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ROLES OF REGULATORY INSTITUTIONS IN THE MANAGEMENT OF CAPITAL FLOWS IN NIGERIA

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Abstract: *This paper highlights the role of the relevant institutions in the management of capital flows in Nigeria. The paper among other things, also describes capital flows to consist of foreign direct investment, Portfolio equity and debt flows, commercial lending and official flows. The paper concludes by identifying specific roles for regulatory institutions to include effective supervision, strict enforcement of laws, adoption of sound monetary policies and the strengthening of the financial superstructure amongst others.*

INTRODUCTION

Recent changes in technology, along with the opening up of many regions previously closed to investment, have led to explosive growth in the international movement of capital. Flows from foreign direct investment and debt and equity financing can bring countries substantial gains by augmenting local savings and by improving technology and incentives. But as was underscored recently by the economic and financial crisis in several Asian countries, capital flows can also bring risks. Hence the need to evolve appropriate policies that will enable the monetary authorities to determine the optimal level of the capital flow that will support any economic agenda being pursued at a point in time.

In Nigeria today, there is no doubt that the economy requires an optimal amount of capital flow (net) in order to bridge the gap between the desired level of investment and domestic savings so as to accelerate the pace of economic growth and development on a sustainable basis under the ongoing macro-economic reform programme – **National Economic Empowerment Development strategy** (NEEDS). However, because of the inherent risks involved in such flows, there is therefore the need for the relevant regulatory institutions to devise means and ways of managing such flows so as to minimize such

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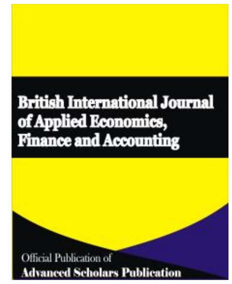

risks bearing in mind the overall objective of seeking to promote rapid economic growth and development.

CONCEPTUAL ISSUES AND THEORETICAL FRAMEWORK

Composition of Capital Flows

Capital flows basically consists of foreign direct investment, portfolio equity and debt flows, commercial lending and official flows. Available data from the World Bank shows that while medium income countries experienced more portfolio equity inflows as a percentage of total capital inflows in recent years, low income countries like Nigeria and other countries in sub-Saharan African relied heavily on official debt flows.

There is no clear consensus on reasons for the existence of different forms of capital flows or why some forms are dominant in one region or the other. Most empirical studies available tend to examine the composition of flow from the position of desirability. Pontes (1999) argues that Foreign Direct Investment (FDI) is a desirable form of capital flow to the host countries as it may bring positive externalities such as technology and management experts. Griffith-Jones (2003) concurs with those reasons and adds that FDI ends tends to be more long term and less easily reversible. On the other hand, a foreign inventor may be motivated to invest in another country other than his own by other non-financial strategic reason such as market share. Portfolio equity flows to countries with well developed macroeconomic policy instruments and strong banking institutions though they can be less stable than FDI. Short term bank lending are often rank the most volatile while long-term bank flows are considered least volatile though there have not been any statistical support for such ranking.

REASONS FOR CAPITAL FLOWS

Beyond the primary motives of higher returns and risks diversification, several potent factors have motivated the rapid growth of capital flows among nations. Chief among these reasons are the removal of statutory restrictions on capital account transactions, macroeconomic stabilization and policy reforms in the developing nations, the liberalization of trade and the revolutionary changes in information and communication technologies.

BENEFITS OF CAPITAL FLOWS

Economists tend to favour the free flow of capital across national borders because it allows capital to seek out the highest rate of return. Beside this, international flow of capital reduces the risk faced by owners of capital by allowing them to diversify their lending and investment. Secondly, the global integration of capital markets can contribute to the spread of best practices in corporate governance, accounting rules and legal traditions. Thirdly, the global mobility of capital limits the ability of government to pursue bad policies.

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In addition to these advantages, which in principle apply to all kinds of private capital inflows, Martin F (2000) note that the gains to host countries from FDI can take several other forms:

- FDI allows the transfer of technology particularly in the form of new varieties of capital inputs that cannot be achieved through financial investments or trade in goods and services. FDI can also promote competition in the domestic input market.
- Recipients of FDI often gain employee training in the cause of operating the new businesses, which contribute to human capital development in the host country.
- Profit generated by FDI contributes to corporate tax revenue in the host country.
- Capital mobility creates valuable opportunities for portfolio diversification, risk sharing and inter-temporal trade.

RISKS OF CAPITAL FLOWS

Despite the strong theoretical case for the advantages of free capital flows, the conventional wisdom now seem to be that many private capital flows pose countervailing risks. Hansmann and Fernadez-Arias (2000) suggest why many host countries, even when they are in faovur of capital inflows, view international debt flows as bad cholesterol". Most recent empirical works including Grabell I. (1995), Clerke (1996) and Corrigam (1989) argued that the processes of diversification, globalization and innovation have increased both efficiency of volatility in the financial market. Volatility adds another source of risks, not only making the pricing of financial assets more difficult but also generating portfolio flows that are potentially more unstable.

Capital flow in form of FDI is not only transfer of ownership from domestic to foreign residents but also a mechanism that makes it possible for foreign investors to exercise management and control over host country firms. The transfer of control may not always benefit the host country because of the circumstances under which it occurs, problems of adverse selection or excessive leverage.

Through FDI, foreign investors gain crucial inside information about the productivity of firms under their control. This gives them an informational advantage over "uninformed" domestic savers, whose buying of shares in domestic firms does not entail control. Taking advantage of this superior information, foreign direct investors will tend to retain high productivity firms under their ownership and control and sell low productivity firms to the uninformed savers.

REGULATORY INSTITUTION AND CAPITAL FLOW MANAGEMENT

In order to appreciate the role of the regulatory institutions in the management of capital flows in Nigeria, it is pertinent to identify the relevant regulatory authority involved in the issues of capital flows, their broad objectives in relation to capital flows the associated risks posed by capital

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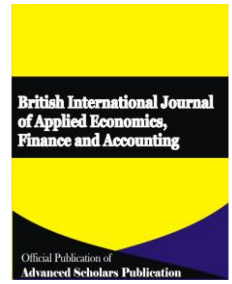

flows and the role of the institutions in managing such risks.

In view of the fact that capital flows involves cross boarder transaction and are carried out mainly, through the financial system, particularly the banking system, the main regulatory institutions in the case of Nigeria's will include the Federal Ministry of Finance, the National Planning Commission, the Nigerian Custom Service, the CBN, the NIDC, SEC and the Debt Management Office as well as the law enforcement agents such as the Nigeria Police and EFCC among others. These regulatory institutions would aim at achieving the following objectives in relation to capital flows:

(a) Attain optimal level of capital flows that will ensure the achievement of the desired investment level with a view to accelerating the pace of economic growth and development.
(b) Ensure the safety, soundness and stability of the nation's financial system.
(c) Ensure price stability i.e. the stability of general prices of goods and services, exchange rate and interest rates in the domestic economy.
(d) Ensure the protection of investors.
(e) Minimize the incidence of financial crimes associated with capital flows.

In order to promote capital flows, the regulatory institution should evolve appropriate means of monitoring and verifying the genuineness of capital flows. The role of the institutions in this regard will involve the adoption of the following tools:

1. **Adoption of Sound Monetary Policy**

Where the next capital inflow into a country exceeds the absorptive capacity of the economy, the monetary authorities should adopt appropriate monetary policies to sterilize excess funds in order to forestall overheating of the economy, which directly threatens the attainment of price stability. The use of open market operation, and reserve requirement become instrument of monetary policy to management such excessive net inflow.

2. **Effective Supervision**

All the relevant regulatory institutions particularly the CBN and the NDIC should strengthen their supervisory capability by ensuring strict compliance with the applicable regulations on capital flows. Restriction could be placed on the quantum of short-term capital as this is highly volatile and could threaten stability of the banking system.

3. **Strengthening Corporate Governance**

Responsive corporate governance remains a critical success factor for the viability and survival of banking institutions. Many banks in the country are yet to imbibe the canons of good corporate governance. The apparent lack of transparency and accountability on the part of some operators may make tracking of capital flows a lot difficult thereby making its management a herculean task.

Giving the foregoing, the regulatory authorities should review the existing code of conduct for directions of licensed banks to include highest standard of ethical conduct and behaviour and crate a conducive environment for whistle blowing. A zero tolerance for unethical behaviours and breaches of rules and regulations must be strictly enforced. Generally, sanctions should be targeted at the directors and officers rather than the institutions.

4. **Effective Co-ordination of External Debts**

Experience has shown that the economy became neck-deep in external debt problems by the lack of effective co-ordination by successive administration in the country. As a result, many external debts were contracted for projects whose feasibility studies were suspect and hence many were not available such that the determinations of the exact quantum of external debts of the country became a debatable issue. This made management of capital flows from this source difficult. The present administration since inception has given due recognition to this problem and has taken some pragmatic steps at addressing the issues.

5. **Thorough Inspection of Imported Materials**

One of the means through which developing countries, including Nigeria experienced capital flight is over-invoicing. This requires that Nigerian Custom Services address this challenge through thorough inspection of imported materials so as to determine the actual value of what is imported. This requires capacity building in the form of skill enhancement and acquisitions of necessary infrastructures.

6. **Strict Enforcement of Laws**

The law enforcement agencies are constantly being challenged by the frequent incidence of threat to life and property, perpetration of financial crimes such as money laundering, outright fraud and corruption. Every investor local or foreign, requires conducive socio-political environment where there is absence of bribery and corruption, effective enforcement of property right and security of life and property among others.

Nigeria is generally believed not to have a good record on these variables and this has accounted for her relative unattractiveness to foreign investors, donors and creditors.

SUMMARY AND CONCLUSION

An attempt has been made in this paper to highlight the role of the relevant regulatory institutions in the management of capital flows in Nigeria. The paper has described capital flows to consist of foreign direct investment, portfolio equity and debt flows, commercial lending and official flows. The paper also identifies the concerned regulatory institutions to include the Federal Ministry of Finance, the Nigeria Customs Service, CBN, NDIC and the Debt Management Office as well as the law enforcement agents such as the Nigeria Police and the Economic and Financial Crimes Commission (EFCC), among

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other. While capital flows in any country has its obvious merits, there is the need to ensure their effective management in order to minimize the associated risks by such flows to the regulatory objectives. These objectives have been identified in the paper to include the attainment of optimal level of capital flow that will ensure the achievement of the desired investment level with a view to accelerating the pace of economic growth and development; ensuring the safety, soundness and stability of the nation's financial system;ensuring price stability in the domestic economy; ensuring the protection of investors; and minimizing incidence of financial crimes associated with capital flows. The paper concludes with the specific roles of the regulatory institutions in the management of capital flows in Nigeria. Some of these roles include effective supervision, adoption of sound monetary policies, strengthening the financial superstructure, strengthening corporate governance practices, strict enforcement of laws and effective co-ordination of external debts. It is my belief that efforts in the direction of measures indicated above will go a long way in ensuring that the economy derives the expected maximum benefits from capital flows.

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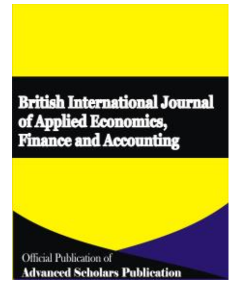

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