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THE RELATIONSHIP BETWEEN FOREIGN DIRECT INVESTMENT AND CAPITAL FLIGHT IN NIGERIA

[1]Gbadebo Adedeji Daniel & [2]Mohammed Nuhu
Department of Economics and Statistics
Faculty of Social Sciences, University of Benin, Benin City-Edo State

Abstract

In this study, we empirically explore the interactions between foreign direct investment (FDI) and capital flight in Nigeria. Essentially, theory has it that capital flight is detrimental to economic growth while FDI promotes development in any economy. Owing on this facts, over the years, Nigeria has allowed tremendous increase in FDI flows but unfortunately it effects has not materialized on economic growth despite great availability of natural resources and large market size because capital flight (with it attendant negating impact) has also increased simultaneously. With seeming evidence of symbiotic interactions between them, we cannot conclude on mere observations but utilized the simultaneous equation approach in econometric to quantitatively examine the relationship between them. In particular, generalized instrumental variable estimation and the Cochrane Orcutt Method (to correct serial correlation) were adopted following the review of relevant literature. The finding was that there is a significant positive relationship between FDI flows and capital flight in Nigeria for the periods studied. This finding was justifiable because all measures of capital flight incorporate FDI as one component of its estimation.

Keywords: Foreign Direct Investment, Capital Flight, The Types of Capital Flight, Source of External Finance and The Categories of Foreign Direct Investment.

Background of the Study

The contribution of foreign direct investment (FDI) to the development of any nation has been debated quite persistently in literature. Kant (1996) noted that this debate has focused on the channels through which FDI may help to raise growth in recipient countries particularly in developing countries. Some economists have argued that the impact of FDI on any economy is largely a function of some prevailing economic circumstances in the recipient countries. However, empirical studies investigating the relationship between FDI and economic growth on the one hand, and the role played by the circumstances FDI is confronted with whenever it enters a recipient country on the other hand, are scarce. The debate essentially persists because FDI has been the largest single source of external finance for developing countries specifically since 1993. For instance, in 1995, the share of developing countries in global FDI inflows reached an historic high of 38 percent. There are so many reasons that could usher in FDI into a country especially in Africa. As noted by Asiedu (2005), when it comes to FDI in Sub-Saharan Africa (SSA) of which

Nigeria is one, the common perception is that FDI is largely driven by natural resources and market size. This perception seems to be consistent with the data: the three largest

Recipients of FDI are Angola, Nigeria and South Africa, from 2000 to 2002, these countries absorbed about 65 percent of FDI flows to the region (World Bank 2004b). But, this perception if true is troubling for three reasons. First, it suggests that FDI in the region is largely determined by an uncontrollable factor, and that natural resource-poor countries or small countries will attract very little or no FDI, regardless of the policies the country pursues. Second, the countries in SSA are small in terms of income, 23 out of the 47 countries in the region have a GDP of less than US$3 billion. Indeed, in 2002, the total GDP of SSA excluding South Africa was US$214 billion, which was equal to about a quarter of the GDP of Brazil and about one-half of the GDP of Mexico (World Bank 2004b). Third, FDI in resource-rich countries are concentrated in natural resources and investments in such industries tend not to generate the positive spillovers (e.g., technological transfers, employment creation) that are often associated with FDI (Asiedu 2004).

Capital flight in Nigeria is more severe than it is elsewhere in other SSA countries. Nigeria is one of the heavily-indebted countries where the issue of capital flight has been regarded as important Reliable and comprehensive data does not exist on the magnitude of capital flight from countries of low-income Africa, but it is believed that capital flight particularly from Nigeria has been substantial. Upon this, policy observers, researcher and academicians have observed that foreign debt and capital flight (in most developing countries, Nigeria inclusive) accumulate simultaneously as in the case with private external borrowing guaranteed by governments (which escalate with capital flight). This off course has raise leading question whether FDI inflows in developing countries facilitate capital flight (as private external borrowings do), or do they, instead, mark a reduction in capital flight or a return of flight capital to the resident developing countries? Or put more relevant to the Nigeria case which is the central focus for this study, has FDI resulted to a plough back of capital flight? And expressing the simultaneity more pronouncedly, has capital flight resulted in reducing FDI?

Statement of the Problem

The critical role of FDI inflow in stimulating economic growth has been enunciated by number of empirical works, but however juxtaposing this with capital flight has recently become an issue to development economist and policy makers. Given the varied arguments that most of the FDI inflow to Sub-Saharan Africa, including Nigeria flows out in a reverse form, it becomes paramount to understand the existing relationship. Capital flight as it were reduces the amount of FDI inflow into any country. This has the potential of making such economies susceptible to high risks in a reverse circle. With the reduction in FDI due to capital flight, the potential for economic growth is reduced in such countries.

Given Nigeria's quest to make the economy one of the principal destination for FDI inflow, the phenomenon of capital flight would put this in serious jeopardy. With the dwindling level of FDI in Sub-Saharan Africa and the consequent low level of complementary foreign capital to augment domestic resources, particularly Nigeria in recent time, the issue of capital flight occupies a central place within the realms of policy making. Reduction in FDI inflow or through capital flight can make the debt profile of a country aggravate to an unreasonable proportion making such country unhealthy to attract additional external finances and could cause deterioration in the foreign value of the domestic currency, with worsening terms of trade conditions and the consequent low growth. It is against this background that a study as this becomes imperative.

Objective of the Study

The major objective of this study is to find out the relationship exist between foreign direct investment and capital flight in Nigeria.

Literature Review

There is generally an agreed framework definition of foreign direct investment (FDI) in the literature. Specifically, FDI also called foreign investment simply refers to an investment made to acquire a lasting management interest (normally 10% of voting stock) in a business enterprise operating in a country other than that of the investor defined according to residency (World Bank, 1996). Such investments may take the form of either "green field" investment (also called "mortar and brick" investment) or merger and acquisition (M&A), which entails the acquisition of existing interest rather than new investment. The International Monetary Fund (IMF, 1993) defines foreign direct investment as an "investment that reflects the objective of obtaining a lasting interest by a resident entity in one economy in an enterprise resident in another economy. Depending on whether the FDI is given out or being received by the resident countries, there are two categories of FDI: inward foreign direct investment (which represents a FDI in the resident country) and outward foreign direct investment (which represents FDI given out by the resident country to another country) thus both resulting in a net FDI inflow (positive or negative, respectively) and also stock of foreign direct investment (which is the cumulative number of FDI for the country in a given period). Theoretically, there are various types of FDI that can enter a country (or various ways in which FDI can enter a country). According to Chryssochoidis, Millar and Clegg (1997), there are five different types of foreign direct investment (FDI). The first type of FDI is taken to gain access to specific factors of production, e.g. resources, technical knowledge, material know-how, patent or brand names, owned by a company in the host country. The second type of FDI is developed by Raymond Vernon in his product cycle hypothesis. According to this model the company shall invest in order to gain access to cheaper factors of production, e.g. low-cost labour. The third type of FDI involves international competitors undertaking mutual investment in one another, e.g. through cross-shareholdings or through establishment of joint venture, in order to gain access to each other's product ranges. The fourth type of FDI concerns the access to

customers in the host country market. In this type of FDI there are not observed any underlying shift in comparative advantage either to or from the host country. The fifth type of FDI relates to the trade diversionary aspect of regional integration. This type occurs when there are location advantages for foreign companies in their home country but the existence of tariffs or other barriers of trade prevent the companies from exporting to the host country.

Regarding Nigeria, it has been noted that Nigeria as a country, given her natural resource base and large market size, qualifies to be a major recipient of FDI in Africa and indeed is one of the top three leading African countries that consistently received FDI in the past decade. However, the level of FDI attracted by Nigeria is mediocre (Asiedu, 2003) compared with the resource base and potential need. Further, the empirical linkage between FDI and economic growth in Nigeria is yet unclear, despite numerous studies that have examined the influence of FDI on Nigeria's economic growth with varying outcomes (Adelegan, 2000; Akinlo, 2004). Erbe and the World Bank (1985) which defined and measure capital flight estimate as CFWB = 4ED + FDI + CAS + FR, where CF denotes capital flight, ED external debt (from the World Bank data), FDI foreign direct investment, CAS current account surplus and FR change in foreign reserves. This is the broadest capital flight measure that can be found in the literature. It takes change in gross external debt (World Bank) and net foreign direct investment as the sources of finance and subtracts current account deficit and building up of foreign reserves from it. The resulting residual includes assets of both the banking and non-banking sector in the estimate of capital flight. Next is Morgan Guaranty Trust Co. Estimate which measure capital flight as CFMORGAN = 4ED + FDI + CAS + FR + B, where B stands for the banking system foreign assets. This is slightly narrower measure of capital flight since the previous definition was modified by excluding the acquisition of foreign assets by banks. The reason behind this has not been explained by the authors of this measure but we assume that this was done to allow for portfolio adjustment of the banking sector. Also under the Broad Measure, the Narrow Measure can be considered as a measure. This measure defined capital flight as CFCUDDINGTON = - (EO + STCO), where EO is net errors and omissions and STCO are the private short-term capital outflows. This measure was first used by Cuddington (1986). It is based on the idea that capital flight goes unrecorded due to its illegal nature; this is captured by errors and omissions; and also on the idea that capital flight refers to short term speculative outflows of capital.

Aside the broad measure, Capital Flight can also be measure as a Response to Asymmetric Risk. This measuring procedure aims at distinguishing between normal and flight motivated flows of capital and can be found in various studies (see Dooley (1986), Deppler and Williamson). This measure is assuming that capital flight can be explained by differences in risk perceived by residents and nonresidents in holding claims on residents of the country which is being scrutinized. Due to the fact that this method of measuring capital flight is very demanding on the data quality and the fact that estimates obtained by this method are of subject to large measurement errors, we will only describe Dooley's method at this place. Dooley's method sees capital flight as the total amount of

externally held assets of the private sector that do not generate income recorded in the balance of payments statistics of a country. Or, stated otherwise, capital flight is all capital outflows based on the desire to place wealth beyond the control of domestic authorities. According to this method, capital flight is CFDOOLEY = TCO - 4ES. But TCO = FB + FDI + CAS + FR - EO - 4ED, where FDI, CAS, FR, FB and EO denote foreign direct investment, current account surplus, change in foreign reserves, change in external debt(World Bank data) and errors and omissions respectively. TCO stands for the total amount of capital outflows and ED is foreign borrowing as reported in balance of payments statistics. ES = IE/rUS, where ES, IE and rUS denote respectively external assets, reported interest earnings and US deposit rate.

On autonomous empirical studies regarding the determinant of capital flight, numerous studies have been conducted to identify the pivotal determinants of capital flight in different countries of the world. Dornbusch (1985), Pastor (1989), Pasto (1990) and Ajayi (1992, 2001) found that exchange rate misalignment is a critical determinant of capital flight.

Empirical Methodology and Model Specification

Methodology and evaluation criteria

The nature of the problem under investigation and the objectives of the research normally determine the research method to be used for any empirical study. This study attempts to investigate the synchronous relationships between capital flight and foreign direct investment in Nigeria. With Assumed simultaneous interactions, according to Sims (1989) and Todd (1990), if there is true simultaneity among a set of variables, they should be treated on equal footing, and there should not be a priori distinction between endogenous and exogenous variables. Although different method can be used to estimate system equation such as specified above but in the spirit of our employed equation, we decide to estimate our developed model based on the general instrumental variable method (ILS). This the general instrumental variable method in the absence of possible econometric problems gives estimates that possess the desired properties called BLUE (best, linear and unbiased estimators) like the usual Ordinary Least Square, OLS approach which is the work horse of econometrician. In addition to this, another simple justification for the choice of this method is that it allows for model specifications (which are given below), parameter estimation and appropriate tests of hypotheses. And for an appropriate and systematic evaluation of our estimated model, the following standard criteria will be employedR2 (adjusted coefficient of determination) - for testing the goodness of fit of our estimated regression equation; the 'F' ratio - for testing the significance of the overall model estimated; the 'T' ratio for testing the significance of each regression coefficient and the Durbin Watson (DW) statistic for testing the randomness of the residuals (to check for presence or absence of autocorrelation) and other relevant statistics.

Model Specification

Although In theory, the determinants of capital flight and foreign direct investment (FDI) has remained traditionally independent of each other but some scholars have recently emphasized the interaction between them. More importantly, it has been argued that FDI is a component of capital flight measurability. However, since part of capital flight could also be used as investment in foreign countries thus capital flight is symbiotically also a crucial part of FDI. As such, the relationship between them is one of a mutual interdependence. Before stating our model it important to recall as already stated that although there are varieties of definitions of capital flight which have resulted in even more measure of capital flight that can be employed to obtain capital flight estimates. But for the purpose of this study we employ the Erbe and the World Bank broad measure of capital flight given by:

$$CF = \Delta ED + FDI + CAS + FR \quad (1.1)$$

Where CF denotes capital flight, ED external debt, FDI foreign direct investment, CAS current account surplus and FR change in foreign reserves. Essentially, this measure is adopted for two reasons-first, it is the broadest capital flight measure that can be found in the literature and second, it takes change in gross external debt and net foreign direct investment as the sources of finance and subtracts current account deficit and building up of foreign reserves from it. As such, it possibly upholds our methodology of study which relates simultaneity of interactions between our variable of interests. And according to Sims and Todd, if there is true simultaneity among a set of variables, they should be treated on equal footing, and there should not be a priori distinction between endogenous and exogenous variables. Following this, our simultaneous equation model for this empirical work contains two endogenous equations viz:

$$MCF = F(FDI, BOP, GDP, EXR, BM2) \quad (1.2)$$

$$FDI = F(MCF, BOP, GDP, EXR, BM2) \quad (1.3)$$

And in linear form with time subscript our equation above is restated as:

$$MCF = {}_0 + {}_1FDI + {}_2BOP + {}_3GDP + {}_4EXR + {}_5BM2 + \hat{\imath} \quad (1.4)$$

$$FDI = ø_0 + ø_1MCF + ø_2\,BOP + ø_3GDP + ø_4EXR + ø_5BM2 + ? \quad (1.5)$$

Where MCF = measure of capital flight (given by Δ ED + FDI + BOP + FR);

FDI is foreign direct investment; FPI is foreign private investment; BOP is balance of payment balance (deficit or surplus); RGDP is real gross domestic product; EXR is exchange rate; and BM2 is broad money supply. ? and ? are residuals for our equations. With simultaneous equation specification then a prior specification of coefficients may not be necessary.

Empirical Data Result and Discussions

In this section, we present the empirical results of the model specified in equations 1.4 and 1.5. At first, both the result of the generalized instrumental variable estimation for both equations were presented and analysed as against the popular ordinary least square, OLS methods, in order to

avoid presenting a spurious or nonsense result which is normally inherent in the OLS approach. Next, due to attendant problem of serial correlation detected in the model, we then forged ahead to correct such by further presenting the result of the Cochrane Orcutt method which thus represented our main model and with complete absence of aforementioned problem in this model (and estimates that are BLUE), we thus suggest that such model could be useful to policy makers in the area of our objective. The results of the generalized instrumental variable estimation for both equation 1.4 and 1.5 are presented in table 1 and 2 below.

Table 1: Generalized instrumental variable estimation (Result for equation 1.4)

Regressand	Regressors	Coefficients	Standard Errors	T-statistic
CFM	INT	12129.7	4268.5	2.8417
	FDI	1.2263	0.06629	18.4982
	BOP	1.0053	0.00342	293.2019
	GDP	-0.1499	0.07552	-1.9858
	EXR	-71.2481	22.90890	-3.1101
	BM2	0.0049	0.00058	8.3651
R-Bar Squared = 0.9994		F-Statistic = 41199.7		
Prob.(F- statistic) = 0.0000		DW-Statistic = 0.96868		

Table 2: Generalized instrumental variable estimation (Result for equation 1.5)

Regress and	Repressors	Coefficients	Standard Errors	T-statistic
FDI	INT	-4912.5	1823.7	-2.6937
	CFM	0.91919	0.012485	73.6240
	BOP	-0.92825	0.013159	70.5388
	GDP	0.24666	0.32028	0.77015
	EXR	48.2373	13.4256	3.5996
	BM2	-0.00490	0.000368	13.3164
R-Bar Squared = 0.9958		F-Statistic = 5561.2		
Prob.(F- statistic) = 0.0000		DW-Statistic = 0.6173		

Taking a critical look at the results presented in table 1 and 2 above, we noticed along with the objective of our study that the results speak well. All the coefficient of our variables including the intercept coefficient were significant at five percent level except for the coefficient of the real GDP in the equation FDI presented in table 2 thus implies that there is no enough evidence to adduce that economic growth has a significant effect on FDI for the periods studied. Also, although the system equations show good fits as the adjusted R-squared is robust being significantly high with little influence of residual or random disturbances and the overall model (judging with the F-statistics) is highly significant but the equations are override by the presence of positive autocorrelation as the DW statistical is abysmal low. This thus implies that the model cannot be accepted by policy makers for decision making and policy formulation. So to correct this deficiency and enhance our model for policy purpose, we next present (in table 3 and table 4) the results of a generalized instrumental variable estimation autocorrelation model using the Cochrane Orcutt Method AR (9) technique which converged after some not predetermined and not necessary analogous Iteration.

Table .3: Cochrane Orcutt Method Converge AR (9) converge after 7 Iterations
(Result for equation 1.4)

Regress and	Repressors	Coefficients	Standard Errors	T-statistic
CFM	INT	1446.0	1691.2	0.85500
	FDI	1.0036	0.01855	92.4636
	BOP	1.0042	0.00122	818.5908
	GDP	0.460	0.02141	2.15011
	EXR	-29.0211	18.1870	-1.5957
	BM2	0.00487	0.000685	7.1114
R-Bar Squared = 0.9999		F-Statistic = 90322.2		
Prob.(F- statistic) = 0.0000		DW-Statistic = 1.99240		

Table .4: Cochrane Orc utt Method Converge AR (9) converged after 8 Iterations
(Result for equation 1.5)

Regress and	Regressors	Coefficients	Standard Errors	T-statistic
FDI	INT	-1249.1	1521.9	-0.82074
	CFM	0.9827	0.01076	91.3055
	BOP	-0.9874	0.01047	-94.3055
	GDP	-0.0451	0.02071	-2.1815
	EXR	34.1916	16.8337	2.0311
	BM2	0.0048	0.00061	-7.7908
R-Bar Squared = 0.99846		F-Statistic = 4896.2		
Prob.(F- statistic) = 0.0000		DW-Statistic = 2.0072		

In these results, our aim is achieved. The models show complete absence of serial correlations. In addition, the coefficients of all our modeled variables are significant at 5 percent level except for the coefficient of exchange rate which was however, significant at 12 percent level. Although the intercept terms in both models are not significant but they are of no economic implication to our estimation so they can be discarded. With this non autocorrelation model, economic growth has significant impact on both foreign direct investment and capital flight. Also, the system equations show good fits as the adjusted R-squared (i.e. coefficient of determination) are both robust being significantly high with little influence of the random disturbances and the overall system equations (judging with our obtained F-statistics) is highly significant at 1 percent level. More importantly, this model can be accepted by policy makers for decision making and policy formulation regarding issues on FDI and how to prevent capital flight with attention on attendant modeled variable macroeconomic option incorporated in our model.

Discussion of Findings

1. A significant level of FDI is an integral component of capital flight and part of capital flight is a crucial part of FDI. Thus, a mutual dependence exists between FDI and capital flight. The implication of this finding is that policies direct at encouraging FDI inflow should also be directed at curtailing capital flight.

2 With rising economic growth the potential for capital flight is reduced. This, the growth rate of an economy is a critical determinant of capital flight. Given, this finding the size or growth rate of the economy would determine the amount of FDI inflow to the country. Thus, increased economic growth would invariably stimulate FDI into the country while reducing capital flight

3 Monetary expansion could encourage capital flight, while reducing FDI inflow into the country. This is an important policy issue, particularly as witnessed in the domestic economy where increased money supply leads to situation where large amount of such money either in cash or investments are stockpiled abroad with the consequent fall in economic growth.

4 The balance of payment position determines to a large extent determines the amount of FDI inflow to the country and capital flight as well. With surplus balance of payment, the potential for capital flight might be heightened if appropriate policies are not put in place to prevent such occurrences, and ,

5 Exchange rate is a critical variable in the FDI- Capital Flight nexus. This implies that the exchange rate policy can be used to achieve the objective of simultaneously encouraging capital flight while reducing the tide of capital flight.

Conclusion

The paper seeks to assess the interaction between foreign direct investment (FDI) and capital flight in a developing country taking Nigeria as a case study. The study was motivated by the fact that both FDI and capital flight have increased tremendously in the country, for the periods studied, and this calls for attention to know whether there is any relationship between them given the contradictory effects of both and their attendant impacts on economic growth and development. Essentially, it is practically believed that capital flight is detrimental to economic growth while FDI promotes development for both developed and developing economies especially in recent times. Nigerian was chosen as the case study because for the periods of interest, due to her endowed natural resources and market size, FDI which though could not be said to have benefited the economy as expected enters into the countries in a great deals in various forms. Aside this, the country was also massively molest with gigantic capital flight by her political leaders especially during the military administration which lasted for decades. As such, with the inflow of FDI in various forms especially in form of external debt the Nigeria became heavily indebted, capital flight increases; with capital flight also exacerbating and magnifying the debt problems of the country (see Glynn and Koening, 1984). To this the end, since it seems obvious that a relationship exists between both phenomena, we therefore try to empirical estimate such using available data. So having review relevant theoretical and empirical literature we utilized the

simultaneous equation approach in econometric to quantitatively examine the relationship between our endogenous and exogenous variables. In particular, generalized instrumental variable estimation and the Cochrane Orcutt Method (to correct for serial correlation) were adopted.

In synopsis, we discovered a significant relationship between all our exogenous and the endogenous variables in our system equations. Essentially, with no a priori specification established on expectation, our empirical work provides a direction of existing relationship between FDI, capital flight and their determining variables modeled. In effect, we observed that there is a direct relationship between FDI and capital flight. FDI seems to increase capital flight and vice versa. This is justifiable because all estimates of capital flight maintain FDI as component of its measurability. However, since parts of capital flight could also be used objectively or otherwise as foreign investment abroad thus capital flight is symbiotically also a crucial part of outflow of FDI.

Recommendations

Based on the findings from the empirical analysis, the following recommendations are made for desired policy action.

(i) Sound macroeconomic policies to encourage higher economic growth should be put in place in that will encourage FDI inflow and reduce the incidence of capital flight.

(ii) Unguarded and unconscionable monetary expansion should be discouraged by monetary authorities in Nigeria in order to discourage capital flight and stimulate FDI inflow into the country.

(iii) Sound and realistic exchange rate policy should be adopted that will encourage FDI inflow into the country and as well discourage capital flight.

(iv) Institutional and regulatory mechanism should be put in place to discourage capital flight at all cost in order to propel economic growth in Nigeria.

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