Is Monetary Expansion Always and Everywhere, Detrimental to Capital Inflows? Some Policy Lessons for Nigeria.

AIGHEYISI, Oziengbe Scott[1*] and EDORE, Julius Ovuefeyen[2]

1. Procurement Division, University of Benin Teaching Hospital, Benin City, Nigeria.
2. Department of Banking and Finance, Delta State Polytechnic, P.M.B. 5, Ozoro, Nigeria.

*Email of corresponding author: oziengbeaigheyisi@gmail.com

ABSTRACT

The paper employs error correction methodology to investigate the effect of monetary expansion on the flow of FDI into the economies of Nigeria, Ghana, Argentina, Australia, China, the U.S. and the U.K. using annual time series data covering the period from the 1980s to 2010/2011, sourced from the World Bank's World Development Indicators. The empirical evidence indicates that monetary expansion has negative, but insignificant effect on FDI inflows in middle-income countries of Nigeria, Ghana and Argentina, and positive effect on FDI inflows in high income countries of Australia, China, the U.K. and the U.S., though the effect in U.K. and U.S. is statistically insignificant. With the exception of Ghana and Australia, the paper also finds that economic growth has positive effect on net FDI inflows, though insignificant for the U.K economy. The paper argues that monetary expansion is not always and everywhere detrimental to FDI inflows, but that the effect depends on several factors such as the source of the expansion, level of development of the financial system, economic growth, etc. The paper recommends *inter alia* that the middle- income countries channel efforts at developing their financial systems and the growth-linked sectors of their economies so as to attract more FDI, and assuage the negative effects of excessive FDI inflows, ultimately enhancing the growth of the economy.

1. Introduction

Several empirical works have shown that monetary expansion in most developing countries is detrimental to the inflow of foreign capital into such countries. Although the researchers put forth some tenable arguments to buttress their findings, the questions begging for answers in this regard include: "Is monetary expansion always and everywhere, detrimental to capital inflows?" Or asked alternatively, "can the paucity of foreign capital in developing countries be blamed largely or solely on monetary expansion?" "Will capital not flow into an economy that promises high returns on investment even if monetary expansion is pursued by the government of the country?" "Do not other factors such as bad governance, international un-competitiveness, overvalued currency, the level of foreign savings, etc. also contribute significantly to the decline in the inflow of foreign capital into a country than monetary expansion does?", and one more question---this time from the assumed trade-off between monetary expansion and capital inflow---"Is it not possible for monetary expansion to be complementary to foreign capital in a country's quest for development?" Answers to these questions and other issues will form significant portion of discussion of this paper whose main objective is to investigate whether or not, monetary expansion is always and everywhere detrimental to the inflow of foreign capital into a country. One of the submissions of this paper is that the effect of monetary expansion (defined in this context as increase in broad money) on foreign capital inflows in an economy (developed, developing or emerging market) depends to a very large extent on the source of expansion, that is whether the expansion is as a result of increased capacity of the financial institutions to give credit or loans to the private sector, which is an indication of financial sector development, or whether it results from additional currency printed by the Central Bank. Where the former is the case, monetary expansion could be favourable to the flow of foreign capital into a country in the country's quest for sustainable development. However where the latter is the case, the effect may be different. It is the opinion of the authors that with good governance and sound macroeconomic policies, backed by unwavering commitment on the part of political office holders to attract more foreign capital into the economy, monetary expansion (engendered by enhanced capacity of the financial institutions to make loans and advances to the private sector, i.e. financial development) could set the stage for the flow of foreign capital into an economy, especially where there is credit crunch, so long as interest rates respond to the policy of monetary expansion (in a system of deregulated rates), and once this is achieved, it can then be eased using monetary and fiscal policy tools, whichever is considered more potent in the prevailing economic circumstances, to curtail unintended inflation that may have transpired. What determines whether monetary expansion is detrimental or beneficial to an economy is the use to which the additional money created is channeled and the responsiveness of investment to changes in interest rates.

We would like to point out in this introduction that while it is largely acknowledged that expansionary monetary policy breeds inflation, which could be detrimental to development prospects, beyond some structural break point or threshold (Bassey and Onwioduokit, 2011), it is also widely acknowledged that some economic agents benefit by it. One of the main goals of monetary policy is the attainment and maintenance of low and stable inflation, not the complete or outright eradication of it as inflation could be tolerated and favourable to economic growth below some limit or threshold. For this reason the monetary authorities make use of discretion in the implementation of monetary policy. Thus monetary expansion could therefore be seen as a two-edged sword, which could be detrimental or beneficial to various economic agents depending on how it is handled.

This paper is structured into seven sections. Section 2 contains a critical analysis of the link between capital inflows and money supply, with brief review of the literature. Section 3 contains some theoretical considerations on the nexus between monetary policy and capital flows. In Section 4, the model for the empirical investigation is specified, and the method of estimation is discussed. The estimation results and discussions are presented in Section 5. The summary and conclusion of the research, as well as policy lessons for Nigeria are presented in section 6, while the areas of future research are highlighted in section 7.

2. Capital Inflows and Money Supply: A Critical Analysis, and Review of the Literature

Empirical works such as those of Edo(2007), Bini Smaghi (1982), Cumby and Obstfeld (1983), etc. have shown that expansionary monetary policies in developing countries of Africa, Asia and other developing regions of the world contributed significantly to the decline in capital inflows into the countries within the period covered by their studies. One of the researchers suggested that “efforts need to be intensified to attract more foreign capital, instead of undue emphasis on monetary expansion” (Edo, 2007, abstract).

This suggestion obviously implies that foreign capital inflows facilitate rapid economic growth. While this may be true to some extent, We would like to point out a fact widely acknowledged in macroeconomic theory of international capital flows, that excessive inflow of foreign capital into an economy if left uncontrolled (as it could be controlled either by increase in residence capital outflows, accumulation of reserves or large current account deficit (International Monetary Fund, 2013)), could result in the expansion of money supply and liquidity in the economy overtime (Vujcic, n.d, Kim and Yang, 2008, Hashmi, et al, 2011), and monetary expansion could result in high rates of inflation which, beyond some threshold, has also been acknowledged to impede growth and development (Lee, 1997). In fact, inflation in China has been attributed to the huge inflow of foreign capital into the country. Jian, Shaoyi and Yanzhi (2011) also observe that large capital inflows into China have forced the country into a dilemma on making a choice between achieving monetary independence and exchange rate stability. It is also acknowledged in the literature on international capital flows that excessive inflow of foreign capital into an economy could cause an appreciation of the domestic currency (Okpanachi, 2013), and overvaluation of the domestic currency is acknowledged to reduce the international competitiveness of a country in international trade as its export commodities become less competitive in the global market. The overall effect of this is that the country’s export earnings will significantly nosedive. (This however is the case where the demand for the country’s export commodities is elastic in the global market). It is also acknowledged in the literature that the overvaluation of the local/domestic currency, apart from reducing the international competitiveness of a country’s export commodities in the global market, also has the tendency to reduce the inflow of foreign capital into the economy. This is the rationale for the deliberate maintenance of relatively high exchange rate for the domestic currency of some countries by their monetary authorities. It has been argued that the local currency of China (the Yuan or Renminbi) is undervalued, and the country has consistently used this exchange rate policy to maintain and strengthen its competitiveness in international trade, and as a result, she has consistently achieved surpluses in her balance of trade accounts in recent times.

What becomes obvious from the foregoing discussions is that while the developing or underdeveloped countries are making frantic effort to attract foreign capital into their economies (through tight monetary policy and other policies), they are simultaneously attracting what will result in the situation they assiduously try to avoid or escape from---high and rising inflation and overvaluation of currencies resulting from excessive, misguided and poorly managed capital inflows which could keep them underdeveloped. And so, it is not enough to put measures in place to attract foreign capital into an economy. Measures should also be put in place to curb the negative consequences that the inflow of foreign capital could engender in an ill-prepared economy, like the developing and underdeveloped economies of the third world, and these measures include inter alia, developing the nation’s financial system.

3. Monetary Policy and Capital Flows: Some Theoretical Considerations.

Monetary policy is the deliberate effort by the monetary authority to control level of economic activities by adjusting the stock or the supply of money in the economy. Policies aimed at expanding the money stock in the economy are known as easy or expansionary monetary policies, while those aimed at reducing the supply of money in the economy are known as tight or contractionary monetary policies.

It is acknowledged in monetary theory (the IS-LM framework) that an increase in money supply (or monetary expansion) brings about an increase in income and a decrease in interest rate, where the savings, investment and liquidity preference functions are relatively elastic with respect to changes in interest rate. It is also acknowledged in the theory that where the savings and investment functions are inelastic with respect to the rate of interest, then monetary expansion has no effect (expansionary effect) on income and that where the liquidity preference curve is completely or perfectly elastic with respect to the rate of interest (i.e. when the economy is in a liquidity trap), an increase in money supply will have no effect on the rate of interest. Except under these conditions (i.e. inelastic savings and investment functions and perfectly elastic liquidity preference function), monetary expansion inevitably leads to decrease in interest rate and increase in income.

If monetary expansion contributes significantly to the decline in the inflow of foreign capital to an economy (as argued by some researchers), it follows logically that the decline in capital inflow could have resulted (partly) from its (monetary expansion) effects on income and interest rate. In other words, the increase in income and the decrease in interest rate associated with monetary expansion must have been (partly) responsible for the decline in capital inflow into the economies studied by the researchers. But how true is this? Is increase in income or decrease in interest rate (or simultaneous occurrence of both) always detrimental to capital inflows. Is it not possible for capital to flow into an economy with high income levels and low interest rate? While it is acknowledged that low interest rate is unattractive to short-term foreign capital, can the same be said of long-term capital such as foreign direct investment (FDI)? Is it not acknowledged in the extant literature on capital flows and argued by some anti-capital flows economists such as Joseph Stiglitz, that short-term capital could be harmful to an economy owing to its uncertain and volatile nature? If short-term capital, with its volatile nature, could be detrimental to economic growth, is it economically rational to put measures in place to attract it where the mechanism to cushion its effect is not in place? Now, let's assume a policy of tight money, i.e. contractionary monetary policy. Theoretically, all other things being equal, this would engender an increase in interest rate and the rise in interest rate has been demonstrated by Mackinnon (1973) and Shaw (1973) to result in increase in savings or loanable fund, in a system of deregulated interest rates. This in turn would engender increase in investment depending on the demand for loanable or investment fund, which also is determined by the prevailing interest rate and some other variables, and in the long run, the rise in investment could result in an upsurge in income through its (expansionary) effect on money supply. Furthermore, tight monetary policy resulting in increase in interest rate in a flexible exchange rate system, is believed to, *ceteris paribus* attract foreign capital into an economy and this inflow could engender appreciation of the domestic currency which also has its own dark side or adverse consequences particularly on exports.

It is well known fact that the amount of FDI that flows into African countries is quite meager compared to what goes to countries like China and some other Asian economies. And the FDI that flow into African economies head straight for those sectors that promise high returns on investment, such as the extractive (oil and gas, etc.) and telecommunications sectors, while very little goes to the main (productive) sectors, such as manufacturing, energy, agriculture and education sectors. Does not this buttress the assertion that foreign investors are like nomads who would move their cattle to places where there are green pastures? Can we rightly attribute the difference in the amount of foreign capital that goes into the various sectors to expansionary monetary policy? Will it be right to say that monetary expansion makes certain sectors of the economy unattractive to foreign capital? Certainly, not!

4. Model Specification and Empirical Methodology

In this section, we attempt to answer the question posed by the research topic, by investigating the effect of monetary expansion on capital inflows in the economies of some randomly selected countries of the world categorized as high income, middle income and low income. To this end we specify our model functionally as:

$$KI = f(\pm BM, X) \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots (1)$$

Where KI = Capital inflows, BM broad money, and **X** represents a battery of explanatory variables (acting as control variables) that are also identified in the literature to affect the flow of capital into an economy. For this study, index of real effective exchange rate, and real GDP per capital are chosen. The sign on BM represents the *a priori* expectation, and indicates that the relationship between BM and KI for each country is either positive or negative, and it is a subject of empirical investigation.

In this paper we specifically examine the effect of monetary expansion on the flow of foreign direct investment into the economies of Nigeria, Ghana, Argentina, Australia, China, United Kingdom and the United States of America. Equation 1 is therefore re-specified as:

$$FDI = f(\pm BM, X) \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots(2)$$

Where FDI represents net inflow of foreign direct investment

The method of co-integration and error correction will be employed for the investigation. The choice of this methodology is informed by the need to investigate the short-run and the long-run effects of monetary expansion on capital inflows into the economies of the selected countries.

The error correction model adopted for the study is specified in its empirical form, i.e. the form in which it is to be estimated as:

$$\Delta LNFDI_t = \alpha_0 + \Delta LNFDI_{t-1} + \sum_{i=0}^{m}(\beta_i \, \Delta LNBM_{t-i}) + \sum_{j=0}^{n}(\gamma_j \, \Delta LNX_{t-j}) + \delta ECM_{t-1}$$

………………. ...…………..(3)

Data used for the estimations are annual time series data obtained from the World Bank's World Development Indicators (WDI).

5. Empirical Results and Discussions

5.1 Presentation of Results

The results of the estimation of the error correction model specified for the investigation is presented in the table below. Due to space constraint, the results of unit root tests for the variables are not presented. However, it is acknowledged in time series econometrics that most time series data are non stationary in levels, but attain stationarity after first differencing (Gujaratti and Porter, 2009). The results of tests for cointegration are also not shown here. However, negative signs on the coefficients of the error correction term (i.e. lagged residual) in the estimated equations indicate the existence of long-run cointegrating relationship between the variables. The error correction estimation results are presented in Table 1 and Table 2 below.

Table 1. Error Correction Estimation Results for the Randomly Selected Countries

Dependent Variable is LNFDI$^{\#}$							
Variables	Nigeria **1983-2011**	Ghana **1982-2010**	Argentina **1982-2011**	Australia **1982-2010**	China **1984-2010**	United Kingdom **1985-2011**	United States **1982-2011**
dLNFDI (-1)	-0.23313 (-1.2696)	-	-	-	-	-	-
dLNBM	-0.49550 (-1.4687)	-0.30381 (-1.3255)	-0.002241 (-0.32481)	0.13116*** (2.5415)	1.4681*** (3.7764)	0.86746 (1.0783)	1.0021 (1.4167)
dLNBM (-1)	-	-	-	0.16068*** (2.8044)	-	-	-
dLNREER	-0.090314 (-0.55299)	7.506*** (2.5467)	-	3.83E+07 (0.11765)	-	1.95E+09** (2.0403)	-1.2141* (-1.6877)
dLNRGDPPC	5.3826*** (3.2406)	-0.45581** (-1.9219)	1068312** (2.2938)	-6219257*** (-3.0709)	3.2941* (1.6392)	3.231179 (0.88613)	12.4763*** (3.4905)
dLNRGDPPC(-1)	-	-	-	-	5.5900**	-	7.4165** (1.9405)

					(2.2574)		
Dc	-10.5814** (-2.2789)	-27.0102** (-2.2449)	-1.1440 (0.263)	1.50E+11*** (2.9083)	-14.2283*** (-3.3131)	-2.17E+11*** (-2.9063)	-8.0891 (-0.96891)
ECM(-1)	-0.92036*** (-3.3268)	-0.34148** (-2.4343)	-0.76296*** (-4.1192)	-1.5913*** (-9.0955)	-0.74609*** (-4.1856)	-0.75329*** (-3.7189)	-0.44645*** (-2.9220)
R-squared	0.63802	0.43142	0.39530	0.82252	0.69637	0.45144	0.60810
R-Bar-squared	0.55939	0.33665	0.32552	0.76336	0.62407	0.33715	0.50587
F-stat.	8.1078	4.5525	5.6655	19.4641	12.0406	4.9377	7.1377
D.W. stat.	1.9514	1.7559	2.0578	2.2192	1.6907	1.8974	2.2770

The error correction models for Argentina, Australia and the United Kingdom were estimated using the raw data for the variables, not logarithms to obtain a more accurate representation.
*, **, *** indicates statistical significance at the 10%, 5% and 1% level
d = first difference operator
Source: Extracts from authors' estimation using Microfit 4.1 for windows

Table 2. Estimated Long-run Coefficients

Dependent Variable is LNFDI						
Variables	Nigeria	Ghana	Argentina	China	United Kingdom	United States
LNBM	-0.53837 (-1.5496)	-0.88966 (-1.0159)	0.12510 (2.2397)	1.9677 (8.7916)	1.7185 (2.4157)	2.2447 (1.2796)
LNREER	-0.098129 (-0.52694)	-21.9806 (0.9022)	-	-	3.6179 (1.9716)	-2.7196 (-1.4017)
LNRGDPPC	5.8483 (10.5300)	-1.3348 (-1.2822)	1.0530 (3.4786)	-2.4620 (-4.6102)	-3.7621 (-1.1842)	-1.0480 (-0.20474)
C	-11.4970 (-3.3639)	-79.0966 (-1.8020)	9.9264 (4.4135)	-19.0705 (-5.9214)	-1.4772 (-0.6678)	-18.1185 (-1.1268)

Source: Extracts from authors' estimations using Microfit 4.1

5.2 Discussion of Results

The results presented in Table 1 show that monetary expansion has negative but insignificant effect on inflows of foreign direct investment into the economies of Nigeria, Ghana and Argentina. Monetary expansion is however observed to have positive effect on the inflow of FDI into the economies of Australia, China, United Kingdom and the United States, though the effect is not significant for the U.S and the U.K. Specifically, a unit increase in broad money (measured in local currency unit) in Australia is associated with a unit rise in the inflow of foreign direct investment into the economy, while a 10% increase in broad money is associated with about 15% increase in the inflow of FDI into the Chinese economy. The long-run estimation results presented in Table 2 shows that the effect of sustained expansion in (i.e. the long-run effect of) broad money on FDI inflows is negative but insignificant in Nigeria and Ghana, positive but insignificant in the United States, and positive but significant in Argentina, China and the United Kingdom. These results suggest that monetary expansion cannot be blamed largely for paucity of FDI inflows to economies generally. The observed short-run and long-run effects of monetary expansion on FDI which are opposite in signs for the Argentine economy indicates that monetary expansion does not always adversely affect the flow of FDI into the economy.

It is also observed from Table 1 that in most of the countries sampled (with the exception of Ghana and Australia), economic growth, proxied by real GDP per capital is favourable to FDI inflows, and its short-run effect on FDI is quite significant for the economies of Nigeria, Argentina, China and the United States. This is in line with the findings of Ahmed and Zlate (2013). For the economies of Ghana and the U.K., increase in the index of real effective exchange rate is favourable to the inflow of FDI.

6. Summary, Conclusion, Recommendation and Policy Lessons for Nigeria.

6.1 Summary and Conclusion

The amount of foreign capital that flows into an economy is determined by various factors, some of which are qualitative and others quantitative. A major qualitative factor is the attractiveness of the economy to foreign capital and this is determined by various factors as governance, domestic macroeconomic policies, the prevailing investment climate, etc. Although quantitative factors (such as money supply, etc.) also affect it, the paper argues that expansionary monetary policy is not always and everywhere detrimental to the inflow of foreign capital, but could be complementary to capital inflows depending on country-specific conditions.

The study finds that the short-run effect of monetary expansion on FDI inflows into the developed economies of Australia, China, U.K. and the U.S. (all with highly developed financial system) is positive (though insignificant for the U.K and the U.S.), while the reverse is the case in developing (middle income) countries of Nigeria, Ghana and Argentina, though it was statistically insignificant. This difference in the effects may be attributed to the differences in the level of development of the nations' financial system. The findings suggest that monetary expansion could be detrimental to the flow of FDI into an economy with poorly developed financial system. However, economic growth appears to be a more relevant factor explaining FDI inflows in most of the countries studied.

It is recommended therefore that developing countries channel more efforts at accelerating the growth of their economies in order to make them more attractive to foreign capital, and to put measures on ground to cushion the adverse effect of excessive capital inflows, as it could be a double-edged sword which could unleash beneficial or detrimental effects on an economy depending on how it is handled.

This paper has contributed to the extant literature by showing empirically that monetary expansion is not always and everywhere detrimental to the inflow of foreign direct investment into economies, and that economic growth is a more important factor explaining inflows of FDI into economies.

6.2. Some Policy Lessons for Nigeria

The negative, though statistically insignificant effect of monetary expansion on the flow of FDI into Nigeria's economy is an indication that the nation's financial system is not highly developed, and that monetary expansion in the country does not stem from improved credit to the private sector *per se*, but from other sources e.g. printing of additional currencies by the Central Bank through the Nigerian Security Printing and Minting Plc., increased remittances from abroad, etc. which have the tendency to induce inflation, making it (i.e. monetary expansion) unfavourable to FDI inflows. These stress the need for the development of the nation's financial system, as well as reduction in the rate at which the CBN prints additional currency.

The empirical evidence emphasizes the relevance of economic growth to the flow of FDI into Nigeria's economy. The implication is that the amount of FDI that flows into Nigeria strongly depends on the growth of her economy. This therefore calls for channeling of efforts and resources towards developing the various growth-linked sectors of the economy such as education, health, agriculture, manufacturing, financial and technology. The development of these sectors will not only engender the development of the entire economy, but will also ensure that FDI flows into the various sectors, instead of concentrating in a few sectors as it is presently.

7. Areas of Further Research

The study calls for further research. The effect of monetary expansion on the flow of foreign portfolio investment (FPI), which is also a form of foreign capital, into various economy could be investigated by future researchers. Furthermore, alternative methodology could be explored to investigate the relationship. For example, an appropriate simultaneous equation method (2SLS, LIML, etc) could be employed, given that a two-way relationship could exist between monetary expansion and FDI, and monetary expansion and FPI, as the inflow of FDI and FPI could lead to monetary expansion, just as monetary expansion could also affect the flow of FDI and FPI into any given economy.

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