Innovations

Capital Inflows and Economic Growth in Nigeria

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Abstract: *This study examined the impact of capital inflows on economic growth in Nigeria. Capital inflow stimulates economic growth and development of an economy. It contributes in technology transfer, employment generation and diversification of the industrial base of an economy. However, low level of investment, inadequate capital formation, low technological innovations, social and political instability have mitigated the growth rate of Nigeria's economy. The study therefore, examined the impact of foreign direct investment, foreign remittance and portfolio investment on economic growth in Nigeria within the period of 1981-2022. The econometric technique adopted to achieve the objectives were unit root, co-integration and Vector Error Correction Model (VECM), in which foreign direct investment (FDI), Portfolio Investment (PFV), Foreign Remittances (FRM) and Exchange rate (EXR) were regressed on gross domestic product (GDP) using annual time series data from CBN statistical bulletin. The result of unit root test revealed that all variables were stationary at first difference and long run relationship among the variables was also found. The results of the VECM model indicated that foreign direct investment, Foreign Remittances and portfolio investment had positive and significant impact on gross domestic product in the long run while exchange rate had negative and significant impact on gross domestic product. Based on the findings above, the researcher recommends that there is need for security at all levels in the country to be overhauled in order to boost foreign investors' confidence; as instability in any nation scares away prospective investors.*

Keywords: *Capital Inflows, Economic Growth, Vector Error Correction Model (VECM), Nigeria*

Introduction

From the inception of economics, the importance of capital inflow into an import dependent economy cannot be overemphasized. This is simply because; capital inflow helps in a very big way in stimulating the economic growth and development of an economy (Odo, Anoke, Nwachukwu & Agbi, 2016). This is achieved by improving on the managerial knowledge and skills and efficiency in production of goods and services; which promotes exports and hence, has a positive influence on the country's balance of payment. Therefore, it contributes in technology transfer, employment generation and diversification of the industrial base of an economy. That is why; it is believed to be a facilitator to economic growth and development through its ability in industrializing the economy in the long run. This validates why economists and policy makers agree that capital inflows plays a crucial role in the growth and development of an economy as it is a source capital, managerial knowledge and technology, for both growth and transition of the economy in general (Obidike & Uma, 2013).

Conceptually, Capital inflows represent the movement of financial resources into a country from foreign sources. These inflows can take various forms, such as foreign direct investment (FDI), portfolio investment, remittances, and official development assistance (ODA). Each form of capital inflow has distinct characteristics and implications for the receiving economy (Emmanuel , 2016).

Foreign direct investment involves the acquisition of a lasting interest in an enterprise in one country by an entity based in another country. FDI typically involves a significant degree of control or influence by the foreign investor over the management and operations of the invested enterprise. FDI inflows contribute to economic development by providing capital for investment, technology transfer, job creation, and infrastructure development. It equally entails the flow of capital and personnel from abroad, for investment into another country (Melnyk, Kubatko and Pysarenko (2014).

Portfolio investment on the other hand entails the purchase of financial assets, such as stocks and bonds, in foreign markets with the expectation of earning a return. Unlike FDI, portfolio investment does not involve direct control or management influence over the invested companies. Portfolio inflows can be volatile and subject to market sentiment, making them potentially destabilizing for recipient economies.

Remittances refer to transfers of money by foreign workers to their home countries. Remittance inflows represent an important source of income for many developing countries, often exceeding official development assistance and FDI. Remittances contribute to poverty reduction, household consumption, and investment in education and healthcare.

Official development assistance (ODA) consists of grants or loans provided by governments or international organizations to support the economic development and welfare of recipient countries. ODA inflows can finance infrastructure projects, social programs, and capacity-building initiatives in sectors such as education, healthcare, and agriculture.

For decades of years now, Nigeria as a country has been immensely endowed with both natural and human resources. In spite of all these abundant resources, economic growth in Nigeria has not grown to the expected standard. This from the empirical studies, is observed to be attributable to low level of investment, inadequate capital formation, low technological innovations, social and political instability which scare away the foreign investors (Udabah, 2002; Odo, Anoke ,Nwachukwu, & Agbi, 2016). This means that as Nigerian economy is still faced by agrarian economy and much reliance on foreign industrialization, the country's balance of payment has been adversely affected. Even though that Nigeria remains one of the major recipients of FDI in African, but the investment environment together with its level of industrialization discourage FDI and trade flows outside the oil. Due to high dependence on primary commodity exports, Nigeria ranges among the countries that are exposed to high price volatility and always suffering from supply shocks as a result of fluctuating market prices. This leads to porous trading pattern which exerts heavy costs in terms of capital, income, indebtedness, poor investment and economic development, and thus, reducing the possibility of diversifying the nation economy and as well, creating a poverty trap for the country.

To address this situation, Nigeria has embarked on policies and structural reforms, leading to increased openness, reduction of trade liberalization, domestic financial market and as well, removed restriction to capital movements (Essian and Onwioduokit, 1999). However, the economy has not attended its expected growth that can promote the levels of living of people in this country. For instance, we observed using statistical data that official development assistance (ODA) to Nigeria averaged 67.8% per year between 1981 and 2020 while that of foreign direct investment inflow into the country averaged 76.5% per year within the same period. However, foreign portfolio investment inflow declined massively, averaging -1321.6% per annum between 1981 and 2020. Again, foreign remittances increased from 71% of GNP in 1992 to 85% in 1997; while foreign aids decreased from 10.03% of GNP to -0.74% respectively. Hence, there exists so many socio-economic problems, ranging from high rate of unemployment and inflation, low level of living and increased crime, and all these factors mitigate the growth and development of an economy. Therefore, having observed the above stated problems, the need to research on the impact of capital inflows on Nigeria's economy is felt.

Literature Review

Taiwo (2024) examined the effect of remittance inflow on the economic growth of Nigeria. The study mainly analyzed the short-run and long-run effects of personal remittance inflow on the GDP growth rate of Nigeria. The result showed that in the short run remittance inflow had an insignificant negative effect on the GDP growth of Nigeria, while in the long remittance inflow had a significant positive effect on GDP growth rate.

McCloud, Delgado, and Jin (2024) investigated foreign capital inflows, exchange rates, and government stability. Using a semi-parametric system of simultaneous equations to empirically characterize the relationship between FDI and the exchange rate, with each country's level of government, their results showed that across developed and developing economies, the most prevalent type of symbiosis between FDI and the exchange rate was a positive effect of FDI on the exchange rate, but no effect of the exchange rate on FDI.

In the course of investigating the impact of capital flows on exchange rates in developing countries using a panel data set of 82 countries covering the period 2001-2020,Ejaz and Azam (2024)used Generalized Method of Moments (GMM) and their results showed a positive and significant effect of capital inflows on exchange rates with the zeal to investigate the relationship between remittance inflows and economic growth in South Africa, ranging from 1970 to 2017, Nyasha and Odhiambo (2020) used data on the real GDP growth rate, financial development, the ratio of cross-border remittance inflows to GDP, trade openness, and domestic savings. Adopting an ARDL co-integration and the Granger causality these researchers found no causal association between remittance inflows and economic growth.

While investigating the link between overseas remittances and economic growth in Sub-Saharan African countries ranging from 1980 to 2017,Saidu and Salisu (2020) made use of panel data on GDP, remittance, openness, FDI, and domestic investment were used in the study. Their panel co-integration model results demonstrated that remittances had a long-run positive impact on economic growth.

Mba and Chijioke (2023) evaluated how remittance inflows and foreign direct investment stimulate economic development in developing countries. The ordinary least squares method and time series data collected from secondary sources, and the Error correction models (ECM) were utilized in their study. Their findings showed that remittances and foreign direct investment impacted positively and significantly on economic development, whereas exchange rate negatively influenced economic development.

Theoretical Frame work

Mundell-Fleming Model: The Mundell-Fleming model, developed by Robert Mundell and Marcus Fleming in the 1960s. The Mundell–Fleming model opined that

an economy cannot simultaneously maintain a fixed exchange rate, free capital movement, and an independent monetary policy. An economy can only maintain two of the three at the same time. In particular, the model assumes that: 1. the economy is a small open economy; 2. domestic and foreign assets are perfect substitutes for each other; and 3. there are no restrictions of any kind on capital movements across the border. Hence, it is a cornerstone of international macroeconomics that provides insights into the relationship between capital flows and exchange rates. This model combines elements of the IS-LM framework with an open economy to analyze the effects of fiscal and monetary policies under different exchange rate regimes.

In the Mundell-Fleming model, the exchange rate is determined by the intersection of the demand for and supply of domestic and foreign currency in the foreign exchange market. Capital flows play a crucial role in influencing the exchange rate through their impact on the money supply, interest rates, and exchange rate expectations. For instance, an increase in capital inflows, such as FDI or portfolio investment, can lead to an appreciation of the domestic currency as foreign investors demand more of the domestic currency to invest in the country.

Furthermore, the Mundell-Fleming model highlights the importance of monetary and fiscal policies in shaping exchange rate dynamics. Under a fixed exchange rate regime, monetary policy is constrained by the need to maintain the exchange rate peg, while fiscal policy can be used to stimulate or restrain aggregate demand. In contrast, under a floating exchange rate regime, monetary policy can be used to target domestic objectives, such as inflation or output stabilization, without direct concern for the exchange rate.

The Mundell-Fleming model provides a useful theoretical framework for understanding the transmission mechanisms through which capital inflows affect exchange rates in developing countries. By incorporating both monetary and fiscal policy channels, this model helps identify the potential policy trade-offs and implications of capital inflows for macroeconomic stability and economic growth.

Endogenous Growth Theory

This theory was postulated by Romer (1986). The endogenous growth theory assumes that economic growth is due to factors that are internal to the economy and not because of external ones. The theory is built on the idea that improvements in innovation, knowledge, and human capital lead to increased productivity, positively affecting the economic outlook. According to Helpman (2004), endogenous growth theory emphasized two critical channels for investment to affect economic growth: Firstly, through the impact on the range of available products, and secondly, through the impact on the stock of knowledge accessible for research and development. Economic models of endogenous growth have been applied to examine the effect of FDI on economic growth through the diffusion of

technology (Khaliq & Noy, 2007). FDI can also promote economic growth through creation of dynamic comparative advantages that leads to technological progress (Khaliq et al, 2007).

In contrast to all these positive conclusions, Reis (2001) formulated a model that investigates the effects of Foreign Direct Investment on economic growth when investment returns may be repatriated. She states that after the opening up to FDI, domestic firms will be replaced by foreign firm in the Research and Development sector. This may decrease domestic welfare due to the transfer of capital returns to foreign firms. Furthermore, Firebaugh (1992) lists several additional reasons why FDI inflows may be less profitable than domestic investment and may even be detrimental. According to the study, the country may gain less from FDI inflows than domestic investment, because of multinationals are less likely to contribute to government revenue; FDI is less likely to encourage local entrepreneurship; multinationals are less likely to reinvest profits; are less likely to develop linkages with domestic firms; and are more likely to use inappropriately capital-intensive techniques. FDI may be detrimental if it crowds out domestic businesses and stimulates inappropriate consumption pattern.

Methodology

Unit root test, Co integration test and Vector Error Correction Mechanism (VECM) model were the analytical method engaged in the investigation. The test of stationary is used to determine the rank of integration of the parameters of the model, while Co integration test and Vector Error Correction Mechanism (VECM) were applied to determine the long run relationship between capital inflows and economic growth in Nigeria. In capturing the study, these parameters are used as proxy:

GDP = f (FDI, PFV, FRT, EXR) 1

Then, the econometric form of the model is written as:

$GDP_t = \beta_0 + \beta_1 FDI_t + \beta_2 PFV_t + \beta_2 FRT_t \beta_3 EXR_t + \mu$ 2

Where: GDP = Real Gross Domestic Product; FDI = Foreign Direct Investment; FRT = Foreign Remittance; PF V = Portfolio Investment; EXR = Exchange rate

B_0 = Constant; while B_1, B_2, B_3 are parameters to be estimated and

μ_t = Error Term

Results

Table 1: Augmented Dickey-Fuller (ADF) Unit Root Test (at level)

Trend and Intercept

Series	ADF Test Statistic	5% critical values	Prob. Value	Order	Remarks
LGDP	-0.320380	-3.523623	0.9873	1(0)	Not Stationary
LFDI	-1.790942	-3.523623	0.6909	1(0)	Not Stationary
LPFV	-2.579138	-3.526609	0.0679	1(0)	Not Stationary
LFRM	-2.869972	-3.523623	0.1824	1(0)	Not Stationary
EXR	-0.564770	-3.523623	0.9759	1(0)	Not Stationary

Source: Researcher's Compilation from Eview 9

Table 2: Augmented Dickey-Fuller (ADF) Unit Root Test (at first difference)

Trend and Intercept

Series	ADF Test Statistic	5% critical values	Prob. Value	Order	Remarks
LGDP	-5.390889	-3.526609	0.0009	1(1)	Stationary
LFDI	-7.076731	-3.526609	0.0000	1(1)	Stationary
LPFV	-6.878530	-3.536601	0.0000	1(1)	Stationary
LFRM	-7.416599	-3.526609	0.0000	1(1)	Stationary
LEXR	-5.016315	-3.526609	0.0011	1(1)	Stationary

Source: Researcher's Compilation from Eview 9

Tables 1and 2 above show the summary result of the Augmented-Dickey-Fuller unit root test at level and first differencing, respectively. In table 1, at 5 percent level of significance, none of the variables was stationary at level since their Augmented Dickey-Fuller (ADF) statistics were less in absolute values than their respective 5% critical values. However, at first differencing as contained in table 2,gross domestic product (GDP), Foreign Direct Investment (FDI), Foreign Remittance (FRT), Portfolio Investment (PFV) and Exchange Rate (EXR) all became stationary as their Augmented Dickey-Fuller (ADF) test statistics were greater than their critical value at 5 percent level of significance. Thus, the series though possessing no unit root at level became stationary at first difference by being integrated of order one I (1). This is a sign that the variables might be cointegrated which need to be ascertained through the conduct of cointegration test of long run relationship.

Table 3: Unrestricted Co integration Rank Test (Trace) for the series; GDP and the explanatory variabless; FDI, PFV, FRT and EXR.

Hypothesized		Trace	0.05	
None *	0.643834	89.68258	69.81889	0.0006
At most 1 *	0.462856	48.38829	47.85613	0.0445
At most 2	0.287352	23.52872	29.79707	0.2211
At most 3	0.208920	9.978021	15.49471	0.2824
At most 4	0.014981	0.603763	3.841466	0.4371

Source: Researcher's Compilation from Eview 9

Table 4: Unrestricted Cointegration Rank Test (Maximum Eigenvalue)

Hypothesized		**Max-Eigen**	**0.05**	
No. of CE(s)	Eigenvalue	Statistic	Critical Value	Prob.**
None *	0.643834	41.29428	33.87687	0.0054
At most 1	0.462856	24.85958	27.58434	0.1074
At most 2	0.287352	13.55069	21.13162	0.4030
At most 3	0.208920	9.374257	14.26460	0.2563
At most 4	0.014981	0.603763	3.841466	0.4371

From the result above (table 3), the Johansen co integration indicated two co integrating equations. Under the Johansen Co integration Test, it could be said that there is a co integrated vector. Co integration is said to exist if the value of computed statistics is greater than 5% critical value. From the trace statistics, two of the absolute value of the variables are greater than 5% critical value. In other words, the null hypothesis of no co integration among the variables is rejected since two of the equations at 5% are statistically significant. The test result shows the existence of a long-run equilibrium relationship among the variables.

Table 5: Vector Error Correction Model (VECM) System Equation

Variable	Coefficient	Std. Error	t-Statistic	Prob.
	LOG (LFDI)	0.376211	0.05233	7.18965
Longrun	LOG (PFV)	0.632030	0.11328	5.57930
	LOG(FRM)	0.746174	0.11220	6.65018
	LOG(EXR)	-0.019191	0.00381	-5.04335
	VECM (-1)	-0.175045	0.073580	-2.378980.0226
	D(GDP(-1))	0.583256	0.19138	3.047580.0028
Shortrun	D(FDI(-1))	0.020139	0.01500	1.342650.1816
	D(PFV(-1))	0.021028	0.02444	0.860510.3910
	D(FRM(-1))	0.021909	0.06578	0.333070.7396
	D(EXR(-1)	-0.000177	0.00157	-0.113220.9100
	C	0.062005	0.04153	1.492930.1378

R^2 = 0.722948, D -W= 1.763214, F-statisti = 4.690693

Source: Researcher's Compilation from Eview 9

Table 5 above shows the result obtained when gross domestic product (GDP) is regressed against, Foreign Direct Investment (FDI), Foreign Remittance (FRT), Portfolio Investment (PFV) and Exchange Rate (EXR). From the long run results obtained in table 4, the coefficient of Foreign Direct Investment (FDI) is 0.376211 with T-statistic value of 7.18965. This entails that a one percent increase in foreign direct investment will bring about a 0.4 percent increase in GDP and its statistically significant. The coefficient of Portfolio Investment (PFV) is 0.632030 with T-statistic value of 5.57930. This implies that, one unit increase in portfolio investment will

bring about 0.6 percent increase in gross domestic product and it is statistically significant. The coefficient of Foreign Remittance (FRT) is 0.746174 and its T-statistic is 6.65018. That is to say that foreign remittance is positively related to gross domestic product and statistically significant in the long run. The coefficient of Exchange Rate (EXR) is 0.019191 with its T-statistic of --5.04335. That is to say that exchange rate is negatively related to gross domestic product and statistically significant in the long run within the period of the study.

On the short run aspect of the results, the VECM result shows that the co integrating coefficient is -0.175045 with its associated P-value of 0.0226. This reveals that the speed of adjustment from the short-run disequilibrium towards long-run equilibrium is 0.18percent annually. This means that the system corrects its previous period disequilibrium at a speed of approximately 18% annually. The sign of co integrating coefficient is negative, fractional and statistically significant. Hence, this upholds the Granger Representative Theorem (GRT) which holds that a negative and statistically significant error correction coefficient is a necessary condition for the variables to be co-integrated.

The coefficient of determination (R^2) is 0.722948 which indicates that 72% of the total variations in GDP are adequately explained by changes in the explanatory variables while the remaining 28 percent are accounted for by influences of other variables not included in the regression model.

The coefficient of Foreign Direct Investment (FDI) is 0.020139with its P-value of 0.1816. This entails that a one percent increase in foreign direct investment will bring about a 0.02 percent increase in GDP and its statistically not significant. The coefficient of Portfolio Investment (PFV) is 0.021028with P-value of 0.3910. This implies that, one unit increase in portfolio investment will bring about 0.02 percent increase in gross domestic product and it is statistically significant. The coefficient of Foreign Remittance (FRT) is 0.021909 and its P-value is 0.7396. That is to say that foreign remittanceis positively related to gross domestic product and statistically not significant in the short run. The coefficient of Exchange Rate (EXR) is -0.000177 with its P-value of 0.9100. That is to say that exchange rate is negatively related to gross domestic product and statistically not significant in the short run within the period of the study.

Conclusion

The need for foreign capital inflows arise when desired national investments exceed actual savings. They are essentially necessary especially in relation to investments with long gestation periods that generate non-monetary returns; growing government expenditure that are not tax-financed and when actual savings are lower than potential savings owing to repressed financial markets, and even, capital flight. Hence, capital inflows can be effective if it is directed at improving and expanding managerial and labour skills. In other words, capital inflows into Nigeria will not on its own lead to sustainable economic growth except it is combined with the right structures and infrastructures that could facilitate

fruitful results. Hence, the study examined the impact of capital inflows and Nigeria's economic growth for the period 1981-2022. Ex-post facto research design is adopted in the research. Multiple regression analysis is the econometric approach employed in the investigation in which co-integration test and VECM are the methods used in the research; and the study found positive impact of capital inflows on economic growth in Nigeria.

Recommendations

The following recommendations are made based on the findings of this study:

- That level of security at all levels in the country should be overhauled in order to boost foreign investors' confidence as instability in any nation scare away prospective investors.
- The foreign sector in Nigeria should be liberalized, all barriers to trade that are inimical to cross-border trade such as arbitrary tariffs; import and export duties and other levies should be reduced to the barest minimum or, if possible removed.
- Policies that encourage foreign direct investment, moderate exchange rate depreciation, increasing trade openness should be implemented

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