The Effect of Financial Sector Development on the Nigeria's External Sector, 1986-2012

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Abstract

One of the basic macroeconomic objectives of any nation is to maintain external balance. This requires that the nation's export would at least equal and at best be positive. The drives towards this objective are to be led by the financial sector. It is on the basis of this that this research work is situated within the theoretical framework of the supply leading hypothesis. The work adopts the 3 stage least square to estimate the 5 equations of the external sector in investigating the effect of Nigeria's financial sector development on the external sector. The work finds out that financial sector variable has serious impact (both positive and negative) on the dependent variables but at different significant levels. For example, for FDI, only MCAP was statistically significant but for IMPK only ROT was not significant of all the financial variables used. All the variables have a robust goodness of fit as none of the R adjusted is less than 88%. The simulation results showed that shocks in the financial markets would create disturbance in the external sector. The paper therefore recommends that exchange rate and interest rate should not be absolutely left to be determined by the free forces of demand and supply. Alternative trade agreements with other countries using other international currencies than Dollar would help strengthen Naira against Dollar rather than further devaluing Naira. When these are done, it is expected that the long desired external balance would be achieved/close by.

Keywords: Financial Sector Development,External Sector, Import of Non-capital, Import of Capital, Export of Non-Petroluem, Export of Petroleum, Capital Balance, Foreign Direct Investment, Net Export, Import, Export, and Simulations.

INTRODUCTION

Modern economies are opened at varying degrees. This is because no economy is an island on its own. The basis for external trade are hinged on differences in natural resources endowment, differences in geography, costs and efficiency of labour, specialization, etc. Thus there is the need to engage in external trade with other countries. Therefore it is clear that the dynamics of trade and its consequences on the economic development of any country cannot be over-emphasized. For example Nigeria produces mainly primary goods for exports and imports both consumer goods and intermediate goods which constitute inputs into the domestically produced goods.

Statistics showed that Nigeria's export of primary products is dominated by crude oil. The value of petroleum exports was N8920.6billion while that of non petroleum export was N552.1billion and the total exports of both petroleum and none-petroleum products was N9472.7billion in 1986. In 2006he these figures rose to N7324681billion, N133595 and N7458276billion for petroleum exports, non-petroleum exports and the total, respectively. By 2012 the crude oil export further increased to N14526757 billion while that of non-petroleum increased to N476110 billion and the total came to N15002867.7billion (CBN 2013).

On the other hand the total import of the country was dominated by import of capital goods and non-capital goods. In 1986 total imports of capital and non capital goods was

N19537 billion which increased to N3533810.6 billion in 2006 and by 2012, the figure rose to N9426140 billion.

Generally, it is expected that both imports and exports would have been about equal but in some years especially most recently, there have been important swings. The huge excess of imports over exports in the mid and late 1980s which spanned through the years till now, is a subject of great concern to especially less developed countries including Nigeria.

The quantity of goods and services flowing into and out of Nigeria is not the only dimension of external trade. How much that has to be paid for imports and how much we get for our exports also matter. In this respect, the nominal or naira flows and foreign exchange flows are important in foreign trade.

From the foregoing it can be pointed out that Nigeria experience of adverse external trade payment cannot be hidden. This is more so, where the terms of trade at the international market have not been favourable to her in the face of the fall in the price of international market for crude oil. In addition to that is the dwindling value of Naira at foreign exchange market. Persistent adverse balance of payment could result to external borrowing. Between 1994 and 2004, external debt as a percentage of GDP varied between 80.7% in 1999 and 42.9% in 2004. The figures for 2006 and 2007 were 2.4% and 1.9% respectively. This sharp decline however was as a result of liquidation of Paris club debt. However of recent president Buhari is agitating for external

borrowing. However, the nation's balance of payment became stable while its external reserves soared to $51.335 million in 2007 and further rose to $60.5million in 2008. By 2012, Nigeria's foreign reserve stood at about $199million. This was due mainly to steep upward movement of international oil price but one must quickly add that no sooner than later, the price of crude oil began to fall.. Nevertheless, the naira external value dropped sharply as a dollar officially exchanged for N148.9 while the parallel market rate was about N176 in 2009. By 2012, Naira further depreciated to N157.3 to a dollar. Since then, the value of Naira has been plummeting. These, of course have serious implication for the country's balance of payment and trade. Thus, the dynamics in the financial sector has serious implications for external trade and external trade payments. Therefore, this paper sets out to investigate the effect of financial sector development on the external sector of Nigeria.

The paper is divided into five sections. The preceding section discussed introduction while the second section discusses literature review and theoretical nexus. Section three contains methodology while section four discusses empirical results. Section five gives the summary conclusion and recommendations.

LITERATURE REVIEW AND THEORETICAL NEXUS

There are lots of time series studies conducted on the impact of external trade and growth both internationally (Severn, 1986; Voivodas, 1973; Ram, 1985; Rajapatiran, 2007) and in Nigeria (Hensly, 1971; Fajana, 1979; Oyejide, 1986; Egwakhide, 1989; Ekpo and Egwakhide, 1994; Odusola and Akinlo, 1995; Chete, 2004; Ajakaiye, 2005; Soyinbe, 2005;). Most of these papers made use of the Granger causality methods to assess the impact of trade variables on growth. However Adama (2014), made use of ordinary least square method to examine the effectiveness of trade and exchange rate policies for macroeconomic adjustmen and their impact on the economic performance of Nigeria. Most of these papers concentrated on the foreign exchange market and external trades at the neglect of other financial markets such as money and capital markets. Theory posited that money market instruments such as rate of interest as well as development in the capital market would affect external trade.

In order to correct for the methodological weaknesses inherent in the previous studies as well as the narrow concentration on the foreign exchange market as the only financial markets of importance, this work adopts the supply leading hypothesis rather than the demand leading hypothesis, as the theoretical foundation using the 3 Stage least square method to assess the impact of financial sector development on the external sector of Nigeria.

The demand following hypothesis believes that it is the real sector that drives the financial sector. To them, real sector growth and stability would lead to increase in the demand for financial services which in turn promotes the creation of stability in the financial sector (Nwani 1973, Gurley and Shaw 1976; Rogerst etal 2005). According to Mohammed (2004) the demand following hypothesis would result in; Increasing advantages to the colonial powers as it solidifies the competitive advantage of foreign entrepreneurs; A conservation form of financial development that slows down the pace of economic development; And discrimination against borrowers in all sectors which may lead to the development of monopoly trade.

On the other hand, the supply leading hypothesis believes that it is the development in the financial sector that induces real sector growth and stability. This is achieved by mobilizing savings, evaluation of projects, risk management, management control and financial institutions. It transfer resources from the traditional sector to the modern sector and also ensures the flow of financial resources between the domestic and external sectors of the economy. This role played by the financial sector at the initial stage of development constitutes the major channels through which economic activities take place.

Both Nwani (1973) and Mohammed (2004) identified the following roles that the financial sector plays; there would be an increase in both the monetization of the economy and the deepening of the money civilization process; Aiding of economic development plans by channeling investible funds to areas of priorities; Enabling a nation to break the chains of total external control; and promotion of fair and greater competition. These are the reasons why Nigeria embarked on the liberalization of the financial sector in 1986. Thus, the supply leading hypothesis provides an explanation to the policy direction of Nigeria since the deregulation exercise of the financial sector in 1986.

MODEL SPECIFICATION

For model specification of the External sector block, it has been argued that the connection between the production block and aggregate demand block ensures that the growth of the external sector (i.e positive net export) is accompanied by an increase in investment, an increase in greater utilization of productive capacity, an increase in employment, exploitations of scale and technological improvements. These are just direct effects of for example, export expansion on the rate of output growth (Wadinga 2011).

The above suggests that the aggregate performance of the macro variables due togeneral increase in incomes is associated with the initial rise in exports. This made Maizels (1968) to argue that the marginal

propensity to save (mps) in the export sector would be larger than elsewhere in which case the increase in aggregate savings is magnified. Increase in savings translates to increase in investment in physical and human capital hence increase in the rate of economic growth.

Maizel (1968) also argued that direct foreign investment (DFI) and foreign loans may be stimulated by the expansion of the export sector since investment and lending decisions take into consideration the repayment ability of the country out of her export earnings.

In the same vein, export provides the necessary foreign exchange for importation of capital goods and raw materials for which there are no appropriate domestic substitutes. Thus greater export performance generally is linked with better growth performance (Kruger 1978 and Balassa 1978).

Another factor considered to affect net export is interest rate. Net export is believed to depend negatively on the interest rates. When the Nigerian interest rate is higher than interest rates of other countries, it becomes attractive for people in those countries to put their funds in Naira-i.e, to lend funds to businesses in Nigeria and to the Nigerian Government. By the same way, it becomes less attractive for Nigerians to put their funds in other currencies-i.e, to lend overseas, where returns are lower. This means that Naira becomes more attractive, and this drives up the price of Naira-that is, the exchange rate rises. But a higher exchange rate makes Nigeria goods more expensive to foreigners and it also makes foreign goods less expensive to Nigeria residents. Less expensive foreign goods will make Nigeria imports rise.

Similarly, more expensive Nigeria goods will make Nigeria export fall. On both accounts net exports (EXP-IMP) fall when Nigeria interest rate rises because the exchange rate rises.

On the other hand, the International Standard Trade classification of import includes raw materials, capital goods, foods and others as imports. Import is therefore directly related to domestic credit level which is determined by interest rate, GDP, Exchange rate, foreign reserves and capital balance.

Export function is broken down into oil and non-oil. Thus the model is specified as below;

$$NEX = EXP - IMP\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots..\ldots1$$

Where
NEX= Net Export
EXP = Total Export
IMP = Total Import

$$EXP = XNP + XPET + FDI \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots..\ldots2$$

Where, EXP = Total Export
XNP = Export of Non-Petroleum products
XPET = Total export of Petroleum Products
FDI = Total Foreign Capital Inflow proxied by foreign direct investment

$$IMP = IMPK + IMPNK + KBAL \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots.\ldots\ldots\ldots3$$

Where, IMP = Total Import
IMPK = Total Import of Capital Goods
IMPNK = Total Import of Non-Capital Goods
KBAL = Capital Balance (a proxy for Balance of payment position).
Since EXP = Export of petroleum products and is exogenously determined by OPEC,
Equation 2 was disaggregated as below;

$$XNP = C_1 + C_2 ROT + C_3 MS + C_4 EXR + C_5 XNP_{t-1}\ C_6 GDP + U_t \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots4$$

Where
XNP = Export of Non-Petroleum Products
ROT = Rate of Interest
MS= Money supply
EXR = Exchange Rate
XNP_{t-1}= Lagged values of Export of Non-petroleum products
GDP = Gross Domestic Products

$$FDI = C_7 + C_8 EXR + C_9 ROT + C_{10} MCAP + C_{11} GPL_t + C_{12} GDP + U_t \ldots\ldots\ldots\ldots\ldots.5$$

Where
FDI = Foreign Capital Inflow proxied by foreign direct investment
EXR = Exchange Rate
ROT = Rate of Interest
MCAP = Market Capitalization
GPL_t = Current General Price level
GDP = Gross Domestic Product
Note; The reason for the inclusion of MCAP is hinged on the fact it indicates strong stock market and the safety of the foreign direct investment.

$$IMPK = C_{13} + C_{14} ROT + C_{15} MS + C_{16} EXR + C_{17} FRS + C_{18} IMPK_{t-1} + C_{19} GDP + U_t \ldots\ldots\ldots6$$

Where;

IMPK = Import of Capital Goods

ROT = Rate of Interest

MS = Money supply

EXR = Exchange Rate

FRS= Foreign reserve

$IMPK_{t-1}$= Lagged values of Import of Capital goods

GDP = Gross Domestic Product

$$IMPNK = C_{20} + C_{21}ROT + C_{22}MS + C_{23}EXR + C_{24}FRS + C_{25}GDP + C_{26}IMPNK_{t-1} + U_t \ldots\ldots\ldots 7$$

Where;

IMPNK = Import of Non- capital Goods

ROT = Rate of Interest

Ms = Money Supply

EXR = Echange Rate

FRS = Foreign Reserve

GDP = Gross Domestic Product

$IMPNK_{t-1}$= Lagged values of Import of Non-capital Goods

Capital balance which is a proxy balance of payment equation thus becomes

$$KBAL = C_{27} + C_{28}ROT + C_{29}MS + C_{30}EXR + C_{31}FRS + C_{32}XNP + C_{33}XPET + C_{34}KBAL_{t-1} + U_t \ ..8$$

Where;

KBAL = Capital Balance which is a proxy for balance of payment

ROT = Rate of Interest

MS = Money supply

EXR = Exchange Rate

FRS = Foreign Reserve

XNP = Export of Non-petroleum Products

XPET = Export of Petroleum Products

$KBAL_{t-1}$ = Lagged values of capital balance

Equations 4 to 8 become the 5 equations of estimate using the three stage least square method (3SLS).

EMPIRICAL RESULTS

The results of the external sector block are presented in table 1. The block consists of five equations: the export of non-petroleum (XNP), capital inflow (FDI), import of capital (IMPK), import of non-capital (IMPNK) and capital balance (KBAL) equations.

All of the financial policy variables are correctly signed for equation 4 export of non-petroleum products (XNP). Their coefficients were high with the exception of MS, The low coefficient of MS is predicated on the fact that large chunk of the MS is stacked in treasury bills due to increase in confidence in the instrument because it is less risky. Government on the other hand has delayed in the implementation of her budget especially in the non-oil sector. However it is only money supply that is statistically significant. The overall fit of the equation showed that about 98% of the variation in XNP is explained by the independent variables.

Table 1 Empirical Results for External Sector Equations

$XNP = 1722.13 - 558.60ROT + 0.02MS + 40.95EXR + 0.52XNP_{t-1} +$

Pr   (0.97)   (0.62)   (0.0009)   (0.82)   (0.0001)

$0.03 GDP$……………………………………………………………………4

(0.76)

$R^2 = 0.98$

$Ř^2 = 0.97$

$FDI = 22463.98 + 280.61EXR - 1916.4ROT + 15.84MCAP + 1134.50GPL +$

Pr   (0.69)   (0.37)   (0.30)   (0.0000)   (0.004)

$0.092GDP$…………………………………………………………………..5

(0.67)

$R^2 = 0.95$

$Ř^2 = 0.93$

$IMPK = 546774.7 + 6431.08ROT + 0.18MS - 13726.85EXR + 0.81FRS + 0.44IMPK_{t-1} -$

Pr   (0.71)   (0.85)   (0.05)   (0.02)   (0.0000)   (0.0000)

$1.06GDP$…………………………………………………………………6

(0.8)

$R^2 = 0.93$

$Ř^2 = 0.91$

$IMPNK = -32265.30 + 318.89ROT + 0.38MS + 12235.61EXR + 0.81FRS + 0.71GDP$

pr (-0.97)   (1.00)   (0.0000)   (0.004)   (0.0000)   (0.79)

$0.038MPNK_{t-1}$ ………………………………………………………7

(0.48)

$R^2 = 0.88$

$Ř^2 = 0.84$

$KBAL = 261592.1 - 11572.89ROT + 0.45MS - 1652.85EXR + 0.99FRS + 9.49XNP -$

Pr   (0.31)   (0.40)   (0.0000)   (0.36)   (0.008)   (0.007)

$0.77XPET + 0.08KBAL_{t-1}$…………………………………………………8

(0.0000)   (0.29)

$R^2 = 0.88$

$Ř^2 = 0.83$

For equation 5 foreign direct investment (FDI), all the financial variable were equally correctly signed with high coefficients but it is only market capitalization (MCAP) that is statistically significant among the financial variables. The high coefficient of EXR shows that depreciation attracts foreign direct investment as it creates overall advantage for them in terms of prosperity. The overall fit showed that about 95% variation in FDI is explained by the variation in the independent variables.

Most of the financial variables in equation 6 import of capital goods (IMPK) were correctly signed with high coefficients. Only MS had a low coefficient. This is because even when MS is high, people may not spend it on importation of capital but on import of non capital goods since Nigerians consumption pattern is import oriented. Thus, this erodes away the size of the coefficient of MS in determining IMPK. All the financial variables' impact on IMPK was statistically significant with the exception of ROT. High interest rates did not actually attracts importation of real capital but rather financial capital which are stacked in treasury bills because it is seen as a less risky venture for the would be investors. Thus the impact is not significant. The overall fit showed that about 93% of the variation in the dependent variable (IMPK) is explained by the variations in the independent variables.

Equations 7 and 8 are import of non capital (IMPNK) and capital balance (KBAL) respectively. For IMPNK, only money supply was correctly signed. ROT and EXR were incorrectly signed. This is because for one thing the Nigerian economy is import consumption oriented. So, even when interest rate is high, consumers will still go ahead borrowing to satisfy their import appetite. Also when EXR depreciates, it is expected that importation would become dearer and domestic consumption would be encouraged but the psychology of an average Nigerian is tailored towards consumption of imported goods. These explained why the increase in both ROT and EXR would make IMPNK to rise the coefficients of MS and FRS are low. The fits of the model is tight and showed that about 88% of the change in dependent variable is explained within the model. For the capital balance equation (KBAL), most of the financial variables were correctly signed. However MS and FRS are of low coefficients while ROT and EXR are of high coefficients. Of statistical significance amongst the financial variables are EXR and FRS. The overall fit showed that about 88% of the variation in KBAL is explained by the model. The probability values are generally insignificant because out of the 29 explanatory variables used in the block, only 14 are statistically significant. Of note here are the financial sector development variables which include MS, MCAP, EXR and FRS. It is interesting to note that Exchange rate effect on capital balance was not

significant. This is because theory posits a direct link between devaluation (EXR) and correction of balance of payment deficit suggesting that the balance of payment impact of devaluation is not through the current account. This explains the definition of balance of payments simply as EXP-IMP as in Sodersten (1980). Of most significant is the MS effect on KBAL. This is because a deficit in balance of payments leads to a decrease in foreign assets holdings (which is the foreign exchange holdings of the Central Bank -CBN, and the Deposit Money Banks -DMBs, after netting out the claims of foreigners) and ultimately, the money stock while a surplus in balance of payments leads to an increase in net foreign asset and money stock. This explained why FRS was positively signed and equally statistically significant.

Simulation Results

The baseline simulations results are hereby presented in table 2 following while discussion follows immediately;

TABLE :2.   Simulation Experiments and Results for the Money market

A	MONEY MARKET	
S/NO	EXPERIMENTS	RESULTS
1	A decrease in Money Supply (MS) by 10%	XNP will decrease by 2.11% FDI will decrease by 9.26% IMPK will decrease by 1873.21% IMPNK will increase by 3.84% KBAL will increase by 35.66%
2	An increase in Money Supply (MS) by 10%	XNP will increase by 0.48% FDI will increase by 0.24% IMPK will decrease by 1.26% IMPNK will reduce by 0.17% KBAL will increase by 8.94%

B	MONEY MARKET CONTINUATION	
S/NO	EXPERIMENTS	RESULTS
3	Decrease in Rate of Interest (ROT) by 10%	XNP will decrease by 0.48% FDI will increase by 0.01% IMPK will increase by 6.71% IMPNK will decrease by 0.14% KBAL will decrease by 0.14% GPL will decrease by 0.47%
4	An increase in Rate of Interest (ROT) by 10%	XNP will increase by 0.48% FDI will decrease by 0.01% IMPK will decrease by 0.72% IMPNK will increase by 0.14% KBAL will increase by 0.14%

C	CAPITAL MARKET	
S/NO	EXPERIMENTS	RESULTS
5	A Decrease in Market Capitalization (MCAP) by 10%	XNP will reduce by 0.28% FDI will decrease by 0.43% IMPK will increase by 4.51% IMPNK will decrease by 2.00% KBAL will decrease by 1.52%
6	An increase in Market Capitalization (MCAP) by 10%	XNP will increase by 0.28% FDI will increase by 0.43% IMPK will reduce by 8.23% IMPNK will increase by 2.50% KBAL will improve by 1.52%

C	FOREIGN EXCHANGE MARKET	
S/NO	EXPERIMENTS	RESULTS
7	Decrease in Exchange Rate (EXR) by 10%	XNP will increase by 0.03% FDI will increase by 1.27% IMPK will reduce by 0.96% IMPNK will increase by 1.59% KBAL will improve by 1.35%
8	An increase in Exchange rate (EXR) by 10%	XNP will increase by 0.48% FDI will decrease by 0.01% IMPK will reduce by 0.72% IMPNK will increase by 0.14% KBAL will improve by 0.14%

Source: Computed as Baseline Simulation Experiments

Discussion of the Baseline Simulation Results
This study examined how the instability in the money, capital and foreign exchange markets affect the selected external sector variables and found the following:

Money Market
The study shows that with the contractionary monetary policy of reducing money supply, import of non-capital goods increased while foreign direct investment, export of non-petroleum products and import of non-capital goods were reduced.

When money supply was increased, only foreign direct investment, capital balance and export of non-petroleum products increased while all other endogenous variables such as import of capital and non-capital goods reduced.

With the reduction in interest rate, foreign direct investment and import of capital goods increased while export of non-petroleum products, import of non-capital goods and capital balance reduced.

When interest rate was increased by 10%, import of non-capital goods, capital balance and export of non-petroleum products were all increased but it has dampened effects on foreign direct investment and import of capital goods. These implied that financial shocks from the money market had effects on selected external sector variables.

Capital Market
This study found out that the capital market played a key role in long term investment in Nigeria up till 2007. The increased awareness by the public and the privatization programme of the Federal government coupled with the raising of public bonds by the three tiers of government at the market expanded the activities of the market. The domestic bond market catered for public and private bonds. The market allows the public sector to place non-inflationary government debt instruments. It also provides the baseline for assessing credit worthiness and interest rates, thereby facilitating rational pricing of private debt issues. In this regards, a liquid public bond market is essential for the development of a private bond market. In Nigeria, the private bond market is not very active while the relative level of transaction in public bond market, comprising mainly development stocks issued by the Federal, State and Local Governments are low. It was found that the cost of going public, raising additional equity from the capital market was very high. Such costs were brokerage fees, stamp duties and other charges imposed by the stock brokers and Security Exchange Commission (SEC). Also, the fraudulent declaration of profit and sharp practices by companies made the public to lose confidence in the private market. Finally, the market could not attract much foreign investors needed for the economyto grow and expand. Therefore, the global economic meltdown and the poor performance of the national economy made the market vulnerable to both domestic and international shocks. This was why the decrease in market capitalization led to the increase only in import of capital while other selected external sector variables reduced.

When market capitalization was increased by 10%, the results showed that foreign direct investment, import of non-capital goods, capital balance and export of non-petroleum products increased while only import of capital goods reduced. These implied that financial shocks from the capital market had effects on the selected external sector variables in Nigeria.

Foreign Exchange Market
This study found that exchange rate was an important price variable in the economy which has contributed significantly to attainment of macroeconomic instability. The Nigerian's experience in exchange rate management was mixed in terms of regimes and effectiveness. Various exchange rate systems (regimes) existed. They included adjustable peg system, the crawling peg system, and managed floating system before a market-determined exchange rate system emerged as the only efficient way of allocating foreign exchange resources. The major problem in the market include supplying constraints, the skewness of supply with CBN dominating the market, a high demand structure and speculative activities of the market operators. With a decrease in exchange rate, all the selected macroeconomic variables increased with the exception of capacity utilization rate, general price level and import of capital goods.

When foreign exchange rate was increased by 10%, import of non-capital goods, capital balance and export of non-petroleum products increased while foreign direct investment and import of capital goods, reduced. These implied that financial shocks from the foreign exchange market had effects on the selected external sector variables.

With the outcome of the policy simulation exercise, it is imperative that some measures of controlled be pursued on money supply, interest rate and exchange rate. These imply that the Federal government should not print or release money into the economy as she likes. It called for fiscal discipline on the part of the government. Also the Federal government should intervene in the determination of interest rate and exchange rates when necessary and should not be left completely to the forces of the market.

SUMMARY, RECCOMENDATIONS AND CONCLUSION

This paper investigates the impact of the development in the Nigerian financial sector on the external sector of the economy. The paper recognized the importance role that is played by the three major financial markets; money, capital and the foreign exchange market. The paper finds out that;-

Money supply (MS) and exchange rate (EXR) are the only financial variable that positively impacted upon export of non-petroleum product (XNP) for the period under study. However, it is only MS that was statistically significant.

Exchange rate (EXR) and market capitalization (MCAP) had positive relationship with capital inflow (FDI) over the period under study. However, it is MCAP that was statistically significant.

Rate of interest (ROT), Money supply (MS) and foreign reserve (FRS) had positive relationship with import of capital goods (IMPK) over the period of study. However it was only FRS that was statistically significant.

Rate of interest and (ROT) and money supply (MS) had negative impact on import of non-capital goods (IMPNK) from 1986 to 2012. However only rate of interest (ROT) that was not statistically significant.

Money supply (MS) and foreign reserve (FRS) had positive impact on capital balance (KBAL) between the period 1986 and 2012 and they were both statistically significant.

The simulation experiments show that a contractionary monetary policy, that is 10% decrease in money supply, interest rates and exchange rate produced the following results.

The results under scenario 1 show that there was moderate increase in most of the external sector variables. Substantial increase was noticed in import of capital goods and capital balance but the results under scenario 2 show that only capital balance substantially increased as a result of the expansionary monetary policy through increase in money supply.

The results under scenario 3 show that there was moderate increase in most of the endogenous variables with import of capital good leading while the results under scenario 4 show that there was a moderate increase in the endogenous variables.

The results under scenario 5 show that there was minimal increase in some of the selected external sector variables with import of capital leading while the results of scenarios 6 showed that most of the selected endogenous variables increased moderately.

The results of scenario 7 showed that the selected endogenous variables increased moderately while the results of scenario 8 showed that most of the variables increased minimally.

From the findings in this study, it was concluded that financial markets had both positive and negative effects on the external sector of the economy. Nigeria underwent so many reforms and this brought in many developments in the financial sector. The development in the financial sector is very essential for the realization of the nation's macroeconomic objectives. The results of the analyses of this study show that in spite of the challenges in the Nigerian financial sector, the sector made significant positive impacts on the economy. With the goodness of fits for all the models, it was concluded that developments in the financial sector were strong determinants of the external sector variables in Nigeria.

However it was difficult to establish which of the three financial markets, namely, the money market, the capital market and the foreign exchange market had the greatest impact on the external sector variables in Nigeria.

In light of the foregoing findings, the following policy measures are hereby recommended if there must be improvements in the external sector performance of the nation.

The paper points out that the complete deregulation of the interest rate is not appropriate. The guided deregulation of interest rate by the Central Bank should be continued through the manipulation of the minimum discount rate.

Furthermore the foreign exchange conditions that would make naira appreciate should be put in place. The total subjection of the foreign exchange determination of naira to the dictates of the market should be looked into. Government should intervene when necessary and abstain when the market improves thus there should be guided deregulation of the foreign exchange market. This will help in improving the gross fixed capital formation of the economy as well as foreign direct investment and balance of payment situation of the country.

This is because devaluation or depreciation of Naira has serious implications for an import dependent economy like Nigeria. Depreciation was found to lead to an imported inflation as it raised the cost of imported inputs needed for the domestic economy. Thus foreign exchange management should therefore not be absolutely left to the whims and caprices of the forces of the market but requires intervention when it is necessary.

Alternatively, government should seek bilateral trade agreement and economic agreement with other countries than America which constitute the major trading pattern of Nigeria. This type of agreement should be the one that would facilitate the use of other international currency directly to reduce the demand for dollars in Nigeria which has been the major problem against the appreciation of Naira.

Also activities in the capital market should be encouraged. This could be done by reducing the cost of

going public and the sharp practices by some companies especially banks which eroded the confidence of the public in the market should be addressed. When these are done activities in the capital market would rise and foreign direct investment would improve.

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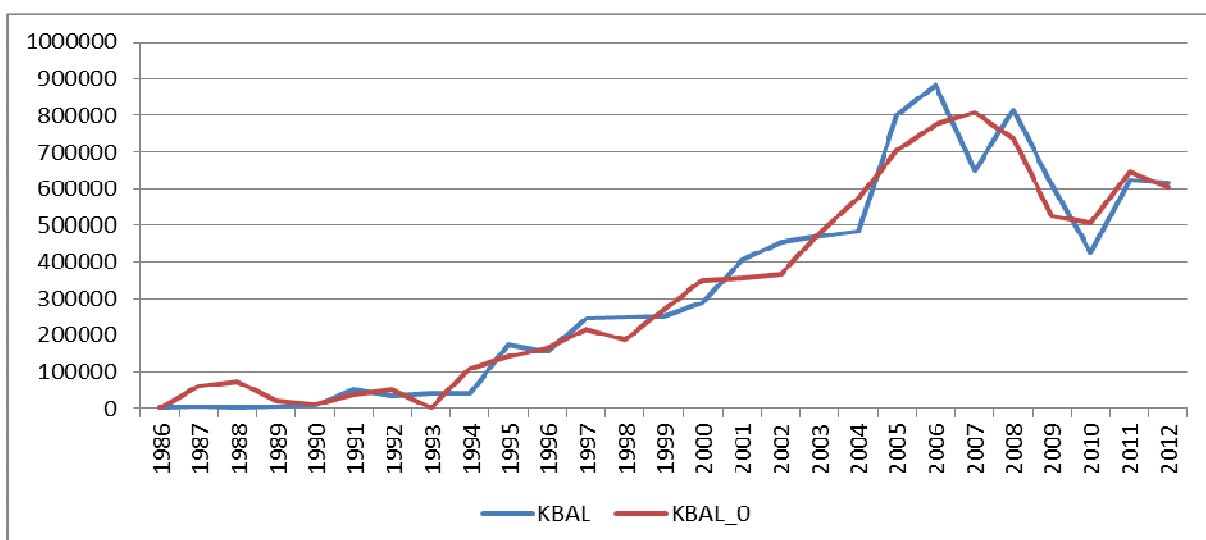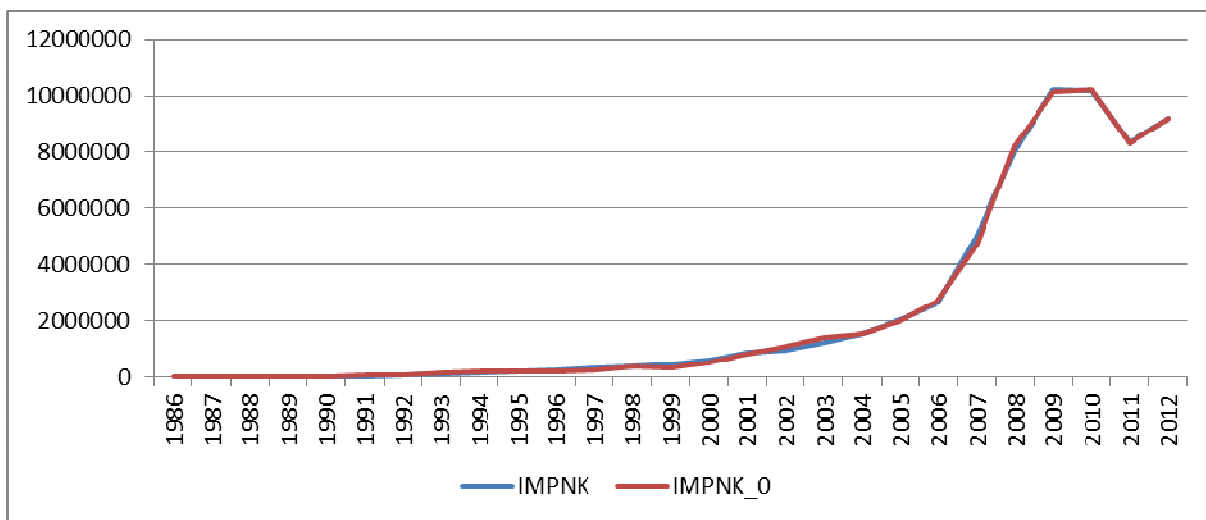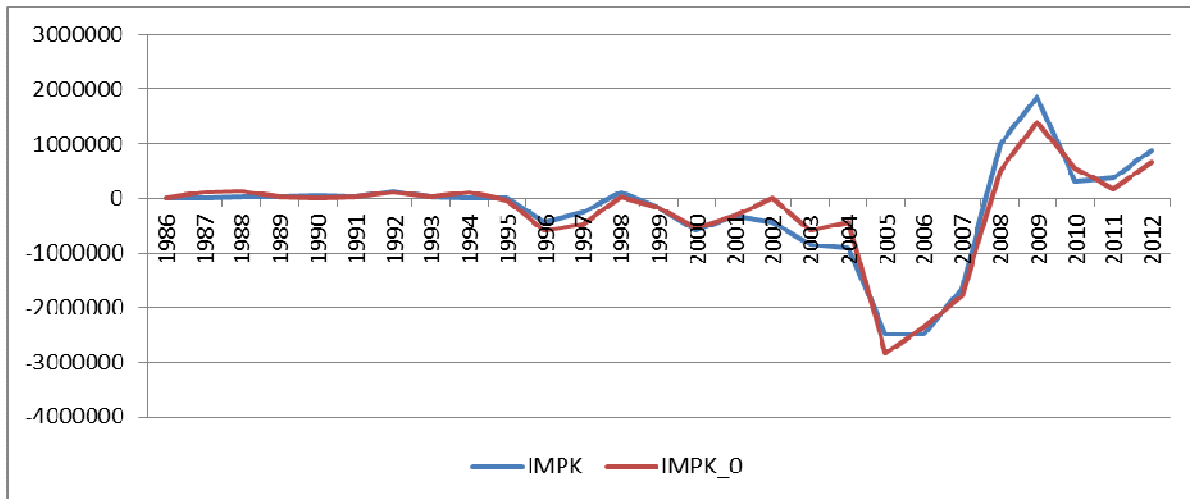
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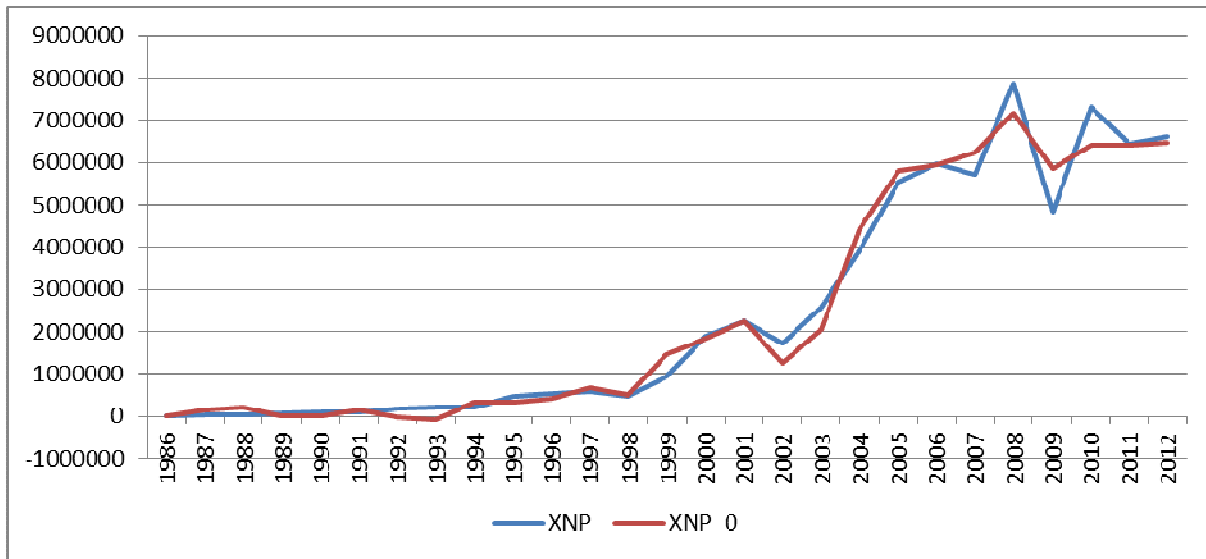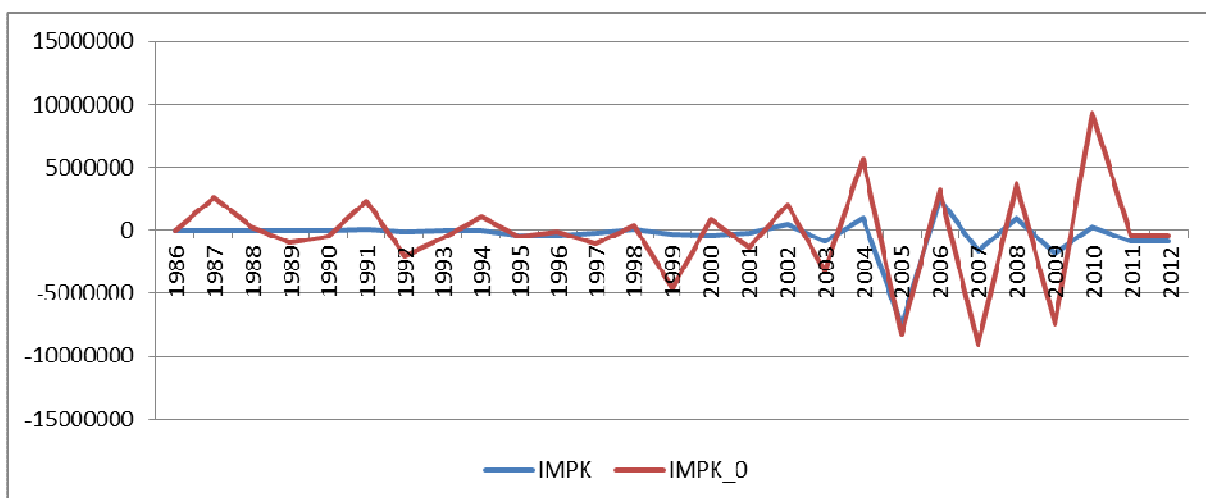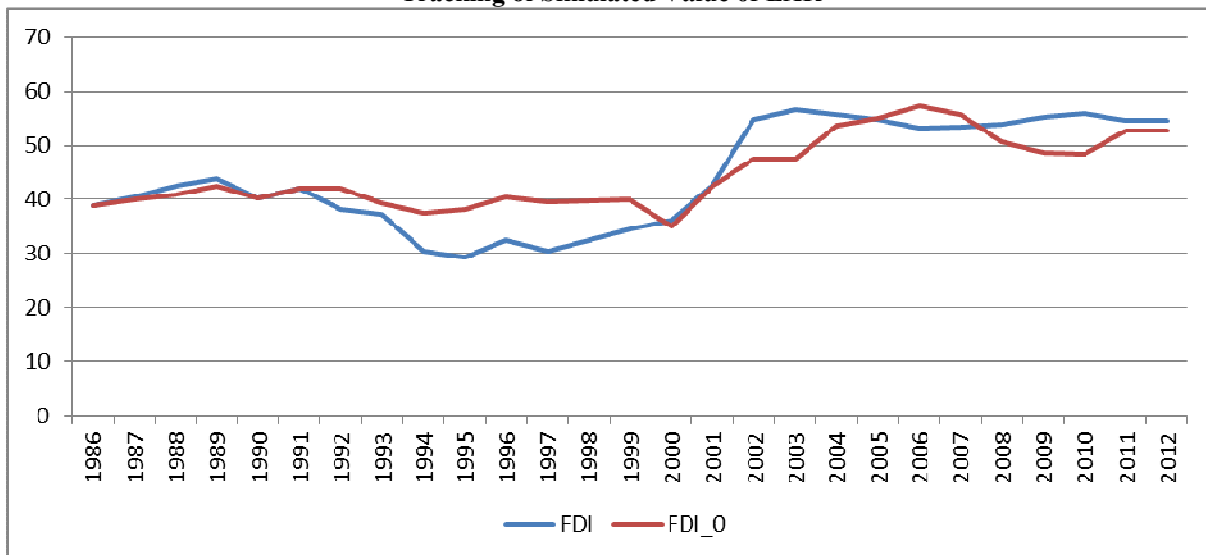## TRACKING OF ACTUAL AND SIMULATED VALUES
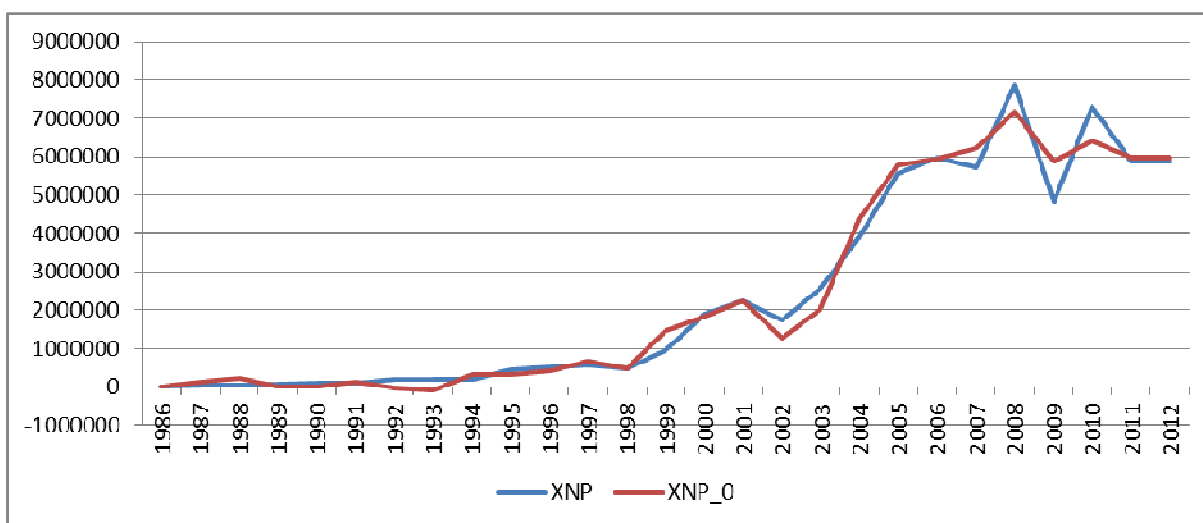### Tracking of Simulated Values of Money supply
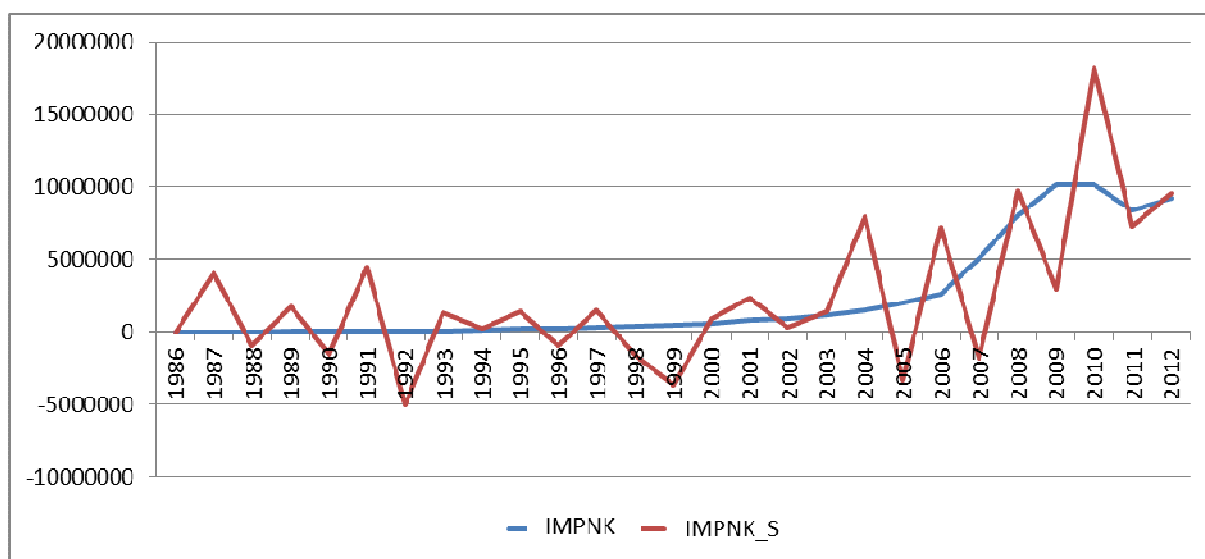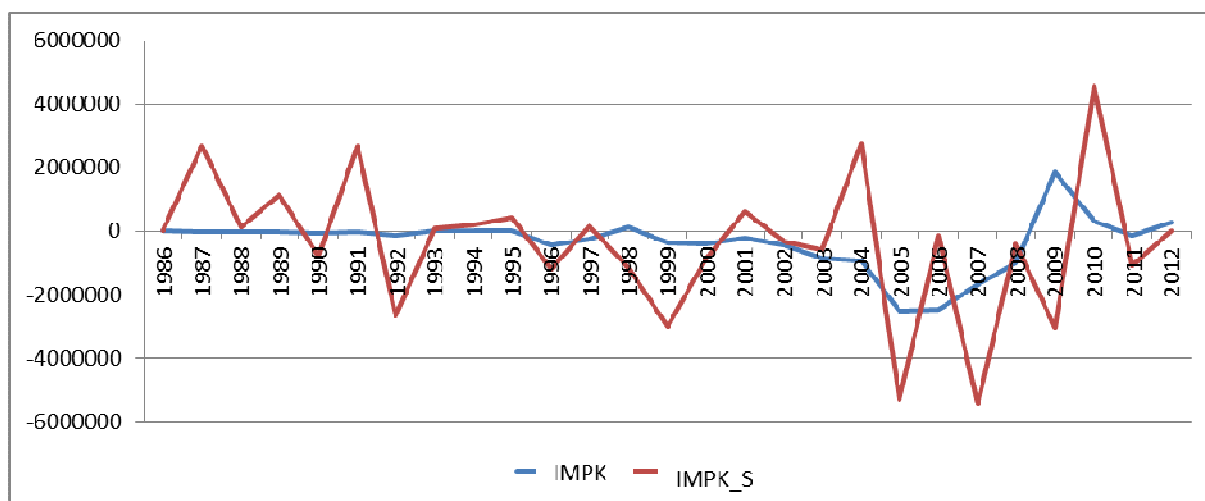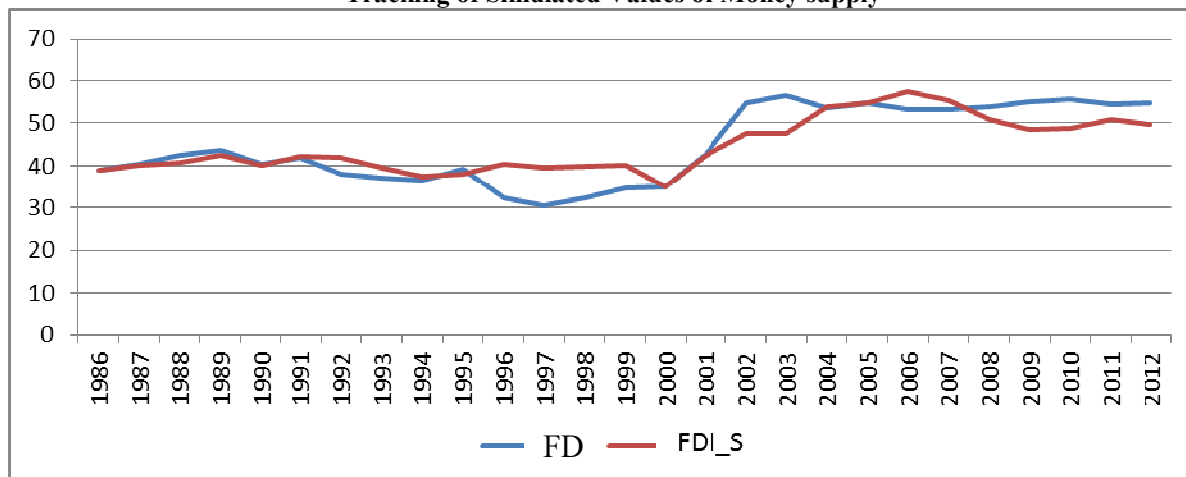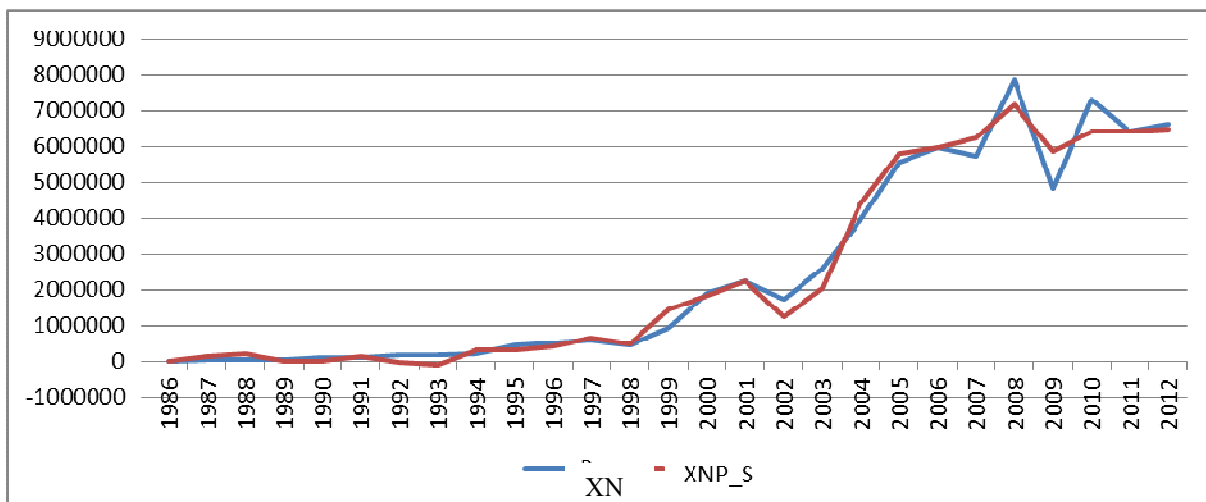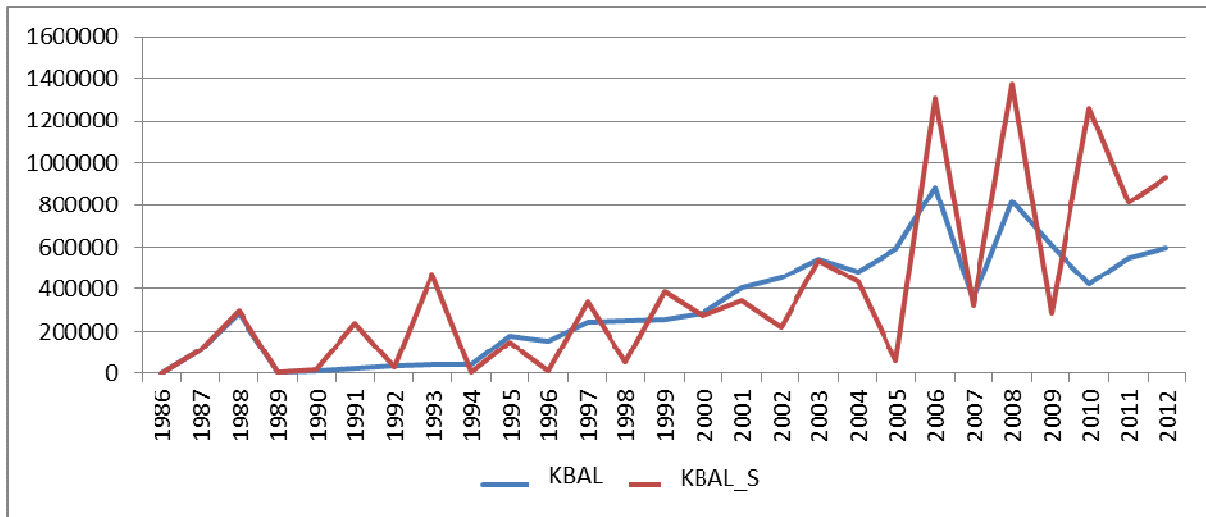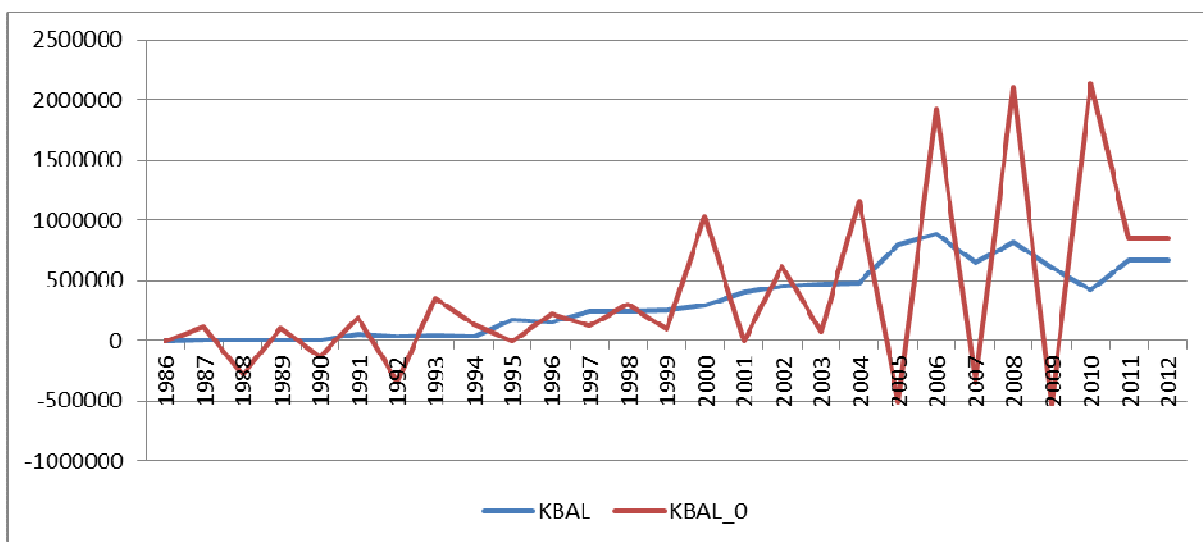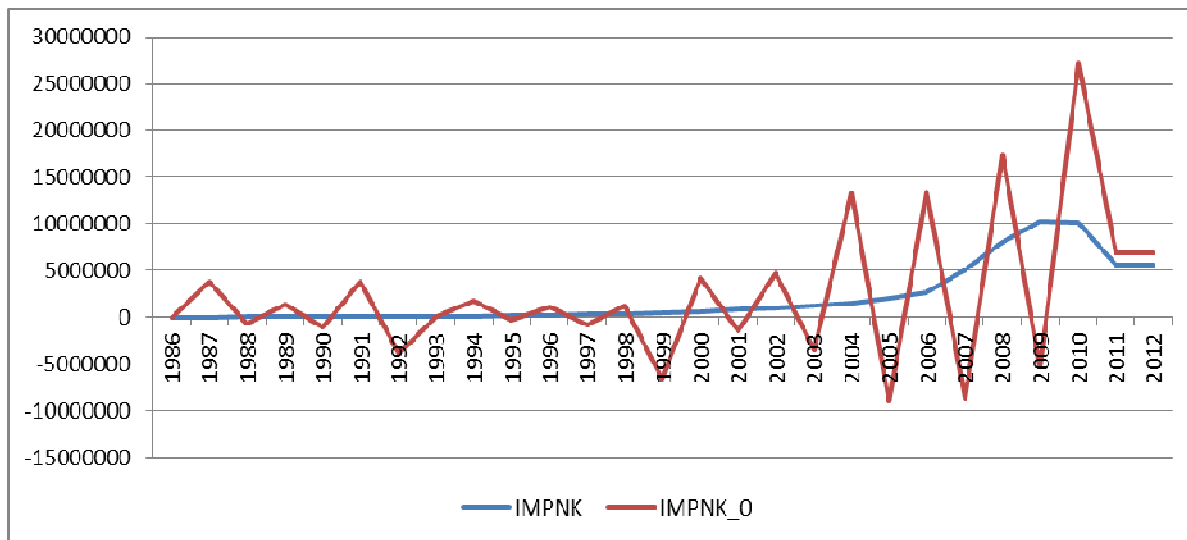
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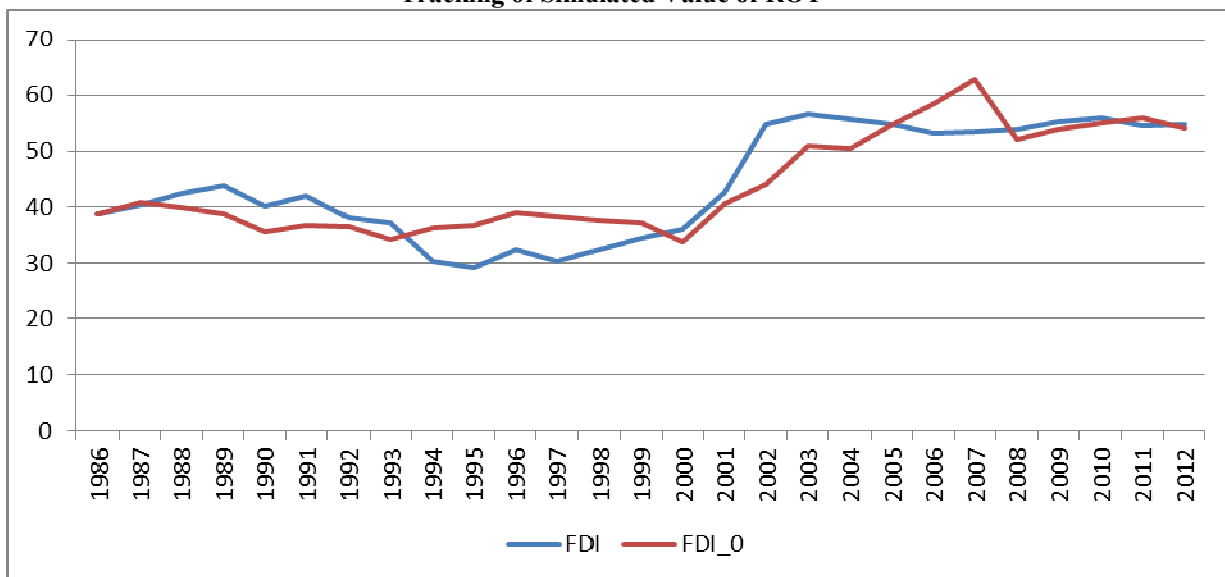
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