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Capital account liberalization in Nigeria: problems and prospects

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Capital Account Liberalization in Nigeria: Problems and Prospects

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I. Introduction

Capital account liberalization is one of the lynchpins of globalisation and it is often seen as an inevitable path to economic development for developing countries. This is based on the premise that liberalizing capital account would permit financial resources to flow from capital-abundant countries, where expected returns were low, to capital scarce countries where expected returns are high. The extant literature is replete with the potential benefits of capital account liberation. The policy when effectively implemented, allows resources to flow into the liberalizing countries thereby reducing cost of capital, increasing investment and promoting economic growth (Fischer, 1998 and 2003; Henry, 2003a).

While capital inflows could provide important resources for economic development, its surges, reversals and volatility may create new sources of systemic risks. Until the experience of the past one and a half decades, the main issue of contention was about timing and sequencing of capital account liberalization within the context of overall macroeconomic reform or stabilization. However, the widespread of financial crises across the continents of the world (with particular attention to Asia and Latin America) brought some form of concern about whether to even liberalize or not. To some extent, capital account precipitates inflow of speculative hot money, which is a major causative factor of financial crises in many countries. Although the argument of whether capital account liberalization is predominantly beneficial or harmful remains inconclusive, the consensus is however moving towards the type of liberalization that throws up minimal development challenges. This

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paper examines the problems, prospects and challenges of foreign private capital flows in Nigeria. To this end, the paper is structured into six parts. Following the introduction is section two that provides the framework for capital account liberalization. Section three examines the Nigerian experience on capital flows while section four highlights best practices from proximate economies. Section five addresses the key challenges and prospects of managing effective capital accounts while section six concludes the paper.

II Framework for Capital Account Liberalization

II.1 Conceptual Issues

In a generic sense, capital account liberalization is about allowing capital to flow freely into and out of a particular country. This connotes a deliberate policy that allows domestic businesses to borrow from foreign banks, foreigners are allowed to purchase domestic debt instruments as well as invest in the domestic stock market (Henry, 2003 a and b). As defined by Stiglitz (2002), it entails stripping away the regulations intended to control[1] the flow of hot money in and out of the country, especially short term loans and contracts that are usually taken during favourable exchange rate movements. These regulations could take several forms: direct or administrative control (e.g., outright prohibition, explicit quantitative limits, and approval procedures), indirect or market based controls (such as multiple exchange rate system, explicit or implicit taxation of cross border financial flows, and other price- and quantity-based measures) (Ariyoshi, et al, 2000).

Capital account liberalization (CAL) is the process of removing restrictions from international transactions related to the movement of capital. It can involve the removal of controls on both domestic residents' international financial transactions and investments in the home country by foreigners. Liberalization can apply to both inflows and outflows of capital. Capital account restrictions can take various forms including: limiting domestic banks' foreign borrowing; controlling foreign capital coming into the economy; limiting the sectors or industries in which foreigners can invest and restricting

[1] *Capital control could also serve other important purposes, including national sovereignty, protecting national security, and achieving specific social objectives.*

the ability of foreign investors to repatriate money earned from investments in the domestic economy.

Capital account liberalization can be categorised into two broad categories: debt and equity. Debt market liberalization occurs when domestic economic agents (banks, companies and even governments) are free to borrow in hard currencies from foreign banks to finance investment activities. Experience has shown that this is more problematic and often very difficult to sustain. The main danger of this type of liberalization is that more attention is always given to short-term borrowing[2]. This often generates a mismatch between the term structure of borrowers assets (which is always long term) and their foreign currency denominated liabilities (that are usually short term) thereby making the country in question to be exposed to high level of vulnerability[3]. Whenever the lenders are reluctant to issue new loans, liquidity problems ensue. If this is not well managed, it could precipitate the onset of serious financial crises as experienced in many Asian and Latin American countries in the 1990s.

An emerging consensus on capital account liberalization is that the magnitude and maturity profile are very important for success. In specific term, the size and maturity profile of a country's external debt liabilities are compatible with the magnitude and maturity profile of its assets. Any attempt to disregard this basic principle could expose the country to vulnerability that could trigger some deleterious effects.

Liberalization of the stock market is another variant of capital account liberalization. With this, foreigners are allowed to hold shares in domestic capital market. Through inflow of foreign funds, stock market liberalization leads to lower interest rates. Arising from diversification benefits associated with stock market liberalization, which increase stock market values, equity premium is reduced thereby leading to lower cost of equity capital (Henry, 2000 and 2003b). The reduction in cost of capital, to a large extent, encourages firms to expand their operations through increase in installed capacity, i.e.

[2] *This refers to a loan with a maturity of less than one year*

[3] *In addition to expansion of existing businesses, reduction in cost of capital arising from stock market liberalization provides opportunities for businesses that were not profitable before liberalization to become more profitable after liberalization.* .

building new factories and installing new machineries.[4]

Managing capital account liberalization could be challenging and the associated benefits are not automatic. Benefits from capital account liberalization are a function of the soundness of the domestic financial system. When the financial system is in quagmire or badly managed, many of the advantages whittle away. Whenever the news of imprudent lending or corporate insolvency emerges, economic prospects and stock market responds accordingly. Ordinarily, as a rational economic agent, when this happens, foreigners and even domestic investors are more disposed to moving their funds to less risky but high return yielding economies. What are these benefits and costs? These are examined below.

II.2 Benefits of Capital Account Liberalization

The theoretical benefits of the linkage between capital account liberalization and the overall economic growth have been well referred to in the literature (Fischer, 1998; Henry, 2003b; Obadan, 2004; and Le Fort, 2005). The much-mentioned benefit of capital account liberalization is the opportunity of increasing the array of assets available in the local markets as well as efficiency and competition in the provision of financial assets. As a corollary of market competition and efficiency, it promotes preservation of policy disciplines. It also allows for inter-temporal optimisation and risk sharing through portfolio diversification. Within the saving-and-foreign exchange gaps theory, growth benefits abound for developing countries that are traditionally short of capital through foreign capital inflows. Investment is no longer constrained by domestic savings. There is therefore the potential for enhanced economic growth through increased capital accumulation.

Growth could also arise from efficiency gains such as efficient allocation of resources through financial deepening, exposure to higher standards in accounting, auditing and disclosure principles. In most cases, prudential frameworks that tend to enhance the level of efficiency in the financial system

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[4] *In addition to expansion of existing businesses, reduction in cost of capital arising from stock market liberalization provides opportunities for businesses that were not profitable before liberalization to become more profitable after liberalization*

always accompany capital account liberalization. In addition, increased international competition can force domestic players to become more efficient, stimulate innovation and improve productivity. If the distribution of growth arising from these various sources is well managed, it could spur improved welfare conditions for the majority of the citizens.

Another source of growth and welfare enhancement, as postulated by Wang (2002), is intertemporal optimisation. This allows for an economy that is experiencing temporal recession to borrow from foreign economies to smoothen its consumption stream, which reduces its dampening effect on domestic aggregate demand. If external debt position is adjudged sustainable, this contributes significantly to welfare enhancement.

Liberalization of capital account also allows for international portfolio diversification. Domestic market agents have the opportunity of diversifying country specific risks, which ordinarily cannot be diversified under capital account restrictions. However, because most asset transactions in developing countries are restricted to banking transactions, foreign direct investment gains from portfolio diversification are often limited to developed countries.

As established by Henry (2003b), the evidence on cross-sectional analysis reveals that cost of capital falls and capital market activities boom when capital accounts are liberalized. The study revealed that cost of capital fell by 2.4 percent, growth rate of capital stock rose by 1.1 percentage points and output per capita grew by 2.3 percentage points over a period of five years in 18 countries (including Nigeria) that implemented capital account liberalization[5]. Consequently, investment activities rise as profit maximizing firms reduced marginal products of capital thereby raising the growth rate of capital stock. The declining cost of capital and investment booms are the first effect generated by capital account liberalization. As a direct consequence of growth accounting framework, investment boom generates temporary increase in the growth rate of output per worker and the overall growth of the economy.

[5] *Other countries included Argentina, Brazil, Chile, Colombia, India, Indonesia, Jordan, Korea, Malaysia, Mexico, Nigeria, Pakistan, The Philippines, Taiwan, Thailand, Turkey, Venezuela and Zimbabwe.*

Although the theory of capital account liberalization is about capital accumulation, the issues of total factor productivity and technological change do not enter into the story, some proponents have however argued that this could be a derived or indirect effect. As argued by Obstfeld (1994), any economic reform that raises the efficiency of a given stock of capital and labour will also increase the growth rate of technology. In specific terms, liberalization may ease binding capital constraints thereby allowing firms to adopt technologies that could not be financed prior to liberalization. Besides, it is also possible that increased risk sharing associated with liberalization could encourage riskier or higher growth technologies.

In a more simplistic way, this policy would enhance stability by diversifying the sources of funds to developing countries. Such funds assist in bridging the resource gap that many developing countries often face. The reality however is that this can only happen in tranquil and stable periods. As experienced in the post 1997 crisis in Asia and Latin America, banks find it very difficult to lend to countries in crisis.

Ordinarily, liberalization creates a climate to attract investment both within and outside the country. Foreign direct investment (FDI) in particular creates employment opportunities, facilitates the process of technology adaptation and promotes growth. FDI, for instance, has played important role in the economic development of countries such as Singapore, Malaysia and China[6], not so much for capital because of high savings rate or for the entrepreneurship, but for the access to markets and new technology that accompanied such investments. Foreign capital was translated to growth and development because these countries were able to check the abuses of foreign investors. This is not to say a similar thing applies to all countries. The cost in term of displacement of local industries and predatory pricing could be serious particularly in countries where there is weak or no competition law.

[6]*It is important to note that this is not always the case in all countries. Experience has shown that when foreign businesses come in they often destroy local competitors with deleterious impact on entrepreneurial spirit and growth. For instance, the entrance of Coca Cola and Pepsi into any domestic market has overwhelmed soft drinks manufacturers around the globe. There is hardly any country they entered where one of the domestic companies become a price leader in the market.*

II.3 Costs Associated with Capital Account Liberalization

Capital account liberalization is not costless. It does not only overheat the economy as a result of capital surge and expansion of aggregate demand, it also increases volatility in prices and exchange rates due to volatile movement of capital flows and transmission of foreign shocks. The opponents of capital account liberalization however pose a contrasting view to some of the arguments raised above. Dani (1998) and Stiglitz (2002) argue that capital account liberalization attracts speculative hot money[7] that makes the economy more susceptible to financial crisis. Due to asymmetry of information in many developing economies, markets become inefficient and negative effects of capital account liberalization could manifest in such forms as adverse selection, moral hazard and herd behaviours (Wang, 2002). In the case of Latin America and Asia, abrupt outflow of money left behind collapsed currencies and weakened banking system. To them, the effects on investment, output and other real variables are apparent and do not have any serious impact on the welfare. While capital account liberalization does not necessarily lead to financial crisis or welfare reduction, it is true that high capital mobility can easily drive an emerging country to be more vulnerable to outside shocks by complicating macroeconomic management.

Although most of the Latin American economies were emerging from heavy regulation and control, as argued by Eichengreen (2005) and DeLong and Eichengreen (2002) the zealous push for capital account liberalization by the Fund was not as a genuine intellectual and policy conviction that capital account liberalization could lead to economic transformation. Rather, it was a way of expanding the political and bureaucratic mandate of the International Monetary Fund as well as the US Treasury.

Stiglitz tried to point out the dangers of capital account liberalization. He posits thus (Stiglitz, 2002:65):

[7] *As defined by Stiglitz (2002:7), this refers to money that comes into and out of a country, often overnight, often little more than betting on whether a currency is going to appreciate or depreciate.*

> *Whereas the more advanced industrial countries did not attempt capital market liberalization until late in their development-European nations waited until the 1970s to get rid of their capital market controls-the developing nations have been encouraged to do so quickly.*

He argued that developing countries are not equipped to manage what had proved under the best circumstances to be very difficult and fraught with risks. The argument that capital account liberalization promotes investment boom is questionable. In practical sense, speculative money cannot be used to build factory or create jobs. Loans of short-term maturity cannot be used to finance long-term investments that often induce growth. In a way that always constrains the operation and expansion activities of business entities, firms that benefit from volatile capital inflows are often advised to set aside in their reserves an amount equal to their short term foreign -denominated loans.

Evidence abounds in the literature about the danger of capital account liberalization. In many countries, liberalization of capital account has become a new source of financial instability, which exacerbated financial disruptions whenever they occurred. As examined by Arora (2001:58), "...financial crises seem to have been occurring with greater frequency at the same time that the economies are becoming globalized". Empirical evidence has shown that capital account liberalization played a very critical role in the financial crises of Mexico (1994-95), East Asia (e.g., Malaysia, Korea, Indonesia and Taiwan in 1997-98), Russia and Brazil (1998), Turkey and Argentina (2001), and Nigeria in the 1990s (Nordhaug, 2002; Fay and Nordhaug, 2002; Moskow, 2000; Odusola, 2001 and 2002). In explaining the critical role of globalisation in the vicissitudes of the newly industrializing countries of Thailand, Malaysia and Indonesia, Fay and Nordhaug (2002:77) posit thus:

> *Large volumes of volatile foreign short term credit and portfolio investment have frequently been invested in non-tradable and assets market speculations, while this hot money and herd behaviour of international investors increase the risks of financial crisis.*

While capital account liberalization precipitates financial crisis, when such crises loom large, large withdrawal of capital by foreign investors and creditors propagate economic recession in many countries. For example, external loans and security lending to the financially fragile countries of the East Asian region declined abruptly from $23.0 billion in the second quarter of 1997 to an outflow of almost the same amount in the third quarter of the same year and by the first quarter of 1998, the outflow has reached $35.0 billion (Kaufman, 2000 and Odusola, 2004). The situation is even worse in private capital flows. Net private inflows, which were $103.0 billion in 1996, dropped to near zero in 1997 and to an outflow of $28 billion in 1998 (Council of Economic Advisers, 1999). In the case of Thailand, for instance, capital reversal amounted to 7.9 percent of GDP in 1997, 12.3 percent in 1998 and 7 percent for the first half of 1999 (Stiglitz, 2002). The effects are not limited to this region alone, they are also high in Latin America and Africa. This point to the fact that the emerging financial system has become more volatile and this volatility could pose a serious threat to financial stability in specific and macroeconomic stability in general.

Another good example of the benefits of capital account liberalization that is often put forward by its proponents is that foreign banks are necessary for domestic macroeconomic and banking stability. The reality has shown that the outcome is not as rosy as predicted. In Argentina, prior to the banking collapse of 2001, foreign banks dominated the financial landscape. The other side of the story is that they merely lent to multinationals while very big and medium scale enterprises complained of lack of access to capital. Even when the government rose to bridge the credit gap, this could not make up for the market failure. Although the influx of foreign banks in Argentins stabilized the banking system from total collapse after the 2001 crisis, it did not insulate the economy from economic turmoil and decline. Foreign banks contributed to banking stability but created macroeconomic instability. It is easy to create sound banks (banks that do not lose money to bad loans) by investing in non-risky and non-real sector activities. The same situation holds for Bolivia when foreign banks decided to pull back on lending in 2001 during the financial crisis thereby complicating the macroeconomic environment (Stiglitz, 2002). The main challenge therefore is not to create normative sound banks but to create sound banks that are eager to provide credit for real sector growth.

Le Fort (2005) reveals that credit booms fuelled by capital inflows that precipitate expansion in domestic aggregate demand which considerably exceed the potential output endanger macroeconomic stability. This results in unsustainable high current account deficit, a swing in real exchange rate, and a vulnerable banking system.

Another cost of capital account liberalization is that the management of domestic monetary policy becomes complicated. The barometric role of the central banks becomes relatively ineffective. The subtle form of influence by the monetary authority often becomes weakened under a liberalised capital account. Foreign banks are less responsive to policy signals of expanding credit when the economy needs stimulus and of contracting it when there are signs of being overheated.

The foregoing shows that capital account liberalization is not costless. It does not only create macroeconomic instability but could also fuel financial crisis (banking and currency crises). It promotes high-level speculation and complicates domestic monetary policy management. Most funds that come particularly through short-term inflows are not often directed at financing the real sector of the economy. Other costs include the opportunity costs of concessions offered by governments, adverse effects on domestic savings, discouragement of domestic entrepreneurship, adoption of inappropriate technology, erosion of domestic economy autonomy, and adverse effect on balance of payments.

III. The Nigerian Experience

Although substantial efforts have been put in place to attract foreign investment into the country since the attainment of political independence in 1960, the adoption of the structural adjustment programme (SAP) in 1986 augmented these efforts. With a view to setting the pace for capital account liberalization, the financial system was liberalized in 1987 with the attraction of many foreign investors. The foreign exchange market was equally reformed. A more liberalized system replaced the erstwhile regulated one. This included the Second-Tier Foreign Exchange Market (SFEM) and the

Autonomous Foreign Exchange Market (AFEM), the establishment of Bureaux de Change, etc. Other policy initiatives that were aimed at liberalizing the capital account included the abrogation of the Nigerian Enterprise Promotion Decree, the introduction of new industrial policy, the Industrial Development Coordination Committee, the Privatisation and Commercialisation Decree, and the debt conversion programme which by June 1997 had approved applications that were worth $2,851.50 million, among others.

As a matter of fact, most policies on capital flows were directed at foreign direct investment because portfolio investment is relatively new and still remains less significant in Nigeria. While FDI is acquired for lasting interest and to secure effective control of management of the affected enterprise, portfolio investment aims at benefiting from dividends, capital gains or interest earnings. Because the latter is more volatile, it makes the effect of capital reversal detrimental to the recipient economy. Hence, most countries try to be cautious on outright liberalization. As examined in the earlier section of this paper, portfolio investment has become a notable feature of developed and emerging economies of the world. Portfolio flows accounted for substantial part of the Asian and Latin American capital flows over the last two decades.

The total inflow of foreign capital, which stood at ₦251.0 million in 1970, rose to ₦757.4 million in 1975. The zeal with which the government was encouraging foreign capital waned in the early 1970s because of the diminutive impact on local enterprises and the economy. Outflow of interest, profits and dividends on accumulated investment and repatriation of capital put pressure on the country's balance of payments. In order to protect local entrepreneurs and reduce the pressure on balance of payments, the Nigerian Enterprises Promotion Decree of 1972 and 1977 was promulgated. This Decree bared foreigners from participating in certain economic undertakings and required indigenous equity participation that ranged from 40 percent to 60 percent in some sectors of the economy. This to a large extent led to the liquidation of some companies especially in the banking sector.

Consequent upon this development, cumulative private investment that grew by 201.0 percent between 1970 and 1975 declined at an annual average of 0.3 percent between 1976 and 1978 and by 3.8 percent between 1978 and 1981. As indicated in Table 1, it grew by 14.3 percent between 1980 and 1985 partly as a result of the dramatic growth rate recorded in 1982 (it jumped from ₦584.9 million in 1981 to ₦2, 193.4 million in 1982). With the introduction of SAP in 1986, a near annual steady growth of 9.9 percent growth was recorded between 1986 and 1990. It would be recalled that SAP provided the basis for deregulating the economy under which a number of institutional, structural and market reforms were undertaken to open up the economy with a view to creating the enabling environment for attracting the requisite foreign investment. In 1988, for instance, FDI-friendly framework was put in place through the establishment of the Industrial Development Coordination Committee (IDCC) as embodied in Decree No 36 of 1988. The IDCC streamlined the multiplicity of institutions responsible for registration and approval of foreign companies in the country. In addition to the Commercialisation and Privatisation that removed restrictions placed on foreign ownership of enterprises in the country, the industrial policy of the same year also created some opportunities for foreign investment in the country. These to a large extent accounted for the appreciable average annual growth of 77.0 percent during 1990-95. The rapid growth of 615.6 percent experienced in 1995 led to the remarkable annual average growth for the period.

The year 1995 is often regarded as a year when the most serious commitment was made in creating a conducive environment towards attracting foreign private investments into the country. Through Decree 16 of 1995, the Nigerian Investment Promotion Commission (NIPC) was established with the primary mandate of promoting foreign private investment in the country. To complement Decree 16 in removing all forms of impediments to foreign investments, the Foreign Exchange (Monitoring and Miscellaneous) Decree No 17 of the same year was also promulgated. In addition to this, fiscal incentives to encourage foreign investment include the 100 percent tax holidays for 7 years and tax reduction for investors that provided their own infrastructure and undertook research and development (CBN, 2001 and

Obadan, 2004). Consequently, cumulative private investment rose from ₦57, 929.88 million during 1991-95 to ₦143,008.50 million and ₦188, 943.1 million during 1996-2000 and 2001-2004, respectively. This represented an annual average growth of 5.9 percent and 10.9 percent, respectively.

Table 1 also shows the growth rate of the various components of foreign private investment. As shown in the Table, the growth rate of paid-up capital is steadier than other liabilities. The former oscillated between 8.0 percent and 49.5 percent between 1980 and 2004 while the latter ranged between -3.9 and 755.5 percent during the same period.

Table 1: Cumulative Foreign Private Investment (Value and Growth Rate)

	Paid -Up Capital (million naira)	Other Liabilities (million naira)	Cumulative Private Investment (million naira)	Growth of Paid -Up Capital	Growth of Other Liabilities	Growth of Cumulative Private investment
1980-85	2,898.33	2,423.77	5,322.10	13.2	17.2	14.3
1986-90	6,203.10	4,193.32	10,396.42	19.6	-3.9	9.9
1991-95	29,479.56	28,450.32	57,929.88	49.5	755.5	77.0
1996-00	65,927.60	77,080.94	143,008.50	8.0	4.2	5.9
2001-04	10,2183.00	86,760.08	188,943.10	19.0	2.5	10.9

Source: CBN (2004): Central Bank of Nigeria Statistical Bulletin, Volume 15, December 2004.

As evident in Table 2, the flow of foreign private investment predominantly favoured the mining and quarrying sector although it experienced some lull between 1980 and 1990. This notwithstanding, its relative share has been on the declining trend since 1995. From a share of 47.5 percent in 1995, it declined through 2004 to 24.9 percent. Although the share of manufacturing and processing was at the peak in 1990, it declined to about 23.0 percent between 1995 and 2003 before rising to 41.3 percent in 2004. Clearly, agriculture was seriously marginalized with a relative share that was less than 1.0 percent between 1997 and 2004. A major implication of this is that for capital account liberalization to be pro-poor, it must be able to expand the sector where the poor people's economic activities dominate. In the case of Nigeria, agriculture, small and medium scale enterprises are pivotal. A similar observation of marginalization is also made for transport and communication, building and construction, and trading and businesses. However, due to the deregulation of the communication subsector and the banking consolidation, foreign inflows into these areas are beginning to rise in recent times.

The role played by the privatisation of public enterprises as a vehicle to liberalize capital accounts was of particular importance. It created ample opportunities for foreign firms to come as technical partners during the privatisation efforts. Cement companies are a good example of this. The deregulation of the communication sector through the introduction of global system of mobile telecommunication in 2000 also ushered in many foreign investors, particularly from South Africa. The same is true for the banking consolidation of 2004/2005 that attracted $652.00 million from foreign investors.

The United Kingdom was a major source of foreign inflows up till 1990 when its contribution ranged between 37.5 percent and 65.4 percent while the share of USA has equally dwindled since 1975. The share of USA's foreign inflows into the country in recent times is merely above 50.0 percent of its contribution in 1975. The rest of Western Europe became prominent when UK's contribution declined. However, the Western Europe's share has been on the declining trend. It declined from 64.9 percent in 1995 through 2004 to 34.7, percent, see Table 3.

Net outflows were not a serious problem until 1989 and 1990 when, for the first time, the net aggregate outflows were negative. The net outflows rose from ₦439.4 million in 1989 to ₦464.3 million in 1990. A number of factors have been alluded for this development. First, the deregulation of the foreign exchange market and the introduction of Bureaux de Change resulted in substantial outflows. The second factor, as presented by Obadan (2004), is the divestment of investment interests by USA and some European countries from the Nigerian enterprises perhaps as a result of outstanding obligations not honoured.

Figure 1 reveals the pattern of FDI, portfolio investment and other long-term capital in the country between 1980 and 2004. Non-internalisation of the country's money and capital market and non-disclosure accounted for why portfolio investment is relatively a new phenomenon in the country. It did not feature in the country's balance of payments until 1985. Portfolio investment in Nigeria comprises transactions in bonds, debentures, promissory notes, equity investment, preferred shares or stocks, mutual funds, investment trusts and treasury bills (Obadan, 2004). Net portfolio inflow rose from N151.6 million in 1986 to N4,353.1 million in 1987 but declined through 1991. It recorded net outflows between 1989 and 1998, excepting 1992. It is important to note that between July 1995 and July 1996, about US$6.0 million foreign portfolio investment was made in the Nigerian capital market through the Nigerian Stock Exchange (NSE) for the first time since 1962. Foreign investment raised through the NSE rose from US$1.14 million in 1995 to US$32,99 million in 1996[8]. From 1999, however, it has been on a rising trend though still remaining marginal. The rising trend since 1999 resulted from the stable macroeconomic environment, strong anti-corruption initiative, commitment to economic reforms especially the deregulation of the telecommunication sector, banking consolidation, privatisation efforts and the IMF's backed Policy Support Instruments (PSIs). An important feature of the portfolio investment is the inherent high level of instability that may not be congenial for macroeconomic management. Figure 1 shows a good picture of this endemic instability. Figure 2 also provides the trend of the gross inflows of portfolio investment in the country.

[8]*For details see Onosode (1997).*

Figure 1: Dynamics of Net Portfolio Investments

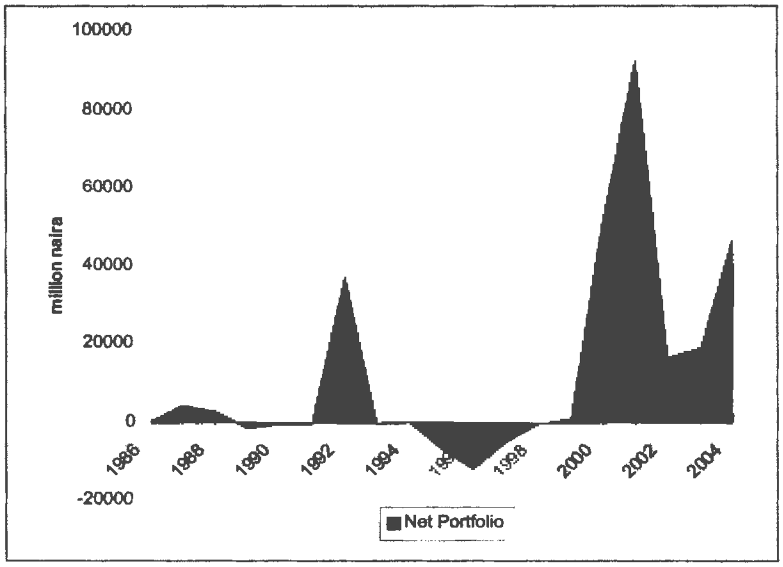


Table 2: Distribution of Cumulative Foreign Private Investment by Sectors

Year	Mining & Quarrying	Manufacturing and Processing	Agriculture, Forestry & Fisheries	Transport & Communication	Building & Construction	Trading & Businesses	Miscellaneous Services
1970	51.4	22.4	1.1	1.4	1.4	20.6	1.8
1975	41.9	22.1	0.8	1	4.9	25	4.2
1980	18.7	41.5	3.3	1.7	8.5	19.1	.7
1985	10.9	33.5	1.9	1.3	6.7	39.7	6.2
1990	10.5	60.7	3.2	2.3	7.1	16.4	-0.2
1995	47.5	23.2	1	0.3	1.3	2.5	24.2
1996	46.3	24.3	1	0.4	1.5	3	23.5
1997	46.2	24.4	0.9	0.5	1	2.8	24.2
1998	39.3	22.6	0.8	0.5	2.6	6.9	27.4
1999	38.2	23.5	0.8	0.5	2.6	7.1	27.3
2000	38.5	23.7	0.8	0.5	2.5	7.1	26.8
2001	38.3	23.5	0.7	0.6	2.6	7.4	27
2002	37	24	0.7	1	2.6	7.4	27.3
2003	34.6	25.6	0.7	1.6	2.5	8.1	27.5
2004	24.9	41.3	0.5	1.7	2.1	8.1	21.5

Source: CBN (2004): Central Bank of Nigeria Statistical Bulletin, Volume 15, December 2004.

Table 3: Percentage Distribution of Foreign Private Investment in Nigeria by Sources

Year	Total(million naira)	UK (%)	USA (%)	Western Europe (%)	Others (%)
1970	1,003.2	44.3	22.9	22.4	10.4
1975	1,812.1	37.5	23.4	25.8	13.3
1980	3,620.1	39.3	15.6	30.6	14.5
1985	6,804	52.8	12.6	23.5	11.0
1990	10,436.1	65.4	2.0	14.5	18.1
1995	119,391.6	13.2	15.5	64.9	6.4
2000	157,535.4	20.8	13.9	53.6	11.7
2001	162,343.4	22.0	14.1	52.5	11.8
2002	166,631.6	22.1	13.5	51.8	12.6
2003	178,478.0	23.4	14.2	49.5	12.6
2004	249,220.6	19.7	11.4	36.7	32.4

Source: CBN Statistical Bulletin, Volume 16, December 2004.

In Nigeria, foreign direct investment could either be for the establishment of new enterprises or expansion of the existing ones through increase in paid-up capital, profit ploughed back into the business, trade and suppliers credits, and net liabilities to head offices of the parent companies (usually in the form of loans, royalties and technology). Foreign capital inflows through newly established enterprises rose from ₦27.9 million in 1990 through 1993 to ₦1,405.4 million but later declined to ₦292.5 in 1994 partly because of the political crisis that resulted from the annulment of June 12, 1993 Presidential election. Over the entire period, investment in machinery and equipment grew by an annual average of 57.7 percent while cash in foreign currencies grew by 42.3 percent (Obadan, 2004). Overall, capital inflows through newly established enterprises remain grossly inadequate.

Generally, the inflow of FDI rose from ₦212.5 million in 1976 to ₦735.8 million and ₦2,452.8 million in 1986 and 1987, respectively. The rate of growth during this period averaged 151.5%. The sharp increase was largely attributed to the implementation of foreign investment policies, particularly the various components of SAP such as the financial sector and exchange rate reforms as well as the privatisation policy. The amendment of the 1958 Income Tax Relief in 1988, which expanded the tax incentives and concessions under the Pioneer Status, also contributed to this. After the amendment, the pioneer status entails 100 percent tax-free period for 5 years for pioneer industries and 7 years for those pioneer industries located in economically disadvantaged areas. Tax holiday in respect of dividends received by non-Nigerian companies having not less than 10 percent holding in Nigerian companies for a period of three years while withholding tax on dividends was also reduced from 15 percent to 5 percent. In addition, 30.0 percent tax concession was given to companies adhering to local raw materials utilization for five years.

With the Privatisation and Commercialisation Decree of 1988, total inflow of FDI rose to ₦13,877.4 million in 1989, representing a growth rate of 707.7%. In 1990, it declined to ₦4,686.0 million. With the promulgation of the Export Processing Zones Decree No. 34 of 1991, inflow of FDI rose to ₦14,463.1 million, a growth rate of 109.1%. By 1995, when the NIPC came into existence, inflow of FDI was ₦75,940.6 million and later rose to ₦111,295.0 million in the following year, with an average growth rate of 144.1%. Total inflow of FDI from 1997 to 2004 was ₦1.3 billion. Figure 2 presents the trend of FDI from 1980 to 2004. This achievement was possible because of additional incentives that government put in place which included, but not limited to:

10 percent tax concession for five years on local value added efforts particularly to encourage local fabrication in the engineering sector;

2 percent tax concession for five years on in-plant training concession;

10 percent tax concession for five years for companies exporting not less than 60 percent of their products;

20 percent of the cost of providing additional basic infrastructures such

as road, water, and electricity as tax relief;

100 percent tax holidays for seven years for locating in economically dis-advantaged places;

Abolition of excise duty with effect from January 1998;

Other export incentives include duty drawback, refund of excise duty paid on export manufactures, retention of 100 percent of export proceeds in the foreign currency domiciliary account by non-oil exporters, tax-free interest earned on export loans, accelerated tax depreciation and capital allowance for manufactured exports, abolition of export licence, rediscounting and refinancing facilities, Export Development Fund (with respect to export promotion activities), establishment of Calabar Export Processing Zone, the Export Expansion Grant Fund Scheme (EEGFS), and the Nigerian Export Credit Guarantee and Insurance Scheme later replaced by NEXIM.

In spite of the policy initiatives introduced by government since 1986 and the avalanche of opportunities that abound in the country, the performance of FDI could be adjudged to be low, see figure 2.

As shown in Figure 2, other long-term capital (net) is a major source of deficit for the balance of payments. What appeared marginal prior to 1995 became volatile and exceedingly negative after the promulgated NIPC and Foreign Exchange Decrees of 1995. This is an issue deserving serious attention from policy makers. This tends to suggest a debt market liberalization problem that needs to be seriously managed for sustainability. This phenomenon depicts a situation where long-term debts are used to finance short-term assets. The need to examine the relevant provisions with a view to realigning this component of FDI inflows to the health of the economy is imperative.

Other areas of policy concern are the net errors and omissions otherwise called the unrecorded net flows. What appeared undisruptive prior to 2000 has turned out to be an economic management challenge since 2000, see Figure 4. This tends to suggest that it has become a major source of capital flight in the country. The monetary authorities and the Economic and Financial Crime Commission need to direct their searchlights into this direction.

Over the past years, political instability, inhibitive investment policies, weak macroeconomic fundamentals, and structural weaknesses manifesting in excessive transaction costs of doing business were considered to be major impediments to foreign investment in the country. While macroeconomic stability has been achieved which has improved the global rating of the health of the economy, structural weaknesses still abound. Poor infrastructure as manifested in inadequate and costly telecommunications services, erratic and epileptic electricity supply, inadequate water supply, poor road networks; corruption and insecurity of life and property, especially the recent developments in the Niger delta region remains a challenge.

Specifically, the performance is considered to be very marginal given the rate at which the naira depreciated during the period. However, when compared with other large economies in Africa (South Africa, Egypt and Algeria), Nigeria's performance seems bad. Nigeria is next to South Africa. Due to limited openness in such countries like Egypt and Algeria, they both ranked behind Nigeria in terms of FDI inflows (Table 4 and Figure 3). On average, Nigeria accounted for 14.0 percent and 8.2 percent of Africa's FDI inflows in 1996-99 and 2000-03 periods against South Africa's 18.1 percent and 16.7 percent. This to some extent shows that Nigeria still needs to brace up to the challenges of attracting foreign private capital into the country.

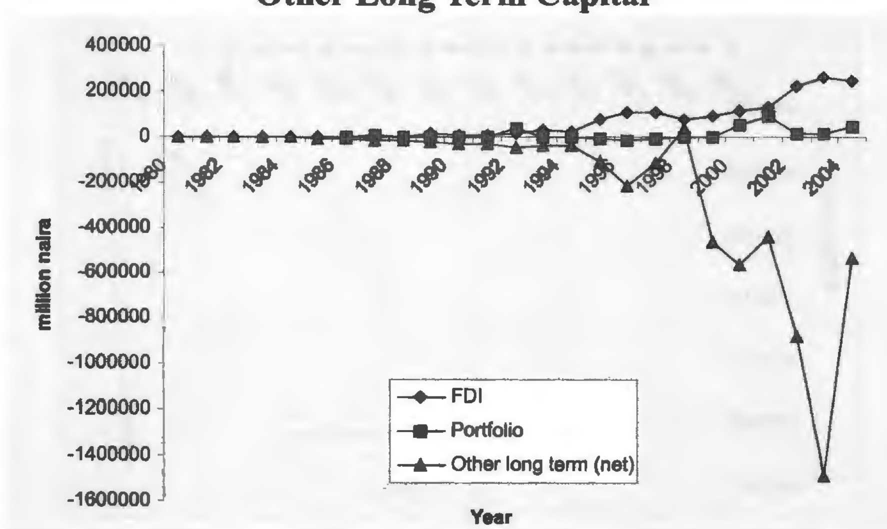
A major conclusion from the foregoing is that capital account liberalization has not really posed a serious problem to the economy. First, portfolio investment still remains a new phenomenon with relatively small size. However, things might change as a result of the consolidation of the banking sector. Second, the share of FDI in gross fixed capital formation remains relatively small. Between 1998 and 2003, it ranged between 9.2 percent (2003) and 12.2 percent (1998). Three, net outflow is not yet a serious issue in Nigeria with the exception of the experience in 1989 and 1990 which came as a result of exchange rate deregulation during the period. This notwithstanding, both net outflows of other long term capital and unrecorded net outflows are posing a threat to balance of payments. The fact that the costs of incentives put in place might outweigh the quantum of foreign investment attracted may tend to suggest limited effectiveness of the incentive structures put in place.

Table 4: FDI Inflows in Africa and Selected African Countries

Year	Africa	Nigeria	South Africa	Egypt	Algeria	Ghana
1996	5331	1593	818	636	270	120
1997	10919	1539	3817	887	260	82
1998	9144	1051	561	1076	501	56
1999	11590	1005	1502	1065	507	267
2000	8728	930	888	1235	438	115
2001	19616	1104	6789	510	1196	89
2002	11780	1281	757	647	1065	50
2003	15033	1200	762	237	634	137
1996-99	9246	1297	1674.5	916	384.5	131.25
2000-03	13789.25	1128.75	2299	657.25	833.25	97.75

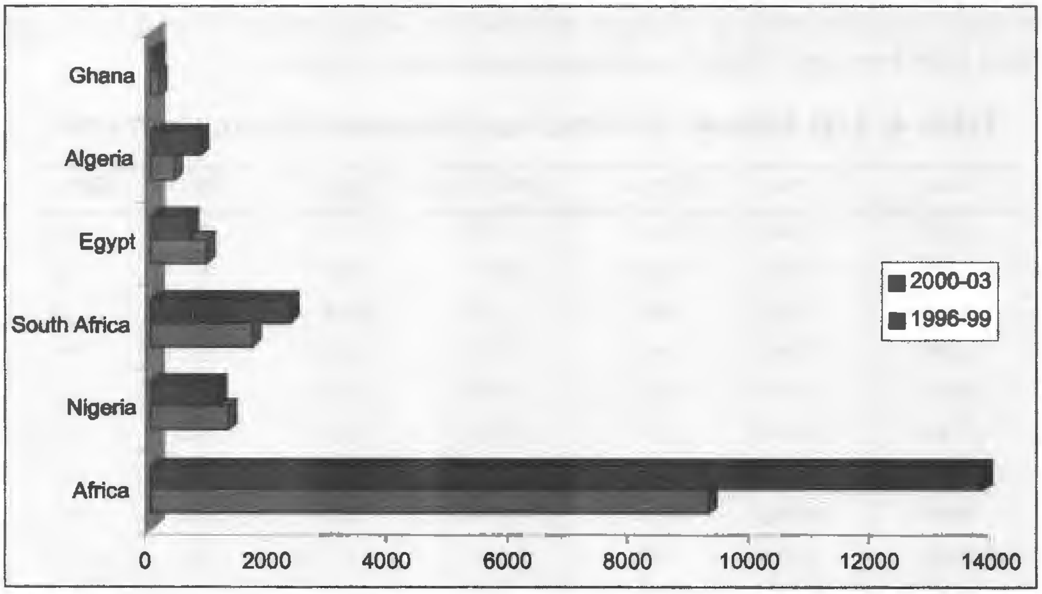
Source: AfDB and OECD (2005): African Economic Outlook 2004/2005

Figure 2: Foreign Direct Investment, Portfolio and Other Long Term Capital



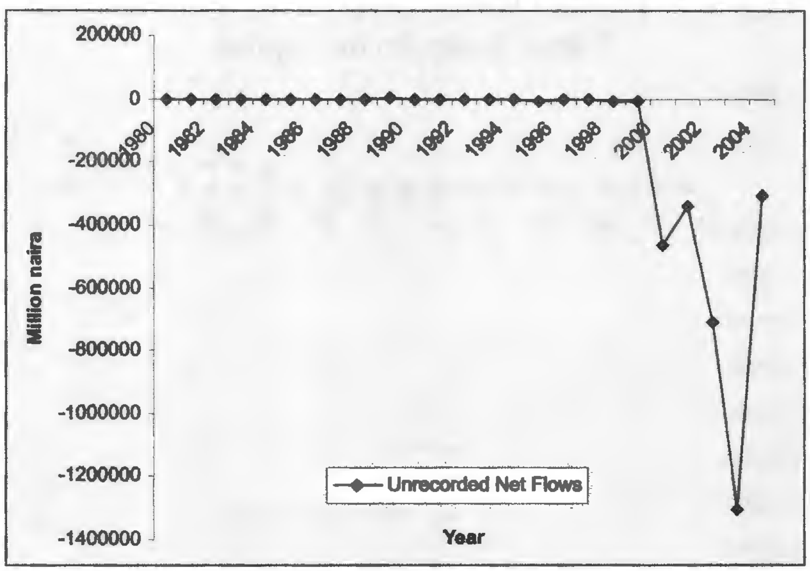
Source: Computed from CBN's Statistical Bulletin Volume 15 December 2004.

Figure 3: Gross FDI Inflows in Selected Countries in Africa, 1999-2003



Source: Computed from AfBD and OECD (2005).

Figure 4: Unrecorded Net Flows in Nigeria, 1980-2004



Source: Computed from CBN's Statistical Bulletin Volume 15 December 2004.

IV. Best Practices from Proximate Economies

The fact that the Nigerian situation has not really posed a serious threat to the economy does not mean there are no opportunities for the country to learn from what is happening in other parts of the world. Both the global and individual country's experiences offer lessons for Nigeria. As a global response to the vicissitudes of capital account liberalization, the Basel Committee has amended the capital adequacy framework to promote safety and soundness in the international financial system by giving special attention to the activities of large and internationally active banks (Basel, 1999). The modified framework is now giving greater scope for the use of internal credit ratings and portfolio models in establishing minimum capital. Although the Basel modification did not change the capital adequacy ratio from 8.0 per cent, many countries are now considering the possibility of increasing the ratio[9].

The new framework has developed some measures that now influence banks' international activities. Some of these include using external risk assessment prepared by rating agencies in establishing risk weights for sovereign borrowers[10]. Attaching weights to over-the-counter derivatives and securitized assets is another specific aspect of the new framework. There is also a provision for prudential oversights over highly leveraged institutions. In addition, sound practices for loan accounting, credit risk disclosures and bank transparency will help in mitigating the impact of capital flows in any economy.

Prudential guidelines are not costless. If not carefully designed and applied, they could have unintended and undesirable consequences by providing distorted incentives that result in excessive risk-taking in specific areas, as well as facilitate contagion. It could also lead to self-fulfilling downturn in the

[9] *Increasing capital adequacy has the advantage of making financial system failure less likely and when they do occur, the private sector bears the major cost and also reduces incentive for banks to gamble for resurrection. On the other hand, higher capital adequacy ratio raises banks' cost thereby reducing the level of intermediation. To some extent, large differences in capital adequacy ratio between countries reduce competition thereby reducing capital flows in countries with higher ratios (Ariyoshi, et al, 2000, p: 34-5).*

[10] *In the 1988 Accord, sovereign risk weights are based on a generalized approach, i.e., whether a country belongs to the OECD or not.*

economy in terms of capital withdrawals to other economies where the incentives are higher.

Mistakes many countries made on prudential guidelines during turbulent capital flows is that they fail to strike appropriate balance between reducing threat of excessive risk taking and containing freedom of institutions to take the normal risks inherent financial intermediation. To this end, monetary authorities should ensure that regulation against capital flows is not done at the expense of weakening the role of prudential policies in maintaining safety and soundness of domestic financial system.

Countries like India and China were able to insulate their economies from the contagion of the late 1990s because their current account liberalization mostly emphasized opening up of the economy to foreign direct investment and portfolio equity investment. These countries to a large extent reduced significantly reliance on volatile short-term debt flows. Other factors include maintaining flexible exchange rate system and adequate stock of foreign exchange reserves.

Arising from liberalization of capital account, many countries experienced very volatile movement of capital in the late 1990s. This, to a large extent, weakened the monetary policy autonomy in directing monetary policy towards domestic objectives, impaired the stability of the monetary and financial system, and added undue pressures on foreign exchange and inflation. This informed the reintroduction of prudential policies and capital control. For instance the use of capital controls to limit short-term capital inflows was experienced in such countries as Brazil (1993-97), Chile (1991-98), Colombia (1993-98), Malaysia (1994) and Thailand (1995-97). The following shows case studies from some countries on the policy responses to capital account liberalization.

Brazil: In changing the composition of capital account from short to long-term inflows, Brazil restricted or banned investments in certain assets, increased the entrance tax[11] for some portfolios, and used other measures to increase the

[11] To influence the level, maturity and composition of portfolio, differentiated tax rates was adopted in Brazil. Taxes were imposed based on their inverse relationship with maturity of capital especially during the Mexican crisis in 1995.

maturity of permissible investments. Other measures include banning the use of short-term capital for fixed income investments, restricting foreign investors access to market derivatives, raising the minimum maturity level especially minimum maturities for all currency loans to three years. During this period, Brazil experienced massive sterilization of accumulated reserves with substantial fiscal costs in terms of fiscal deficits, exchange rate appreciation and current account deterioration. In fact, most of these measures were circumvented through financial engineering and sophistication of the financial market that reduced the cost of circumvention relative to the incentive to circumvention thereby necessitating additional restrictions.

Chile: Arising from the strengthened external sector between 1984 and 1988[12], there was a surge in capital inflow from 1989. The boom in capital inflow in Chile presented a classical case of monetary policy dilemma (Ariyoshi, et al, 2000). During the structural and macroeconomic reform in Chile, the monetary authorities assigned monetary policy a domestic inflation target while exchange rate was assigned current account target. However, when the capital account was fully deregulated, it became very difficult to set monetary and exchange rate policies independently.

At the onset, government sterilized foreign exchange intervention and tightened fiscal policy that imposed substantial cost on the central bank[13]. In response to this, selective controls on capital inflow were imposed in June 1991. Some of these involve imposition of 20 percent unremunerated reserve requirement (URR)[14] on foreign borrowing, a minimum stay requirement for direct and portfolio investments from abroad, regulatory requirements for

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[12] *The current account deficit was cut from 11 percent of GDP in 1984 to 1 percent in 1988 and the economy grew at an average of 5.7 percent over the period.*

[13] *This is in the form of the difference between the interest cost of sterilization and return on foreign assets, which was estimated to be about 1 percent of GDP per annum in the 1990s (Ariyoshi, et al 2000).*

[14] *The imposition of URR, a market based capital control and a variant of Tobin tax, served multiple purposes. These are to discourage short term inflows without discouraging long term foreign investment; to reduce the risks faced by institutions intermediating on these type of investment and to increase the autonomy of the monetary institutions by minimizing the effects on the exchange rate of tight monetary effect as well as reduce the burden of monetary policy dilemma (Ariyoshi, et al 2000). Ab initio, URR was only charged on debt flows but was later extended to non-debt flows such as trade credit, foreign deposits and some foreign direct investment that are speculative in nature when they became a major channel of short term capital inflows.*

domestic corporation borrowing from abroad, and extensive reporting for banks for external transactions (Ariyoshi, 2000 and Le Fort, 2005). These were complemented by further liberalization of capital outflows, widening of exchange rate band and continuation of tight fiscal policy. When the 20 percent URR was becoming less effective, it was raised to 30 percent but was later reduced to 20 percent[15] when the contagion effect of the Asian crisis substantially reduced the flow of short-term capital in the region. As shown in Le Fort (1999), URR altered the composition of capital in Chile substantially. The share of medium- and long-term capital increased from 23 percent of total inflows in 1990 to 62 percent in 1997-98[16]. Figure 5 further supports the finding of Le Fort particularly with net portfolio flows and foreign direct investment responding appropriately to the policy changes.

The Chilean experience on prudential framework presents a good case study in that it gave credence to the need to strengthen the financial system, adoption of sound macroeconomic policies especially fiscal policy stance that moved from excessive deficit to surplus condition and flexible exchange rate system. To reduce the heat of capital inflows on the system, gradual capital outflow liberalization was also encouraged. One of the factors that contributed to the success made in Chile is the development of prudential framework for the financial system which established high disclosure standards, stringent rules for loan classification and provisioning, strict limit on connected lending and on banks exposure to foreign exchange risks, clear procedure for correction of liquidity or solvency problems and strict compliance of all banks to the Bank for International Settlements for capital adequacy ratio. These contributed substantially to the sound health of the financial system[17].

A major conclusion from the Chilean experience has been that capital controls

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[15] *This was further reduced to 10 percent and 0 percent in 1998 when the contagion effects from the Asian crisis was significantly reduced. URR was focused on large transactions and individual foreign exchange transactions of less than US$200,000 were exempted (Le Fort, 2005: 11).*

[16] *Quantitative evidence on the effectiveness of URR is inconclusive partly because of conflicting official statistics on capital flows.*

[17] *For instance as at March 1999, the level of non-performing loan was as low as 1.68 percent while provision for bad loans was at a comfortable level of 127 percent. The financial system maintained a capital adequacy level of 11.5 percent.*

are an integral component of the overall economic reforms programme and that the country recognised the significance of financial sector reform quite early in terms of establishing prudential guidelines and sound credit culture in the financial system.

Colombia: Following the comprehensive structural and economic adjustment programmes that covered trade system, capital account system, exchange rate system, banking sector, privatisation, and strong regulatory framework undertaken by government, Colombia also experienced a boom in capital inflows in the 1990s. Private capital inflows for instance rose from 0.2 percent of GDP in 1990 to over 7 percent in 1997 with an annual average of about 4 percent between 1990 and 1997. As obtained in Chile, prudential guidelines that entailed sound banking regulation and supervisory framework, domestic strategy for financing public sector, tight credit conditions and emphasis on foreign direct investment were integral part of the economic reform programmes.

Although the surge in capital inflows helped in financing the widening current account deficit, it however created some destabilizing effects on the system. Apart from exerting upward pressure on the exchange rate it also raised a serious concern about external competitiveness of the country's tradable. This generated some policy responses from government. An immediate policy response was the partial sterilization the ripple effects of inflow through aggressive open market operations (OMO). Apart from the cost on the financial balance of central bank, which was as high as 0.8 percent of GDP in 1991, the aggressive OMO also raised the domestic interest rate, which further attracted short-term foreign capital inflows into the country. To stem the tide of rising interest rate, an expansionary fiscal policy was adopted which weakened the effectiveness of monetary policy. As a response to this development, the local currency (peso) was devalued, restrictions on capital outflow were eased, and import liberalization was also accelerated.

In spite of these measures, capital inflows were still on the rising trend. Consequently, far-reaching policies were introduced. A 10 percent withholding tax on transfers and non-financial private services was introduced in July 1992. Another form of capital control was introduced in September 1993 with the emergence of URR[18] for all external borrowings. To mitigate the effect on exchange rate, a crawling peg regime was introduced in early 1994 with the bandwidth set at ±7 percent and the rate of crawl based on the expected inflation differential with major trading partners (Ariyoshi, et al, 2000).

These measures were able to change the structure of external debt stock from medium - and long-term share of total debt stocks of 40 percent in 1993 to 70 percent in 1996. However, net private capital flows remained very strong (it rose from 2.1 percent of GDP in 1992 to 5.9 in 1997).

Malaysia: Malaysia experienced an unprecedented level in both short- and long- term capital surpluses between 1990 and 1993. While the short-term capital as a ratio of GDP rose from 1.2 percent to 8.9 percent during the period, the ratio for the long-term capital stood at 5.7 percent in 1990 and 8.2 percent in 1993. As pointed out by IMF (1995), economic fundamentals accounted for the inflow of long-term capital while interest differential accounted for the short-term flows.

The monetary authorities was faced with the trade off of either solving the problem of inflation by maintaining high interest rate or address the destabilizing effect of short-term capital by reducing the interest rate differential against Malaysia. The latter option was considered important by the monetary authority and a combination of monetary and exchange rate policies were adopted. Sterilization was considered as the best option but its implementation was very costly due to weak financial structure in the system and interest rate also rose. Hence, capital flows rose, the ringgit became more appreciated with its destabilizing effects on trade and investment. Besides, government lost control over monetary aggregates and inflation and the financial system became unstable.

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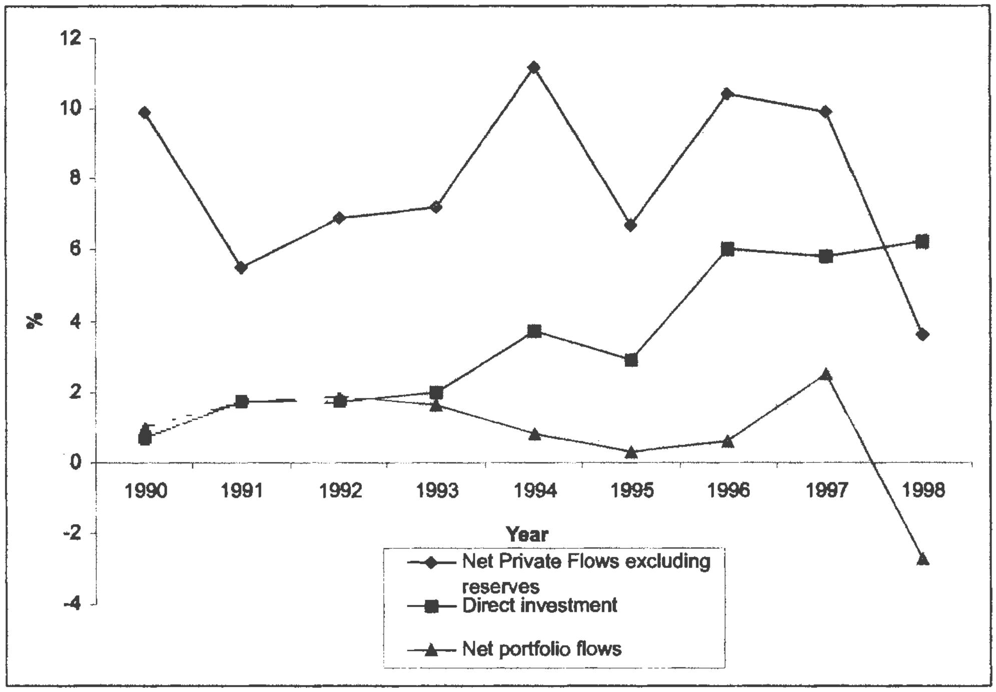
[18] *The URR was adjusted many times to reflect the current reality with a view to making it better focused. Generally, it was imposed on external loans with maturity of 18 months or less. Certificate on URR facility is originally denominated in foreign currency but redeemable in local currency after 18 months.*

Figure 5: Foreign Investment Flows in Chile, 1990-98



To arrest the level of macroeconomic and financial instability in the system, direct control measures which were primarily aimed at limiting short-term capital inflows in the form of bank foreign borrowing and ringgit deposits by bank or non-bank foreign customers were introduced in 1994. Among the measures include: prohibiting residents from selling Malaysian money market securities of less than one year maturity to non-residents; commercial banks were prohibited from engaging in non-trade related bid-side swaps or forward transactions with non-residents; imposition of ceilings on banks net liabilities excluding trade related and foreign direct investment; and commercial banks were mandated to place with the central bank the ringgit funds of foreign banking institutions and maintained non-interest yielding accounts.

One clear message from this set of policies is that the control measures were meant to be a temporary one. Hence it was discontinued at the end of 1994 but the prudential guidelines remained in place. The measure led to depreciation of the ringgit and correction of the stock market. Due to sharp narrowing of interest rate, short-term capital inflows were curtailed. Monetary aggregates decelerated and exchange rate became stable. Important lessons from the Malay's experience is that control was effective because of consistent mix of monetary and exchange rate policies; and because of continuous strengthening of the prudential regulations.

Thailand: Capital account liberalization took place quite early in Thailand. Promotion of free capital flows (especially portfolio and equity investment) started as early as 1985 but became more pronounced between 1990 and 1995 while outflows were liberalized only gradually during 1990-92 and 1994. Banks were not restricted from foreign borrowing but were placed on net open position limits. Residents, on the other hand, could be contracted freely but they were subject to the provision that proceeds should be repatriated through authorised banks or placed in foreign currency account.

The liberalized capital market coupled with the pegged exchange rate since 1984, created wide interest rate differential in favour of the country. This created strong incentives for interest rate arbitrage and speculative activities, which resulted in high volatile short-term capital inflows; this was estimated at over 60 percent as at 1993. Consequently, the Thai economy, in spite of being noted for tight fiscal policy, became overheated from the middle of 1993. This manifested in the form of demand pressure, which resulted in high inflation and increased current account deficit.

In the face of fixed exchange rate policy and limited indirect monetary instruments, monetary policy became quite complicated. The main policy responses were combined monetary policy, prudential guideline and market based capital controls. To reduce the inflationary impact of the inflow, interest rate was raised in March 1995, credit plan was extended to cover large finance companies and related institutions, loan-deposit ratio was reduced whenever it was above the accepted average, and sterilization operations was stepped up. Specific measures were put in place in August 1995 to control capital inflows. These included: establishment of asymmetric open position limits for short- and long-term positions; establishment of a reporting requirement for banks on risk control measures in foreign exchange and derivative trading; and a 7.0 percent reserve requirement[19] on non-resident baht accounts with less than 12 months maturity and on finance companies' short term foreign borrowings. Banks were also restricted from extending credit to non-priority sectors during the period. These measures generated desired results at the early stage. The effects were however short-lived because of the decline in US interest rates. Consequently, capital account surplus rose from 8.5 percent of GDP in 1994 to 13.1 percent in 1995. While short-term capital rose from US$7.4 billion in 1994 to US$12.7 billion in 1995, long-term capital (mostly portfolio investment) also increased from US$4.6 billion to US$8.1 billion during the same period.

Following, the need to reverse increase in capital inflows, the 7 percent reserve requirement was extended to non-resident baht borrowing with a maturity of less than one year and to new short-term offshore borrowing of maturity of less than one year by commercial and Bangkok International Banking Facility (BIBF) banks. This, apart from reducing the net flow of capital substantially also reduced the composition of capital inflows. Short-term capital inflows fell from 62 percent in 1995 to 32 percent in 1996 (Ariyoshi, et al 2000). The share of long-term loans of BIBF rose from 14 percent in 1995 to 34.3 percent in 1996, reduced the non-resident holding of baht accounts as well as reduced the share of short-term debt to total debt stock from 50 percent to 43 percent during the same period[20]. Some key lessons are discernible from the country's experience. The effectiveness of the measures was hindered because reforms in the financial system lagged behind capital account reforms. The goal of liberalizing current account position cannot be maximized when the interest rate differentials between the liberalizing country and its trading partners or neighbouring economies do not align or reduce substantially. Besides, capital controls are not substitutes for prudential guidelines and sound macroeconomic policies.

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[19] *The reserve is kept with the central bank.*

[20] *It is instructive to note that the measures were unable to reduce substantially credit to unproductive sectors with no foreign exchange earning potential.*

V. Key Challenges and Prospects

One of the major arguments of capital account liberalization is that it allows for fund diversification and it bridges the domestic saving-investment gaps. Unless a guided approach as exhibited in Malaysia in 1997 is undertaken, the pro-cyclical nature of foreign capital may not lead to the desired economic transformation. In practical sense, capital flows out during recession, when they are mostly needed, and flows in during a boom, when the need for it is relatively lower thereby exacerbating inflationary pressure.

The challenge of ensuring macroeconomic stability especially monetary and exchange rate policies is commonplace in the literature. Large and persistent inflows complicate the implementation of monetary policy, as is the case in Thailand. The boom in capital inflows could also present a classical case of monetary policy dilemma. In the face of high capital account liberalization, it becomes difficult for monetary authorities to assign domestic inflation targeting to monetary policy while at the same time assigning current account targeting to exchange rate policy. Setting monetary and exchange rate policies independently is always a herculean task.

Financial institutions are a major stakeholder in international transactions. Because they accept cross-border and foreign currency deposits, initiate external borrowings; make foreign loans and investments, have branches across borders, and intermediate cross border transactions, they are often exposed to excessive risk taking. Rapid inflows and sudden reversals could impact on the health of the financial institutions and systems. These shocks if not properly handled could trigger financial panics and systemic crisis as experienced in Malaysia and Thailand in 1997/8, Spain in 1992 and Venezuela in 1994-96. The recent consolidation in the country further increases the likelihood of exposure if prudential guidelines are not fully enforced and monitored. This is more demanding given the fact that capital inflows into the banking system could fuel credit expansion, foreign exchange risks and maturity mismatches in foreign currencies[21].

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[21]*As argued by Johnson and Otker-Robe (1999), capital account liberalization could introduce additional risks (credit risk, market risk, and liquidity risk) that may increase the magnitude or complicate the management of risks that banks typically faced in their domestic activities.*

For capital control to be effective, it has to be comprehensive and forcefully implemented. China and India provide a good example of this up till the 1990s. It is important to note that irrespective of the effectiveness of capital account control at the initial stage, it often loses effectiveness over time as markets exploit the potential loopholes in the system to channel the 'undesired' inflows. It is only in sophisticated financial system (as experienced in Brazil) and strong enforcement capacity (as is the case in China and Chile) that the incentives could be reduced appreciably as experienced in Brazil. Colombia also reduced circumvention by subjecting some trade credits to URR. One major lesson from the implementation of capital account liberalization is that it should be approached slowly and very cautiously. Many mistakes were made in most of the countries that have implemented capital account liberalization. This relates to mistake of sequencing and spacing. For instance, forcing liberalization before safety nets are put in place, before adequate regulatory framework and before the country could withstand the adverse consequences of sudden changes in market sentiments do not produce the desired results. In practical sense, when the financial system is characterised by structural weaknesses, capital account liberalization poses significant risks, hence it should be of lower priority in the short-term.

An emerging reality from the experience on capital account liberalization over the past one decade is that there has been a good deal of learning. The major lesson from the experience is that capital account liberalization is a particular aspect of the larger process of economic and financial development. Emerging countries have learned that the regulation of capital flows in and out of a country is only one aspect of the larger task of economic and financial regulation and financial markets regulation is only one part of the broader process of economic and financial development. Capital account liberalization can occur naturally in the course of economic and financial development. However, because the development of financial markets differs in different countries, one-size-fits-all advice regarding capital account liberalization is unlikely to be productive. It would be imprudent to attempt to apply the same advice regarding the structure and sequencing of policies toward the capital account. Hence, premature capital account liberalization, initiated before the development of domestic financial markets can be dangerous and counterproductive (Eichengreen, 2005)[22]. Clearly, addressing a complex issue like policy toward the capital account in a very simplistic manner often suggested by the international financial architecture could only lead to more frustration and deleterious effect on developing countries' economies.

Prudential guidelines have been used extensively to mitigate the effect of capital account liberalization in many countries of the world. Prudential guidelines, if well implemented, are capable of strengthening the capacity of the financial system to withstand volatile market conditions. Argentina and Chile have made substantial progress in using prudential guidelines in mitigating the effects of destabilizing capital flows. Evidence from successful countries have shown that establishing and maintaining prudential standards rests on some fundamentals, namely, public regulation and supervision, internal practices and control, and market discipline. The monetary authorities would have to examine these very critically and determine to what extent Nigeria has adhered to these pillars before the benefits of prudential guidelines on cross border transactions can be maximized. It is important to note that even in advanced economy, managing prudential guidelines are weakened to some extent by the rapid innovations in financial technology. The fact that management and supervision of financial system cannot keep pace with the technological innovation, timely identification of financial risks becomes compromised.

VI. Conclusion

Capital account liberalization has not posed a serious problem to economic management in Nigeria. Portfolio investment still remains a new phenomenon with relatively small size while the share of FDI inflows and net flows as a proportion of gross domestic product between 1990 and 1997, for instance, remained at 4.4 percent and 1.2 percent. In fact, net outflow is not yet a serious issue in Nigeria. The effect of banking consolidation might change the scenario if appropriate prudential guidelines are not put in place. However, net outflows of other long-term capital and unrecorded net outflows are posing a

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[22] *Eichengreen was a former Senior Policy Advisor at the International Monetary Fund.*

threat to balance of payments. The fact that the costs of incentives put in place might outweigh the quantum of foreign investment attracted may tend to suggest limited effectiveness of the incentive structures put in place. While a wide spread between the deposit and lending rate may suggest an inefficient financial system, it is also important to address the structural impediments to foreign investment in the country. Issues such as adequate provision of electricity, water, roads as well as fight against corruption and maintenance of security of life and property are vital to addressing this.

This notwithstanding, Nigeria has a lot to learn from other countries that experienced vicissitudes of capital accounts. Experience across the globe indicates that various policy responses accompanied surge in foreign capital inflows. Depending on the nature of inflows, policy options often given serious consideration include sterilization through OMO, increase in reserve requirements, fiscal tightening and greater exchange rate flexibility. Other policy options are further trade liberalization, removal of restrictions on capital outflows, and tightening of restrictions on capital inflows. An emerging consensus is that none of these brings the desired solutions because each of them involves significant costs or brings different policy challenges. Evidence from different studies however shows that unremunerated reserve requirements was successful in changing the composition of inflows towards longer-term maturities thereby reducing countries' vulnerability.

No matter the extent of effectiveness of capital account control, it often loses its steam over time as markets exploit the potential loopholes in the system to channel the 'undesired' inflows. An alternative approach to managing the risks associated with capital flows is not to impose administrative control, but to limit the vulnerability of the economy to the risks associated with the flows through the application of prudential framework to the financial institutions. On the other hand, liberalization of capital account does not just happen by sentiment or by coercion. Rather, some economic prerequisites are needed. It should be an integral element of a comprehensive economic reform programmes with some form of sound regulatory framework. Greater exchange rate flexibility and more stable and robust financial system are needed before capital account liberalization is embarked upon.

An emerging issue is how to manage the risks of international capital flows which to a large extent has led to the adoption of capital controls in many countries, particularly in controlling the volume, composition and volatility of such flows. The facts emerging from the experience of capital control as a way of reducing the effect of liberalization are that no single measure is effective across the country; selective controls targeted against some range of transactions, as opposed to comprehensive measures, are easily circumvented; administrative capacity and level of financial development matters in achieving results; sound macroeconomic policies, strong prudential policies and effective supervisory capacity of the monetary institutions matter. The sequencing of financial and external liberalization has also become a critical factor in the literature. Financial sector reform and consequently financial stability are precursor of capital account liberalization. External sector liberalization has serious implications on the entire financial infrastructure such as market development, governance, prudential regulations and supervision, and monetary operations.

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