CAPITAL INFLOW, TRADE OPENNESS AND CURRENT ACCOUNT BALANCE IN NIGERIA

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Abstract
Using time series, autoregressive distributed lags (ARDL)-bound test approach and error correction model (ECM), this paper examined the effect of capital inflow (proxied as foreign direct investment) and trade openness on Nigeria's current account balance. Results revealed evidence of long run co integrating relationship as well as short run relationship among the variables. The result indicated a negative relationship between FDI inflow and current account balance. The result also revealed that both in the short-run and long run there exist a positive relationship between trade openness and current account balance. Based on these empirical findings, we strongly recommend that government should focus on the policy that encourages trade openness.

Keywords: foreign direct investment, trade openness, current account balance and capital inflow

1. Introduction

Capital inflows have attracted the interest of policy-makers, central banks, international institutions and academia, mainly because the volume of flows has grown since the beginning of the 1990s (De Santis & Ehling, 2007). Reinhart and Rogoff (2009) however opined that the increase in international capital inflows, accompanied by a series of financial crises in the past three decades, has given rise to concerns about the impact of the flows in economies. Basically, international capital inflows take two major forms: Foreign Direct Investment (FDI) and Foreign Portfolio Investments (FPI). According to Rahman (2016), foreign direct investment inflows (FDI Inflows) is a basic determinant of capital for developing countries. Foreign capital inflow is widely considered as a way of raising the level of investment and encouraging economic growth as well as for building-up of foreign exchange reserve (Yang-Yung, 1997). Pontes (1999), believes that capital inflow is widely used in developing economies to raise their level of investment as well as build up their foreign exchange reserves. According to Williamson (1995), "capital inflow is seen as a piece of good fortune that permits a country to enjoy a larger real income" (cited in Udoidem & Udofot, 2014: 175).

According to the UNCTAD (2018), FDI flows to Africa dropped to USD 42 billion in 2017, a 21 percent decline from 2016. While the total FDI flows to Nigeria fell from USD 3.5 billion in 2017 to USD 1.9 billion in 2018, representing 25.1 percent of the country's GDP. The decline was as a result of weak oil prices and harmful ongoing macroeconomic crises. FDI is a financing source having no debt and it is a major part of capital account, a part of balance of payments

(BOP), and it could be used to finance the deficit in current account in short run (Yalta, 2011). In Nigeria, the current account balance as a percentage of GDP was 2.76 percent in 2017. This indicate an increase from 0.67 percent in 2016 (Census and Economic Information Center (CEIC), 2018). Several countries consider inviting and attracting FDI inflows as a directional approach towards achieving economic development because FDI comprises of movement of Capital, managerial skills and technology transfer (Egbo, 1998). Capital inflow in terms of foreign direct investment generally encourages exports by gross capital formation, technology transfer, productivity enhancement and competitiveness, introduction of new technology in production, better managerial skills, and open access to new markets which enhances the current account balance (Krkoska, 2001; UNCTAD, 2002). On the other hand, foreign firms coming to the receiver country can import fundamental inputs from their international suppliers or give royalties to their mother company for technical knowledge resulting to rise in imports (Onwuka & Zoral, 2009). Consequently, current account balance is likely to aggravate. More so, profit return of foreign capitalists appears in current account of balance of payment and larger expression on this account also aggravates current account balance (Yalta, 2011).

FDI as one of determinant of economic growth and development stimulates technology and knowledge overflows, lead to international trade and commerce by raising exports and improves efficiency in production of the recipient country. Economic growth increases by improving FDI and trade in the host country (Gilal *et al.,* 2016). At the same time the increase of deficit in current account is one of the negative impacts of FDI. Calvo, Leiderman and Reinhart (1996) said that developing countries generally face deficit in current account and capital inflows to less developed countries have corresponded with spreading deficits in current account in many countries. Thus, relationship between capital inflow (FDI), external trade and current account balance is empirical issues which need to be further investigated.

In line with this, this paper aims to investigate the effect of capital inflows (FDI) on Nigeria's trade openness and current account balance. Evaluation of such a relationship is important for country like Nigeria where deficit in current account is one of macroeconomic problem. At the same time, efforts were made by the policy makers and government to relax some policy measures in order to allow foreign investment to Nigeria. The idea behind such relaxation is that FDI will increases domestic investment and gives chances for growth in technology and knowledge overflows along with providing employment opportunities. However, the costs or benefits of FDI are related with country's exposure to FDI as there is evidence of FDI crowding in investment domestically (Gilal *et al.,* 2016). The remaining part of the paper is divided into: section two review of literature, followed by section three which is the methodology. Discussion of results and findings are given in section four and section five is the conclusions and recommendations.

2. Empirical Review

The observed increase in trade openness and FDI in some Africa countries over the past few years has resulted in a decline in the current account. Between 2005 and 2010 for example the major oil producing countries in Africa (Equatorial Guinea, Angola, Nigeria, Algeria, Egypt and Libya) experienced trade surplus except Egypt. All these countries also witnessed positive FDI

except Angola. Only four out of these six countries had a current account surplus as it shows in table 1. While in 2015, almost all these countries experienced a deficit current account balance coupled with a negative trade and FDI as a percentage of GDP. The indication of this may be as a result of economic crisis, increase in imports and weak oil prices in the world. Trade deficits can be evidence that domestic firms suffer from low productivity and cannot compete with foreign firms.

Table 1: Current Account, FDI and Openness of Trade in Selected Economies in Africa

Years	Angola			Equatorial Guinea			Nigeria			Algeria			Libya			Egypt		
	CAB	FDI	TRA	CAB	FDI	TRA	CAB	FDI	TRA	CAB	FDI	TAD	CAB	FDI	TRA	CAB	FDI	TRA
2005	14	-3	25	16	9	57	20	3	13	20.	1.1	23	32	2.2	35	2.2	6	-3.8
2010	9	-4	19	-20	17	24	4	2	3	7.6	1.4	6.1	21	2.4	23	-2.1	3	-5.1
2015	9	9	-3	-10	2	0.9	-3	0.6	-4.8	-16	-0.3	-15	-53	0	-55	-5.4	2.1	-9.6
2018	7	-6	14	-5	2	-	1	0.5	-0.9	-9.1	0.8	-7	2.6	0	-	-2.5	3.2	-10

Source: UNCTADstat (2018), (NOTE: CAB=Current Account Balance % of GD: FDI= Foreign Direct Investment % of GDP: TRA= Trade % of GDP)

The review of existing literature shows a mixed response towards the impact of FDI on components of balance of payment (BOP) and its impact on the host countries' foreign trade (Rahman, 2016; Gilal *et al.,* 2016). Empirical evidence indicating connections between FDI and foreign trade has shown inconsistent results ranging from uni-directional connections to bi-directional connections and even no connections between the two variables (Pramadhani, Rakesh & Driffield, 2007). Thornton (1996) and Abdulnasser & Manuchehr (2000) carried out a bivariate causality tests and shows a unidirectional Granger Causality from exports to economic growth. In this situation, focusing only on trade may not be appropriate (Goldberg & Klein, 1999). This means there is need to measure the impact of FDI inflows on BOP. The impact of FDI on home and host economies has been the subject of many studies (Dunning, 1993; Enderwick, 1985, and UNCTAD, 1997).

The empirical results show that FDI has a negative effect on current account and a positive effect on capital account. Fry, Claessens, Burridge and Blanchet (1995) reveals that the more liberal is a country's foreign exchange system is the more likely is FDI to show insignificant impact on BOP. Baye and Jansen (1995) also observed the patterns of macroeconomic variables in Thailand and concluded that FDI have a positive impact on private investment and growth but it can also have an adverse effect on BOP. Sahoo and Mathiyazhagan (2002) indicated long-run relationship between Gross Domestic Product (GDP), FDI, and export and also argued that FDI does not matter in the growth of the economy, but export contributes to the growth. The economic impact of FDI on the level of economic activity has been extensively investigated across different countries. Results from studies suggest that FDI inflows can crowd-in or crowd-

out domestic investment depending on the specific elements of the economy (Pitelis & Teece, 2010; Meyer & Sinani, 2009). The key factors in determining the magnitude of the impact of FDI include availability of resources, and stock of human capital (Hossain, 2008). Sen, 1995 suggested that FDI may have a more positive impact on the BOP of the originating country than on that of the recipient country.

More so, some studies show that FDI exhibit a positive effect on receiving countries' exports (Chavez & Dupuy, 2010; Vural & Zortuk, 2011; Hossain, 2008). Fry *et al.,* (1995) noted that FDI is independent of current account, and neutrality increases with rise in openness of the exchange system. Samsu *et al,* (2008) also provides evidence of positive effect of FDI on Malaysian exports. Similar conclusions are derived by Ehimare (2011) for Nigeria a country rich in natural resources and large population which signifies a large market. There is also evidence of negative effects of FDI on recipient countries' current account (Svensson, 1996; Turkan, 2006; Mencinger, 2008; Siddiqui & Ahmad, 2012; Jaffri *et al.,* 2012). The inconsistent of the effects of FDI to the recipient country may be due to, imports raised when international companies import the materials that are not already available in the recipient country (Alguacil & Orts, 2003). Also, if import substituting industry is being targeted by FDI, then it will affect the imports negatively because the products that were imported earlier would now be made in the recipient country by multinational companies (Blonigen, 2001). Kinoshita (2011) shows that during 2000-07, FDI inflows concentrated to non-tradable sector of fifteen Eastern European countries. As a result of it, local demand rather than supply in host countries increased at a reasonable pace. This situation would lead to imports more, and then to high level of current account deficit. Faster growth in imports against exports has been revealed to be the result of continuing imbalance in current account balance in Uganada (Muwanga-Zake & Katamba, 2005). Liuyong and Yanping (2007) also found negative effect of FDI on current account and positive effect on capital and financial account for China.

3. Methodology

3.1 Model specification
To examine the interactions among trade openness, foreign direct investment and current account balance dynamics in Nigeria the study follows the model proposed by Erauskin (2015) and the empirical model can be specified as follows:

$$CAB_t = \alpha_0 + \beta_1 FDI_t + \beta_2 TRADOPEN + \beta_3 EXRATE_t + \beta_4 LogRGDP_t + \beta_5 TOT_t + \varepsilon_t \quad (1)$$

Where: CAB is the current accounts balance as a percentage of GDP, TRADOPEN is trade openness proxied by total trade as a percentage of GDP, FDI is Foreign direct investment inflow as a percentage of GDP, a proxied for capital inflow. Other variables used in this study includes: exchange rate (EXRATE), a higher exchange rate would attract low FDI, while a lower exchange rate indicates that an economy is doing well which may lead to attracting FDI which in turn makes a country have a favourable current account balance, Term of Trade (TOT), Real Gross Domestic Product (RGDP) used as an indicator of macroeconomic stability and ε is the error term.

3.2 Data and Econometric Techniques

Study's data was obtained from CBN statistical bulletin and World development indicators (WDI) from 1980 to 2017. The methodology used in this study is based on the autoregressive distributed lags (ARDL)-bounds testing approach, which was developed by Pesaran, Shin and Smith (2001). It has advantages over other cointegration methods (Tchouassi, 2014). Autoregressive distributed lags approach does not need that all the variables under study must be integrated in the same order. It can be applied when the underlying variables are integrated in order one and at level. Also, ARDL test is relatively more efficient in the case of small and finite sample data sizes. The autoregressive distributed lags (ARDL) technique involves two steps. In the first step, the ARDL model of interest is estimated by using the ordinary least square (OLS) in order to test for the existence of a long-run relationship among the relevant variables. The existence of a long-term relationship does not necessarily imply that the estimated coefficients are stable. There is need to perform a series of tests diagnoses on the model (Bahmani-Oskooee & Brooks, 1999). This study tests the reliability of the variable by conducting stability diagnostic test and residual diagnostic test of normality test, serial correlation test, heteroscedasticity test and wald test to ensure that the estimated model is statistically robust.

4. Empirical Results

4.1 Stationarity Test

The unit root test of the variables was carried out to determine the degree of stationarity and ascertain that the variables were not stationary at higher order, given the fact that ARDL does not require pretesting of stationarity as the techniques involve using the variables in differenced form. For this purpose, our study uses the conventional Augmented DickeyFuller (ADF) tests. The ARDL bounds test is based on the assumption that the variables are I (0) or I (1). The determination of the order of integration of all variables is to ensure that the variables are not I (2) so as to avoid spurious results. The test was done for two alternative specification, first, it is tested with intercept but no trend (i.e. constant but no trend) and then intercept and trend (constant and trend). The result of the unit root test in table 1 gives an indication that current account and trade openness are stationary at level that they are I(0) for ADF while other series were stationary at first differenced which means they are I(1) with only intercept.

Table 1: ADF Unit Root Test Result

Variables	Augmented Dickey-Fuller Test		
	Intercept (t-statistics)	Intercept and Trend (t-statistics)	Order of integration
CAB	-3.356638*	-3.753532*	I(0)
FDI	-3.475091*	-3.491684*	I(1)
TRADOPEN	-8.150987	-5.366515	I(0)
LRGDP	-3.339751*	-3.259346**	I(1)
TOT	-5.125971	-5.027167	I(1)
EXGRATE	-3.297372*	-3.799113*	I(1)

Source: Authors' computation

Note:*, ** and*** indicates significant at 1%, 5% and 10% respectively

4.2 Stability Test

In addition to the above diagnostic tests, the stability of the short-run dynamics and long-run coefficients for the selected ARDL model was examined using the cumulative sum (CUSUM) and the cumulative sum of squares (CUSUMSQ) stability tests of the recursive residuals. These tests are very crucial since the short-run dynamics seems to be very vital in investigating the long-run coefficients stability (Pesaran *et al.,* 2001). CUSUM test identifies any systematic changes in the model coefficients, whereas CUSUMSQ test reports any unexpected departure of the model's coefficients from the stability. The test statistics of this stability tests is graphed to identify not only their significance but also at what point of time a possible instability (structural break) occurred. The decision rule is that if the plot of CUSUM and CUSUMSQ statistic moves between the critical bounds (at 5% significance level), then the estimated coefficients are said to be stable. In figure 1, the results show that coefficients of the estimated model are stable as the graph of CUSUM lies in the critical bounds and do not cross the neither lower nor the upper bound critical limits. The presence of convergence in CUSUM and CUSUMSQ graphs confirm that short run estimates is stable. Thus, confirming the short run coefficient of the determinants of the current account in Nigeria. CUSUMSQ (figure 2) statistics oscillated between the critical bound. This indicates the presence of instability and structural break in the long run estimates.
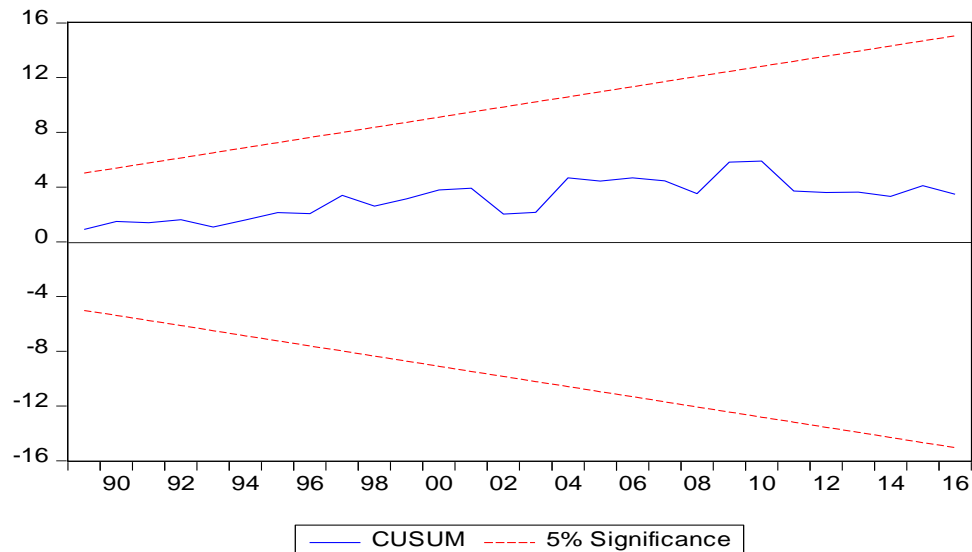
Figure 1: Plot of cumulative sum of recursive residuals (CUSUM)
Source: Authors' computation
Note: The straight lines represent critical bounds at 5% significance level
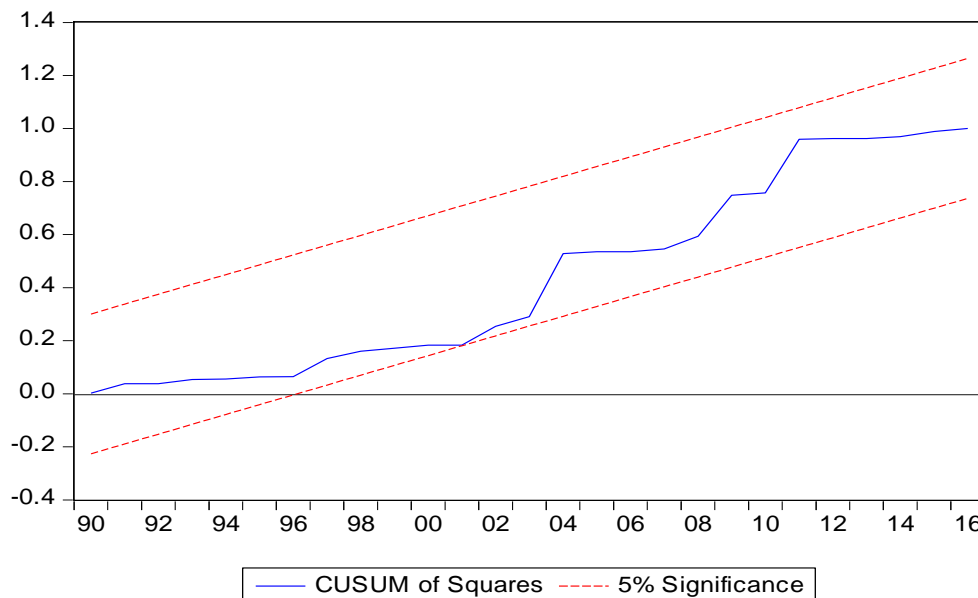

Figure 2: Plot of cumulative sum of square of recursive residuals (CUSUMSQ)
Source: Authors' computation
Note: The straight lines represent critical bounds at 5% significance level

4.3 ARDL Bounds Test
The first thing in the bounds test approach of co-integration is estimating the ARDL model using the appropriate lag-length selection criterion. In this study Schwarz information criterion (SIC) was taken as a guide and a maximum lag order of one was chosen for the conditional ARDL

model. The results in table 2 below provide evidence in favour of rejecting the null hypothesis of no long-run relationship between current account and the explanatory variables where the value of computed F-statistics (3.80) is greater than the lower bound critical value and upper bound critical value at 5% and 10% levels. From table 2, the bounds test result with an intercept and trend shows that the calculated F- statistics 3.80 is higher than the Pesaran *et al.,* (2001) upper bound critical values at 5% and 10% level of significance respectively. This implies that the null hypothesis (no long-run relationship) against its alternative (there is long-run relationship) is rejected based on the values at 5% and 10% levels of significance. The decision rule is that whatever level of significance chosen, if the computed F-statistics value is compared with the lower bound and upper bound critical values tabulated in table CI(v) case IV of Pesaran *et al.,* 2(001), given the k-value, if the F-statistics is found greater than the upper bound, I(1) of the critical values, then there is long run relationship among the variables. Based on this, it is evidence from the results that there is a long run relationship between current account and the explanatory variables since even at 5% level of significance, the F-stat of 3.80 approximately is greater than the lower and upper bound, I(0) and I(1) of the critical value of 2.62, and 3.79 respectively. The next step requires the ARDL method to estimate the short run and long run relationship of the variables.

Table 2: ARDL Lower and Upper Bound Critical Value

Test Statistics	Value	Significant Level	Bounds Critical Values (unrestricted intercept and unrestricted trend)	
			I(0)	I(1)
F-Statistics	3.801908	10%	2.26	3.35
		5%	2.62	3.79
		1%	3.41	4.68
No of Observation	35			
Optimal Lag	1			
No of Variables	6			

Source: Authors' computation

4.4 Short-run Error Correction Estimates and Long run Results

The short run error correction estimation result is presented in table 3 below. The error correction representation is the dynamic behaviour of the ARDL model where the coefficient of the error correction term is correctly signed (negative) and highly significant. The short-run adjustment process is measured by the error correction term ECM_{t-1} and it shows how quickly the variables adjust to a shock and return to equilibrium. For stability, the coefficient of ECM_{t-1} should carry the negative sign and be statistically significant. In table 3 below, the estimated coefficient of the ECM_{t-1} equals -0.75, correctly signed and significant at 5% which confirms the existence of the long-run relationship between the underlying variables and represent the speed of adjustment with which the model attains the long-run steady state equilibrium. The ECM_{t-1} estimated coefficient indicates that the deviation from the current account balance equilibrium path is

corrected by nearly 75% over the period of study. The statistically significant of ECM_{t-1} confirms the presence of long run equilibrium relationship between the current account FDI and trade openness variables in Nigeria. The implication of the highly significant term is another proof for the existence of stable relationship among the variables.

The overall reliability test of the model shows that the explanatory variables account for approximately 55% of the variation in the current account balance in Nigeria within the period under study has revealed by the r-squared. However, as shown by the Durbin-Watson statistics of 2.0 approximately, autocorrelation doesn't exist in the regression equation. The F statistics shows that the relationship among variables is statistically significant.

The degree of trade openness (TRAOPEN) and term of trade (TOT) in the short run and long run as it shown in table 3 and 4 are positively related to current account position in Nigeria with TRAOPEN and TOT statistically significant in the short run. This may be an indication that country's openness contributes to current account balance. This also shows that the more open the economy, the more is expected to generate foreign exchange earnings. However, the degree of Nigeria trade openness is measured by the ratio of exports and import to GDP. In Nigeria, balance of trade is the largest component of a country's current account in which oil exports is the main drive of the account. Thus, the relationship is expected to be positive. The impact of TRAOPEN on current account position indicates that a one percentage increase in the ratio of exports to GDP leads to improvement in the current account balance of about 0.057 (6%) in the short run. This result supports the findings of Monokroussos and Thomakos (2014) and Yang (2010) who found positive and strongly significant relationship between openness and current account position in Greece and emerging Asian economies respectively. The finding is also consistent with the findings of Huntington (2015) who found positive relationship between trade balance and current account balance in oil exporting countries.

The short-run and long run results in table 3 and 4 also indicates negative effect of FDI on current account balance in Nigeria, implying that an increase in FDI resulted in a deterioration of the current account position in Nigeria. Negative effects of FDI may be that foreign-owned firms compete for the same customers and "crowd out" domestic firms (De Backer & Sleuwaegen, 2003). And it can also be that the recipient country imports rose due to FDI when international companies import the materials that are not already available in the recipient country (Alguacil and Orts, 2003). The result collaborates the findings of Siddiqui & Ahmad, (2012) Jaffri *et al., (*2012) and Mencinger, (2008) who found a negative relation between FDI and current account.

Table 3: Short-run Error Correction (ECM) Results
Dependent Variable: D(CA)

Regressors	Coefficient	Standard Error	t-Statistics	Probability
D(FDI(-1))	-0.148498	0.683857	-0.217148	0.8297
D(TRAOPEN(-1))	0.058859	0.105295	0.558992	0.0580
D(TOT(-1))	0.127440	0.041579	3.064974	0.0049
D(LRGDP)	4.187929	9.310064	0.449828	0.6564
D(EXGRATE(-1))	0.009855	0.057511	0.171358	0.8652
ECM(-1)	-0.745658	0.185380	-4.022331	0.0004
ECM=CA(-1) − (-0.1992*FDI + 0.0789*TRAOPEN + 0.0020*TOT + 5.6164 *LRGDP + 0.0132*EXGRATE -61.6879)				
R-squared	0.545086	Durbin-Watson stat	1.925976	
F-Statistics	4.621690	Prob(F-Statistics	0.001666	

Source: Authors' computation

A stable exchange rate is expected to improve current account balance. The relationship between exchange rate (EXCHR) and current account is positive both in the short run and long run analysis. Theoretically, exchange rate has an ambiguous impact on current account position. In Nigeria, it implies that depreciation of the exchange rate which in turn impact positive on the current account. A depreciation of the exchange rate, will lead to an increase in the cost of buying imports and this will lead to a fall in demand for imports and this will improve the current account balance positions.

Table 4: Estimated Long – run Coefficient using ARDL
Dependent Variable: Current Account

Regressors	Co-efficient	Standard Error	t-Statistics	Probability
FDI	-0.199151	0.913724	-0.217955	0.0291
TRADOPEN	0.078936	0.132167	0.597244	0.0555
TOT	0.002003	0.045903	0.043630	0.9655
LRGDP	5.616421	12.194837	0.460557	0.6488
CEXGRATE	0.013217	0.077774	0.169935	0.8663
C	-61.687904	114.457119	-0.538961	0.5943

Source: Authors' computation

5. Conclusion and Policy Recommendations

In this paper, we evaluated the effects of FDI and trade openness on current account of Nigeria using annual time series data from 1981 to 2017. ARDL bounds testing approach as well as error-correction model (ECM) to examine the linkage was used for conducting the analysis. This

method was adopted because all the variables of interest were non stationary in level and at first difference which ARDL was capable of accommodating. Results provide evidence of short run and long run negative relationship between FDI and current account balance in Nigeria. And a positive relationship between trade openness, term of trade, real Gross domestic product exchange rate and current account.

Based on these empirical findings, the study strongly recommend that government of Nigeria should focus on the policy of trade openness and ensure that the foreigners coming to invest in the country are not those that will crowd out the domestic investors. Policy makes should also ensure to promote policies that will encourage exports and discourage import so as to boost the current account balance of the country.

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