Does Foreign Direct Investment Affect Financial Stability in Developing Countries: The Nigerian Experience

Kolawole Ebire
Department of Banking and Finance,
Nasarawa State University Keffi
Kolawole.ebire@gmail.com

Lucky O. Onmonya
Department of Accounting,
Nile University of Nigeria

Christopher Enny Ofikwu
Department of Banking and Finance,
Nasarawa State University Keffi

Maurie Nneka Nwala
Department of Banking and Finance,
Nasarawa State University Keffi

Abstract

The relationship between Foreign Direct Investment (FDI) and financial stability is of increasing concern among economies. The volume and structure of FDI can affect the financial system's stability. This study examines the effect of FDI on financial stability in Nigeria between 2003:1 and 2019:4. The data were subjected to a stationarity test using the Augmented Dickey-Fuller test, and the test result shows that all variables were integrated in the order of 1. The Johansen cointegration test result showed a long-run relationship between all the dependent and independent variables. The hypotheses were tested using Error Correction Mechanism (ECM). It was found that the short runs deviations will adjust to their long-run equilibrium by 17.3% quarterly. The findings show that FDI as a percentage of GDP positively affects Nigeria's financial stability. In contrast, FDI as a percentage of fixed investment and net FDI have a significant negative effect on Nigeria's financial stability. The study, therefore, concluded that inflows of FDI play a significant role in the Nigeria's financial stability. Based on the findings, the study recommends that authorities such as Ministry responsible for trade, commerce, and investment create an enabling investment environment such as regulations for protecting investors interests to attract FDI into the system.

Keywords: *Net FDI, FDI as a percentage of GDP, FDI as a percentage of fixed investment, Financial stability*

1. Introduction

Financial stability refers to the smooth operation of the financial system's critical components (financial markets, institutions, participants, instruments and services). A stable financial system can allocate resources efficiently, manage financial risk, keep employment levels stable, and eliminate volatile movements of financial assets that may affect its stability. Financial institutions such as commercial banks are reluctant to finance viable projects in the absence of financial stability, leading to a fall in assets' intrinsic values. Consequently, affecting confidence in the financial system, leading to bank runs, rising inflation rates, or stock market crashes (World Bank Group, 2020). In contrast, a robust financial structure can reduce the instabilities that could lead to a financial crisis. In various economic circumstances, the stable financial system is versatile enough to continually allocate financial resources underpinning economic fundamentals that continue to operate on the market and conduct payment transactions efficiently and expeditiously in response to economic fluctuations. In addition, a stable financial system is internally stable to prevent significant financial disruptions or external shocks that can lead to a financial crisis. Capital flows have a significant role in a country's financial stability and understanding the link between the two is crucial for policymakers and investors.

Capital flows such as Foreign Direct Investment (FDI) play significant roles in a country's financial stability. The volume and unexpected changes in FDI could disrupt financial stability. According to Ebire and Daniels (2022), these flows can threaten a nation's domestic resources if not properly managed. The inability of the financial system to absorb these shocks and, in turn, prevent disruptive tendencies could lead to crises. Data has shown that FDI flows to Nigeria have been unpredictable from the 1980s to date.

Prior studies such as Ebire, Onmonya and Inim (2018) studied the determinants of FDI in Nigeria. Adeola (2017), Obiechina and Ukeje (2013); Olasode (2015); Akanyo and Ajie (2015); Okafor, Ugochukwu and Chijindu (2016) and Adekunle and Sulaimon (2018) studied FDI effect on economic growth in Nigeria. Also, empirical studies on financial stability have neglected the disaggregated inflow of FDI (Seghir, 2009, Milesi-Ferretti and Tille, 2011, Dornean, Isan and Oanea, 2012, Bhowmik, 2018). Thus, this study contributes to the existing body of knowledge by disaggregating FDI into inward FDI flow as a percentage of Gross Domestic Product (GDP), inward FDI flow, inward FDI flow as a percentage of fixed investment and net FDI. This paper aims to examine the effect of FDI on financial stability in Nigeria.

Hypotheses testing

The following hypotheses are formulated to guide this study:

H_{01}: FDI as a percentage of GDP has no significant effect on financial stability in Nigeria.

H_{02}: FDI as a percentage of fixed investment has no significant effect on financial stability in Nigeria.

H_{03}: Net FDI has no significant effect on financial stability in Nigeria.

The remainder of this study is structured as follows. Following this introduction, the paper reviews the conceptual framework and empirical studies on FDI and financial stability. Methodological issues, including the estimation techniques and model specifications, were presented in section III. Section IV presents the econometric estimates, while section V concludes and presents policy recommendations.

2. Conceptual review

Theoretical framework

This study is based on the Financial Instability Hypothesis (FIH) and the theory of capital control. Minsky (1984) proposed the FIH, claiming that financial crises became inherent in capitalism as economic growth cycles made lenders and borrowers increasingly reckless. Excessive optimism causes financial bubbles and subsequent busts. Based on this hypothesis, he claimed that Capitalism tends to go through times of financial security and times of instability. Furthermore, Minsky (1984) asserts that financial instability can be defined as excess successes that lead to a crisis or economic stability that creates instability.

The theory of capital control is based on the works of John Maynard Keynes. In his general theory, Keynes (1936) saw controls as important for ensuring stability, directing investment toward productive growth, and successfully promoting capital transaction regulations at Bretton Woods. Therefore, the capital control theory is relevant in explaining the direction of capital flows. According to Palley (2009), capital controls theory explains the direction of capital flows, i.e. whether controls are placed on capital inflows or outflows. According to Erten, Korinek, and Ocampo (2019), policymakers in a number of emerging markets responded to the financial instability by actively managing capital flows, such as by enforcing capital controls that loosen during times of stability and tighten during times of instability or counter-cyclical controls.

Conceptual review

Financial stability has no single consensus definition that is widely accepted. Several attempts by apex banks and scholars have been made to conceptualise the term. For example, the Central Bank of Nigeria (CBN) (2013) views financial stability as the resilience of the financial system's to unexpected negative shocks while allowing the intermediation activity inside the financial system to continue operating normally. Schinasi (2004) described financial stability as a financial system capable of promoting rather than impeding an economy's success and dissipating financial imbalances that occur endogenously or as a result of major adverse and unanticipated events. Therefore, this study defines financial stability as a financial system including financial intermediaries, markets, and infrastructures in a range of stability whenever it can ease an economy's performance. This involves extending credit to productive investment opportunities to boost economic activities by providing financial intermediation processes and eliminating various forms of endogenous risks that occur naturally or due to major adverse and unexpected events. Based on the above definition, this study proxy financial stability as non-performing loans as a ratio to gross loans, which is defined as loans whose contracted payments have been unpaid or overdue for more than a specified number of days. If left unresolved, NPL will compound into a financial crisis when they surpass bank capital in a relatively large number of banks. Prior empirical studies have linked non-performing loans to financial

instability (Atoi, 2018; Ebire, Ullah, Adeleye & Shah, 2021; Fofack, 2005; Dhiman, 2018; Kingu, Macha & Gwahula, 2015; Nyarko-Baasi, 2018,).

The United Nations Trade and Development Conference (UNCTAD) (1999) defined inward FDI as a long-term investment that reflects a company resident in a different economy's long-term interest and control (FDI) or parental enterprise by a resident entity in the same economy (FDI enterprise, affiliate enterprise or foreign affiliate). This view by UNCTAD emphasises that there is a long-term investment and significant control of the investor. However, it does not describe FDI characteristics and the percentage of foreign investment that qualifies an investment as FDI. On the other hand, the International Monetary Fund (IMF) (2008) described inward FDI as a type of cross-border investment that occurs when a resident of one economy exercises significant control or influence over managing a business in another economy. However, the view by IMF does not stipulate the percentage of control that qualifies a flow as FDI.

Therefore, this study adopts the definition put forward by the OECD (2008), which refers to inward FDI as a cross-border investment made by a resident entity in one economy to acquire a long-term interest with a significant degree of influence over the enterprise's management of at least 10% of the voting power in a resident enterprise in another economy. Based on this definition, this study proxy FDI as a percentage of GDP, FDI as a percentage of fixed investment and net FDI.

Empirical review

Various researchers have explored the link between inward FDI and financial stability. For example, Seghir (2009) analysed the link between inward FDI and Tunisia's financial stability from 1980 to 2005. The variables used in this study include inward FDI and financial market stability, measured using dummy variables of 1 to represent periods of instability and 0 for otherwise. The Ordinary Least Square (OLS) result shows that the stock exchange market's stability may explain the large and statistically significant influence exerted on inward FDI. On the contrary, Bhowmik (2018) found out that financial instability negatively impacts inward FDI. In his study of how inward FDI and outward FDI have changed during several financial instabilities in India, spanning from 1971 to 2015. Secondary data were adopted for this study, and the variables used include GDP, inflation rate, inward FDI. Using causality, cointegration and VECM. The study contended that inward FDI in India has been catapulting at the rate of 21.56% per year. Also, the study concluded that FDI does not granger cause financial instability but financial stability granger cause FDI.

Some studies on inward FDI and financial stability focused on developed economies. For example, Milesi-Ferretti and Tille (2011) revealed that the contraction flows during the instability were concentrated on inward FDI. Their study of the impact of capital flow patterns during the financial instability of 75 OECD countries between 2006 and 2009. The variables used in this study include GDP growth, debt, inward FDI, inward portfolio investment, and dummy variable of 1 to represent the period of instability and 0 for otherwise. The scope of four years may be too short and may affect this study's findings' robustness. Likewise, Dornean, Isan and Oanea (2012) findings align with Milesi-Ferretti and Tille (2011), who found that financial instability directly affects the inward FDI level. They analysed the relationship between financial instability and inward FDI in Central and Eastern Europe over the period of 1994 to 2011. The variables used in this study include inward Flows, GDP growth and financial

instability (measured as a dummy variable taking 1 for years of financial instability and 0 for otherwise). The result from the panel regression implies that due to the magnitude of the financial instability in 2008, a negative effect on inward FDI was experienced in Central and Eastern European countries.

Using the World Bank's classifications of 121 economies, Ebire et al. (2021) investigated the effect of various types of capital flows on financial stability in middle-income nations from 2010 to 2017. In this investigation, a panel spatial correlation consistent technique was applied. Their study offers compelling evidence that financial stability is positively and significantly predicted by capital flows in middle-income countries, and that the financial systems of advanced economies are more stable than those of emerging and developing nations. Outward FDI however, have the greatest chance of ensuring financial stability.

The above studies were conducted outside Nigeria and mainly concentrated on developed economies. Most of these studies used a panel of developed economies that eroded country-specific features. Prior studies examined inward FDI effect on economic growth. Also, the findings from these empirical studies mixed. While prior studies found a negative effect, others found no effect. This study, therefore, disaggregates FDI into FDI as a percentage of GDP, FDI as a percentage of fixed investment, and net FDI.

3. Methodology

This study employs an ex-post facto research design. Quarterly secondary data were extracted from the World Bank data set (2020) and Economist Intelligence Unit (2020). The secondary data, which are time series, were collected on the following variables inward FDI as a percentage of GDP, inward FDI as a percentage of fixed investment and net FDI between 2003Q1 and 2019Q4. This period is justified based on data availability and covers periods of instabilities in Nigeria.

Model specification

The multiple regression that captures the effect of FDI on financial stability in Nigeria is stated below:

$$NPL_t = \beta_0 + \beta_1 FDI\_GDP_t + \beta_2 FDI\_FI_t + \beta_3 NFDI_t + \varepsilon_t$$

Where,

NPL – Ratio of non-performing loans to total loans
FDI_GDP – FDI as a percentage of GDP
FDI_FI – FDI as a percentage of fixed investment
NFDI – Net FDI
β_0 is the constant term
$\beta_1, \beta_2,$ and $\beta_3,$ - beta coefficients
ε is error term
t = Time

Table 1: Variables, Measurement and Apriori Expectations

S/N	Variable	Nature	Measurement	Apriori expectation
1.	Non-performing Loans	Dependent variable	Measured as the ratio of defaulting loans to total loans	
2.	FDI as a percentage of GDP	Independent variable	Net flows of direct investment capital by non-residents into the country, as a percentage of GDP.	+
3.	FDI as a percentage of fixed investment	Independent variable	Net flows of direct investment capital by non-residents into the country, as a percentage of GDP.	+
4.	Net FDI	Independent variable	Net flow of direct investment	+

Source: Author's Compilation (2023)

Technique of estimation

The technique employed for this study is Error Correction Mechanism (ECM). The ECM method is an econometric technique developed by Engel and Granger (1987) to reconcile an economic variable's short-run behaviour with its long-run behaviour. The data were subjected to a stationarity test to avoid spurious regression and analysed using Eviews 10.

4. Result and discussion

The analysis of the data and discussion of results are presented in this section. Below are the findings.

Presentation of data

Table 2: Descriptive statistics

	FDI_FI	FDI_GDP	NFDI	NPL
Mean	16.45882	1.617647	4.835294	12.39412
Median	10.90000	1.500000	4.900000	9.837500
Maximum	54.20000	3.000000	8.900000	39.58438
Minimum	4.200000	0.500000	1.900000	2.790625
Std. Dev.	12.73444	0.778238	2.343092	9.099455
Skewness	1.461410	0.274073	0.328423	1.189592
Kurtosis	4.998955	1.845334	1.811781	4.110094
Jarque-Bera	35.52630	4.628867	5.222714	19.52966
Probability	0.000000	0.098822	0.073435	0.000057
Sum	1119.200	110.0000	328.8000	842.8001
Sum Sq. Dev.	10865.12	40.57882	367.8353	5547.605

| Observations | 68 | 68 | 68 | 68 |

Source: Eviews output (2023)

Table 2 shows the descriptive characteristics of the variables in this study. It is observed that the average of each variable is not exactly positioned at the middle (median) of the distribution. Table 2 also shows the distribution's skewness, which measures the length of the tail of the distribution. Findings revealed that all variables FDI_FI, FDI_GDP, NFDI and NPL are positively skewed. Thus, they have a long right tail. Implying that the distribution extends more to the positive side. The table also shows the kurtosis (peakedness or flatness) o the distribution. All variables are platykurtic, that is, the distributions are flat relative to the normal. Also, the result of the Jarque-Bera test shows that FDI_GDP and NFDI are normally distributed while FDI_FI and NPL are not normally distributed.

Unit root test

To circumvent the problem of spurious regression, a stationary test of time series was done on all of the variables. This study applies the Augmented Dickey-Fuller (ADF) (1981) unit root test.

The ADF model is specified as:

$$\Delta Y_t = \beta_1 + \beta_2 t + \delta Y_{t-1} + \sum_{i=1}^{m} \propto_i \Delta Y_{t-i} + \varepsilon_t$$

Table 3: Augmented Dickey-Fuller Tests

Variable	ADF t-statistics	P-value	Order
NPL	-4.554664	0.0027	1
FDI_GDP	-6.942975	0.0000	1
FDI_FI	-7.904641	0.0083	1
NFDI	-8.246972	0.0000	1

Source: Eviews Output (2023)

Table 3 displays the stationarity test results used to check for the existence of the unit root, which was done at a 5% Mackinnon critical value. The ADF method was used in this analysis since it involves supplementing the previous three equations with the dependent variable's lagged values. The goal is to employ enough terms to create a serially uncorrelated error term. All variables (NPL, FDI_GDP, FDI_FI and NFDI) were stationary at the first difference, that is, I(1).

Table 4: Lag Length Criteria

Lag	LogL	LR	FPE	AIC	SC	HQ
0	-590.1217	NA	1359.409	18.56630	18.70123	18.61946
1	-366.3874	412.5102	2.063436	12.07460	12.74926*	12.34038*

2	-347.3438	32.73109*	1.887948*	11.97949*	13.19387	12.45790
3	-342.4855	7.742937	2.715789	12.32767	14.08176	13.01870
4	-336.8124	8.332307	3.861619	12.65039	14.94420	13.55404

* indicates lag order selected by the criterion

Source: Eview output (2023)

To estimate the long-run relationship between the variables, the optimal lag length requirements for the variables we determined using the lag length criteria. From the analysis, it was found the 2 lag was more appropriate.

The cointegration technique is employed in this study to test the non-stationarity of time series variables using the Johansen cointegration test.

Table 5: Johansen Cointegration test

Rank	Trace Statistics	5% critical value
None *	49.56901	47.85613

Trace test indicates 5 cointegrating eqn(s) at the 0.05 level
* denotes rejection of the hypothesis at the 0.05 level
Source: Eviews output (2023)

The trace statistics show one significant cointegration equation at 5% from the Johansen cointegration test. This suggests a long-term connection between the variables. Therefore, an Error Correction Mechanism (ECM) is employed to estimate the hypothesis.

Error correction mechanism

The ECM was used to describe the potential short-run deviations from the long-run cointegration equation estimate and evaluate the hypotheses presented below:

$$\Delta NPL_t = \beta_0 + \beta_1 \Delta NPL_t + \beta_2 \Delta FDI\_GDP_t + \beta_3 \Delta FDI\_GDP_{t-1} + \beta_4 \Delta FDI\_FI_t + \beta_5 \Delta FDI\_FI_{t-1} + \beta_6 \Delta NFDI_t + \beta_7 \Delta NFDI_{t-1} + \propto_i \Delta Y_{t-i} + \varepsilon_t$$

Table 6: ECM table

Variables	Coefficient	t-statistics	P-value
D(NPL(-1))	0.589960	5.579666	0.0000
D(FDI_GDP)	15.78630	7.072746	0.0000
D(FDI_GDP(-1))	-5.964856	-2.099147	0.0402
D(FDI_FI)	-0.428087	-4.876967	0.0000
D(FDI_FI(-1))	0.200913	1.975671	0.0530
D(NFDI)	-2.991534	-4.795192	0.0000
D(NFDI(-1))	0.784426	1.135095	0.2611

ECM (-1)	-0.172491	-3.472845	0.0010
R^2	0.654006		
Adj R^2	0.605446		
F-statistics	13.46787		
DW	2.50		

Source: Eviews output (2023)

The ECM estimation suggests that the R^2, also known as the coefficient of determination, is 65.4%, implying that the explanatory variables – FDI_GDP, FDI_FI AND NFDI account for 65.4% of the total variations in financial stability. The remaining 34.6% represents the changes in the dependent variables, which were not included in the equation. Therefore, after the R^2 is adjusted, the total variation is 60.5%. Additionally, the model's fitness was evaluated using F-statistics, which indicates that the model is statistically fit at 1% level of significance. Also, the Durbin Watson test shows that serial correlation is absent, as indicated by the test statistics of 2.27, which is within the threshold.

From the econometric analysis in table 6, The ECM term corresponds to the *apriori* expectation. The ECM's negative sign and statistical significance of 1% indicate that 17.2% of the adjustment will be done quarterly. As a result, the ECM will behave appropriately to correct any short-run dynamics deviations to the long-run equilibrium by 17.2% quarterly.

Table 7: Diagnostic Tests

Test	F-statistics	P-value
Serial Correlation	0.666629	0.5179
Heteroskedasticity	0.465714	0.4975

Eviews output (2023)

The study residuals were subjected to a variety of diagnostic tests. The residuals were tested for serial correlation using Breush-Godfrey serial correlation LM test (See table 7). Findings indicated that there was no serial correlation. Lastly, the study tested for Heteroskedasticity using Autoregressive Conditional Heteroskedasticity (ARCH) (See table 7), and findings indicated that the residuals were not heteroskedastic (i.e., there were homoskedastic). This is important because ignoring the impact of heteroskedasticity on time series residuals can negatively affect the estimators.

Discussions of Findings

The empirical result shows that a one-year lag of NPL positively affects financial stability in Nigeria at a 5% significant level. Similarly, FDI as a percentage of GDP positively and significantly affects Nigeria's financial stability, which is evident at 5% level of significance. On the basis of this result, the null hypothesis is rejected. This finding implies that a unit increase in FDI as a percentage of GDP increases financial stability by 0.59 unit *cetris paribus*.

Also, the one-year lag of FDI as a percentage of GDP was negative but statistically significant at 5%. These findings align with the studies of Milesi-Ferretti and Tille (2011) and Dornean et al. (2012), and Ebire et al. (2021) who found a significant positive relationship between inward FDI and financial stability.

The result shows a significant negative effect of FDI as a percentage of fixed investment on financial stability in Nigeria at 5% level of significance. As a result, the null hypothesis is rejected. Implying that a unit increase in FDI as a percentage of fixed investment results in 0.43 unit decrease in financial stability in Nigeria *cetris paribus*. On the other hand, an increase in the one-year lag of FDI as a percentage of fixed investment positively affects Nigeria's financial stability. This study corroborates Bhowmik (2018) findings which found that FDI negatively affects financial stability.

The analysis shows that net FDI negatively affects financial stability in Nigeria at a 5% level of significance. The implication for this finding is that an increase in net FDI decreases financial stability by 2.99 units *cetris paribus*.

5. Conclusion and recommendation

This study examines the effect of FDI on Nigeria's financial stability between the first quarter of 2003 to the last quarter of 2019. An econometric model was specified using ECM method to ascertain the independent variables' effect on the dependent variables. The variables were first tested for stationarity, using ADF and the analysis revealed that all variables were integrated in the order of 1, that is I(1). This influenced the decision to conduct cointegration analysis to ascertain the long-run relationship between the variables, which revealed a long-run relationship. The ECM test confirmed that long-term equilibrium speed was achieved with a quarterly adjustment of 17.3%. The hypothesis testing results revealed that one year lag of financial stability positively affects the financial stability in Nigeria. Also, FDI as a percentage of GDP positively affects financial stability in Nigeria. However, the one-year lag of FDI as a percentage of GDP negatively affects financial stability in Nigeria. FDI as a percentage of fixed investment and net FDI negatively affect financial stability. Based on these findings, the study concludes that FDI significantly affects financial stability in Nigeria. Based on the findings, the following recommendations are given:

i. FDI was found to increase financial stability in Nigeria. Therefore, the Ministry responsible for trade, commerce and investment needs to create an enabling investment environment, such as regulations protecting investors' interest to attract FDI into the system.

ii. An increase in FDI as a percentage of fixed investment leads to the expansion of economic activities, but if not properly managed, it can affect the financial system. Therefore, Federal and state tiers of government in Nigeria should guarantee long-term investment to attract and secure investment into the state and country at large.

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