of capital flight, because of the possibility of abuse of the statistical discrepancy. When the Net Errors and Omission in the BOP is consistently large and comes with a regular sign over the years then it is sign that the accounts are not correctly stated (IMF, 1993). If the NEO is positive, it means that the sum of current account balance and capital account balance is understated and vice versa a negative.

NEO item represents the unrecorded use of part of capital inflows outside the economy Thus, it is easy to suspect the possibility of capital flight when there is a large negative figure, especially when there is a regime of fixed exchange rate or devaluation or depreciation of the currency is anticipated. Large positive figures occur when the funds return to the country under various guises and names completely obliterating its original source. Sometimes the ingenuity of the authorities is needed to decipher where the inflows come from. It is clear that the estimation of Dooley’s capital flight relies on the errors and omissions (E and O for short). It is also clear from the above that its use as balancing entry or statistical discrepancy allows the BOP figures to agree, but it is nevertheless open to much abuse.

**2.7.4 The Abuse of Net Errors and Omissions**

With the popular belief that misinvoicing in foreign trade transactions which affects the current account is a common route of capital flight, the role being played by non resident investors in the flight process makes capital flight studies much more intriguing. That investors have to resort to clandestine efforts to transfer capital out is known in Nigeria. This method of transferring capital out of Nigeria will continue until there is a full and freely floatation of the domestic currency by the authorities and a conducive investment environment exist, which will make foreign currency to be available at a price.

A common method of transfer usually involves the exportation of goods and commodities in high demand overseas by the individuals or firms engaged in capital flight. It starts with the accumulation of the capital to be transferred and the placement of such for purchasing exportable items. Once the goods are bought, the persons or firms interested in exporting capital ships them out of the country for sale. Once this is done, they are sold and the proceeds simply are not repatriated back to the country. One cannot say if crude oil (Nigeria main export) is employed for these private transactions since it is also heavily used by the government to make international payments. Nevertheless, the abuse is commonplace in the exports of agricultural produce such as cocoa, coffee and rubber.

The reverse of this transactions often occur when capital whose origins cannot be disclosed is being brought into the country by importers. Importers simply bring in highly demanded goods without disclosing where the capital to purchase such items is coming from and it is declared as personal effects by the importer. The changes are reported in the net errors and omissions or the *statistical discrepancy* of the Balance of Payments. The effects of these forms of transactions are that records do not reflect the true nature of transactions going on with the country. In addition, much of the outflows of foreign exchange is not backed by letters of credit (L/Cs) indicating a pure transfer of capital out of the economy. This could be for external portfolio investment and ends up as capital flight rather than for the purpose of purchase of needed capital goods in the economy.

**2.7.5 Requirements of Capital Account Liberalisation**

de Swaan (1999), in a discussion on the subject says that the liberalization of capital account should follow the underlisted steps and should be preceded by the redressing of major fiscal and monetary imbalances in the domestic economy.

1. The liberalization of trade.
2. The easing of labour regulations sufficiently, and
3. A sound regulatory and supervisory framework for the domestic banking sector.

While capital account controls have not been condemned entirely, there is a consensus on the desirability to have a liberalized capital account regime. The IMF has been heard condemning covertly the use of capital controls and has insisted that it is costly for the economy (Camdesus, 1998). Where such capital controls have been used it should be temporary to allow for the correction of macroeconomics imbalances. A good example of this was Chile, which used the controls twice between 1979 - 1982 and 1991 – 1998. These episodes were generally acknowledged as successful. The use of capital controls has basic objectives of control of inflation, while the exchange rate should be kept stable, and to limit the country’s vulnerability to exchange rate fluctuations. Edwards (1998) insists that the key is the control and adequate management of the macroeconomic variables and not capital account control. The obvious demerits of capital controls can be listed as:

1. They keep countries from reaping the fruits of free capital flows, that is, a better allocation of savings and higher economic growth: they may even, intentionally or otherwise, serve as barriers to trade;
2. They require large and costly enforcement efforts (bureaucracy) and often leads to corruption, and tends to be progressively evaded;
3. They have a tendency to perpetuate themselves and postpone the necessary improvements in macroeconomic policies, the regulatory and supervisory systems in the financial sector, and the often excessive government interference in the corporate sector;
4. The introduction of restrictions on capital outflows tend to discourage capital inflows and raise the risk premium on those inflows for a much longer period.

The complete liberalization of capital account, in spite of its advantages, is not being fully practiced in the OECD or the EU, with the OECD Code of Liberalisation of Capital Movements with Article 7 on clauses of derogation, and 11 through 17 on the procedure. This Code was adopted in 1961 and subsequently extended, notably in 1989 to cover all capital movements including short-term capital flows and, the Treaty establishing the European Community, Articles 56 through 60 and 114 (formerly: Articles 73b through 73g and 109c).

In spite of the advantages of opening up of the current and capital accounts of the BOP, it should be noted that it should not be done in one fell swoop or suddenly, because of the disturbing effects it might have on the economy and the welfare of the people. A regime of adequate prudential controls is often seen to be more meaningful than capital controls, for the following reasons:

1. Cautious prudential regulation and supervision is generally endorsed, in contrast to restrictions on capital flows which is also less visible;
2. Evasion would seem to be more difficult in the case of prudential regulation

Adequate prudential regulations will undoubtedly assist to *dis*allow financial markets attract heavy inflows that might turn out to be unsustainable in the long run which might precipitate a run on the economy, leading to continuous capital outflow and eventual capital flight. Gradual, systematic and a proper timetable need to be followed to liberalize the capital accounts section of the BOP. This would not encourage capital flight.

While the current account is concerned with the issue of persistence, the capital account is concerned with the control of flows through the public economy and therefore the ability of the country to manage its macroeconomic variables properly. While the current account components all seem to be the net of tradeables with the resultant effect of surplus or deficit leading to acquisition of assets or debts by the country, the capital account is involved with the flows of resources and the need to engage the resources to earn returns either domestically or overseas. Both have instantaneous effect on the exchange rate of the currency of the country. This may be continued with or be liquidated depending on the investment horizon and objectives the investor. *Traders* conduct the transactions on the current accountwhile the persons involved in the capital account are *investors.*

There is no doubt that this was the state of developing countries before the urge for a sudden liberalisation of the capital accounts became rife, and was the state of Nigeria before 26th September 1986. However, the government has progressively opened the economy from fixed to floating of the exchange rates, deregulated financial system and lately liberalized (of some sort) capital account. Most importantly, governments that simultaneously fix exchange rates and open up the capital accounts give up monetary policy autonomy because interest rates cannot deviate seriously from those in countries to which the domestic currency is tied, for example the dollar in Nigeria.

The following are the elements of the less restrictive capital account regime already in existence in Nigeria, according to the Foreign Exchange Monitoring and Miscellaneous Provisions Decree of July 1995 applied retrospectively from January:

* 1. There is guaranteed convertibility and transferability of dividends and proceeds of invested capital, wholesale or partial liquidation of business, dividends or profits.
  2. Foreign investors can invest through any of the Autonomous Foreign Exchange Market (AFEM) or other accredited dealers their incoming capital.
  3. Nigerians are allowed to invest abroad so long as proper documentation is used, though bank deposits abroad are not permitted.
  4. There is no limit to the equity holdings of foreigners in Nigerian registered business firms except for the crude oil and gas industries.

Before the country got to that stage, the sudden liberalization experiences of the South East Asian countries that encouraged capital flight in each case have sent countries back to the drawing board to see if it was a wise decision at all, as those countries lost out in the process (Brune *et al*, 2001). Brune *et al* argue that there are financial and economic dynamics involved in the capital account liberalization process. The democracies of the world do not fare better in the capital account openness in escaping the challenges that come with such openness contrary to Epstein and Schorr (1992). It is clear that the developing or *poor* countries tend to have less open accounts, thus countries with higher per capita national income have more open capital accounts, and countries with fixed exchange rates were likely to have somewhat more closed capital accounts. Countries integrated into world capital markets and those with internationalized stock exchanges are more likely to have open capital accounts, which can imply that Transnationals (TNCs) can be influential in the capital account transfers of those countries where they operate. However, the descriptions above can only take place in a liberalized economy: that is such economy must be running an open capital account where the movement of resources is not hampered in any way

With the status of Nigeria on capital account of the BOP, it is clear that the country has liberalized somewhat but not fully. Nigerian companies’ have been sourcing funds from overseas and other portfolio investors have been investing in the capital market, and some amounts of resources have come in as FDI. All these signify the opening of the capital account. The foregoing infers that the Nigerian capital account has the following characteristics:

1. The capital account of the Nigeria BOP was somewhat restricted
2. Foreign direct investments seem to dominate over the other type of inflows
3. The recent experiences tend to prove that the capital accounts is somehow open

What does this imply for the country? The current state of the liberalization of the capital account of the BOP in Nigeria implies that capital is fully free to move into the country and exit whenever the investment objectives of the investor are fulfilled. If the capital account is more open, then one should expect a surge in capital outflows when any of the attendant risks occur.

**2.8 CAPITAL FLIGHT AND FINANCIAL GLOBALIZATION**

**2.8.1 Definitions**

Capital flight could be more exacerbated by the onslaught of financial globalisation. A general definition of the topic is the increased economic integration between countries through the flow of information, goods, services, technology and people (Adubi, 2005). Globalization has led to a degree of homogenization of products and services across the globe of consumption preferences and options shaped by expectations of what can be acceptably sold in richer countries across the globe (Kydd, 2003). Under economic globalization, financial globalization is important, and it is often mixed up with financial integration. Financial globalization is an aggregate concept that refers to rising global linkages through cross-border financial flows (Khose *et al*, 2007). Financial integration on the other hand, refers to an individual country linkage to the international money or capital market, and is seen as a gradual process through which cross border capital flows increase, financial markets co-movements become stronger and products prices and market infrastructure converge to common standards (Belaisch and Zanello, 2006).

The process of globalisation was said to have begun in the 15th century, powered by imperial conquests of new lands and the need to accumulate resources by the first world from the new unconquered world (Petras, undated). Africa was one of the regions that had to be conquered by the forces of Portugal and Spain – dominant powers then. These economies were built using the domestic resources from the respective economies to finance overseas conquest and private capital accumulation. Since then, the process had gone through many phases and is used currently mainly by Transnationals to exploit trade and commerce. The cyclical process has always seen the periods of expansion and contractions. Expansion, when proactive efforts are made to increase trade and contractions, when agents of globalization recede and nationalism takes over. It is neither a new phenomenon as some would have people believe, nor is it a culmination of history. The process however picked up again in the mid 1980s, presumably due to prevailing democratic governance. Globalization is an important aspect of economic life in the world today and it can no longer be denied that it affects every facet of existence of the people and countries in the world. Many scholars have worked on different aspects of globalization, and these have led to categorization of the process into different aspects. Virtually every discipline has an aspect of globalization or how it has been influenced by it.

Thus, we have economic, social, military, political, cultural, legal, technological as well as environmental globalization. This has led to the process being variously defined by authors, scholars and researchers. According to United Countries Commission on Trade and Development ((UNCTAD, 1991) globalization is defined as the third layer of internationalization; the first layer being the expansion of international trade, the second layer was the financial integration that was witnessed in the 1970s on the adoption of flexible exchange rate regimes. The third layer now referred to as globalization, which commenced in the 1980s has been *enabled* by information technology. As the Table 2.2 reveals, the general level of globalisation of Nigeria has oscillated between 0.187 and 0.42, which indicates that the country is yet to reach half the level of expected globalisation of countries around the world. The variables included in the measurement of the economic sub group off the total include FDI and trade but not foreign portfolio investment. The financial integration or globalisation measure is more important in this study and is adopted for the study.

**2.8.2 Financial Globalization and Integration**

Globalization, with its different aspects and types, and as a multidimensional process that has been accepted as an overwhelming force that can hardly be resisted by countries and cultures across the globe has its various impact on capital flights and investment in the domestic economy. There are fifteen known areas of interest and studies on the subject, but broadly divided into five main areas. This range from information to military globalization; and financial and trade globalization: the different areas are easily subdivided into three areas of economic, political and social. Under economic globalization, financial globalization can be studied separately from other aspects of economic globalization especially, trade. Financial globalisation essentially deals with the integration of the world financial markets. A synonymous aspect of financial globalization is financial integration. For instance, increasing financial globalization is perforce associated with rising financial integration and is often blamed for contagion resulting from damaging financial crises that sweep across countries when economies are intra-regionally connected rather than being inter-regionally connected. Financial globalization is based on the effects of the different types of financial flows namely:

1. Foreign direct investments which is increasing across the borders of countries
2. Equity flows that have steadily climbed up in recent times
3. Debt flows which have considerably reduced.

Foreign direct investment has increased in importance because it tends to be more stable and less prone to reversals and is believed to bring with it indirect benefits of foreign investment in terms of managerial and technological expertise. The main benefits of the financial globalization or integration can be seen in the immediate advantages of the improvement in the financial market conditions of the country which has been recorded as more efficient international allocation of capital that enables international investors to move capital where it is most needed can earn the required return. Capital deepening and international risk sharing that allows more credits to flow to needed areas while it also focuses on the channels of capital flows that directly increase Gross Domestic Product but reduces consumption volatility.

**Table 2.5**

# Nigerian *General* Globalization Index 1991 – 2004

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Year** | **Economic** | **Social** | **Political** | **Overall** | **% Change** |
| 1987 | 0.157 | 0 | 0.315 | 0.187 | ----- |
| 1988 | 0.155 | 0 | 0.347 | 0.205 | 9.62 |
| 1989 | 0.159 | 0 | 0.383 | 0.231 | 12.682 |
| 1990 | 0.181 | 0 | 0.387 | 0.247 | 6.93 |
| 1991 | 0.192 | 0.002 | 0.421 | 0.277 | 13.76 |
| 1992 | 0.171 | 0.002 | 0.493 | 0.309 | 11.55 |
| 1993 | 0.21 | 0.003 | 0.574 | 0.386 | 24.92 |
| 1994 | 0.192 | 0.003 | 0.585 | 0.381 | -1.3 |
| 1995 | 0.2 | 0.002 | 0.589 | 0.388 | 1.837 |
| 1996 | 0.187 | 0.002 | 0.603 | 0.389 | 0.003 |
| 1997 | 0.193 | 0.004 | 0.575 | 0.376 | -3.34 |
| 1998 | 0.179 | 0.004 | 0.575 | 0.367 | -2.393 |
| 1999 | 0.182 | 0.003 | 0.603 | 0.386 | 5.177 |
| 2000 | 0.202 | 0.003 | 0.631 | 0.416 | 6.995 |
| 2001 | 0.198 | 0.003 | 0.583 | 0.384 | -7.692 |
| 2002 | 0.103 | 0.005 | 0.592 | 0.331 | -13.802 |
| 2003 | 0.101 | 0.005 | 0.529 | 0.29 | -12.39 |
| 2004 | 0.101 | 0.005 | 0.624 | 0.35 | 20.69 |

# Source: (a) Columns 1 – 5 from Lockwood and Redoano (2005)

**(b) Column 6 from the author’s calculations**

Financial market development as major benefit enables the recipient country to have better economic system that allows a long-term development effort to be meaningful. It allows the increase in the number of financial institutions that allows financial products to be multiplied in the financial system. Others are regulatory and institutional development, which allows the regulatory institutions in the country to develop the capacity to manage the onslaught of various capital flows both outwards and inwards. Better governance occurs in the corporate practises of the firms in the domestic economy. Issues such as transparency and good corporate governance become part of the culture of the firms. Lastly, macroeconomic discipline is ensured especially the fiscal side of the economy to handle variables such as inflation, money supply and effective implementation of enunciated programmes.

The globalization process, which has turned the financial world environment into one is steadily allowing indigenes to make cross border investment with little restrictions and equally allowing entities from other countries to invest in the domestic economy of other countries and transfer the proceeds without restrictions (UNCTAD, 2003). In this way, capital mobility encourages a “race to the bottom” in the provision of social and environmental infrastructure and amenities both within decentralized states and sub regional states and among countries in the world capital markets. This motivates governments to reduce corruption, waste and inefficiency and to provide a more business oriented, competition-friendly environment (Keen and Marchland, 1996).

In addressing this issue, Cai and Tresiman (2003) exhaustively discuss the environment of the country as important. This is because more naturally and humanly endowed countries will do better since most countries are unlikely to start from the same level, and less endowed countries tend to give up because of little competitive strength, but Nigeria is an exception. This may not hold true as Mauritius, a small country off the Horn of Africa, is doing very well in the globalization process having fully opened up and completely transformed by other measures as far as inflows of foreign investment and outflows are concerned (UNCTAD, 2006).

Globalization has almost become a monster that is conquering countries at will and subduing countries opposed to it, and in the process seriously curtailing the ability of the State to deploy independent monetary policies (Ojo, 2010) and limiting the powers of the national monetary authorities. With the zenith of nationalism winding down, in the mid 20th century, globalization has taken over and has been the main driving force in world affairs. The implications of this is that, there is the transfusion of the bad side of globalization in form of pollutions, contagions (Whalley, 1991, 182) and good side as a true international price for factor costs, especially of labour and capital**.** Equally, it has led to seriousreduction inthe cost of goods and services in the ensuing process engendered by competition.

Financial globalization - the opening of a country's financial markets to foreign capital and financial institutions- is far from complete, therefore still developing. The process is seen to be at an advantage to the rich countries rather than the poor ones as the paradox of finance, moving capital from rich to poor countries to take advantage of cheap labour is not operating, but the reverse is the case. Nevertheless, capital has been observed to move a lot more freely within the circle of developed countries and a negligible part of the funds have move to the emerging markets where they have been more return chasing than anything else. Developing countries benefit only where certain factors have been established. Mishkin (2006) enumerates three major benefits that the process brings to a developing country like Nigeria in the following areas:

1. Lowering the cost of capital, thereby encouraging investment, which in turn promotes growth,
2. It improves the allocation of capital.
3. The most important benefit and one not usually emphasized--globalization of a country's financial system, if it is designed to promote competition in domestic financial markets, helps promote the development of better property rights and institutions.

Major areas of financial integration are grouped into four and as, Foreign Direct Investment (FDI), debt flows between the corporate and industrial world, debt flows between governments on bilateral basis and portfolio investments have all increased the process of financial globalisation in one way or the other. Kenen (2007) is particularly interested in the units’ involvement in the process by dividing the units into two, the public sector and the corporate world. The involvement of the public sector is seen in the issuance of debt instrument under either of the national laws: domestic or foreign (the country where such instrument is domiciled and priced). The corporate sector is involved through cross border merger, acquisitions, and FDI. They are also involved when they sell or buy stocks overseas; holding the corporate debt instruments of other countries. Finally, the introduction of the banking sector by worldwide interbank market lending and borrowing is a new phenomenon, though this is seen as dangerous in retrospect of the Asian Financial crises in the late 1990s.

While the flows have continued, the benefits derivable from the process have been country- specific and cannot be generalised. This goes to show that countries have specific attributes and features that have aided or discouraged growth or development with financial globalisation in place. Main precursor of financial globalisation challenges have been the excessive debt (both foreign and domestic) and fixed exchange rates. For countries and economies that have liberalised their capital accounts, management of the fixed exchange rates regime and domestic inflation automatically become problems. Both have compounded the problems of developing countries in the management of capital flows affecting their countries. However, the much believed hypothesis of development and growth accompanying globalisation cannot be fully accepted in the face of robust tests that *insignificantly* prove this theory – though the theory cannot be wished away. Edison, Levine, Ricci, and Slok (2002) after thorough and rigorous tests of financial globalisation impacts on development could not conclude in the alternative because of variety of reasons adduced are soft rather than hard for this phenomenon.

These *soft attributes* are those that Prasad, Rogoff, Wei, and Kose (2003) believe are responsible for the different results and non robustness of the results that emanate from the theory that financial globalisation aids development. The soft attributes are what contribute to the total factor productivity in these countries. Ayhan Kose *et al* (2003) assert that these factors are 'social infrastructure'. These factors are governance, rule of law, and respect for property rights, efficient allocation of capital and expanded international risk-sharing opportunities, growth and stability benefits, rather than just capital-labour relationship. Domestic markets liberalisation has also made it impossible for a full understanding of why this theory cannot be established. It is argued that a lot depended on the issues like governance, ethics and freedoms to ensure that incoming capital is put to its best uses to earn growth-inducing returns otherwise, such capital will leave the economy as capital outflow.

In assessing the impact of Total Factor Productivity (TFP) in conjunction with financial globalisation at aiding growth, the thought of which of these comes first: Total Factor Productivity (TFP) factors or capital account liberalisation becomes important. If TFP factors aid growth, then it must have been in place to synergise with the incoming capital flows. Ayhan M Kose, Eswar Prasad, Kenneth Rogoff, and Shang-Jin Wei (2006) in an exhaustive study refer to the TFP factors as “collateral benefits” as being some of the immediate possible gains of financial globalization where there was none before.

**Figure 2.1**

**Financial Globalisation and Growth and Development**

Foreign Capital inflows

` Collateral Benefits Total Factors Productivity (TFP)

Domestic Capital Flight (Outflows)

**Diagrammatic Effect of the Collateral Benefits and Total Factor Productivity in Financial Globalisation**

For capital account liberalisation to work favourably for a developing country like Nigeria, the threshold expected of these soft factors must have been achieved. The strength of these soft factors determines the impact of the inflows for growth or development of the domestic economy. The factors also depend so much on the development of supporting institutions and markets.

If the financial market is sufficiently developed, the institutions already have adequate capacity, strong governance and rule of law are in place, then it can be expected that capital inflows can be of benefit to the domestic economy. The issues dovetail to the importance of investment in these soft areas to improve the quality of life and of governance and then investment becomes the variable to explain the varying factor to growth in developing and emerging financial markets of the world such as Nigeria.

Mishkin (2006) also argues that the developing countries are not poor because there is not enough capital and that the key factor in economic growth is that it is far from clear that emerging market economies are finance constrained, in other words, they may not have trouble getting money for investments. However, throwing money at investments does not work, which in most cases has resulted in bad and misapplied loans.

**2.8.3 Financial Globalisation, Capital Outflows and Volatility**

The role of financial globalisation in economic development certainly has its side effects in reduction of consumption. It has been the major cause of consumption volatility in developing countries (consumption being a better measurement of living standards than direct capital accumulation or acquisition according to Kose, Prasad, and Terrones 2003). Sudden outflows of capital resources are seen as volatility and can seriously affect the standard of living and per capita income of the domestic residents. Calvo and Reinhart (2000) document that emerging markets currency crises, which are typically accompanied by sudden stops or reversals of external capital inflows, are associated with significant negative output effects which invariably affect domestic residents. More than this, the capital outflows that happen during the reversals of capital inflows cannot be properly addressed as capital flows.

Capital flows that happen when capital flees to safety and may be regarded as reverse flows when it is non-resident capital; but can be taken as capital flight when it is resident capital leaving the economy for external investment. This scenario is usually preceded by risks in the domestic economy. Since international capital is highly averse to risk and therefore very volatile, countries that depend so much on any of the three way flows expose themselves to volatility. The flows are not equally volatile as FDI is seen to be more stable and reliable than the other two. Therefore, the promotion of FDI is seen to be a better option for a country that must expose itself to inflows of foreign capital. The success of this is, however, limited by the macroeconomic factors that are the attributes of differing growth rates of capital inflows as a result of capital account liberalisation that is the *soft attributes*. This situation brings in the type of policies initially put in place to attract FDI and such policies that is in place to sustain its continuance or growth. The matters at issue are that capital account liberalisation that impels financial globalisation cannot be undertaken in isolation without sound domestic policies in place, nor can it be done without algorithmic steps for its implementation. In addition, there must be capacity to manage its eventual outcomes and counter cyclic effects.

**2.8.4 Financial Globalisation and Capital Account Liberalisation**

The influence and impact of globalization on capital flight become of interest in the light of these discussions. The flows of capital in an unrestricted manner through financial integration or globalization can lead to a serious financial instability in an economy if not handled well. Opportunities thrown up by the process and its allure are far too gleaming to be thrown overboard; the incredulity of a possible global market for financial products and services is too tempting to ignore (Quelch and Hoff, 1993). The flow of finance in the international arena means that funds can move in an unrestricted manner between countries as it seeks returns higher than or commensurate with its attendant risks. Helleiner (1994), adduces the following reasons to the re-emergence of globalization of finance:

1. The growth of global telecommunications networks which reduced the costs of transferring fund, for example, through the Society for Worldwide International Financial Telecommunications (SWIFT).
2. The restoration of market confidence and the safety of international financial transactions since the late 1950s.
3. The increase in the demand for global finance stemming from the growth in number and size of multinationals and international trade in the 1960s.
4. The large surplus of financial capital in oil producing States after 1973.
5. The adoption of floating exchange rates from the early 1970s, which created a need for diverse currency portfolios.
6. The evasion of domestic regulatory controls.
7. Subsequent market innovations such as currency, interest rate futures, options and swaps transactions.

Each of these reasons can significantly lead to capital flight or the reaping of the benefits in the process of financial globalization. These are the main reasons for the statement within international monetary and financial circles that financial globalization is neither the magic wand to turn an economy around nor can it be unmanageable (Summers, 2000).

The process of globalization has magnified the problem of capital flight as the resultant effects of unfair competition with unequal trading partners and thus unequal rewards (Ojo, 2007) which have taken roots in the movement and flows of capital across countries of the world and Africans countries are at the receiving and losing end. The World Finance Governing Institutions often prescribe the same treatment for a myriad of different problems facing the developing countries that approach it for assistance on issues such as competition in the financial market, privatization of government or state owned enterprises, budgetary and austerity measures, good governance, currency devaluation and possible dollarization of the domestic currency (Agbese, 1992). The treatments being prescribed to the developing and poorer countries of the world are disturbing such that Stiglitz (2003) decried the whole process, that what should have brought succour to these countries but is now bringing untold misery. These institutions, Stiglitz says, simply promoted the Wall Street activities and capital markets of the developed countries by promoting special corporate interest with flawed economic theories, lack of transparency to the public and not living up to their avowed goals. This resulted in net outflows of capital in the long run from developing countries including Nigeria.

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The financial globalization experience of Nigeria as revealed by Table 2.2 shows that the country started late and is yet to catch up with other countries, as one would expect. The process was on initially in 1987, only to drop off later in year 1997. This particular trend shows the inconsistency of policies resulting in inconsistency of inflows of foreign investment in Nigeria.

**2.8.5 Financial Globalisation and Financial Development**

One of the acclaimed benefits of financial globalisation is financial development and deepening that is possible with the introduction of inflows to the domestic economy. Inflows of capital must be invested to yield a higher rate of return for the investor, which can only happen when the domestic financial system is deep enough to accept new inflows. Such inflows must be invested in the needy areas of the economy to be meaningful for economic development and returns that benefit the domestic economic and financial system. It is arguable if integration or globalisation can engender financial deepening, and thus autonomous of foreign inflow of capital. However, Klein and Olivei (1999) and Levine (2001) show that financial liberalisation promotes financial development which Beck *et al* (2000) proves it fosters productivity more than capital accumulation.

Bonfiglioli (2007) proves that the stage of development of the country concerned is paramount, as countries spend a lot more on investment i.e. higher aggregate expenditure on physical capital and development of infrastructure before maturing. As a result of this financial globalisation is more impactful on the developed countries investment than other emerging and developing countries. Also, noticeable in the findings is that financial development also has positive impact on productivity, which favours the convergence in productivity. The conclusion is that financial liberalisation has a positive direct effect on productivity, while it spurs capital accumulation only with some delay and indirectly, since capital flows rise with productivity in countries with minimum level of financial development.

**2.8.6 Studies on Nigeria’s Globalisation**

Nigeria’s experience on the financial globalisation terrain has not been documented (as this study found out). However, a sociological perspective of the economic globalisation indicates that the experience has not been salutary as it appears to have been foisted on most developing countries as part of the debt settling projects. It is (was) not an independent programme to encourage development or growth of the country and is therefore counterproductive – on the balance (Olikoshi, 1998). Onyenoru (2003) reports the dismal performance of the real sector and the benefits globalisation has been to the multinational firms and developed countries rather than developing countries. He recommends the model of the Asian governments where there was a purposive intervention of the government to bring out the celebrated miracles especially on industrialization and attendant economic growth.

The issue remains that the financial globalization or integration may not be impactful on domestic financial system if globalisation generally had negative impact on economic or industrial development. Furthermore, the inflow of capital needs to be complemented with adequate structures and infrastructure on ground before it can yield the expected and theorised dividends. Investment in the soft areas is important for Nigeria and other developing and emerging countries to reap the benefits of financial globalisation or integration.

**2.8.7** **Models and Measurements of Financial Globalisation**

Adegbite (2007b) is replete with the different measurements of financial globalisation. Trade is the most important of all the measures of financial globalisation as there would be no financial flows if real goods and services do not exchange hands across countries. Trade is also indicative of the level of real inter-relation between the domestic economy and the rest of the world. The following measures are often adopted:

1. Participation in international trade: this measures the level to which the economy is globalised by way of trade with the economies around the world and measured by (*X+M/GDP)* where X and M are for absolute values of exports and imports respectively and GDP is Gross Domestic Product.
2. Participation in International Capital Markets (PICM) measures the extent to which the country has borrowed or lent to the international capital market either as recipient or as user of capital. This happens through the surplus on the current account as the country makes the balances owed to it by the rest of the world available to finance other countries trade imbalance measured as (*CUB/GDP*) where CUB is Current Account balance. The level of economic activity in the country is indicated in the current account balance of the country. The higher the ratio the more globalised the economy is.
3. Penetration of Foreign Capital into the Economy is the extent to which the country is open to foreign direct inflows. Higher ratio shows that the country is more globalised. For the purpose of this study, a combination of Foreign and foreign portfolio inflows is adopted *(FDI+FPI/GDP).*
4. Real Interest Rate Parity is the extent to which the interest rate in the country equals the world’s rate of interest as most investors are indifferent in the countries because interest rate equality is expected to hold under the law of one price and therefore the interest rate differential between country *i*  and the rest of the world is expected to e zero with the following formula: *Rtwd = rtw – rtd = 0* where *rtwd* is real interest rate differential, *rtw* is real interest rate differential world and *rtd* is the differential for country *i*. This is akin to the Risk-Neutral Efficient-Markets Hypothesis” (RNEMH) deviations of H Ito and Mchin (2007) which is explained below.

Various models have been developed to measure the level of financial globalization by various academics and researchers, which have not agreed on the variables to include or exclude. Basic approaches have been on the level of *relaxation of controls* and generally the relative *level of openness* each being measured from different angles. The earliest of such measurement is Quinn (1997, and the most recent is Potchamanawong (2007). However, Chinn and Ito (2007) provide an Exchange rate based, as well as regulatory environment based measurement of financial openness. The second measurement is known as KAOPEN made up of four cognate measures of open BOP when controls are not in existence. The index is measured from the point of regulation and therefore *de jure*, which implies that the *de facto* conditions may not follow the index. They are:

1. variable indicating the presence of multiple exchange rates (*k1*);
2. variable indicating restrictions on current account transactions(*k2*);
3. variable indicating restrictions on capital account transactions (*k3*); and
4. variable indicating the requirement to surrender export proceeds (*k4*).

From all indications, the *de facto* measure, which should be superior, could be illegal in most developing and emerging economy countries, which is the case of Nigeria. The *de facto* measure derived by Ito and Chinn (2007) adopts the UIP method that is based on deviations from the parity. The Uncovered Interest Parity model uses a price-based measurement rather than asset and liability based approach adopted by Lane and Milesi-Ferretti (2008).

The Uncovered Interest Parity (UIP) takes its root from the Law of One Price (LOP). The rational expectation that no risk premium exist is sometimes termed the “Risk-Neutral Efficient-Markets Hypothesis” (RNEMH) which show the unbiasedness of the expected parity conditions in interest rates. The essence is to test the exchange rate and interest rate differentials. The method adopted a Fama Regression process to test the proposed hypothesis. It relies specifically on the use of deviations to test the attraction of the currencies of different countries that was tested. The variables involved in the index were, *FD (*financial development), the first principal component of private credit, creation, stock market capitalization, stock market total value, private bond market capitalization, public bond market capitalization, inverted net interest rate margin, and life insurance premium as a ratio to GDP. Financial development is notoriously is difficult to measure and measurements are not uniform across countries. Some studies have used financial deepening as proxy being a better measure for developing countries. Another model developed by Baltagi *et al* (2008) relates financial development to financial openness and it uses the following regression:

*FDit = 0 + ln FDit-1 + 1 ln Yit-1 + 2 ln TOit-1 + 3 ln FOit-1 + 4 {ln FOit-1 x lnTOit-1} + uit*

where *FD* is an indicator of financial development, *Y* is per capita income, *TO* is trade openness, *FO* is financial openness and *u* is an error term that contains country and time specific fixed effects: *uit = μi + t +ν it*

where the *ui*t are assumed to be independent and identically distributed (*iid*) with mean of zero and variance σν2 .

A more popular measurement is asset and liability based which shows the integration of the financial system to that of the world and is referred to the drivers of financial globalization.

Fi = *α*+ *β* \_ TRADE*i* + *g* \_ FINDEV*i* + *r* \_ GDPPC*i* + *d* \_ POP*i* +*s* \_ *CAPOPENi* + *f* \_ EUR*i* + *h* \_ FINCTR*i* + #i

where F*it* is the level of foreign assets or liabilities, TRADE*it* is the trade-GDP ratio, FINDEV*it* is a measure of domestic financial development and CAPOPEN*it* is the *de jure* index of capital account openness developed by Chinn and Ito (2007). In spite of the popularity of its high level of correlation with earlier measures enumerated in appendices of their paper, it has not been a significant measure in the estimates where it has been used **February 2008 1**

The acceptability of the Lane and Milessi-Ferretti measures is seen in literature citing the measure apart from the understanding of the fact that the true measurement of integration lies in the assets and liabilities acquisition and not in the deviation of interest and exchange rate differentials. This helps in the choice of the measure for the Nigerian financial globalisation experience.

**Table 2.6**

**The Drivers of Financial Globalization**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | **All countries** | | **Developed countries** | | **Emerging countries** | |
| **Determinants** | **Assets** | **Liabilities** | **Assets** | **Liabilities** | **Assets** | **Liabilities** |
| Trade | \* | - | \*\* | - | - | - |
| Financial Dev | \*\*\* | \*\* | \*\* | - | \*\*\* | \* |
| GDPPC | \*\*\* | \*\*\* | \*\* |  | \*\*\* | \*\*\* |
| Population | \* | \*\*\* | \*\* | \*\* | \*\* | \*\*\* |
| Capopen | - | - | - | - | - | - |
| Europe (intgr) | \*\*\* | \*\*\* | - | \*\* | - | -- |
| Financial Centre | \*\*\* | \*\*\* | - | \*\* | - | - |
| Constant |  | \*\*\* | \*\* | \* | \* | \*\*\* |

**Source: Adapted from Lane and Milesi-Ferretti (2008) “The Drivers of Financial Globalization”.**

**Note:** The asterisks denote the level of significance \*, \*\*, and \*\*\* for 10, 5 and 1 respectively. **t)**

This is the *de facto* method by Lane and Milesi-Ferretti (2008) employed to find out the main variables that are important in the process of financial globalization, and they adopted the model of least square regression as follows:

**2.8.8 Nigeria’s efforts at Globalization and ECOWAS**

Most economic integration attempt starts with Regional Integration Areas, and Nigeria in this quest cannot be an exception. Falegan (1987) insists that the Nigeria globalization experience should start from the ECOWAS sub region, where it would be easy for the country to play a significant role, being the most resilient and largest economy in the region. The recent consolidation exercise in the banking industry that has induced the institutions to raise equity capital to an average of $1,000 million per bank is expected to spur the process of financial globalisation within the West Africa sub region. This was expected to force the institutions to be more outward looking for the purpose of investment. For the banks to participate adequately they would have to establish branches and subsidiaries in these ECOWAS countries to participate in their local economies. Some Nigerian banks have now established branches and strong footholds in countries such as Ghana, Liberia, Sierra Leone, Gambia, Benin Republic and Senegal.

**Table 2.7**

**Pre and Post Consolidation Asset Holdings of Selected Nigerian Banks**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **S/No** | **Bank** | **Pre Consolidation Asset $ B’** | **Current Shareholders Fund $ B’** | **Post Consolidation Assets $ B’** | **Countries Represented** |
| 1 | UBA Plc | 1.7 | 1.46 | 10.4 | 7 |
| 2 | Zenith Plc | 1.7 | 1.0 | 10.2 | 4 |
| 3 | First Bank Plc | 2.9 | 3.09 | 13.0 | 2 |
| 4 | Intercontinental Plc | 1.6 | 1.45 | 6.08 | 2 |
| 5 | GT Bank Plc | 1.5 | 1.35 | 6.3 | 5 |
| 6 | Union Bank Plc | 3.3 | 0.930 | 0.7 | 3 |

**Source: From Various Financial Reports of Respective Banks for 2007.**

This shows that Nigerian banks have undertaken some foreign investment which could only be possible with capital account liberalisation within the sub region. Ojo (2005) says capital account liberalization will engender an efficient financial sector and competition and mentions three strategies to facilitate this as:

1. Promotion of macroeconomic stability through compliance with the specified convergence criteria for the actualization of a monetary union.
2. The need for deeper financial sector integration in the sub-region through the development of an efficient payments system, development of capital markets and the achievement of price stability and,
3. The pursuit of programs for the promotion of regional development and integration, such as roads, marine and communication projects.

Thus, with globalization and capital account liberalizations, it is expected that Nigerians may no longer be interested in holding funds in the domestic economy if there are investment opportunities abroad and capital can be moved out with little or no difficulty. This scenario will encourage continuous outflow of capital out of the economy. This position is precarious for an economy that is still in need of capital to meet basic infrastructure and encourage growth. However, the current situation in the banking industry where toxic assets amounting as much as $6,490,000.00 (about ₦973 billion of which ₦400 billion is traceable to the capital market) Sanusi (2009) may hamper the progress already made. This has developed as result of the global economic meltdown occasioned by the credit crunch induced by the American mortgage subprime crises and have left at least of two these fledgling banks insolvent.

**2.9 CAPITAL FLIGHT IN OTHER DEVELOPING COUNTRIES**

Capital flight is a common phenomenon around the world and much more common in emerging and transiting economies. In developed economies, flights of capital would be regarded as a normal capital flows since it is meant for investment outside the shores of these countries and would most likely be repatriated soon. Two factors weigh in capital movements in developed economies according to FitzGerald (2002), interest rates (return quotient) and tax (evasion and avoidance). The two factors boil down o the return maximisation. It is not regarded as capital flight because those countries are not capital poor and therefore can afford to export capital. This is treated as portfolio diversification by the countries and is seen as strategic. Also, in the developed countries, clandestine ways of moving capital out of the economy is not employed though an element of trade misinvoicing or faking exists and levels of corruption in the private sector exist equally (Baker, 2007). Though not much of capital flow can be traced to these sources and more importantly, the situation is not directly open nor can it be measured.

**2.9.1 China**

Though reputed to be the fastest growing economy in the world, the country is also facing capital flight. It is equally credited with the highest rate of foreign direct investment in the world with a minimum annual average inflow of some $50 billion. Gunter (2003) finds that there are many problems facing the country including the position of the nearby enclave of Hong Kong. There are efforts to under-record exports while imports are recorded fully. The nation has at least 22 trading partners. A misinvoicing adjustment yielded almost double - from $58 billion to $110 billion. This is because trade between China and Hong Kong is not fully recorded before 1998 when the territory came under China. Much of the flight of capital out of China in the early years went to Hong Kong. This changed after 1998. For years before 1998, import misinvoicing in China was not exactly offset by export misinvoicing in Honk Kong, indicating that other destinations and countries benefitted from capital flight out of China.

Capital is said to be fleeing China at the rate of about $100 billion per year and over $900 billion have been converted into gold or some other foreign currency (Gunter (2003). The most common way of moving money out the Chinese economy is through trade misinvoicing. In spite of its position as the most favourable point for foreign investment, it had imposed capital controls in 1998-1999. This was successful to an extent such that capital flight reduced in the year 2001 to $37 billion. China has the highest level of foreign reserve in the world, put at $2,430 billion as at June 2009.

**2.9.2 Russia**

The experience of Russia immediately after *glasnost* and *perestroik*a was the spontaneous privatization of state owned enterprisesso that market economy policies would become irreversible. People who moved capital abroad devised complicated ways to move capital out of Russia. Terms like, capital economists who studied the problem used capital export and capital leakage. They agreed however that the effects are the same. Kosarev (2000) and Abalkin *et al* (1999) report that the scale of capital flight to be about $25 billion annually. Abalkin *et al* cumulates the flights at some $133 billion between 1992 and 1999. The most common method of moving funds out Russia is through intricate third party financial transactions that involve trading in (discounting of) bills of exchange. The usual method of trade misinvoicing is also prevalent although it is more complicated in the way it is carried out.

**2.9.3 Thailand**

As one of the four countries that faced capital flight challenges in late 1990s, Thailand faced serious outflow of capital in the 1997 to 1999 period during which an estimated amount of $118.1 billion was lost to the economy. The problem of sudden capital outflow in Thailand was caused partly by a fairly fixed foreign exchange regime and management in place and inappropriate use of inflowing funds by the banking system in the country. Debt, according to Beja (2006) also contributed to the scenario, which culminated in a contagion and affected three other countries in the region. Trade misinvoicing was the major culprit of the episode of capital flight in Thailand.

**2.9.4 India**

Capital account liberalization of India was one sided as the nationals could bring capital but could not take capital out of the economy. This encouraged the nationals to resort to trade misinvoicing to withdraw capital out of the economy during the post reform period. A total amount of capital flight estimated out of India in the period 1990- 1997 was $6.8 to $10 billion. Black market premium was not serious as to encourage a rerouting of currency, though the market often indicate a situation of market perception that was not realised, (Patnaik and Vasudeven 2000). The rate of capital flight in India, by this estimate is low. However, the Chambers of Commerce of the country has raised fears that full convertibility of the currency may result in higher level of capital flight. The capital account of India is *de jure* closed

**2.10 CAPITAL FLIGHT AND OTHER RELATED ISSUES**

**2.10.1 External Debt**

A cause and effect relationship has been established to some extent by researchers between the stock of external debt and capital flight. To some extent, it has been easy to conclude that much of the capital flight experienced in developing countries is due to availability of foreign exchange as provided by foreign debt. Literature has it that, odious governments in place in third world countries often borrow funds overseas for them to appropriate privately outside their countries. Beja (2006) established a revolving door approach to capital flight in South East Asia using the four countries of Malaysia, Philippines, Indonesia and Thailand as case study. Ajayi amd Khan (2000) informs there is now considerable evidence that the increase in capital flights was as a result of increasing debts in sub Sahara Africa. For Nigeria, there seems to be more capital flight during oil boom years than other lean years and more capital escaped from the economy during military governments’ years than civilian. However, it was not established if the military governments were more corrupt than their civilian counterparts were. Episodes of countries securing finance overseas and those funds not reflecting on whatever they were procured for abound in Africa, including Nigeria.

**2.10.2 Aid**

Collier *et al* (2003a) found that aid has substantial effect on capital flight through its attendant effect on corruption by reducing the level of capital flight. This causes aid to be ‘scaled up’ by the induced decisions of domestic wealth holders. The paper made a tentative suggestion that taking a long view of each $ of aid, it might be scaled up by around twenty to forty cents of induced domestic investments that would otherwise have left the country as capital flight.

**2.10.3 Brain Drain (Human Capital Flight)**

Collier *et al* (2003b) analyzed the scenario within the framework of portfolio choice where the allocation of financial capital is determined by the choice of the investor as to where he holds these assets than general migration. The same economic factors influences human and financial portfolio decisions, namely the relative returns and relative risks in the competing locations. While capital flight which was at its peak in the 1990s is steadily being reversed as a result of reduction in the black market premium, reduction in episodes of war and reduction in the level of interest rates in the US financial market, human capital flight have been on the increase. It is believed that the movement of the educated elite into the Diaspora is much more subject to momentum than anything else, because settled migrants assist intending migrants. This dynamic makes it difficult to reduce human capital flight once it has got going. He believes that while capital flight will be reduced in the decade with repatriation, human capital will continue in its exodus out of the African countries. Africa’s past problem has been capital flight; its future problem will be a more generalized high level of both human and financial capital deployed out the continent.

**CHAPTER THREE**

**3.0 THEORETICAL FRAMEWORK AND RESEARCH METHODOLOGY**

The basic and commonest technique for analyzing time series data is the ordinary least square regression, and perhaps the most popular, as it allows fewer restrictions than the more advanced ones. The regression estimates allow the understanding of the relationships that exists among variables and the significance between them. For the study, the OLS is a basic choice when other more advanced techniques with higher explanatory power cannot be adopted or applied.

**3.1 THEORETICAL FRAMEWORK AND LINKAGES**

The existence of capital flight in any economy is indicative of the inability of the economy to sustain a culture of investment, which is due to many reasons some of which may be peculiar to those countries. Capital flight disrupts long term development in terms and savings aggregation and long term development capital, which flees the economy. Additionally, it does not encourage private investors to invest in the economy but encourages them to invest in highly liquid short term investment. This is the basis for the hot money flows that frequently applies to capital flight estimates. Existence of capital flight in an economy is an indication of loss of confidence in the system.

The role of Foreign Direct Investment (FDI) in capital flight is, under a *priori* expectation and rational hypothesis that FDI should eliminate or reduce the impact of capital flight in an economy. Kant (1996) observes that capital flight is invariably related to FDI and concluded that FDI and portfolio inflows would reduce capital flight and this is caused by a general improvement in the investment climate of the country. The issue of investment in domestic economy reduces the role of resident and non-resident capital in capital flight.

While financial globalisation and integration has become topical in the wake of the South East Asian crises, it is easily established that the process began after the oil-shock of 1973 and the collapse of Bretton Woods’s system which encouraged countries to liberalise and float exchange rates. There are four indentified periods of which the period of 1971-2002 – is characterized by floating exchange rates, economic volatility, and rapidly expanding cross-border capital flows (Das, 2006). Cross country flows were initially limited, but have been accentuated by the Transnationals Corporations (TNCs) in the private sector-led foreign direct investment (FDI) into emerging and this economies attempts to reduce the spiralling cost of production (especially the cost of labour) in their host countries. Before the entrance of international financial institutions that introduced international sourcing and domiciling of assets, American and Global Deposit Receipts (ADRs and GDRs) were not so common. The entrance of mutual and hedge funds that are seeking above market returns from developed countries and investing into the capital markets of emerging markets had become noticeable as well. Evans and Hnatkovska (2005) established that the volatility that had earlier been experienced will give way to a more stable and less volatile market with the entrance of smaller units (households, for example) into the international financial market. This would reduce the issues of concern to only the risks involved in the American and Global Deposit Receipts and other portfolio investment outlets. Increasing financial globalisation would therefore provide avenue for capital flight proceeds and reduction in the domestic investment profile of the country.

The research methodologies employed by the various researchers differ from one to another and have been at variance with one another, which has resulted in different estimations and results. Though these results are somewhat close, one to another, they nevertheless point to a cluster of figures that tend to give estimates of the quantum of capital that has left the shores of the country. Those that have studied the topic have used a number of methods to arrive at the estimation of capital flight across the countries of the world.

**3.2 APPROACHES TO MEASURMENT OF CAPITAL FLIGHT**

## 3.2.1 Balance of Payment Approach

The pioneering studies of Cuddington (1986) adopted the Balance of Payment approach that measures capital flight as the sum of recorded short-term capital outflows (K) and unrecorded net flows or net errors and omissions (M) thus we have,

*KF (Bop) = K + M*

Where KF is Capital Flight measured through Balance of Payment approach, *K* and *M* are as defined above. The net flows could be positive when foreign investment is received or negative when there is capital flight. This is the simplest measure through the Balance of Payments

## 3.2.2 The Bank Deposit Approach

Onwioduokit (2001) reports another measure as the increase in recorded foreign bank deposits of a country’s residents. The first challenge of this method is that it is difficult to separate the official from privately sourced deposits and where such is possible the arguments that the private deposits were not recorded would be difficult to prove. The International Monetary Fund (IMF) is compiling data for those countries that supplied data on this to it, and it is arguable if such data is available, neither can it be compiled for Nigeria now. In arriving at the determinants of capital flight from Nigeria, he specified a model as follows:

*KF f (INCF, DINF, PREM, KEAU, GRD, P)*

Where *KF* is Capital Flight, *INCF* is financial incentives for capital flight, *DINF* is domestic inflation, *PREM* as the parallel market premium as proxy for the degree of real exchange rate overvaluation, *KEAU* is used to represent foreign exchange reserves availability proxied by net long term capital flow or as others have used debt or aid. *GRD* is the difference between Nigeria’s growth rates and that of a convenient developed comparable country, while P is a dummy variable for political and external shocks. Its major deficiency is the absence of misinvoicing element, which is one of the major avenues for transferring funds out of a country. However, the data used for this study was not available. It is clear that it is one of the methods that brought out the determinants of capital flight. The estimation was based on the Morgan Trust bank equation.

A later model by Ndukamana and Boyce (2001) introduced debt explicitly; and has generally formed the basis for the revolving door model by Beja Jr. (2006). This results in the following:

*KF = CDET + NKI – CAD – CRES + MIS + UNREMIT*

Where *CDET* is external debt, *KF* is capital flight; *NKI* is non-debt creating capital inflows (foreign investment (direct and portfolio)) *CRES* is large stock of reserves *CAD* is current account deficit, *MIS* is adjusted trade misinvoicing and *UNREMIT* is unrecorded remittance.

The model generally estimated capital flight. This is total capital flight. *UNREMIT* in Nigeria is not ascertainable and therefore would not be incorporated.

In Lawanson (2007), capital flight estimates were based on the two authorities namely World Bank and Morgan Trust Bank and were defined as:

*CF (WBi = FDI + ΔADJDEBTt – (CAD + ΔTRSEG)*

*CF (MT)i = FDI + Δ ADJDEBTt+ ΔFAB – (CADi + ΔTRESG)*

The notations are CF for capital flight, WB for World Bank and MT for Morgan Trust FDI for Foreign Direct investment, *ΔADJDEBT* is the changes in adjusted debt position ΔFAB is the changes in foreign assets holdings of banks *CAD* is current account deficit and ΔTRESG is the changes in total reserves less holdings of gold. The Dooley definition (as recorded in Ajayi (1992)) will also be used to make up four definitions that will be explored on the Nigerian case. (The others are the World Bank, Morgan Trust and Cline.) This will be concluded with econometric analysis of the phenomenon.

**3.3 MODELS SPECIFICATION**

Determining the long run relationship between variables is important as it enables the understanding of the impacts they have one against the other. However, each endogenous variable is explained by its lagged, or past, values and the lagged values of all other endogenous variables in the model; which eliminates the use of any exogenous variables in the model (Gujarati, 2004). Since the methodology allows comprehensive information about the dynamics of the interactions, long-term trends are easily explained. This enables shocks within the regressions and the system to be easily seen. The study adopts the Vector Error Correction Mechanism (VECM) for capital flight regressions. The Vector Error Correction Mechanism (VECM) however, minimizes the shortcomings of the VAR procedure while retaining its attributes as it incorporates the co-integrating variables by forcing the model to converge in the long run. It equally allows for deviations, which are corrected through a series of adjustments that are dictated by the long run relationship.

The relationships and interactions that exist between the variables are in matrix format of coefficients that is an *nxi* vector of disturbances to the system and is assumed to be serially uncorrelated. However, the absence of any co-integrating vectors amongst them suggests the need to use Vector Autoregressive model. Irrespective of the number of variables used in the performance of the VEC, the first vector is the most important co-integrating vector because it is the one associated with the highest Eigenvalue. The number of lagged difference terms to include is often determined empirically, the idea being to include enough terms so that the error term is serially uncorrelated (Gujarati, 2004). In addition, when two time series are co-integrated, then regression results may not be spurious and the usual *t* and *F* test are valid.

**3.3.1 TECHNIQUES OF ESTIMATION OF CAPITAL FLIGHT VARIABLES**

Modelling capital flight to know the relationship between the different variables discussed earlier becomes easy with the various theories, the various indices, and the hypotheses intended to be tested in the study. The study of variables help in the understanding and management for the purpose of ensuring that the capital flight can be reduced by paying attention to those variables for optimum results.

Investors look for returns on their investment in the financial markets and therefore the rate of returns must match the risks involved. Absolute return could be deceptive until it is inflation adjusted which then makes it real. In an environment where inflation can seriously erode the purchasing power of money, then the search for adequate returns to meet and compensate the risk assumed becomes important. To employ the variable, the real rates of return between two countries are considered. The real rates are arrived at in the usual manner: i.e. by *MRR/Inf* for both countries and obtaining the difference on yearly basis. This results in *intdiff* (savings or investment returns differential). The hypothetical country in the developed country is the United States, being the country counterpart currency Nigeria has adopted for use. This represent the portfolio element of capital flight that has been on the front burner of the discussions of capital flight in recent times since one of the reasons often adduced for capital flight is lack and insufficiency of investment outlets in the country.

The financial globalization process is tested with the *de jure* measurement of the capital account opening process, which is different from the actual *de facto* conditions existing, and encouraging flights of capital. Legally, the *de jure* is the implicit and the lawful means by which an economic unit can move funds in and out of the country. The intensity of capital opening processes is noted in the ease at which the institutions allow the flows of capital in various forms to enter the country and leave. The *KAOPEN* measures the intensity of the openness of the capital account, with the median figure being 0 and intensity of the process between positive and negative. It shows the process of the capital account opening process Nigeria has engaged in the previous years. The absolute figure for financial savings is used. The availability of financial savings makes resources available to investors to undertake investments in the economy.

From Komolafe (1996) co-integration progresses from a simple regression equation and as follows:

*Y1 = β xt + µt*.................................................................................................(1)

and the residuals,

*µj* = Yt - βxt which measures the extent to which the system, *Yi* and *Xi* is out equilibrium -*µj* is the disequilibrium error term, and must be stationary.

To test for the order of integration of the data series Dickey Fuller (DF) has been popularly adopted as also stated in this study.

The equation below test the order of integration

*ΔYt = αo  + α1 + α2Yt-1 + µ......................................................................................*(2)

or the more popular Augmented Dickey Fuller (ADF)

*ΔYt = bo + b1t + b2yt-1 + Σ b1 ΔYt-1 + µ1............................................................................*(3)

The inclusion of lag of dependent variable in the ADF equation depends on the existence of autocorrelation though literature has often adopted 2 lags. The *t* statistics of the estimated coefficient of Yt-1  is used to test null hypothesis.

For co-integration which is the next stage of estimation after determining the order of integration to obtain the co-integrating vectors in the regression equation.

*Y1 = β0 + β1x1 + µ...................................................................................................................(*4)

H0 : Yt Xt are not co-integrated

By testing if Durbin Watson is significantly greater than zero using the critical values, the second test examines the estimated residuals

*Δ µt = τµ t-1 + Σi................................................................................................................................................................................*..(5)

Or the commonly used type: ADF

*Δ µt = τμt-1 + Σ δ1  Δ µt + Σi.................................................................................................................................*(6)

*i-1*

The error correction processes are

*Ƥ Ƥ*

*ΔY = -Ƥµt-1 + Σ β1 Δx1-t + Σ Δyt-1 ΔYt-1 + Δ (β)εt.............................................................................................*.(7)

*i-1 i-1*

using the analysis above the capital flight for both World Bank and Dooley estimates can be modelled in a log-linear form as follows;

Log CAPFT *= αo+ β1 logAvexrate it+ β2 logKaopen it +β3 log Invest it +β4 log IntDiff it +β5 log Fsavs it + β6 logReserv it +µ*............................................................................................. .....(8a)

The Dooley alternative is

Log DDCAPF *=*  *αo+ β1 log Avexrate it+ β2 logKaopen it +β3 log Invest it +β4 log IntDiff it +β5 log Fsavs it + β6 logReserv it +µ*..................................................................................................(8b)

where CAPFWB is total capital flight by World Bank estimates, *Avexrate* is the average nominal exchange rate, *Invest* is the investment per year, *Intdiff* is the interest rate differential *Fsavs* is the financial savings *Reserv* is foreign reserves, µ is error term and *DDCAPF* represent Dooley estimates of capital flight and is adopted in all cases as below. The Log represents the log transformation of the variables.

The vector error correction model (VECM) is adopted for capital flight while ordinary least squares (OLS) regression estimations are adopted for investment and financial globalization. The results are presented in a summary form while the signs expectation is presented below

**Variable** Avexrate Kaopen Intdiff invt Fsav Reserv

**Expected Sign** + + - /+ -/+ - -

The *a priori* signs show that higher coefficients of exchange rate and Kaopen would encourage capital flight, while higher financial savings and external reserves would discourage capital flight. The variables of interest differential and investment could go up or down depending on macroeconomic situation of the country.

* + 1. **CAPITAL FLIGHT MEASUREMENT**

An approach developed later by the World Bank using a new model was introduced in the pioneering study of 1985 as reported in Ajayi (1992. This enabled an accurate estimate of capital flight and was adopted in the Boyce and Ndukumana (2000). This is with the understanding that the availability of resources to transfer funds outside or that funds borrowed in form of external debts can end up in private overseas accounts. This naturally accentuates or increases the incidence of capital flight, according to Beja (2006) and forms the revolving door model in developing countries. Earlier, Boyce and Ndukumana (2001) had introduced debt into the equation and estimated Capital flight (*K*F) in a given year *t* for a country *i* was computed as:

*KFit = ∆DEBTit + DFIit - (CAit -∆RESit*)----------------------------------------------------------(i)

where:

*DEBT* is the change in total external debt outstanding, *DFI* is net direct foreign investment, *CA* is the current account deficit, and *RES* is net additions to the stock of foreign reserves. Using the above, the total capital flight experienced by the country is estimated and appropriately capitalized to know the total capital lost to the country before looking at the effect on the development efforts of the country.

CDET is non-debt capital inflows (NKI), which is the sum of, net direct foreign investments (FDI) and net portfolio equity investment plus other investment assets (PORT) represent the external debt equation. The recorded uses of funds are current account deficits (CAD) and net accumulation of international reserves (CRES). “Net” means accounting for all the inflows and outflows of funds. Thus,

*KF = CDET + NKI - CAD - CRES-----------------------------------.------------------------------- (ii)*

The need to introduce an adjustment to the trade figures arises because of the trade misinvoicing (Beja, 2006) or trade faking (Ajayi, 1992) through which multinationals have been able to transfer the proceeds of their resources trapped in countries with serious foreign exchange challenges. The method which was not introduced into earlier models involves adjusting for the over invoicing of import and underinvoicing of export. These have always allowed Multinationals to keep the difference between the actual cost and proceeds of their trade.

Three steps were employed in Beja to adjust for this discrepancy.

*DX = PX – FOB \* X ---------------------------------------------------------------------------------- (a)*

*DM = M – CIF \* PM------------------------------------------------------------------------------------- (b)*

Where PX is the industrialized country trading partners’ from country I, and PM is the industrialized country trading partner exports to country I; X and M are the country’s export and import respectively while CIF and FOB factor are the needed adjustment to the cost, freight and insurance of the external trade. To arrive at this, trade data between the country and its partners were used. Country partner data are utilized as proof since data from the industrialized countries tend to be more reliable. Positive values DX and DM indicate net export under invoicing and net import over invoicing.

The next step is to calculate global (total trade involving the country) import and export misinvoicing. This is done by multiplying the reciprocal of shares of selected industrialized country and trading partners to the country’s total exports (X\_INDUS) and total imports (M\_INDUS) to obtain MISX and MISM where:

*MISX = DX/ X\_INDUS, ----------------------------------------------------------(c)*

*MISM = DM/ M\_INDUS-------------------------------------------------------- (d)*

The third and final stage is to include the misinvoicing into the previous model and thus, we obtain,

*KF = CDET + NKI – CAD – CRES + MIS----------------------------------- (iii)*

The above is also known as Total Capital Flight (TKF), which may be deflated by using the US (a world generally acceptable) producer price deflator to obtain Real Capital Flight (RKF).

Where the monetary value of RKF can be measured by the Treasury bill rate compounded over the number of years, the constituents and the components of the indices agree with the standards set worldwide and thus will be taken as given for the country.

*KF = CDET + NKI – CAD – CRES + MIS*

**3.4.2 Dooley Measure and Estimate**

This study is designed to apply the methods of estimations done by earlier researcher as well as newly contrived ones to measure the variables to be tested. The portfolio approach has been employed in Collier *et* *al* (2003) who did not aggregate his estimates into stocks and Lawanson (2007) who did. One of the methods reported in Ajayi (1990) are adapted from Lessard and Williamson (1987), and are as listed below. The use of the method will enable an update of the Ajayi (1990) comparison method as first used by Lessard and Williamson (1987) for different definitions of capital flight:

**Notations Used In Estimations**

A. Current Account Balance

B. Net Foreign Direct Investment

C. Private Short Term Capital Outflows

D. Portfolio Investment

E. Banking System Foreign Assets

F. Changes in Reserves

G. Errors and Omissions

H. Changes in Deb

I. IMF Credit

K. Reinvested FDI Income

L. Other Investment Income

M. Counterpart Items

The different notations have been used by different institutions to arrive at an estimated figure for capital flight and are as listed below:

Capital Flight Estimates by different Authors: World Bank = (H + B + A + F), Erbe = (H + B + A + F), Morgan Trust = (H + B + A + E + F), Cline = (H + B + A + E) - (J + K + L), Dooley (as in Ajayi 1992) = (H+B+A+F+G+I+M). This study is however adopting the World Bank and Dooley measures for comparison with the investment in this study.

**3.5 DOMESTIC** **INVESTMENT FUNCTION**

The understanding of the drivers of domestic investment in a developing economy stems from imperfect structures and systems which invariably affect the economy. Investment in Nigeria is \_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

\*The Kearney index started in 2001 and it is released yearly, while the Lockwood and Redoano began compiling their globalization index in 1987 with the breakdown of the various segments, the index is revised on annual basis. Lockwood and Redeano (2005) has measurements for other types of globalization but the study is concerned with financial globalization

yet to develop to the level of developed countries and as such the basic theoretical formulations of drivers of domestic investment are adopted in the methodology. Domestic investment *is* a function of financial savings, public sector borrowing requirements and real gross domestic product of the economy. This is attempting to build relationship between the variables in the long run. Investment is also influenced by lending rate, and the inflation rate. Inflation is however adjusted for by the adoption or use of the real gross domestic product. The original variables determining domestic investment in Nigeria can now be taken to include the investment done on the capital market as it has assumed a proportion that is hard to ignore. The study adopts a modified version of the Heim (2008) model discussed in the literature as the variables that affect domestic investment the most in Nigeria. For lack of data and short span of the available ones, some variables are omitted. The following variables are adopted for this study. Reasons and justification for the inclusion of the variables (and some other ones for financial globalization and capital flight) adopted in this study are set out below.

Investment is a function of:

*Invt = f (α0t βi Xi β2X2 β3 X3…βnXn)*..................................................................................... (1)

*INVT = (AVEXRATE, FSAVS, PSBR, RGDP, ALSI),………………….……..…………………* (2)

*INVT = α +β1*AVEXRATE *+ β 2*FSAVS *+ β3*PSBR *+ β 4*RGDP *+ β5*ALSI*..+*µ……….. *(3)*

**Independent Variable Full Name Expected Sign** Avexrate Average Exchange Rate +

Fsavs financial savings +

PSBR Public sector borrowing Requirement -/ +

RGDP Real Gross Domestic Product +

ALSI All share price index  **-/+**

where *INVT Avexrate FSAVS, PSBR RGDP* and *ALSI* represent Investment, average exchange rate, financial savings, Public sector borrowing requirement and All Share Price index, respectively. The variables are subjected to the Augmented Dickey Fuller (ADF) and Hadri unit roots test to test their stationary, though ordinary least square regressions were employed. Coefficients of variables with positive signs all act to increase the level of investment in the economy while those with negative sign reduce investments

**3.5.1 Variables of Investment**

**The Rate of Exchange**

Perhaps the most noticeable of the variables is the risk element involved in the pricing of currencies, which can be noticed in the divergence between the official exchange rate and the parallel rates. The divergence between the two rates leads to the risk premium phenomenon, which is the element of risk that is most discussed in capital flight. The Central Bank Rate being the official rate and is often cheaper than the Parallel market rate. This is the unofficial rate and is seen as more market driven which makes it more expensive than the official rate, but more freely available. If the capital is to be transferred abroad, it is via the exchange process. The Parallel Market Rate presents a ready market price to exchange naira to currency but at a higher rate than the official rate, which is lower but exercise more control through documentations. Higher rate of exchange leads to diminution of assets but encourages market prices to subsist and reduce distortion in the market. This has actually led to improvements in the foreign exchange reserve position through the encouragement of exports (Ojo, Olurode and Adegbite, 1998).

For reasons of the level of understanding, the foreign exchange market the average rate of exchange (*Avexrate)* is used in its absolute form in the various regressions and for compatibility with other variables in the study. In order to show a relationship with the capital flight in Nigeria, the variable on exchange rate is also involved. Since the fear of depreciation or devaluation, tends to increase the rate of exchange and encourages capital flight, then high exchange rate is an inducement for capital flight out of the country. In addition, the country is a major importing nation both for consumption and production goods and the rate of exchange is the passage through which the flights of capital takes place, this is an important variable. Also as a determinant of investment, its stability helps in reducing the risks in the macroeconomic variables of the country. The rate used here is the average exchange rate at which most of the foreign reserves of the country are exchanged and are recorded. The rates have moved from the fixed rate exchange regime of the 1970s to 1980 and partial floating in 1986. The Central Bank of Nigeria at various times changed the mode of operation of the market and adopted different auction methods and processes aimed at arriving at the rate of exchange to be used in the economy. This has changed from autonomous, interbank, Dutch auction to modified Dutch auction. Now Wholesale Dutch Auction System (WDAS) is in use to encourage the *Bureaux d’Change* (BDC) in the market.

Various efforts have been made to remove the risk premium that normally constitutes an incentive to promote speculation, round tripping, capital leakage and flight in order to stabilize the price of the currency and induce foreign investment in the economy. For this reason, the exchange rate policy adopted is crucial to the developmental efforts of the country. Countries like South Africa and Great Britain target the rate of inflation, while the United States of America targets the Federal funds Rate [Treasury Bills in Nigeria as controlled by the Federal Open Market Committee (FOMC)]. Most central banks have a variable that they follow closely and manipulate to influence the macroeconomic conditions of their countries. *AVEXRATE* is the term used for the variable involving the exchange rate. The exchange rate is the window through which assets of the country can be measured and be compared in another currency (Hoffman and Tillman, 2008). It is particularly useful in this study where investment and financial globalisation is being studied. It therefore allows a straight comparison between the concepts being used in this work.

**Public Sector Borrowing Requirements**

This has often constituted a major problem for the Central bank of Nigeria to manage each time the government overshoots its budget by borrowing from the Deposit Money Banks to meet its spending requirements. Sources of deficits include borrowings from the banking sector and financing from the financial system. It is one for the government to influence direction of expenditure and therefore autonomous investment takes place in the process. Its effects on crowding out other investments borrowing makes it important in the functions and drivers of investment in Nigeria. The notation for this variable is *PBSR*. The expected sign of variable is negative with the understanding that other alternative investment is crowded out by the resort to the use of resources from the financial system to power government expenditure. The variable is engaged only in domestic investment regressions.

**Financial Savings**

The savings accumulated by elements in the country do help in the investment made by the various units. *FINSAVINGS* is the resources deposited by the units and this is available through financial intermediation for the various needs of these differing units. It is one of Tobin’s fundamental determinants of investment. In variety of ways, the financial savings is taken as the proxy for investment, as most of the borrowed funds come from the banking system. This is the total quantum of all the savings in the financial and non banking institutions in the financial system. The institutions range from the deposit money banks, mortgage banks and institutions, and others financial institutions. It was transformed into dollars to have a figure comparable to the total capital flight taking place in the country.

**Gross Domestic Product**

The use of the GDP is premised on the fact that it is the figure that gives the total value of services and products produced by the economy over a particular period. Many measurements of the variable include the *current* which measures in an inflated manner. The *Real Gross Domestic Product* (*RGDP*) which is deflated is preferred because it is the annual percentage of constant price GDP at year-on-year changes.

**All Share Price Index**

The investment in capital market is not real investment as the purchase or sale of securities do not add to the structures on ground for further production but allows some investors who take positions to make returns. The transfers of securities between investors equally do not bring in anything to the company. However, it is included in the regression because it is used in finance and a source of income for speculating investors. The index measures the level of capitalization of the market and it shows the level of wealth and investment in the market. The index took off with the base of 100 in 1985 and went up to reach 60,000 before the current financial crises in June 2008. It is now somewhere around 26000.

# 3.6 FINANCIAL GLOBALISATION

Doubts that exist if Nigeria is globalised financially as all are dispelled by the index constructed by Ito and Mchinn (2007) which has become popular among academics and professionals in the industry. However, this index measures the openness of the capital account through which the funds flow in and out of the economy. On the aggregate, Nigeria was grouped alongside countries with =<25 percentile =< KAOPEN <50 percentile, where 50 percentile is 0. The indices measure the regulatory capital account openness and *de jure* restrictions to the capital account rather than price based *de facto* capital account openness.

To measure the level of financial globalization and integration, there is a need to measure accurately the net foreign asset and liability of the country, which according to Helbling, Batini, and Cardarelli (2006) can be estimated as follows

*NFAt* – *NFAt*–1≡ *NXt* + *CTt* +*IAt* + *KAt* + *EOt* + *KGt* ,

where *NX* denotes net exports of goods and services; *CT,* current transfers; *IA,* the investment income balance (with the sum of the three being the current account balance); *KA,* capital transfers; *EO,* errors and omissions; and *KG,* net capital gains (and if losses, negative).

Financial deepening is adopted as a proxy for financial development which is an aggregate for most of the indices of financial development. It is perhaps the most important of the variables of financial development. The others are money supply and credit to the private sector. The term EUR as used by the authors is important because of the economic integration of Europe which however is absent in Nigeria. The more *de facto* integrated the country is, the more easily correlated the financial flows between those countries with which it is integrated is. However, the ECOWAS case is different because the integration contemplated by the founders is yet to take root. Literature asserts that opening up the economy to financial flows enables the financial system to be developed, to assess the impact of the financial openness in the process of financial development. Thus, the generally adopted model for Nigeria in this study is:

FA = α + β AVEXRATE + βTRADEOPENESS + βFINDEEPN + βGDPPC + β POP+ EXPORT + β KAOPEN +i

FL= α + β AVEXRATE + βTRADEOPENESS + βFINDEEPN + βGDPPC + β POP+ IMPORT + β KAOPEN +i

**Variable Full Name Expected Sign**

FA/FL External Financial asset/Financial Liability -/+

Avexrate Average exchange rate +

Tradeopeness trade openness +

Findpeen Financial deepening +

GDPPC GDP Per capita +

POP Population +

Kaopen Capital account Openness - +

Where *FA* and *FL* are the alternate dependent variables for external financial assets or liabilities, *Avexrate* is the average rate of exchange; *findeepn* represents financial deepening i.e. M2/GDP *GDPPC* is per capita output. *POP* represents the population. The use or *IMPORT/EXPORT* is adopted for financial liabilities and assets respectively and *Kaopen* represent the index of capital account opening and *µt* for error term. The coefficients of all the variables further the process while the financial asset or liabilities can go down or up. Kaopen could be reduced or increased.

**3.6.1 The Kaopen Measurement**

The literature is awash with methodologies of how to measure financial openness and globalization. Since the separation between financial openness and financial liberalization is more cosmetic than real, the study has therefore adopted the Ito and Chinn (2008) KAOPEN approach with the following model:

*Kaopen*t,*t = {k3t + k3 t-1 +k3t -2 + k3t – 3 + k3t – 4} 5*

Where share *k3* represents the nearness to openness indicating restrictions on capital account. *k*1, 2 and 4 represent multiple exchange rate, open current account transactions and 4 represents the requirement to surrender foreign exchange earnings by exporters in the domestic economy respectively. Though the index is easily compared against a number of countries and can be estimated fairly.

Following the OLS modelling process, the equations adopted for the *de facto* measurement are

*Financial Asset = α +β1Avexrate +β2GDPPC +β3Findeepn β4Kaopen +β5Tradeopeness +*

*β6 Export*+i *……………………………………………………………....…………………….. (a)*

*Financial Liability = α+β1Avexrat + β2GDPPC + β3Findeepn + β4Kaopen + β5Ttradeopenness + β6Iimport +*i*…………………………...……...........……………….. (b)*

**3.6.2 Variables of Financial Globalization**

One basic variable of financial globalization is the *KAOPEN* measure that measures the intensity of the openness of the capital account of the BOP. It is used in more than one regression in the study. As a *de jure* measure of capital account liberalization, it measures the regulatory aspects of the opening process rather than market and productivity based transactions that the *de facto* measure represents.

Per capita Gross Domestic product measures the GDP per member of the population and product and services or income entitled to by the median person in the economy. It is defined as GDP divided by the population. It is a hypothetical figure normally employed for measuring the living standards of the average (median) person in the economy. For the purpose of this work, *GDPPC* is used.

Major transactions between the economy and other economies lead to exchange in form of payment. The measure of trade openness is the sum of export and import divided by the Gross Domestic Product of the economy. Openness to trade is more propelled by the openness of the current account of the BOP, which is where real values in goods and services are transacted. The ability of the country to exchange goods is measured by the GDP at first before its openness to exchange those goods is measured by its openness to trade as measured by an average of import and export values. *TRADEOPEN* is used in the regression process. It is denoted thus:

*Trade openness =(X +M)/ GDP*

The process of becoming a financial centre can be more propelled by financial deepening (*FINDEEPEN*.) Financial deepening is defined simply as the availability of more financial services and products from both the bank and non-banking financial institutions and can be described as the supplying of more financial services allows more financial services which results in higher circulation of money in the financial system. This is important in Nigeria because of the relative strength of the informal sector. It is adopted because its measurement is more relevant to the Nigeria financial system than overall financial development. It is defined as M2/GDP, which is M1+ savings deposits in the economy, where M1 is the sum of currency in circulation and demand deposits in the economy. Financial deepening is a replacement and proxy for financial development as completely decomposed below.

*M2/GDP = or M2 =DD + CC + SD/ GDP*

The other variables adopted for the estimation of the *de facto* financial globalization of Nigeria are *imports* and *exports*. The two variables are included here to enable the understanding of the importance of each of them in the asset and liability acquisition of the Nigerian entities. The import process allows the use of letters of credit which invariably enables the country to borrow to finance its imports. The involvement of the banking system in the letters of credit administration enables correspondent banks to grant short-term credit between themselves. In addition, the ability of the country to make international investment and acquire assets abroad is also recognized as having foundation in the export drives of the country through its different units and entities since the real resources transfer takes place through export to other countries giving rise to accumulation of reserves. Summarily, exports are included in the asset acquisition, while imports are included in the liability acquisition.

The *avexrate* rate of exchange has been discussed extensively above in the modelling of investment.

**Decision Rule and Significance Levels:** The *p*-value: The strength of evidence in support of a null hypothesis is measured by the *p-value*. If the *p-value* is less than the significance level, we reject the null hypothesis. The decision rule is based on the common significance levels which equal to *0.01, 0.05, or 0.10.* These significance levels are adopted in this study for decision on hypotheses though researchers could choose levels they intend to adopt foe their respective studies.

**3.7 SOURCES OF DATA**

International Monetary Fund (IMF) remains the most authentic source of current data for financial and monetary issues. Data are usually available in different formats and disseminated in different ways. Since most of the data contained in the IMF sources are originally from the countries themselves one can corroborate such data from the original source, in this case from the Central Bank of Nigeria’s Statistical Bulletin of various issues. Cut-off dates for the study are 1970 to 2007.

The following are the sources of the data used in this study:

From *International Financial Statistics* CD-ROM (May 2008)

1. Average Exchange rate (*avexrate*) which can be supported or corroborated from other sources such as Central Bank of Nigeria’s Statistical Bulletin of various issues. Nigeria foreign exchange market had moved from fixed to floating exchange rate regime in September 1986.
2. Inflation and interest rates obtained from the International Financial Statistics (IFS) and supported from CBN, Statistical Bulletin (2008).
3. Average Population figures over the years up to 2007.
4. Errors and Omissions and Current Account Balance figures.

From the IMF’s International Balance of Payments, External Reserves position and Current Account Deficits were obtained.

From *Direction of Trade* CD-ROM (April, 2008) data on trade misinvoicing and incoterms (the terms of contracts in trades and shipping) were obtained. Transaction values of $25 million and above were considered

1. Exports of Nigeria to various countries namely Austria Brazil Canada China France Cote D’ivore Germany Ghana United Kingdom and United States etc. (fifteen countries with trade values of not less than $50 million were considered)
2. Imports of Nigeria from various countries namely Belgium Brazil People Republic of China, China Hong Kong, Canada, Cote D’ivore, France, Germany, India, United Arab Emirates, United Kingdom and United states etc.(nineteen countries with trade values of $50 and million were considered)
3. Incoterms and other terms of shipping cost insurance and freight (*cif)*, and free on board (*fob*) terms.

From *World Economic Information* database WEOI of the IMF, the data on Real Gross Domestic Product per capita was obtained

From the *Central Bank of Nigeria Statistical Bulletin* (2008), the following were obtained and where needed were transformed into foreign currency.

1. Domestic investment which is also contained in the IFS in domestic currency. (This datum terminates in 2004. An average of 5% of increase in the past three years of 2001 – 2004 was used to derive the data for 2005 – 2007)
2. Public Sector Borrowing Requirement (PSBR)
3. Gross domestic capital was transformed into Real Gross Domestic Product (RGDP) with the use of implicit deflator.
4. Financial Deepening (M2/GDP) was obtained from the Statistical Bulletin (2008).
5. External Debt is from Statistical Bulletin (2007) and the most recent years of 2005 to 2007 supported by the Debt Management Office website accessed on July 26th 2009.

*Kaopen* for all countries including Nigeriawas made available at <http://www.ssc.wisc.edu/~mchinn/research.html> with permissions to use from Professors H. Ito and M. Chinn of the Portland State University and University of Wisconsin and National Bureau of Economic Research (NBER) of the United States.

Foreign Direct Investment data was obtained from *United Nations Conference on Trade and Development (UNCTAD*) statistical database.

Federal Funds rate was obtained from the Federal Reserve Bank of New York available at <http://www.ny.frb/markets/org,html>

**3.7.1 Limitation of the Study**

This study takes cognisance of the fact that researchers have worked on capital flight out of Nigeria and have estimated total capital flight out of Nigeria. This study examines this scenario with the influence of globalisation in the process, especially with investment. The period is limited to 1970 – 2007 on which complete data is available. The study takes interest in two different estimates by their definitions: the World Bank estimates and Dooley estimates in an attempt to ascertain which is more relevant to Nigeria and does not compare capital flight across countries. While it tries to use the indirect method of estimation involving the use of net errors and omissions it does not break down other components of balance of payments (BOP). It also attempts to study the aspect of capital flight involved in unexplained in and outflows. The study is not on money laundering or other criminal activities. The study is limited to Nigeria only

**CHAPTER FOUR**

**PRESENTATION AND INTERPRETATION OF RESULTS, AND DISCUSSION OF FINDINGS**

**4.0 INTRODUCTION**

The estimates and results of the models and techniques are presented in this chapter, beginning with the unit roots test that reports all the variables in the various models for capital flight. Variables are tested further for compatibility in Hadri panel tests for stationarity. The result for serial correlation tests is also presented followed by the various regression estimates and vector error correction estimates to determine the long-run relationship between the variables of capital flight. The Ordinary Least Squares (OLS) results for investment and globalisation are followed by the discussion of the hypotheses and other findings.

**4.1 UNIT ROOT TESTS**

Before the estimation of the equations, all the variables were subjected to stationary tests of times series data. If the data series is differenced and it is found that it is stationary, then they can be integrated to the order of one or greater, otherwise, a non-stationary series exists. If *n = 0*, the resulting *I* (0) represents a stationary processes. If the time series are integrated into the order *I* (0) and they are at the same level, cointegration can be done. The unit roots test was evaluated using Augmented Dickey-Fuller (1981) for all the variables in this study. The results of the stationarity test is summarised in the Table 4.1.1 below. Following the above table, it can be seen that the variables of *lending rates* and *financial deepening* are not stationary series and therefore fail the ADF test. For this reason, they were not cointegrated with other variables in the vector autoregressive model that was adopted in the capital flight results. Financial deepening is nevertheless employed in the globalization process to show the assets or liabilities in the financial integration between Nigeria and the rest of the world. The results presented below show the unit roots process that is done in two options, (a) assuming common unit root or (b) individual roots process. The ADF test static that has been used above proves there are no unit roots, at levels and are integrated at I *(1)*. However, Hadri panel group data unit roots tests (Table 4.1.2) which helps to simplify the units roots test at the same level of order and assumes a common units roots for all the variables is presented on page.113.

Table 4.1.3 on page 114 test the serial correlation in the data used for the estimation of this specification. As reported below the existence of serial correlation of Breusch-Godfrey Serial Correlation LM Test is not strong because the *F* and *R*2 records low probability. This is however taken care of by the AR process that was adopted to normalise the regression equation through Cochrain Orcutt to the order of 1. Also, a cursory look at the variables below indicates that there are variables that are significantly affected by serial order correlation with the reported *t* statistic and *p* values. In addition, there is a low *R2* and an insignificant *F* statistic these indicate that the variables are safe for the estimation process in order to avoid spurious regression and estimations that are plagued with problems of serial correlation.

**Table 4.1.1**

**Augmented Dickey Fuller Statistics of the Variables**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Augmented Dickey Fuller Statistics of the Variables** | | | | | |
| **Variables** | **ADF Statistics** | **1%** | **5%** | **10%** | **Decision** |
| Allshare index | 3.923843 | -4.4415 | -3.633 | -3.2535 | 1(1) |
| AveXRate | 0.613353 | -3.6226 | -2.9472 | -2.6118 | 1(1) |
| Capacutlisation | -3.670491 | -4.4415 | -3.633 | -3.2535 | 1(1) |
| Finsavings | 2.95558 | -4.2505 | -3.5468 | -3.2056 | 1(1) |
| DGDP | 2.021294 | -3.6422 | -2.9527 | -2.6148 | 1(1) |
| Inflation | -3.509298 | -3.6228 | -2.9446 | -2.6105 | 1(1) |
| Lendrate | -6.449892 | -4.2412 | -3.5426 | -3.2032 | 1(0) |
| PSBR | -2.00317 | -3.6228 | -2.9446 | -2.6105 | 1(1) |
| Investment | -3.771241 | -3.7856 | -3.0114 | -2.6457 | 1(1) |
| Findepeen | -1.734509 | -3.6228 | -2.9446 | -2.6105 | 1(0) |
| Kaopen | -1.718627 | -3.6228 | -2.9446 | -2.6105 | 1(1) |
| Intdiff | -3.334165 | -3.6228 | -2.9446 | -2.6105 | 1(1) |
| Population | -0.985676 | -3.6289 | -2.9472 | -2.6118 | 1(1) |
| Tradeopeness | -1.060583 | -3.6353 | -2.9499 | -2.6133 | 1(1) |
| CapiFlit | -4.045379 | -4.2324 | -3.5386 | -3.2009 | 1(1) |
| Dollarrate | -1.050226 | -3.6289 | -2.9472 | -2.6118 | 1(1) |
| Reserves | 1.037994 | -3.6228 | -2.9446 | -2.6105 | 1(1) |
| PMPre | -2.2452 | -3.6228 | -2.9446 | -2.6105 | 1(1) |

**Source: Author’s E Views Output**

The above represents individual results for the variables that were employed in this study. Two of the variables *lendrate* and *findepen* were subsequently dropped as they were not of the same order with the rest of the variable as these would produce spurious results if they were co integrated. (*Findepen* was not used in the various estimations of capital flight but in financial globalisation estimation).

The adopted variables are further tested with the results below:

**Table 4.1.2 Panel Group Data Hadri Units Roots Tests**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Null Hypothesis: No Unit Root (Common Unit Root Process) | | | | |
| Sample: 1970 2007 | | |  |  |
| Series: AVEXRATE, CAPFLT, DDGCAPFLT, FSAVS, INTDIFF, INVT, | | | | |
| KAOPEN, RESRV | | |  |  |
| Exogenous variables: Individual effects | | | |  |
| Newey-West bandwidth selection using Bartlett kernel | | | | |
| Total (balanced) observations: 296 | | | |  |
| Cross-sections included: 8 | | |  |  |
|  |  |  |  |  |
|  |  |  |  |  |
| Method | |  | Statistic | Prob.\*\* |
| Hadri Z-stat | |  | 11.2339 | 0.0000 |
| Heteroscedastic Consistent Z-stat | | | 4.64421 | 0.0000 |
|  |  |  |  |  |
|  |  |  |  |  |
| \*\* Probabilities are computed assuming asympotic normality | | | | |
|  |  |  |  |  |
| Intermediate results on D(UNTITLED) | | | |  |
|  |  |  |  |  |
|  |  |  |  |  |
|  |  | Variance |  |  |
| Series | LM | HAC | Bandwidth | Obs |
| D(AVEXRATE) | 0.2954 | 105.0468 | 2.0 | 37 |
| D(CAPFLT) | 0.5000 | 1349884. | 36.0 | 37 |
| D(DDGCAPFLT) | 0.5000 | 6725071. | 36.0 | 37 |
| D(FSAVS) | 0.5157 | 82342.16 | 4.0 | 37 |
| D(INTDIFF) | 0.1650 | 0.110717 | 11.0 | 37 |
| D(INVT) | 0.7711 | 1.06E+09 | 1.0 | 37 |
| D(KAOPEN) | 0.1158 | 0.068816 | 3.0 | 37 |
| D(RESRV) | 0.4284 | 32995934 | 3.0 | 37 |
|  |  |  |  |  |
|  |  |  |  |  |

**E Views Output of Unit Roots Test (2010)**

Hadri test is one of the suites of tests that can be adopted to test the unit roots of panel data. The test assumes a common units roots process for all the variables in the data set which enables an easy decision on the data. The tests statistics of this process are the *Z test* which shows a high level of significance with 11.2339 and heteroscedastic consistent statistic at 4.64421. The test adopted a balanced pool data which is adjusted for incomplete data that may exist in the pool. In addition to these, the intermediate results agree with the above assertion. Further results are shown below in Table 4.1.3.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Table 4.1.3 Breusch-Godfrey Serial Correlation LM Test:** | | | |  |
|  |  |  |  |  |
|  |  |  |  |  |
| F-statistic | 6.192602 | Probability | | 0.006115 |
| Obs\*R-squared | 11.63514 | Probability | | 0.002975 |
|  |  |  |  |  |
|  |  |  |  |  |
| Test Equation: | | |  |  |
| Dependent Variable: RESID | | |  |  |
| Method: Least Squares | | |  |  |
| Presample missing value lagged residuals set to zero. | | | | |
|  |  |  |  |  |
|  |  |  |  |  |
| Variable | Coefficient | Std. Error | t-Statistic | Prob. |
|  |  |  |  |  |
|  |  |  |  |  |
| AVEXRATE | -14.10772 | 37.82459 | -0.372978 | 0.7121 |
| INTDIFF | 129.6622 | 713.9432 | 0.181614 | 0.8572 |
| INVT | 0.012078 | 0.015590 | 0.774756 | 0.4452 |
| KAOPEN | -458.3348 | 1064.515 | -0.430557 | 0.6702 |
| RESRV | 0.121829 | 0.200437 | 0.607817 | 0.5484 |
| FSAVS | -5.447240 | 5.254101 | -1.036760 | 0.3090 |
| C | -1187.771 | 1951.962 | -0.608501 | 0.5479 |
| AR(1) | -1.679339 | 1.608741 | -1.043884 | 0.3058 |
| RESID(-1) | 1.482248 | 1.536929 | 0.964422 | 0.3434 |
| RESID(-2) | -1.280722 | 0.609605 | -2.100906 | 0.0451 |
|  |  |  |  |  |
|  |  |  |  |  |
| R-squared | 0.314463 | Mean dependent var | | 8.07E-10 |
| Adjusted R-squared | 0.085951 | S.D. dependent var | | 3362.336 |
| S.E. of regression | 3214.592 | Akaike info criterion | | 19.21425 |
| Sum squared resid | 2.79E+08 | Schwarz criterion | | 19.64963 |
| Log likelihood | -345.4636 | F-statistic | | 1.376134 |
| Durbin-Watson stat | 2.147828 | Prob(F-statistic) | | 0.247128 |
|  |  |  |  |  |
|  |  |  |  |  |

**Source: Table Generated From E Views Output**

**4.2 CAPITAL FLIGHT**

The various definitions of capital flight lend themselves to different estimates which invariably make it difficult for a common estimate to be arrived at by different studies. The measures adopted as working definitions in this study include capital lost to the economy that can only be brought back into the economy under a different name or another route. However, the estimates arrived at with the adopted definitions bring out some results that show various degrees of significance with the given variables and determinants.

**4.2.1 Capital Flight and Domestic Investment**

Yearly ratio of investment to Gross Domestic Product for each of the broken period represented graphically reveals that there has been higher level of capital flight relative to investment in the economy. The ratio for the pre-globalisation period (1970- 1985) generally depicts that there was a higher level of investment in the economy relative to capital flight. In other words, the economy received more investment than capital flight out of the country. However, the period before globalisation records a better performance of investment over capital flight. Figure 4.1 reveals that except for the year 1974 when capital flight ratio was higher than investment ratio, all the other years had a higher level of domestic investment than capital flight out of the economy. Unlike the pre-globalisation years, the post globalisation period reveals that investment ratio to GDP was lower than capital flight out of the economy relative to GDP.

**Figure 4.1 Pre-Globlisation Period Investment Ratio and Capital Flight Ratio to GDP**

**(1970 – 1985)**

****

**Source: Author’s E views Results (2009)**

The graph and bars chart show that the year 1992 was exceptionally low for capital flight when there was capital flight reversal in the economy. The high level of capital flight experienced in 1974 could be as result of a high external reserves accumulation resulting from sudden increase in the price of Nigeria’s major export: crude petroleum. In addition, the accumulation led to a declaration that “*money was not Nigeria’s problem, but how to spend it*” which was followed by Dutch disease. Paradoxically, the reserves encouraged the construction of many structures, which pushed up the investment profile in subsequent years.

This scenario can equally be compared with 2006 when there were allegations of misuse of the foreign reserves from Central Bank to bribe legislators to vote on the “Third Term agenda” to elongate the life of the administration of Obasanjo’s Presidency. However, all the other years show a generally lower level of investment relative to capital flight out of the economy. From the figure 4.2 capital flight ratio to GDP was especially high in 2006, with years 2002 – 2005 period comparing favourably with investment in the country.

**Figure 4.2 Globlisation Period Investment Ratio and Capital Flight Ratio to GDP**

**(1985 – 2007)**

****

**Source: Author’s E views Results (2009)**

**4.2.2 Equality Tests**

The descriptives (reported in Table 4.2.1, page 119) of each of the variables show that the quantum of capital flight in pre globalisation years was lower comparably to those of the years after the process had begun. Means of capital flight ($3,548.793m) and investment (₦6,467.606m) were considerably lower for the pre globalisation than post globalisation years for capital flight ($4,659.716) and for investment (₦189,460.8m) years. The standard deviation for investment is much higher than for dollar translated investment showing the high measure of risk (unreliability) in the investments undertaken. Translated dollar investment in the pre globalisation years was higher than the post globalisation years, indicating that the total value of investment in dollar terms was less than the period before the onset of financial globalisation.

**Table 4.2.1 Test of Equality between the Series of Variables**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Measures** | **Globalisation Status** | **CAPFLT** | **DLINVT** | **FSAV** | **INVT** | **Reserves** |
| **Mean** | Pre Globalisation | 3548.79 | 9805.16 | 4.34506 | 6467.61 | 3088.84 |
| Post Globalisation | 4659.72 | 3194.58 | 433.7 | 189461 | 7562.2 |
| **Maximum** | Pre Globalisation | 11521 | 18152 | 12.51 | 12215 | 10234 |
| Post Globalisation | 28464 | 6203.9 | 2693.3 | 512450 | 42298 |
| **Minimum** | Pre Globalisation | -679 | 1231.9 | 3410 | 880 | 202.16 |
| Post Globalisation | -2280 | 1353.54 | 13.93 | 5573 | 651.15 |
| **Standard Deviation** | Pre Globalisation | 3335.4 | 6133.04 | 4.00773 | 3786.84 | 2805.73 |
| Post Globalisation | 5971.79 | 983.652 | 663.909 | 179506 | 10082.8 |

**Key:** CAPFLT: Capital Flight; DLINVT: Dollar Investment; FSAV: Financial Savings; INVT Investment RESV Reserves

**Source: Descriptives of the Variables of Capital Flight (2009)**

The standard deviation of investment indicates that it has varied widely unlike the pre globalisation years when the standard deviation was lower. Also from the Table (4.2.1), it can be deciphered that the country made more money and therefore higher level of external reserve in the post globalisation than the pre globalisation period from $3,088.843 million to $7,562.199 million with a much higher volatility than before then.

While financial savings have increased tremendously (from ₦4.345 million to ₦433.6996 million), there is much less investment to show for the growth. The dispersion of post globalisation years of financial savings indicates its potential reliability and possibility of translating the savings to investment. There is no doubt that capital flight has increased in the post globalisation period and less investment has resulted from increased savings during the same period though more reserves have accrued.

**Table 4.2.2**

**CAPITAL FLIGHT REGRESSION RESULTS**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Variables** | **CAPFT (a)** | **LCAPFT(a1)** | **DDCAPF(b)** | **LDDCAPF(b1)** |
| **Constant** | -5.0007 | -1.05011 | -3890.06 | -3.6287 |
|  | (-1.7912)**\*** | (-0.41979) | (-1.656) | (-1.0747) |
|  |  |  |  |  |
| **Avexrate** | -0.38035 | -0.29443 | 27.143 | -0.3835 |
|  | (0.007245) | (1.03470) | (0.6060 | (-1.0832) |
|  |  |  |  |  |
| **Kaopen** | -1793.220 | -1.49486 | -27157.76 | -1.4016 |
|  | (-1.081627) | (-3.51025)**\*\*\*** | (-1.641) | (-2.482)\*\* |
|  |  |  |  |  |
| **IntDiff** | 2063.427 | 0.6244 | 1996.657 | -0.1473 |
|  | (2.14268)\*\* | (1.22725) | (2.33)\*\* | (-0.2250) |
|  |  |  |  |  |
| **Invt** | -0.008736 | -0.050620 | -0.003 | - 0.815 |
|  | (-0.505270) | (-0.081777) | (-0.210) | (-1.0747) |
|  |  |  |  |  |
| **FSavs** | -0.015905 | 0.223799 | -23.002 | -0.1288 |
|  | (-2.7151)**\*\*\*** | (0.613862) | (-3.89)\*\*\* | (-0.2722) |
|  |  |  |  |  |
| **Reserves** | 0.94924 | 0.705916 | 1.019 | 0.3626 |
|  | (3.741654)**\*\*\*** | (2.43031)**\*\*** | (4.272)\*\*\* | (0.7751) |
| **AR(1)** | -0.387927 | - | -0.249985 | - |
|  | (-1.905259) | - | (-1.22386) | - |
| **R2** | 0.55 | 0.54 | 0.57 | 0.51 |
| **Adjusted R2** | 0.45 | 0.42 | 0.47 | 0.38 |
| **Durbin Watson** | 2.2 | 2.1 | 2.15 | 1.92 |
| **F Statistics** | 5.21 | 4.63 | 5.55 | 3.78 |
| **Observations** | 38 | 31 | 38 | 28 |

Capflt = 19.30091037\*Avexrate - 11.80008909\*Fsavs + 1719.527867\*Intdiff - 0.008736060652\*Invt - 2167.122581\*Kaopen + 0.9429726125\*Resrv - 3462.619468 + [Ar(1)=-0.3879242881]

**Note** *t* statistics are in parentheses **\*, \*\*, \*\*\*** denote the level of significance at 1, 5, and 10 percent respectively.

**4.2.3 Capital Flight Regression Estimates**

A look at the OLS regressions estimates (Table 4.2.2 page, 118) show that capital flight determinants and variables are more than presented here as contained in the literature.

The raw variables show a low *R2* giving credence to the value of logged ones. At 0.52 and adjusted *R2* of 0.43, the raw variables show a medium explanatory power for the variables under investigation. The initial Durbin Watson was 2.44 and corrected and *F* statistics of 5.21 shows a suspect regression results before it is adjusted for auto correlation. The complete observations of 38 were employed in the process. The independent variables adopted for the work throughout show that the exchange rate has the expected negative sign and is not significant.

**Figure 4.3 Capital Flight: (World Bank) and (Dooley) Measures**



**Source: Capital Flight Measures (by the author’s Calculations)**

The *Kaopen* index is not significant with the raw variables and equally negative as anticipated. Interest differential that represents the portfolio approach to capital flight is significant at 0.05 level. The previous studies have always attributed the capital flight episodes to the investor’s portfolio choice, which can be corroborated from this study. The investment variable is not significant in that the *t* is low but negative. The implication is that the correlation between investment and capital flight is very low and negative. This means that capital flight increases reduces domestic investment at a very slow rate. The financial savings from which domestic investment is often encouraged show a negative expected sign at 0.05 level of significance. For the raw variables the reserves position is also a significant contributor to capital flight as it is significant beyond 0.01 level of significance. The high external reserves position is an incentive to encourage the capital flight and move capital abroad.

The basic reason for this experiment is that the capital flight variable is dollar based and not Naira. Both have only two variables that are significant at the same level. *Kaopen* is significant in the regressions at 0.01 level indicating that it is important in the scenario of capital flight in Nigeria.

**Figure 4.4**

**Divergence between Naira Real Savings and Dollar Real Savings Rates**

****

**Source: Author’s Calculations (2009)**

The external reserve is also significant at 0.05 level. The significance of the variables are also positive which means that the higher the reserves the higher the capital flight. As a result of the logs, the dependent variable was not complete because of the reversal of capital flight in some years. The observation is 31 reducing by 7 as a result of the logs transformation.

One of the operational definitions adopted in this work is the Dooley (DDCAPF) definition, which included the errors and omissions figure in the measurement. The impact of the errors and omissions is seen in that the much of the inflow and outflows to the economy cannot be fully accounted for. Apart from this, the regressions estimates are broadly similar. The Nigerian economy represents such economy where incomplete records are rife; also, much of the capital flight out the country may have found itself back in many different forms or other forms of unrecorded capital inflows. The results show that capital flight can still be explained by the independent variables as have been adopted.

**Figure 4.5**

**Capital Flight and Investment Ratios and the GDP (1970-2007)**

****

**Source: Author’s Calculations (2009)**

The average exchange rate remains positive and insignificant. *Kaopen* is negative and unlike the main definitions, is insignificant. This implies that flight of capital in Nigeria is not significantly affected by openness of capital account of the Balance of Payments. Investment, as other regression estimates is equally insignificant but slightly negative in Dooley definition. The portfolio choice theory is validated by the interest differential variable, which is highly significant level at 0.05.

**Figure 4.6 Capital Flight (WB) and Domestic Investment**

****

**Source: Author’s Calculations (2009)**

The level of financial savings is negative when compared with the capital flight out of the country and highly significant at 0.01 level. The independent variables of investment and financial saving records similar results with the same signs but different level of significance. The financial savings carried a negative sign with high level of significance while the investment has a negative sign with a low *t* statistic.

**Figure 4.7 Capital Flight (Dooley) and Domestic Investment**

** Source: Author’s Calculations (2009)**

The investment (DINVT: dollar translated investment) commitment over the years show that the country recorded higher level of investment up to 1990, which subsequently reduced from 1992 till in the year 2006, when there was a higher level of capital flight .

**4.2.4 Cointegration Test**

Moving from the logged variables, the data had been subjected to Augmented Dickey Fuller (ADF) and Hadri panel roots test for indentifying those with stationarity problems. The test was carried out with the use of Augmented Dickey Fuller test. The results show some of the variables indicating considerable significance at various levels of 0.1, 0.05 and 0.01. Table 4.2.3 below show the results of World Bank measures

**Table 4.2.3**

**Johansen Multivariate Cointegration Results**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Hypothesized**  **No. of CE(s)** | **Eigenvalue** | **Max-Eigen**  **Statistic** | **0.05**  **Critical Value** | **Prob.\*\*** |
| None\* | 0.895600 | 81.34285 | 46.23142 | 0.0000 |
| ≤ 1\* | 0.787186 | 55.70412 | 40.07757 | 0.0004 |
| ≤ 2\* | 0.677641 | 40.75527 | 33.87687 | 0.0065 |
| ≤ 3 | 0.472975 | 23.05824 | 27.58434 | 0.1710 |
| ≤ 4 | 0.404902 | 18.68503 | 21.13162 | 0.1063 |
| ≤ 5 | 0.281111 | 11.88174 | 14.26460 | 0.1152 |
| ≤ 6 | 0.006022 | 0.217458 | 3.841466 | 0.6410 |

|  |  |
| --- | --- |
| 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 (1999) *p*-values |

1. \*(\*\*) denotes the rejection the Null Hypothesizes at 5% (1%) significance level.
2. VAR is the order of 1 and is computed on the assumption of linear deterministic trend in the cointegrating equations with no trend.
3. Normalized CE at 1% is :
4. **CAPFT=-5994.07 -60.22Avexrate +56.13fsavs -0.849reserves +821.70Kaopen (5.6) \*\*\* ((1.45) (7.08) \*\*\* (4.323) \*\*\* (0.88)**

**-0.0067invt -541.2intdiff**

**(0.375) (0.77)**

**(b) DDCAPFT=-6309.49-66.37519Avexrate+66.3752Fsav-0.88reserves+ 050.66Kaopen**

**(1.389) (7.4443) \*\*\* (3.80) \*\*\* (0.983)**

**- 0.008Invt - 531.6266Intdiff**

**(0.394) (0.662)**

The significant variables at levels can be cointegrated given that they are of the same order. The result is reported in the Table 4.2.3. The essence of cointegration test is to find a long run relationship between the variables in the regressions after ensuring that the variables are of the same order to avoid spurious regression. The regressions that have been estimated employed variables that had been tested for stationarity, though some have very low coefficients but are nonetheless not plagued with the stationarity problems. The cointegrating equation is as reported below indicating that the, external reserves and financial savings are the significant variables in the cointegrating equation. The implication of this is that these are the variables of interest for the policymakers to deal with in order to put an end to capital flight and encourage investment in the current globalisation process. The two results appear broadly similar, however.

**4.2.5 Vector Error Correction Estimates**

When co-integration has been employed, it is also expected to complete the process with an error correction model. The error correction model in the study here assumes a year lag in the variables. The vector error correction (VEC) process helps to observe the convergence in the long run as earlier revealed by the co-integration test. The error correction term has the expected negative sign and is significant. The general significance of the independent variables is shown by the R2 0.80 with other factors accounting for the 0.20. The *F* statistic, which is the measure of the overall significance, shows that the overall significance of the explanatory variables is significant at 0.01 level. The sum square of errors is low signifying that the errors are minimized. From the above independent variables of *avexrate,* interest differentials become less significant. Reserves and financial savings are significant at 1% level because the *t*s are all above 3.

Finally, the rate or speed of adjustment is high but slower with World Bank measures at 69.8 or 70% among the variables and Dooley measures adjust faster at 75%. The effect of this is that the rate of adjustment will enable capital flight the variables to realign at these stated rates. The implication of this scenario is that it would take a long time to eradicate the phenomenon and its impacts.

**Table 4.2.4**

**Vector Error Correction Estimates for Capital Flight in Nigeria**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | | **World Bank measure** | | **Dooley Measure** | | |
| **Variable** | | **Coefficients** | ***t*  statistics** | **Coefficients** | | ***t* statistics** |
| Constant | | -5994.07 | 5.61 | -6209.49 | | -6.57 |
| EC(1) term | | 0.698 | 5.614 | 0.751 | | 6.577 |
| D(LACPF (-1) | | 0.198 | 1.131 | 0.195 | | 1.164 |
| D(LAVEXRATE0 (-1) | | -60.22 | -1.45. | -66.93 | | -1.39 |
| D(KAOPEN) -1) | | 821.70 | 0.88 | 1050.66 | | 0.08 |
| D(LFASV)-1) | | 56.13 | 7.087 | 66.308 | | 7.41 |
| D(LRES) -1) | | -0.8498 | -4.327 | -0.88 | | -3.89 |
| D(LINVT)-1) | | -0.064 | -0.378 | -0.00809 | | -0.394 |
| D(INTDIFF)-1) | | -541.21 | -0.776 | -531.67 | | -0.662 |
|  | | **World Bank** | | **Dooley** | |
| R Squared | | 0.80 | | 0.81 | |
| Adj. R square | | 0.74 | | 0.76 | |
| F Statistics | | 13.5 | | 15.03 | |
| Akaike Inf. Criterion | | 19.4 | | 19.35 | |
| Schwarz criterion | | 19.8 | | 19.75 | |

**Source: E views Output (2010)**

The roles of the variables are reduced over the years as capital flight reduces. However, the most affected of the endogenous variables is the domestic savings and external reserves in the economy with high *t*sunder a one-year adjustment. The reality is that the significant independent variables determine the long run relationship between them and capital flight. Investment is not significant with the *t* statistic of -0.378 but the external reserves is at 4.327 (0.01 percent) same as financial savings at 7.41. External reserve is negative in the long-run, implying that capital flight has a significant negative impact on external reserves and also negative with aggregate savings in the country.

**4.2.6 Paired-Sample** *t* **Tests Results**

The use of the means test of equality shows the significance of relationships between pairs of variables of interests and helps the understanding of the direction or signs expected from the variables of interests. Thus, it is easy to know how important the basic differences are. The pairs of variables that are of interest in this study are those of:

* 1. Capital Flight (WB) and Dollar Financial Savings
  2. Capital Flight (WB) and Domestic Investment
  3. Capital Flight (WB) and Capital Flight (Dooley)
  4. Capital Flight (Dooley) and Financial Savings
  5. Capital Flight (Dooley) and Dollar Domestic Investment

**Paired Differences Results**

The results from the above test indicate that samples of the variables show a high degree of correlations and marked significant levels that cannot be ignored. The general definition shows that capital flight and domestic investment and savings have inverse relationships and are quite significant at 0.005 and at 0.003 respectively. The significant level here is beyond 0.01 and is negative. With *t* results at -3.174 and -3.021 it can be inferred that the higher the capital flight that takes place in the economy the lower the level of financial savings and investment the economy receives.

**Table 4.2.5 Paired Sample Results**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Paired samples** | **95% Confidence Interval of the Difference** | |  |  |
|  | **Lower** | **Upper** | ***t*** | **Sig (2 tailed)** |
| Capflit – Dfsavs | -1112.0380 | -5037.5432 | -3.174 | .003 |
| Capflit – Dinvt | -1097.5378 | -5569.8981 | -3.021 | .005 |
| Capflit – DDCAPFT | 2911.1695 | 104.69204 | 2.177 | .036 |
| Dfsavs – DDCAPFT | 7278.7930 | 1886.6497 | 3.444 | .001 |
| Dinvt – DDCAPFT | 7058.8514 | 2624.4461 | 4.425 | .000 |

**Source: SPSS (abridged) Results 2009**

The test result from the two different types of capital flight is equally significant at 0.05 level with the result at 0.036. The significance of the result show that of the sizeable amount of the capital flight that has left the economy some that have flowed back in cannot be properly accounted for. The result from Dooley’s is more exemplifying as the *t*sshow higher figures and level of significance quite higher. The investment variable is negative in Dooley’s capital flight and was not significant in World Bank’s

**4.2.7 Granger Causality Tests**

The assumption of association does not mean causality, but the use of Engle Granger’s test becomes important to confirm initial results. Granger causality is not signed but direction is often inferred from the results that have been obtained by other means. The variables demonstrate the association that has been exhibited before in the various regressions that have been estimated. Additionally, the results that often come out can be likened to Vector Autoregressive (VAR) output that treats all variables as endogenous.

**Table 4.2.6 Granger Causality Test Results**

|  |  |  |  |
| --- | --- | --- | --- |
| **Null Hypothesis:** | **Obs.** | **F-Statistic** | **Probability** |
|  |  |  |  |
|  |  |  |  |
| INVT does not Granger Cause CAPFLT | 37 | 2.98948 | 0.09288 |
| CAPFLT does not Granger Cause INVT | | 0.06627 | 0.79840 |
|  |  |  |  |
|  |  |  |  |
| RESRV does not Granger Cause CAPFLT | 37 | 12.0912 | 0.00141 |
| CAPFLT does not Granger Cause RESRV | | 5.16249 | 0.02952 |
|  |  |  |  |
|  |  |  |  |
| FSAVS does not Granger Cause CAPFLT | 37 | 8.26730 | 0.00692 |
| CAPFLT does not Granger Cause FSAVS | | 8.18616 | 0.00717 |
|  |  |  |  |
|  |  |  |  |
| INTDIFF does not Granger Cause AVEXRATE | 37 | 6.52340 | 0.01530 |
| AVEXRATE does not Granger Cause INTDIFF | | 0.80518 | 0.37586 |

**Source: E Views Results**

With these results, the inference is that two of the independent variables: financial savings and external reserves have bi-directional and significant causal relationships with capital flight. Of note is the observation of bi-directional causality of two of the independent variables with capital flight. *Financial savings* and *reserves* can granger cause capital flight and vice versa. With these, capital flight revolves around activities impelling increases and decreases in aggregate reserves and financial savings. The variables of *interest differential* and *investment* both have significant relationships with capital flight. As usual, the results are not signed, but by results from the earlier regressions, the interest rate differential and investment are positive. The *Kaopen* and exchange rate variables are not significant but *avexrate* is. Therefore at above *0.05%* investment with *Wald* *F* statistic of *3.36* and *3.8* respectively are significant in the causal relationship by granger causality tests.

The Dooley definition of capital flight somehow presents results that are more significant. The variables of *investment, Kaopen, reserves* and *financial savings* are all significant at various levels. The only insignificant variable here is the interest differential variables, which was significant in the straight World Bank definition. By this technique, investment is significant at 0.01 level, which indicates the capital flight, leads to reduction in domestic investment with *F* statistic of 5.179 but can also increase capital flight. *Kaopen* is significant beyond 0.05 with *F* Statistic of 4.316. The external reserve is significant at 0.1 with 2.5 and domestic financial savings is significant beyond 0.01 with F Statistics of 21.4 respectively. The results as usual are not signed, though it is possible to know which of these is positive or negative by inference to earlier and other results.

**4.3 DOMESTIC INVESTMENT**

The ordinary least squares technique (OLS) was used to obtain regression estimates. Results from the OLS estimates on investment show the significance of the variables both positive and negative. The constant factor shows a negative figure indicating an unstable and widely negative growth of investments during the period in view alongside other variables. This becomes more pronounced as the years go by. Investment during the later years was much less, as it tapered off than in the earlier years as the table below shows (Table 4.3.1 on page 129). It equally shows that the *public sector borrowing requirement* intended to direct the investment of the autonomous sector into particular areas is significant at *t* of 3.4406 gives an acceptable level of significance beyond 0.01 levels and cannot be ignored. By this, the government often borrow to make necessary investment from the financial system, but would be better directed to finance autonomous investment, and would be best utilised on real investment.

The role of the *avexrate* is instructive as the rate of exchange is a significant inducement for investment in the domestic economy. The more stable the exchange rate the more confident the foreign direct investors are sure that no capital losses would be sustained. Therefore, the relationship between the rates of exchange and investment is positive and significant relationship with *t* of 4.531, which is significant beyond 0.01 level.

**Table 4.3.1**

**OLS Regression Results on Investment**

|  |  |  |  |
| --- | --- | --- | --- |
|  | **Pooled Data** | **Pre Globalization Period** | **Post Globalisation (1985-2007)** |
| **Constant** | -82330.45 | -14160.27 | -31809.48 |
|  | (-1.18975) | (-0.2181) | (37062.07) |
| **Finsavings** | 162.517 | 687.146 | 192.5335 |
|  | (37.18)\*\* | (8.426)\*\*\* | (46.035)\*\*\* |
| **Avexrate** | 2052.25 | 679.0332 | 1676.837 |
|  | (195.072)\*\*\* | (4.4135)\*\*\* | (266.765)\*\*\* |
| **PSBR** | 1.239 | -4.7800 | 2.226 |
|  | (0.488)\*\* | (-2.7034)\*\* | 0.7586\*\*\* |
| **DDCapft** | 2.938992 | 0.080295 | -0.994325 |
|  | (3.171252) | (0.139506) | (3.549744) |
| **Kaopen** | 11410.40 | 13934.60 | 12651.21 |
|  | (18531.18) | (15579.01) | (22959.17) |
| **RGDP** | -0.0379 | 0.2447 | -0.0522 |
|  | (0.0208)\*\* | (0.1055) | (0.0252)\*\* |
| **ALSI** | 0.0360 | - | 0.0496 |
|  | (2.2606)\*\* | - | (0.0184)\*\*\* |
| **Caputili** |  | 116.4 | -583.302 |
|  |  | 60.53\* | (930.29) |
| **R Squared** | .976 | .98 | 98 |
| **Adjus. R Squared** | .970 | .98 | 97 |
| **F Statistics** | 276.72 | 378 | 124. |
| **Durbin Watson** | 2.22 | 1.94 | 2.09 |
| **Observations** | 37 | 24 | 23 |

**Note:** OLS estimates. Standard errors are in parentheses. \*\*\*, \*\*, \* denote significance at 1, 5 and 10 percent levels respectively.

As the coefficient is positive then it can be inferred that higher rates of exchange induces investment. The causative determinants are here for both foreign direct and domestic investment. The lead and lag factor is a good reason for investors to take positions on domestic investment while the stable rates of exchange induces foreign investment into the economy.

The all share index variable indicates the importance of financial investment in the economy and is significant at *t* of 2.2606, which is beyond 0.05 level of significance. Financial investment in the economy is not directly a form of capital formation though its impact on the wealth of the investor cannot be ignored.

A noteworthy observation is that the RGDP is not significant, indicating that the growth of investment is not induced endogenously from growth in the economy. Financial savings is however significant beyond 0.01 with the *t* of 2.7900. This conforms to theory that the available savings propel growth of domestic investment in the economy in the financial system. Capacity utilisation, which is the variable that represents the activities of the real sector, is negative and not significant for the post globalisation period, though significant for the pre globalisation at *0.09*. The indication of this is that investment in the real sector has reduced during the post globalisation years. The relationship is positive as well as in the case of the financial savings in both pre and post globalisation periods with significant level of 0.01.

The estimation result for the post globalization period indicates a lower significant level for PSBR. However, this is negative beyond 0.05, which indicates the higher level of borrowing from the financial system that the government had resulted in less investment during the period. It equally proves the theory that PBSR crowds out private investment right. It also indicates that less autonomous investments were made in the economy while the exchange rate shows an inverse relationship, indicating that the higher the rates of exchange of the currency the less the domestic investment that this made during the period. The figure of -2.7034 is significant beyond 0.05.

With the test, the *PSBR* is highly significant beyond 0.01 with a *t* of 3.324. The RGDP at this time is much lower coefficient higher than the initial regression denoting that financial conditions are worse become investment committed as a result of growth had dwindled considerably. The all share price index (*ALSI)* variable was not used because the index came on in 1984. From the regressions estimates, pre globalization PSBR shows a significant diversion of government borrowings from the domestic financial system to other areas that are not captured in the regression. If borrowings from the system were to impact on the system, it would have shown a positive figure. Equally, noticeable is the increase in the level of significance of financial savings during the break period: an indication of the reduction in savings at this time. Financial savings was significant beyond 0.01 for the period before this time as Nigerians saved more in the domestic system than the post globalisation period

The results discussed above adequately explain the investment scenario where the R2 is 0.976 and only less than 0.03 of the investment can be adduced to external factors. The adjusted R2, which takes care of degree of freedom, also is 0.97. The Durbin Watson figure is unadjusted and is 1.86 indicating that the autocorrelation challenges are minimal. The overall statistic reliability shows a robust *F test* figure of 150.999. The break test indicates the lower R2 at 0.98 and the adjusted indicates 0.98. An improved Durbin Watson of 1.94 is recorded here to show that the figure during the period is less plagued by autocorrelation and a higher F statistic at 378, Chow prediction is F 43.56. The fitness of the curve is reliable as the Akaike info and Schwarz criteria show 0.236. The conclusion from the regression is that domestic investment in the country has gone down and has been badly affected by lack of development in the economy, which has reduced the overall level of growth. The rate of exchange that was floated during the Structural Adjustment Plan of 1986 that coincided with the time of the beginning of the current wave of financial globalization has badly affected domestic investment as the insignificant relationship become more serious. Furthermore, the role of Real Gross Domestic Product (RGDP) impacts on the domestic investment and this is evidence that the economy is not making progress in terms of investment.

From the above it can be seen that the country invested more during the pre globalization period than after because the constant which is generally negative showed a lower coefficient for the pre-globalization period at -14160.2 per year on the average while total period return a higher figure of -82330.45. There was generally more investment committed in the economy before globalisation than after as already found out.

* 1. **FINANCIAL GLOBALISATION**

The foundation for the discourse on financial globalization is from the *de jure* point, which deals with what the regulators would consider legitimate transactions in a liberalised foreign exchange market and its role in promoting openness to capital flows. The *de jure* openness index as constructed by Ito and Chinn (2007), is *cine qua non* and foundational to other forms of financial globalization determinants that may be estimated as it denotes what the authority would consider illegal or legal or the monetary authorities consider acceptable international financial transaction. Therefore, the market based determinants, constructed by Lane and Millesi-Ferreti (2008) incorporates the *Kaopen* index by Ito and Chinn. The *Kaopen* measure had become popular as it shows the intensity of the openness of capital account. The *de facto* measure constructed by the

Lane and Millessi-Ferreti, which is asset and liability based only, shows the determinants of interconnectivity between the domestic financial system and the rest of the world. The interaction of both indexes helps the understanding of the status of the country’s financial globalisation. The integration and financial interdependence of the domestic financial system within the world financial system is brought out more openly by the market based assets and liabilities rather than the UIP (uncovered interest rate parity) approach of Ito and Chinn (2007). As such, each of the components of the index is what is analyzed to see the effect on the entire process**.**

The *Kaopen* measure is one of the variables adopted to know the level and the impact of the variable. The *de jure* measure helps to know the lawful transactions that can be carried out as a result of capital account openness. The index ranges from 2.500 for countries with full floating currencies and complete openness regime to -2.500 for countries that maintain fixed currencies regime and with inflexible restrictions on their capital account transactions.

**Table 4.4.1**

**Regression Results of Nigeria Financial Globalization**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Variables** | **Financial Assets (a)** | **Financial Liabilities (b)** | **Pre Globalisation**  **Financial Assets (a)** | **Post Globalisation**  **Financial Asset (b).** |
| **Constant** | 23999.53 | -99451.83 | -1281.549 | -164872. |
|  | (2.548)**\*\*\*** | (-0.84878) | (922.122) | (-10065) |
|  |  |  |  |  |
| **AvexRate** | -3192.14 | 1429.81 | 447.00 | 2444.13 |
|  | (-0.4899) | (1.96685)\*\* | (248.32) | (1.1905) |
|  |  |  |  |  |
| **Kaopen** | 835771.6 | -22977.99 | -850.54 | 3480 |
|  | (3.8271)**\*\*\*** | (-0.952264) | (656.99) | (2.1608)\*\* |
|  |  |  |  |  |
| **GDPP Capita** | 58.2135 | -5.556 | 0.008 | 3.147 |
|  | (0.895975) | (0.429) | (0.0119) | (0.1903) |
|  |  |  |  |  |
|  |  |  |  |  |
| **FinDeepn** | -41965.68 | 2918.39 | -6.746 | 0.0111 |
|  | (-2,0602)**\*\*** | (1.4302) | (4.457) | (0.0264) |
|  |  |  |  |  |
| **Export** | 94.732 |  | -0.0015 | 59.004 |
|  | (7.224)**\*\*\*** |  | (0.003) | (2.548)\*\*\* |
|  |  |  |  |  |
| **Population** | -13066.46 | 256.36 |  | 16636.8 |
|  | (0.8874) | (0.15) |  | (0.9791) |
|  |  |  |  |  |
| **Import** |  | -1.759 |  |  |
|  |  | (-0.6) |  |  |
|  |  |  |  |  |
| **Tradeopenesss** | -2159.77 | 90.516 | 0.294 | 0.0001 |
|  | (-2.8248)**\*\*\*** | (1.0119) | (0.117)\*\* | (0.0004) |
|  |  |  |  |  |
| **D Watson** | 1.73 | 1.71 | 1.62 | 2.06 |
| **R2** | .92 | 0.62 | 0.73 | 0.97 |
| **Adj. R2** | 0.90 | 0.53 | 0.56 | 0.95 |
| **F Statistic** | 49.83 | 6.77 | 4.45 | 67.74 |
| **Observations** | 37 | 37 | 17 | 20 |

**Note**: OLS estimates. *t* statistics are in parentheses. \*\*\*, \*\*, \* denote significance at 1, 5 and 10 percent levels respectively

As most countries made efforts to open up the capital account of their Balance of Payments in the 1990s, the index moved from negative to positive or in some cases like Nigeria, it moved from high negative to low negative. The median being 0, is yet to be attained by Nigeria. The index was -1.18 in the early seventies when Nigeria was on fixed exchange regime and the Central Bank guaranteed the convertibility of the domestic currency.

The *de facto* measurement was formulated to measure the variables that are considered significant in the actual openness of the domestic financial system to the international financial flows. The various factors that influence the actual movements and flow of financial transactions were tested to know how significant each variable was. The results show that the determinants of financial globalization are significant in Nigeria as those emerging markets of Lane and Milessi-Ferretti for the foreign asset acquisition. The population as a determinant is not significant. In the acquisition of financial assets, the exchange rate variable is important, as it is significant in financial assets acquisitions overseas at 0.05 and also for financial liabilities. Also significant is the *Kaopen* measure to buttress the fact the there is a measure of liberalisation in the exchange rate management in Nigeria. Export out of country is significant way of building assets outside the country as it is significant also beyond 0.01 level of significance. This underscores the role of mis-invoicing in siphoning resources of Nigeria and especially export under-invoicing is the commonest methods of engaging in capital flight out of Nigeria. The probability of non-remittance of the full proceeds of exports is also high. The values are positive throughout the period covered by the study. This shows that higher rates of exchange fostered the increase in the foreign financial assets, and liabilities acquisition might be due to further financing advantages that firms borrowing from overseas enjoy.

**Figure 4.8 External Financial Assets and Liabilities of Nigeria**

****

**Financial Assets and Liabilities for Years (1970 – 2007**

The *de jure* measure, which often will provide a measure of confidence to investors, is significant at 0.01 for financial assets but not for liabilities. (This variable is often insignificant in the various regressions where it has been used in the literature.) Absolute values are however higher for assets. To the extent that the capital opening process of the Central Bank of Nigeria has allowed entities in the financial system to invest abroad, capital account openness impact on the borrowing or claims by foreign national on Nigeria. In a way, this means that the exchange rate liberalisation have been significant in the overseas asset acquisition by Nigerians.

**Fig 4.9 Nigerian Financial Globalisation**



**Nigerian Financial Globalisation (1970 - 2007)**

A higher level of *Kaopen* (say in the positive region) would produce higher figures with the assets acquisition becoming more dominant. In addition, the fact that Nigeria recently liquidated most of the foreign debts could have caused the non-significance of the variable in liabilities acquisition. The positive sign indicates that the more *Kaopen* level the country attains, the higher the assets Nigerians will acquire overseas. With every point gained in the index, an increase in external asset acquisition to the tune of $835.771million occurs.

Per capita income (GDPPC) estimates comes with positive coefficients and standard errors but not significant in the financial assets but has negative coefficients in the liability flows. Generally, the population is not investing overseas now nor are they borrowing from abroad. This might be because of the high rate of poverty in the country and the inability to muster minimum requirements of purchase of assets overseas. Financial deepening is negative with high coefficients and significant at 0.05 level. It is however negative under the financial assets. It is instructive to note that while the financial system is developing more products to absorb and dispense finance, the figures shows a negative coefficient indicating that with more financially deepened system less assets would be acquired abroad. This was the *a priori* expectation. There was less acquisition of assets in the pre globalization period. With this result, financial deepening in Nigeria shows promise and it can be used to further discourage overseas investment.

Trade openness was significant during the overall period for financial assets and in the globalisation period for assets acquisition but not for liabilities. The level of significance is 0.001 with low coefficients, which indicates the importance of the current account opening process to the economy and the financial system in Nigeria. It also shows that the financial liabilities acquisition, which was prevalent before globalization, was largely removed in the break point test. Nevertheless, the country exports mainly a monoculture product in raw form.

Trade values of the variables: export and import were tested under assets and liabilities respectively. Import can only lead to liabilities and exports to assets acquisition. Export is significant for asset at 0.001 level while import is not for liabilities for all periods. None is significant during the current episodes of globalization.

Durbin Watson for all the regressions is between 1.62 and 2.29. Serial correlation challenges are minimised if the Durbin Watson is 2 or thereabout. It is believed that there is no serial correlation among the variables to invalidate the results. The *R2* is 0.92 and 0.73 for asset under all periods and globalization period respectively. This shows that the variables could not account for 8 and 27% respectively assets and liability. *R2* for financial liabilities are 0.62 and 0.94 for overall period and breakpoint period respectively. *F* statistics for the estimates are robust except for financial liabilities with 6.77 and the breakpoint period for financial asset which is 4.45. The observations included for all periods were 37 for liabilities and assets respectively while the globalization period has 17 observations each.

Since Nigeria recently paid off a heavy debt (year 2005 and 2006), it is expected that the variable may not show as much promise with liabilities as for assets, even though the debts have begun to rise again. Therefore, it can be concluded that factors that have been responsible for the growth of the financial system and financial deepening are all traceable to internal dynamics of the Nigeria financial system, and not necessarily any financial globalisation as earlier presumed. Issues such as banking sector recapitalisation were not induced by globalisations but the need to prepare the system for the next phase of banking operations, which of course had external growth implications.

**4.5 DISCUSSIONS OF EMPIRICAL FINDINGS**

*Capital flight has not significantly affected domestic savings in Nigeri*a*.*

The results of the raw variables indicate that the portfolio choice theory is important in the decisions of investors and therefore, the need to resort to capital flight in order to earn real higher returns for their capital when it becomes easy or possible to transfer capital out of the country. In addition, the need to diversify investment and rebalance portfolio are serious determinants in the portfolio choice theory. The variable is significant in both World Bank definition and Dooley’s at the same level i.e. at 0.01. The features of the coefficients in both results are similar: *t* statistic -2.041 and -3.893 respectively: and highly magnified in Dooley’s than World Bank’s. It is arguable that the result here can be linked to the reduction in financial savings in the economy because of capital flight. This has caused the domestic economy to lose some amount of financial savings that could have been used to finance further investment in the economy. The financial savings as a variable is also significant at two levels using the raw variables and the logged data. The raw variables of the World Bank and Dooley definition are significant at 0.05 and 0.01 with *t*s of -2.7151 and -4.396 respectively, while the logged variables are not for both. The obvious reason for this is the loss of data that accompanied the logging of the variables. A correlation of the independent variables of capital flight (WB), domestic investment, and financial savings produced a result that was negative at -0.149. The relationship between capital flight and domestic savings is an inverse relationship. The estimates of the VECM notwithstanding, the OLS results of the World Bank and Dooley are exemplifying enough. All other results show a negative impact of capital flight on financial savings. The conclusion that can be drawn for the hypothesis, given the raw data regressions results is that the null hypothesis cannot be accepted. This forces an acceptance of the alternative and a rejection of the null that the capital flight has affected domestic savings aggregation in Nigeria.

**4.5.2** *Risks in the macroeconomic conditions of the country do not have a long run relationship with capital flight out of the economy.*

From the various tests the exchange rates represented by the *avexrate* is negative throughout. The coefficients are low not significant but for both World Bank and Dooley definitions. The raw coefficients and *t*s are not significant ranging from 0.450 to 0.606. The logged *t*s of -1.034 and -1.083 are similar but equally not significant. The VEC results show that *t*s of -1.455 and-1.396 cannot be entirely wished away. The variable indicates by the sign that the higher the exchange rates the lower the capital that flees the economy. If capital flight reduces with high (market-driven) exchange rates, then floating of exchange rates might be more meaningful since the higher exchange rates are associated with floating of exchange rates for the market to determine prices or rates. Another study of the investment estimates would confirm that the high exchange rate in the economy does not reduce investment, as it shows a significant positive relationship with investment. The lead factor may be one of the reasons responsible for this. The exchange rate risk as *proxied* by the average rate of exchange does not significantly affect capital flight. The fact that the relationship is negative shows that capital flight reduces with higher rates of exchange. Here the conclusion is in favour of the null hypothesis. High exchange rates do not significantly increase capital flights out of the economy nor reduce domestic investment.

**4.5.3** *There is no significant relationship between the process of financial globalization and capital flight out of Nigeria*

Financial globalisation has caught many countries unawares, with some moving on with the train while others jumped into the process in a haphazard manner. The financial globalization as defined by two separate researchers on the topic has been defined from two angles of *de facto* and *de jure*. The *de jure* index of financial globalization is more explicit and has been improving gradually, with the process of adjustment programmes Nigeria undertook in the mid 1980s. It is to be noted that the index has a maximum of 2.543 for completely open and floating exchange rates of the United States, Canada, Great Britain and some other developed countries. Index for Nigeria moved from -1.12942 in the seventies to -0.45086 as at year 2007 and has dropped further with current practices. Regulatory policies have steadily improved the landscape for a more liberalized foreign exchange market but this has not been sufficient for Nigeria to reach the mid-point, which in this case is 0. The four indices have continuously been varied to the disadvantage of the foreign exchange market. Therefore, by *de jure* measurement, Nigeria is not financially globalised.

In spite of the *de jure* measurement, what is important is the use to which Nigeria has employed the global financial market in the sourcing and usage of funds and the direct linkages with international financial centres. This is measured by the *de facto* determinants. The determinants of the measure in the regression estimates have showed different signs and various levels of significance for the endogenous variables regressed against financial assets and liabilities. For the rate of exchange *(avexrate)*, financial asset is significant beyond 0.05 level indicating the tendency of lower exchange rates in encouraging the acquisition of liabilities by Nigerians abroad. Export as an independent variable was more significant in acquiring financial assets outside of Nigeria than import was in acquiring liabilities. The indication here is that Nigeria had significantly used its export proceeds to acquire foreign assets and most probably engaged in capital flight, this at 0.01 level of significance.

Other endogenous variables are not significant and their importance can be measured in the signs they carry in the process of the tests. Expectedly, the coefficient of per capita income is positive for asset acquisition but low negative for liabilities, showing the portfolio preference of Nigerians to shift assets abroad. For both periods of pre and post globalisation, the feature is the same as the assets are higher than the liabilities. The *Kaopen* measure has not been significant in some of the countries where it has been used but significant in the World Bank measure at 0.10 level of significance. The various estimates obtained from *Kaopen* indicate that only the logged variables were significant at 0.05 and 0.01. The co-integrated *t* and the error correction are not significant at *t*s of 0.887 and 0.983 respectively. Going by these analyses Nigeria is yet to achieve the level of financial globalization that is expected of an emerging economy that it claim to be, but in spite of this, is being affected negatively through the various indices of measurement of financial globalisation. In the process, one cannot accept the alternative hypothesis that financial globalization has a significant impact on capital flight in Nigeria as the external financial assets has been higher than liabilities irrespective of the globalisation processes.

**4.5.4** *Capital flight out of the Nigerian economy does not have a significant relationship with domestic investment*.

Investment in the domestic economy has low coefficients in the regressions that was run and was not significant at any level. The logged variables performed better as the coefficients were higher. The *t*s are low at -0.505 to -0.210. The logged capital flight (World Bank) independent variables indicate a negative relationship in the regression showing the domestic investment reduces as capital flight increases, the same for raw Dooley results. The co-integrating equations show that the *t*s are low as well but negative for both World Bank and Dooley definitions. Dooley’s definition show a more negative impact in the OLS but a higher insignificant result in the long rum equation is understandable as the effect of the errors and omissions are easily noticed in the inflow of capital that cannot be fully accounted for. This in effect reduces the total amount of capital flight estimates that flee abroad. Capital flight of the World Bank and Dooley’s estimates do impact insignificantly on domestic investment.

The results are more exemplified by the Paired Sample tests (a technique that cares less for economic data). Capital flight and investment when compared, clearly shows a negative sign with a highly significant *t* statistic. At -3.021 the variable is highly significant beyond 0.01 level. The two tailed statistic show 0.005. The impact of the inflows through the errors and omissions account that comes into the economy affects the result in the Dooley definition and is still significant. Granger Causality results also show that capital flight negatively impacts domestic investment at significant level. The indication that capital flight increases with negative effect on the domestic investment is not proved with the result. Since the model is anchored on the regression and the VECM estimates, it is difficult to accept the alternative and reject the null hypothesis that capital flight has significant negative impact on domestic investment in Nigeria.

The overall implication of the results of the hypotheses is that the outflows of capital out of the economy indicate that the environment is not suitable for accommodating domestic investment and sustaining it. Since domestic savings is negatively related to capital flight, the root of investment is impaired and there is difficulty in sourcing capital for investment. That the banking system has not created enough products to meet the financial investment needs of the population is an indication of low level of financial development in which the country is presently.

The effect of the real gross domestic product in the investment process indicates that negative or inverse relationship exists between the two variables. This shows that Nigerian investment process is not significantly benefitting the RGDP or there is insufficient investment to significantly affect the RGDP. This goes to show the dwindling of investment over the years. The Public Sector Borrowing Requirement (*PSBR*) of the government initially shows significance and eventually tapers off showing the trend in government less use of banking resources to finance investment in the country. As at this time, most of the government fiscal imbalance is made up with borrowing from domestic bonds market.

It is evident that the country is yet to be able to align itself with the reality of financial globalisation. The attendant effects from this are that resources leak out of the country in spite of the pronouncement of the country as an emerging economy. Further progress would impel a higher level of capital flight and this cannot be halted. This means that opening up the more could be entirely dangerous for the country leading to serious outflow of resources. Since the continuous globalisation may be economically infeasible, then safeguards in terms of soft and real investment in infrastructure must be put in place to improve the total productivity factors and protect the economy from the downside of financial globalisation.

The per capita gross domestic product (GDPPC) of the country in the financial globalization process shows that the variable does not significantly affect globalization and therefore does not affect capital flight. The inference drawn from this is that few individuals and institutions carry out actual capital flight activities in the economy. External assets acquisition by entities in Nigeria as means of asset diversification has yet to reach a significant proportion since the law allowing this is yet to be fully implemented. The fact the Dooley measurement of capital flight produces a lower figure is because of the inflows that Nigeria has received that cannot be fully accounted for with the net errors and omission that allow balancing entries in the Balance of Payment. Since the flows are part of the accounts, then it cannot be ignored in the process.

A significant finding is the role of the exchange rate in this process. While it is established that the premium on the parallel market rate is a significant cause of capital flight, it is not certain that high nominal exchange rate in itself can lead to capital flight. In order words, the expectation of deterioration in exchange rate may lead to capital flight but not the nominal rate in itself. This implies that a policy to depreciate the rate of exchange below the equilibrium level may increase capital flight but may be hurtful to the economy generally. Meanwhile, market determined exchange rate is positively related to increase in investment rate in the economy. This is also noticeable in the *de facto* financial globalisation determinants in both asset and liability acquisition in the country. Therefore, the exchange rate management process is important to the resolution of the problem.

The correction term shows that capital flight for the country is not significantly influenced by exchange rate. This calls for the need to provide a good and conducive investment environment for both foreign and domestic investor. The relationship between investment and capital flight is interesting in the correction mechanism estimates, as *a priori* expectation was a high *t*. This is an indication that higher investment may result in decrease in capital flight, and vice versa. This should be expected with the increase in foreign investment in the economy and further globalisation. If higher domestic investments in the economy do not lead to capital flight, then more of it should be undertaken. The significance of this is that the more the investment undertaken in the economy, the less the capital available to transfer abroad. The situation can be more worrisome where there is preponderance of financial investment over real investments as presently witnessed in the Nigeria Stock Exchange. Portfolio investment can quickly flow out as it has flown in, still foreign direct investment can flow out by substitution with domestic borrowing. The issue here is the total factor productivity (TFP) allow free mobility of capital to be of benefit to the economy. This resolution to the problem here is continuous undertaking of autonomous investment in the domestic economy to crowd in other investment and make the environment more investment friendly for both foreign and domestic investors.

**CHAPTER FIVE**

**SUMMARY, CONCLUSION AND RECOMMENDATIONS**

**5.1 SUMMARY**

This study has investigated capital flight and investment scenario in the process of financial globalization in Nigeria, with data from 1970 to 2007. There are as many definitions of capital flight as estimates, but only two definitions are explored and presented in this study. The views of the study are twofold. Firstly, capital escaping from an economy is taken as capital flight; but not all forms of capital can be traced in or out of the domestic financial environment. Since, the motive behind capital fleeing is to ensure that capital escapes into safety or secrecy, while the sources and purposes of some returning capital are not declared. The second view is that continuous flights of capital out of the economy reduce investment that could encourage growth and development in the domestic economy. This scenario can be exacerbated by the current financial globalisation process.

From the operational definitions of capital flight and the results arrived at in this study, the various definitions might not all be fitting for Nigeria. Apart from the Dooley and Cuddington measures, Morgan Trust is not appropriate, given its estimation methods and the reality that faces Nigeria. The World Bank measure is basic and is normally used for comparison while Dooley’s should be a preferred choice in the case of Nigeria since the variables are more significant and produced better results with the inclusion of the figures of errors and omission of the Balance of Payments. For practical purposes, nominal capital flight by World Bank estimate is $164,633 million and by Dooley’s $107,331million as at the end of this study - 2007. The impact of net errors and omissions is clearly seen in that there are inflows that cannot be accounted for in Nigeria’s Balance of Payment.

This shows that the impact of the errors and omissions in the Dooley definition is significant in the estimation process since much of the capital that flees leave in various forms and return under different guises and purposes that cannot be fully explained or captured by the records. In addition, the inflows that have been recorded are typical of Nigeria where the real origins of such goods and capital can hardly be established. It is concluded, that the Dooley estimation is more significant with the variables employed than for any other definition in Nigeria.

Flights of capital can be into secrecy or safety. Foreign investors who on noticing a risky circumstance or environment, resort to transfer of capital out of the economy would undertake the flights of capital to safety. The flight to secrecy is undertaken when institutions and entities engage in capital flight through various clandestine means, which include false bottom suitcases. The flight to secrecy often returns in another form different from the way it left initially. Thus, safety flights will include all desperate *recorded* actions that are engaged in transferring capital out of the country. In this way, it is possible to separate legal and illegal capital flight. Legal capital flight is normal economic reaction by investors to transfer capital out of a risky environment into a more suitable one. Illegal capital flight can then be defined as *all flights of capital out of an economy in an unofficial and irregular manner so that the capital becomes untraceable and income from such capital are not known or recorded.* This is the area where corruption and other illicit means of acquiring assets can be situated. This is the more reason why the Dooley definition is more significant for the Nigerian scenario of capital flight and why illegal capital flight is more prevalent in Nigeria.

Savings and investments in the economy are both facing beleaguered times, having been negatively affected by capital flight out of the economy. Savings performance is far better than investment, and savings does not power domestic investment. The Dooley estimates are better in this respect since it shows a more negative correlation with capital flight. This shows that while there is danger ahead, the economy can still muster sufficient resources to enable further investment in the needed areas. But other studies have proved that while there is increased savings it has not translated to increased domestic investment. The first point to address the issue will be to encourage domestic investment by the use of autonomous investment variables (e.g. *public sector borrowing* directed at infrastructural development). This will induce and power the domestic investment process in order to encourage and retain capital that could otherwise flee out of the country. This would then reverse the continuous flights out of the economy first, and then encourage domestic savings, which in due course will promote further domestic investment *ceteris* *paribus.*

That the process of financial globalisation impacts on the capital flight in Nigeria is no longer in doubt, as the country liberalises more on the capital accounts and the exchange rate, more capital flight is expected to take place *ceteris paribus*. Though literature is yet to establish the optimal level of financial globalisation for different countries, it has been able to ascertain the determinants of globalisation in most countries. The factors or thresholds for financial globalisation benefits are yet to be arrived at though each country has specific attributes to power the benefits of financial globalisation. In order to encourage inflows of capital rather than its outflow or flight, the Total Productivity Factors or the soft attributes must be addressed. Equally with or without financial globalisation capital flight has continued which means that the real challenge of capital flight is still ahead if the present circumstances continue.

Findings indicate that the relationship between capital flight and investment is insignificantly negative. However, the relationship exhibited by the Dooley estimates is more pronounced. This could be due to the involvement unrecorded capital inflow in domestic investment. Also it is clear that the level of financial globalisation is not significant in capital flight out of Nigeria. An observation from the various regressions results is the continuous significance of the external reserves in the economy. The interest rate differentials between Nigeria and United States have encouraged capital flight as it is significant in all the estimates. The exchange rate is not significant from the estimates and results but high enough for concern.

The macroeconomic variable targeted by the Central Bank of Nigeria for economic management is the Monetary Policy Rates (MPR) at the present. However, a second look at the exchange rates might produce better results for the whole economy rather than just the external sector. The current methods of exchange rate management have not produced desired results. The importance of targeting the exchange rate can be seen in the fact that the country is a major importing country for both industrial and consumption goods. The impact of this on the economy is enormously evident in the investment and globalisation processes as the nation spends most of its export earnings on imports with few industrial exports.

**5.2 CONCLUSIONS**

From the literature consulted, it is impossible for developing economies to eradicate capital flight, but its prevalence can be controlled. Investments of domestic resources become impossible when capital flight is serious and reaches a higher dimension and percentage than the growth of the economy. From the domestic side, nationals who resort to capital flight are seriously averse to risks existing in the economy and would be afraid that capital losses could happen to their hard-earned resources and thus, would tend to shift capital abroad. Equally, when the investor needs to diversify his investments there may be need for him to consider foreign investment. This type of foreign investment would be classified as legal capital flight, because the domestic monetary authorities know where the resources are going into and in which country and thus return would be expected. Another type could also be because of the portfolio rebalancing where the shifts of investment overseas is based on portfolio reasons, especially if there is real interest rate differential between domestic investment and foreign investment. This will begin to be serious once the pension fund sector is allowed to invest overseas.

Flight of domestic capital assumes serious dimension when foreign investors attempts to shift capital abroad through every means possible as the risk environment becomes serious. The use of every legal possible means to move money out of the country becomes important, though much of this happens illegally. Foreign investors that have invested always want to be able to shift capital abroad at the slightest sign of inclement situation in the business environment. The most common method of shifting assets abroad *via* capital flight is through trade misinvoicing (especially export underinviocing), which simply involves the increasing of imports values or decrease in value of export of transactions that involve the country. In this scenario, it is difficult to fully eradicate the menace of capital flight from any developing economy that is pursing free market system as long as the market is open to foreign investment and there is a relaxation in the capital account to allow inflows of foreign investment into the country. This accounts for the slow rate of adjustment that is witnessed. Since it cannot be fully eradicated, then efforts should be directed towards its minimization.

The Dooley measure of capital flight brings out the type of capital flight being faced by Nigeria in that some unaccounted flows frequently occur and why capital initially transferred overseas may find its way back into the country. The Errors and Omission of the Balance of Payment allows balancing entries to be introduced which makes up for unexplainable entries. The efforts of the country should be directed towards complete documentation in order to ensure that funds do not leave the country anyhow without the possibility of its being traced. Additionally, with more transparency, Nigerians that transfers capital out of the country illegally can be dissuaded if they discover that transfer process is more open than before. Efforts directed at reducing the rate of capital flight in the economy will only succeed if there are avenues for the domestic investment of capital that would otherwise be made overseas.

Therefore, the best option for the country is to provide business-friendly environment on continuous basis for the country to improve the financial system through higher increase in the financial products that investors can invest in. This would improve the savings base which ultimately would provide more funds for further investments in the economy, especially the long term investments so much desired by the country. This has made the financial system to be shallow. (Long-term savings in the financial system has been discouraging for a long time.) The opening up of the country to inflows through the capital account can be controlled through efficient use and good management in the financial system. It is important to ensure that inflow of foreign investment into the country is encouraged to go into the real sector rather than into financial assets that encourages *hot flows* where investments can be quickly liquidated and the investor departs from the country. It should be remembered that the investors anywhere can choose the country that host their investments and that Nigeria has competitors as investment seeking-countries continue to perfect their strategies by making their countries’ environment investment friendly.

The issues to be addressed, in conclusion, in order to substantially minimize capital flight, reduce to two, and at best three simple economic approaches in spite of the onslaught of financial globalisation. They are: proper attention being paid to the issue of exchange rate and the commitment to autonomous investment by the public and private sectors. The third approach deals with transparency and openness in governance. The continuous improvement in the environment might then follow. The issue of market-determined exchange rate might seem costly but is necessary to transfer the cost implications of the foreign exchange market to the participant rather than the government. This enables a realistic exchange rate for the domestic currency, while autonomous investment would crowd in other investments and enable the private sector to thrive. Autonomous investments that would be made in the area of infrastructure would encourage firms, so that they do not have to provide some of the inputs that would be taken for granted elsewhere. If the financial system can be more deepened, such that more products are created, capital flight can be reversed. Nigeria needs to be proactive in stopping capital flight and encouraging domestic savings and investment in spite of the financial globalisation terrain. The world is one marketplace.

**5.3 RECOMMENDATIONS**

Given the above scenarios and the results arrived at, the following recommendations become important and apposite.

**5.3.1 Capital flight**

1. Capital flight management and reactions to capital account restrictions must be factored into the management of external reserves position of developing countries, including Nigeria. In this wise, the opening up process must be backed by adequate internal capacity on the part of the domestic financial institutions. In this case, the Central Bank of Nigeria and the Nigeria Investment Promotion Commission (NIPC), to promote real and industrial investment in the economy rather than short-term and hot-money inducing investments that the country has been experiencing in the capital market. It is common for developing and emerging economies to experience a level of capital flight as long as their economies are not completely open and they receive some inflows of FDI.

1. The monetary authorities should begin to look seriously into how to reduce the unresolved statistical discrepancies that are posted into the Balance of Payments with a view to finding out what make up such figures and how they came about. The errors in capital movements, in particular *period-based* and measurement errors can be separated to remain coverage, which seems to be the main problem. This will reduce many of the financial transactions that cannot be fully explained that find themselves into the errors and omissions in such a way that the Nigerian financial authorities can begin to find the solution to resolving and minimising the problem of *statistical discrepancy* in the BOP.
2. An elimination of the exchange rate misalignment and the premium is good start to reduce flights of capital out of the economy. Expectations should not be allowed to build up before a misalignment is corrected, as this is a major cause of capital flight. This will involve the continuous floatation of the Naira. Technically, the exchange rate premium is what drives the reactions to risk aversion of investors who eventually resort to capital flight, but the World Bank’s estimate of capital flight in Nigeria shows that the nominal average exchange rate as it is, is more a sufficient cause for increase in capital flight.
3. From the analysis, more capital is lost through underinvoicing of exports than over-invoicing of imports. This calls for accurate market analysis to be done when exports are conducted. The process of exports might be made to include the local and the importers’ Chambers of Commerce and Industry Mines and Agriculture to ensure that the country receives the correct proceeds from exports. This process must be instituted in a way not to discourage the exporters of goods from the country.
4. The first proper step to check corruption is to have a completely transparent process of fiscal management at all levels. The passing of Freedom of Information necessarily makes information available for any interested party needing it and must be fully utilised. Some studies have blamed the prevalence of capital flight on the seemingly intractable problem of corruption in most developing countries such as Nigeria. One of the difficulties of measuring accurately the total value of capital flight is the illegal means of transferring ill-gotten funds overseas via clandestine, bizarre and complicated processes. Capital would continue to flee if corruption is not checked in Nigeria. It is yet to be proved to see if corruption can be a significant variable in capital flight estimates; but the hypothesis is a strong proposition.
5. The country must consider the issue of patriotism by Nigerians important. Many of the acts accompanying corruption have their roots in selfishness and lack of patriotism by the perpetrators. An enlightenment campaigns and good governance must be put in place by the government to make such projects credible and acceptable to all. Governments must be frugal and well directed to pursue such enlightenment campaigns to re-brand and reposition the economy.
6. The Central Bank of Nigeria needs to target the exchange rate for now as one of its main control variables to influence national economic indices and may later adopt the control of inflation as a medium term measure. The control of interest rate or monetary policy rates (MPR) to influence domestic investment activities may be adopted in the long run. (Most developed countries adopt the use of interest rate or money supply.) The impact of the exchange rate in most of Nigeria macroeconomic indices is strong as has been proved by its high significant showing in globalization and investment. The market for foreign exchange must be further deregulated to allow several buyers and sellers rather the lopsided structure that presently subsists where most of the foreign exchange in the country is sold by Central Bank of Nigeria. Equally, strenuous efforts must be made to enforce liberalized foreign exchange regulations that must be put in place and ensure that the market is fully transparent and open.

**5.3.2 Investment**

1. Since autonomous investments have dwindled sharply and domestic investment is insufficient to match up capital flight in the post globalisation period, it becomes important to bring the authorities to encourage the increase in autonomous investment in the economy and induce other type investments in the process. In the current era of reduced investment of the government on infrastructure, (the main position of autonomous investment), it is important that the government through Public Private Partnership (PPP) encourage further investment in the economy. The investment expected for the country should be made in the areas that encourage further development of the economy (those areas that improve the country’s collateral benefits).
2. Encouraging long-term savings in an economy where income is low is a challenge, which must be overcome by all possible means. A short-term measure is the pension funds, which may be used as guarantee for the funding of investments in the economy. The government is currently using this to meet its fiscal deficits. The financial savings that enable banks to have resources for investment is shallow and can hardly support any meaningful real investment in the economy.
3. One common method of encouraging foreign direct investment is through good investment environment, which is lacking in the country. One of the ways covered in this study is the use of market determined exchange rates and optimal management of the exchange regime. The efficient management of the external reserves will ensure confidence in the environment by foreign investors before they come in. More than this, the Government must work on the investment environment.
4. Another way of encouraging further investment in the economy is for the provision of infrastructure by the government in country. Then services and more production can take place to increase income of the people. Given the negative sign of the RGDP in the investment results and its magnitude, it is known that the GDP is not contributing to the economy and to investment, as it should.
5. The public sector borrowing requirement, which indicates the level to which the government competes with the private sector in the banking system, was highly significant but subsequently was less significant for pooled data. The indication is that, this source of funding public expenditure has reduced considerably, though not totally. The use of banking funds by the government is dangerous for the economy. Since most banks see guarantee in the government borrowings, they are encouraged by the system to endlessly lend funds to the public sector under various means. This has twofold effects on the financial system. Firstly, the possibility of default by the government is real, as it may not move swiftly as occasion demands in order to pay back borrowed money. This has its attendant effects on liquidity in the banking system. Secondly, the entrance of the government into the banking system to borrow crowds out and out-competes the private sector, which needs the funds a lot more. Often, this results in credit rationing to the private sector or its unavailability, stifling investment opportunities in the process. If the government must borrow, it must be used for the purpose of investment capable of inducing other investment.
6. The encouragement of the banks to provide other investment outlets that yield higher than money market returns and a guarantee fund or insurance by the government to investors of a significant value would be welcome in stemming the rate of resident capital flight out of Nigeria. Further deepening and assistance to the banking system to be more innovative in creation of products that meet the desires of high profile clients would assist in ensuring that capital is invested rather than taken out of the economy. This calls for improvement in deposit guarantee management of the Nigerian Deposit Insurance Corporation (NDIC) to act promptly. This might help the country to retain some resources which otherwise would have flew out the economy.

**5.3.3 Financial Globalization**

As much as globalisation cannot be avoided by countries that seek to develop in the current process, it must be managed so that its harmful side will be minimized and controlled by the monetary authorities. Given the results obtained and the test of the hypotheses, the following are recommended to deal with the present stage the country is in the financial globalization process.

1. It is important to encourage the inflow of foreign resources in to the country through adequate and effective management of the exchange rate in the country. Market determined rates would assist in adequate evaluation of incoming resources. Confidence should be given to the foreign investors through management of the rates of exchange as well as guarantees for incoming ones.
2. The encouragement of export of products out of the economy must be intensified. However, the economy is constrained, as the economy is monoculture and export petroleum only in the raw form. If exports of petroleum must continue then there is need to add value in form of further processing before being exported. Effort must be directed towards industrialization in the country for the country to produce exportable goods in the right quantity and quality. This is the basis for improvements in real Terms of Trade.
3. As Nigeria must advance in the process, further level of financial globalization steps must be accompanied with capacity to develop the collateral benefits to ensure that the benefits of financial globalisation can accrue to the economy and in the process ensure efficiencies in the management of the financial resources of the country. The floatation of the naira and its ability to trade without Central Bank supplying the major quantity should be considered. From the indices constructed to arrive at *Kaopen*, Nigeria is yet to arrive at the middle point. Arriving at this point means that the currency (naira) is at the market place and the next steps will then be the deregulation of the sourcing and pricing of foreign currency.
4. A point to be addressed is the financial services or deepening in the economy to create more financial products for the economy to absorb inflow of foreign resources and thus make Nigeria a financially developing centre. This would stem the outflow of resources for investment overseas. The monetary authorities would have to make a conscious and deliberate effort to bring confidence into the banking system and encourage the creation of more services and products to meet the needs of investors of different types of both lenders and borrowers. The preponderance and skewness of the banking system lending operations towards short-termism cannot encourage growth.
5. The development of institutional capacity to manage the downside effects of the process of financial globalization and integration has yet to be fully ingrained in the Nigeria economic and financial system. This need to be fully looked into and addressed if the benefits that the process brings is to be enjoyed and costs avoided. For instance, the recent international financial and credit crises that came as result of the subprime lending from the United States affected the capital market. From the results, Nigeria does not have challenges exporting if it can produce more. The basic problem of trade-openness is answered if supportive institutions are able to provide infrastructural and regulatory guidelines and perform expected roles as in other emerging markets like Nigeria.
6. Another recommendation is on the need for Nigerian banks to firm up and begin their financial globalization and integration efforts from the Economic Community of West African States (ECOWAS) sub-region, since it is a dominant economy and the forces of financial centre should normally gravitate towards the country. The creation of a financial centre is long overdue in Africa and highly needed in the sub-region of West Africa. Therefore, the country should take the bull by the horns in terms of taking financial (Nigeria had taken political responsibility at a time) responsibility in marshalling efforts to have a viable financial centre created in the ECOWAS before the gains of the last recapitalization exercise in the banking industry are fully lost.
7. The last issue to be addressed, if the country wants to enjoy the benefits of financial globalisation, concerns the factors that make financial globalisation meaningful for countries. They are the collateral benefits or the total quality productivity factors (TFP). These factors are in the quality of education, adequate infrastructure, quality institutions (e.g. executive, legislative, judicial and security) etc. These factors are presently lacking in Nigeria, and must be provided if the country wants to benefit from the present wave. All these address the quality of both *hard* and *soft* infrastructure of the country

**5.4 Contributions to Knowledge**

This study has brought to the fore the relationship existing between capital flight and investment in Nigeria on the one hand, and the impact of financial globalisation on capital flight and investment on the other. The following is a summary of the contributions the study has added to existing body of knowledge on the topic.

1. The Dooley measure of capital flight is more significant in Nigeria. Therefore, measures of capital flight that do not include the errors and omissions of the Balance of Payment may not produce significant results, since some amount of capital enter the economy through other means which, however, is not taken into account in the World Bank measure though its estimates are higher.
2. The study establishes empirically, that capital flight does not impact significantly against domestic investment either in the Dooley measure or World Bank’s, which indicates that there has been insufficient investment over the years. This calls for attention and direction of investments to infrastructure and the real sectors of the economy in order to increase capital formation, induce further private investment and reduce the flight of capital.
3. It shows that errors and omissions section of the Balance of Payments is open to abuse as it can be used to cover much information about inflows and outflows of capital in Nigeria since its fluctuating effect can be seen to affect the total capital flight experienced by Nigeria. Unrecorded Inflows of capital has entered the economy through the errors and omission
4. The study empirically proves that the Nigerian financial system is not financially globalised in spite of the financial interaction of the country with the external community though there has been progress over the years
5. The study shows that financial globalisation as it is, can increase capital outflows and flight out of the Nigerian economy. Given that the economy must continue to open the financial system to outside flows to derive possible advantages, then the need arises to ensure that there is regulatory and institutional capacity to manage the outcomes of possible international financial crises such as the recent mortgage subprime crises.
6. The external reserves if not properly managed can be an inducement for capital flight. Though built up for liquidity purposes, much of it can be frittered away. It is important to estimate optimally the amount required by the country to maintain its external sector payments, the three months reserve holdings can no longer hold given present day realities of capital flows between countries.
7. Capital flight impairs financial savings aggregation and which invariably affects investment in the country and therefore the country needs to deepen the financial system by encouraging bank and non-bank financial institutions to introduce long-term financial products to further deepen the domestic financial market.

**5.4.2 Areas for Future Studies**

Following the areas this study has covered, the areas listed below are recommended for future studies by interested researchers of capital flows and investment in Nigeria.

1. The role of exchange rates volatility in a developing economy and attraction of foreign direct investment (FDI) in Nigeria.
2. The impact of domestic investment in the determinants of Total Factor Productivity (TFP) in Nigeria.
3. Optimal requirement of external reserves for Nigeria as an emerging economy.
4. The components of the Error and omission and the resolution problems.
5. The investment environment and the attraction of capital flows.

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# Definition of Terms

The terms that are listed below occurred frequently in this work. Some of the constructs are found in development economics and international finance. Efforts are made to interpret their full meaning here by everyday normal English. Explanations are provided as to the intended meaning of the words and where it is possible synonyms will be used.

1. **Balance of Payments**: This is a record of economic transactions between one country and the rest of the world often reported on yearly or fairly more frequent but regular basis. It does not report assets held by a country but the flows of such assets.
2. **Capital:** One of the factors of production that can be used to produce other goods without being fully consumed. It can be saved for future consumption. It generates return in form of interest, rents and profits. It can also held in various forms. It is sometimes synonymously used to represent money to be used in business.
3. **Capital flight**: The term means the movement of capital on a continuous basis out of one country to another in order to escape losses or for some other purposes. It is a term used to mean the leakage of financial resources out of an economy.
4. **Capital flows**: this means the movement of capital or money meant for business from one nation to another. The term means that the capital can move depending on business opportunities and adequate return on it.
5. **Corruption:** A common term used to mean the abuse of one’s office for unjust and illegitimate enrichment not necessarily for pecuniary gains. It connotes the improper usage of one’s position or office for personal gains and is illegal in all countries of the world though tolerated in some countries than others.
6. **Errors and Omissions**: This is the statistical discrepancy usually used to balance the BOP. It is not abnormal if the BOP does not balance and therefore an entry must be made that would allow it to balance. The other name for it is statistical discrepancy. It is often caused by a number of factors which could either be deliberate or otherwise.
7. **External Reserves**: The stock of assets available to the country in foreign currency and held by the Central bank of such a country. It is generally used to meet external payments. It could be kept in form of cash, but more often invested in negotiable instruments.
8. **Financial Instruments or Claims**: These are assets held by investors that are capable of yielding returns for the holder. They are investment instruments that can be bought or sold in the capital markets that are recognized.
9. **Foreign investment**: This is investment made by an entity of one country in another country. It usually involves moving money out of the domestic economy and using the money to generate returns in another country.
10. **Globalization**: A process that is ongoing that allows country to open up to the outside world that allows ideas, resources, goods and services to flow into it. It connotes the idea of interdependency of countries on one another.
11. **Gross Domestic Product**. The overall measurement of nation’s wealth and stock of assets. The GDP is a very important variable in macroeconomics that enables the capital formation process to be recorded. Variations of the GDP are used where the GDPPC is used for Gross Domestic Product per Capital and RGDP is Real Gross Domestic Capital or GDP at constant price
12. **LATAM (countries)** These are the countries of south America that have experienced capital account and financial crises, notably Argentina, Mexico Chile and Brazil
13. **Liberalization**: The term occurs frequently to mean the removal of restrictions from a process or system in order to allow free and unfettered transactions. The usage is in connection with the current and capital account of the Balance of Payments.
14. **Misinvoicing:** A term used in international trade and finance that allows an importer or exporter to make inappropriate gains by inflating the value of imports and deflating or reducing the value of exports so that he would keep the difference in another bank.
15. **Risk:** This is a term used in finance to mean the variability or deviation of actual returns from the expected. This normally means that the probability of earning expectations may not be met or may be surpassed. Riskier investments are prone to losses and usually accompanied by high returns when successful. Risk in holding investments is emphasized here in terms of the possibility of expropriation, loss of capital value as a results of nationalization polices and devaluation of domestic currency. These attendant risks exist in holding of assets in a particular currency or country.
16. **Transnational (TNC) or Multinational (MNC) Corporation**: These are international companies operating in many countries and have their head offices in developed countries. They are associated with overseas investment or strategic diversification, which involves transferring into the host country initially, but may transfer resources in form of profits to home countries in subsequent years. They are ambiguously referred to as Multinational Corporations (MNCs) though strictly speaking not the same. Transnationals have shareholders of the firms diffused through many countries in which they may be operating which may not be case for Multinationals

**ABRIDGED CAPITAL FLIGHT DATA ₦’ Million (1970 – 2007)**

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Obs** | **AVEXRATE** | **CAPFLT** | **DDGCAPFLT** | **INVT** | **INTDIFF** | **FSAVS** | **KAOPEN** | **RESRV** |
| 1970 | 0.7143 | -44.7012 | -78.5512 | 880 | 0.869937 | 0.341 | -1.12942 | 202.16 |
| 1971 | 0.6955 | 438.076 | 400.936 | 1280 | 1.247384 | 0.376 | -1.12942 | 408.25 |
| 1972 | 0.6579 | 193.283 | 190.853 | 1400 | 0.952408 | 0.461 | -1.12942 | 355.47 |
| 1973 | 0.6299 | 885.518 | 869.538 | 2620 | 0.525613 | 0.586 | -1.12942 | 558.76 |
| 1974 | 0.6159 | 11521.7 | 11493.62 | 3170 | 0.426165 | 1.137 | -1.12942 | 5602.48 |
| 1975 | 0.6265 | 2819.432 | 2835.842 | 5019.8 | 0.725484 | 1.815 | -1.12942 | 5585.61 |
| 1976 | 0.6466 | 3054.715 | 3074.115 | 8107.3 | 0.995669 | 2.255 | -1.12942 | 5179.84 |
| 1977 | 0.606 | 4505.893 | 4551.923 | 9420.6 | 0.975644 | 2.592 | -1.12942 | 4232.23 |
| 1978 | 0.5957 | 4793.686 | 4615.006 | 9386.3 | 0.874648 | 3 | -1.12942 | 1886.65 |
| 1979 | 0.5464 | 4200.766 | 3967.926 | 9094.5 | 0.477341 | 4.161 | -1.12942 | 5547.9 |
| 1980 | 0.61 | 3572.546 | 4307.796 | 10841.2 | 0.276119 | 5.769 | -1.12942 | 10234.8 |
| 1981 | 0.6729 | 4890.244 | 5017.364 | 12215 | 1.031759 | 6.562 | -1.12942 | 3895.37 |
| 1982 | 0.7241 | 8390.866 | 8386.636 | 10922 | 1.241883 | 7.514 | -1.12942 | 1612.54 |
| 1983 | 0.7649 | 6850.734 | 6727.124 | 8135 | 2.915855 | 9.443 | -1.12942 | 989.9 |
| 1984 | 0.8983 | 1387.037 | 1119.537 | 5417 | 2.443822 | 10.988 | -1.12942 | 1462.31 |
| 1985 | 0.8983 | -679.105 | -544.365 | 5573 | 0.883995 | 12.521 | -1.12942 | 1667.22 |
| 1986 | 2.0206 | 2635.415 | 2817.705 | 7323 | 2.162207 | 13.934 | -0.76441 | 1081.35 |
| 1987 | 4.0179 | 1057.539 | 1363.639 | 10661.1 | 1.072806 | 18.676 | -0.76441 | 1165.26 |
| 1988 | 4.5367 | 928.0265 | 245.5665 | 12383.7 | 1.827292 | 23.249 | -0.76441 | 651.15 |
| 1989 | 7.3916 | 6387.234 | 6259.644 | 18414.7 | 1.251196 | 23.801 | -1.80805 | 1765.59 |
| 1990 | 8.0378 | 1037.005 | 802.2951 | 30626.3 | -0.9742 | 29.651 | -1.80805 | 3864.29 |
| 1991 | 9.9095 | 7424.339 | 7516.969 | 35423.9 | 0.644299 | 37.738 | -1.80805 | 4435.1 |
| 1992 | 17.2984 | -2280.37 | -2158.55 | 58640.3 | 2.080446 | 55.116 | -1.80805 | 967.11 |
| 1993 | 22.0511 | 6068.045 | 6155.695 | 80948.1 | 1.854012 | 85.027 | -1.80805 | 1372.07 |
| 1994 | 21.8866 | 6552.913 | 6692.163 | 85021.5 | 2.789655 | 108.46 | -1.80805 | 1385.88 |
| 1995 | 84.575 | 4985.119 | 5087.959 | 114476.3 | 1.947782 | 108.49 | -1.80805 | 1443.42 |
| 1996 | 79.6 | 4857.806 | 4918.166 | 172105.7 | 1.870648 | 134.5 | -1.80805 | 4075.72 |
| 1997 | 74.625 | 7438.116 | 7549.606 | 205553.2 | 1.969482 | 177.648 | -1.53662 | 7581.88 |
| 1998 | 84.3679 | 7434.494 | 7583.354 | 192984.2 | 2.734871 | 200.065 | -0.58655 | 7100.83 |
| 1989 | 92.5284 | 1769.594 | 1823.904 | 175735.8 | 2.151328 | 277.667 | -0.31511 | 5450.32 |
| 2000 | 109.55 | 6206.459 | 4359.579 | 268894.5 | 0.857594 | 385.19 | -0.7223 | 9910.9 |
| 2001 | 111.943 | 4994.854 | 4215.364 | 371897.9 | 1.773128 | 488.051 | -0.45086 | 10456.6 |
| 2002 | 120.97 | 371.3489 | -411.041 | 438114.9 | 2.71603 | 592 | -0.45086 | 7331.34 |
| 2003 | 129.3565 | 646.2582 | -4967.25 | 429230 | 1.953125 | 655.739 | -0.45086 | 7128.44 |
| 2004 | 133.5 | 1078.318 | -3597.53 | 456970 | 1.530368 | 797.517 | -0.45086 | 16955.6 |
| 2005 | 132.147 | 3020.829 | -6737.38 | 484710 | 1.145916 | 1316.95 | -0.45086 | 28279.6 |
| 2006 | 128.6516 | 28464.78 | 14078.15 | 512450 | 1.060178 | 1739.6 | -0.45086 | 42298.7 |
| 2007 | 120.9705 | 6774.451 | -13201.4 | 540190 | 1.342438 | 2693.5 | -0.45086 | 51334.2 |