



External Debt, Exchange Rate, Foreign Investments and Economic Growth Inter-Relationships Further Empirical Evidence from Nigeria

Abina, Praise Adedigba 

Finance & Banking Department, University of Port Harcourt, Port Harcourt, Nigeria.
Email: praise2009@yahoo.com Tel: 08032227386



Abstract

It is crystal clear for countries to thrive and for industries to compete with themselves there is need for product diversification, these create a niche for foreigners to contribute both in capital and technical skill, this will further lead to exchange of currency across borders and it will also facilitate growth in the receiving country. This propelled this paper on external debt, exchange rate, foreign investments and economic growth inter-relationships. Further empirical evidence from Nigeria, 1981-2018. The study made use of autoregressive distributed lag bond test (ARDL) as the statistical technique. It was revealed that foreign investment to total exports ratio has a positive and an insignificant relationship with external debt to total exports ratio, the result agreed with the earlier anticipated apriori expectation, but the insignificant relationship arises as a result of instability identified between naira to other foreign currency, it also arises as a result of the increase identified with prices of goods and services in the country. It does appear that there is need for foreign investors to participate in the country and for this to take place policies on investment friendly environment will need to be reviewed and corrective measures that will improve the policy will need to be put in place this environment will stimulate and boost foreign participants which will in the long run boost the value of the local currency and make the foreign market of the country to be competitive.

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Contribution of this paper to the literature:

This study contributes to existing literature by examining the relationship between external debt, exchange rate, foreign investments and economic growth inter-relationships.

1. Introduction

Countries interact with the external world in terms of trade and openness has made it possible for the subject matter of interest to be a major economic priority. Developing countries see external debt as a form of deficit financing tool, nation can harness excess revenue through revenue generated from foreign trade and tax that is levied on foreign countries or multinationals in the home country. There have been several debates on the inter-relationships between foreign investment, external debt and the effect of fluctuation in the exchange rate in Nigeria. Foreign investment helps in technology transfer and reallocation of physical resources. Ezirim *et al.* (2000); Ezirim *et al.* (2000) and Awosusi and Awolusi (2014) opined that foreign investment productivity and growth can be enhanced, it can also be a booster to growth of host country, The works of Lee and Tan (2006) discovered that knowledge spillover can be enhanced by foreign investment, Empirics have shown that the cost of transferring knowledge and technology is expensive (Teece, 1976) thus this transfer is enabled by trade liberalization. Hameed *et al.* (2008) in Ezirim *et al.* (2007) and Khan (2007) support the argument that FDI helps in accumulation of capital which will result to economic growth. Umaru *et al.* (2015) recapitulated benefits that is achieved in a country if they are able attract foreigners or multinationals to invest in their country. Ajayi (2006); Falki (2009); Ojong *et al.* (2015) articulate few of the benefits which included; access to international markets, access to huge fund, technology spillover, effective and efficient exploitation and utilization of local raw materials and a source of employment. On the other hand, Ezirim *et al.* (2000) stated some conceivable reasons why foreign investment is not been felt in less developed country, and they include exchange rate fluctuation, political index and the present inflation trend in the country. In another investigation, Ezirim *et al.* (2007) contradicts the findings of Ezirim *et al.* (2000) that exchange rate condition either favorable or unfavorable is not a condition that foreigners will examine to ascertain if they will invest or not. While Obadan (2004) opined that one major problem receiving country face is that foreign investor and its country tend to share out of the good fortune of sound investment in the country. Odozi (2003); Akinlo (2004); Olaniyi (1995) and Adelegan (2008) reported negative contribution of FDI in Nigeria. Danja (2012) noted that payment of interest on loan facility, repatriation or diversion of proceeds also create potential problem to FDI not been able to achieve its desired result. In a further investigation by Ezirim *et al.* (2006) they reported that capital flight and debt service payment also contribute to problem home country faces in their dealings with foreign investors. In comparison (Uzoma *et al.*, 2015) noted that lesser risk is attached to FDI than external debt as a source of capital accumulation to receiving country because it does not add to debt accumulation of the receiving country. In Ezirim *et al.* (2004) it was discovered that both debt stock if properly utilized and its servicing contribute positively to output. This contradicts the findings of Ezirim *et al.* (2006) which stated that in Nigeria foreign debt have been used for capital accumulation, source of financing budget deficit. Also, domestic expenditure is often partly financed by external debt. The aim of this paper is to investigate empirically the interrelationship among external debt, exchange rate and foreign investments in a developing or an emerging economy using Nigeria as the proxy.

2. Theoretical Underpinning

2.1. New Growth Theory

Traditionally, economic theory favors the removal of barriers which will help to hasten growth and placed emphasis on the role of foreign investment as a driver of economic growth, similarly, trade liberalization (removal or reduction of trade barriers) is emphasis is placed on the fact that new and up-to-date technology needs to be acquired in order for local and international markets to compete with each other thereby creating employment opportunity which leads to growth. Dependency theory: This theory negates the existence of foreign investors or multinationals in developing countries. The participation of multinational distorts development in the host country in the long run. Furthermore, Anyanwu (1993) and Aremu (2005) observed that drivers of FDI are exploitative and they are biased in terms of remuneration or payment of wages to the local labour force. They dump outdated technology to the receiving country, and manipulate key sectors in the economy in furtherance of their business motives. Harrod Domar growth model: In an attempt to investigate an interrupted working of an economy, Harrodian model and that of Domar emphasized the dual structure and function of investment placing them at high priority, (demand effect and supply effect) the first role of investment as it increases the capital stock, while the second is it creates additional income, the later helps to enhance capacity in form of production while the former helps in income enhancement in terms of profit generated from sound investment decision. There are key conditions to this, the first which is that so long as investment continue to take place in any economy then capital stock in the form of goods and services (output) and real income will always expand, because this investment will be used for expansion in production and its co-determinant, figuratively there is need for real income and output to expand at the same rate. This will help to maintain full employment, the moment there is a slight modification in any of them without affecting the second then there will be idleness in the capacity utilization, leading to reduction in the income of people in the country.

2.2. Empirical Review

This section explicitly analyzed a number of econometric and finametric studies that have showed the inter-relationship which exist between external debt, exchange rate and foreign investments. Ogunbiyi and Abina (2017) examined foreign investments, exchange rates and external debt inter-relationships in Africa. Further empirical evidence from Africa. Further empirical evidence from Nigeria, the study used predictors as exchange rates, external debt burden, and oil prices in the international markets. The study employed Phillips-Perron unit root test and autoregressive distributed lag bond test (ARDL) as the econometric tools. The results of the descriptive statistics showed that all the explanatory variables were leptokurtic in nature, the study made use of Phillips-

Perron unit root test to avoid spurious estimates. It was discovered that external reserve has a positive but insignificant affiliation with ratio of foreign investment to total exports, while inflationary pressure had positive at level and lag 1 and negative contribution to the ratio of foreign investment to total exports at lag 2. Umaru *et al.* (2015) investigates if any association exists between growth and foreign direct investment in Nigeria. After conducting all necessary tests, it was discovered that there is no serial correlation between the variables. The study discovered that causality flows one way from gross domestic product to foreign direct investment. The same result was shown between gross domestic product and openness. However, causality does not exist from exchange rate to gross domestic product. The study therefore recommends that stability in the country's exchange rate and openness policy of the country need to be streamlined, which will serve as a sweetener to foreign investors in the country. Ebekozi *et al.* (2015) analysed the trend in the inflow of foreign direct investment in Nigeria. They made use of secondary data which were converted to percentage. The study made use of twenty-year (20 year) data points which were split into two. In addition, Duncan multiple range test, regression analysis and Granger test were statistical techniques used in the study. The Duncan Multiple Range showed that FDI is attracted more from the processing and manufacturing sector in the country while that of the construction sector is very poor. The result of regression analysis revealed that the null is accepted in the first hypothesis which states that no significant flow exists between foreign direct investment into construction sector. ($f= 13.2$), but in the second hypothesis, the alternate is accepted which states that there is a significant flow between construction sector and foreign direct investment ($f= 155.133$). In order to harness much-needed funds, the study concluded that there is need for enforcement of prevailing laws. Beyond this, huge investment is needed in infrastructure to boost output in industrial sector. They also suggested that there is need for partnership of both the private and the public in construction of air and sea ports, roads, and dams which will build foreign confidence of potential investors. Macroeconomic situations are worst by debt burden. This propelled (Ezirim *et al.*, 2007) to investigate foreign investment burden, exchange rates and external debt crises in Nigeria. The historical data from 1970-2001 were used while four models were developed to carry out the investigation. Ordinary least square (OLS) and exact maximum likelihood (EML) were the two techniques that aided the research work. It was discovered that increase in debt burden did not and was not a motivating factor for foreigners to invest in the country. They also found out that exchange rate is not a major determinant which foreigners consider if they should invest or not. An increase in oil price leads to a decline of 56% in investment burden in the country. The study recommends that revenue generated from oil proceeds need to be judiciously utilized. This will help to cut down foreign investor's participation in the country. Okumoko and Karimo (2015) investigates the endogenous effects of the nexus between economic growth and foreign direct investment in Nigeria. Thirty-two years time series archival data was used in the study while Johansen's cointegration test, vector autoregression, Kwiatkowski-Phillips-Schmidt Shin (KPSS) and Phillips Perron unit root tests were the employed econometric techniques. It was discovered that FDI persuades growth and not the other way-round. The endogenous effect is rejected in the study. It was recommended that intensive efforts are needed in order to entice foreign investments. Uzoma *et al.* (2015) attempted to investigate if FDI is growth averse or pro to growth. The study made use of annual time series data which were transformed to log from 1981-2009 for the investigation. The model for the study was drawn from the monetarists and structuralists views. It was discovered that the unfavorable environment, fluctuation in exchange and inflation rate have led to FDI's insignificant affiliation in the country. Equally the causal relationship suggests a one-way causal relationship exists between GDP and FDI in the economy. Growth which is achieved by domestic investment leads to foreign investment, they further recommend that there is need to address the problem of insecurity in the country. They opined that if properly addressed, it will lead to increase in domestic investment as well as foreign investors' confidence. In Ojong *et al.* (2015) foreign investment was proxied on market capitalization, openness, level of economic activities and gross fixed capital formation as the exogenous variables which were used to ascertain the determinant of FDI in Nigeria. The study made use of secondary data obtained from the country's apex bank. The least square multiple regression technique was used. It was discovered that openness and level of economic activities attract more FDI in the country while a negative association exist between gross fixed capital formation and market capitalization in the country. Therefore, reorientation is needed in order to increase savings and reduce consumption. There is need for more jobs to be created and this can be achieved with the help of both the private and public sector. In an ex-post facto research design, Ezirim *et al.* (2006) attempted to investigate the impacts of external debt burden and foreign direct investment remittances on output level in Nigeria. The study utilized data from 1970-2000. After conducting various diagnostic tests, it was revealed that the data can be used for forecasting. A two-fold causality was also discovered between foreign direct investment and external debt burden; neither of them contribute positively or significantly to growth. It was also discovered that proceeds from foreign exchange will serve as remittance of income in Nigeria. In Nigeria (Egbetunde, 2012) examined the causal relationship between public debt and economic growth using ex-post facto research design with historical data from 1970 to 2010. On the long run, there is a positive reinforcement relationship between public debt and output, the study recommends that there is need for loan to be sourced within the country because of the revolving effect it has on the economy. Dewan and Hussein (2001) suggested that apart from growth in the labour force, investment in both physical and human capital as well as low inflation and open trade policies are necessary for economic growth. But Antwi *et al.* (2013) studied the impact of macroeconomic factors on economic growth and discovered a long-run economic growth is largely explained by physical capital, foreign direct investment, foreign aid, inflation and government expenditure. It is also evident that economic growth is not affected by short-term changes in labour force. Over time, it has been seen that changes in the micro-economic variables always directly affect changes in macro-economic activities of the nation's production, consumption and expenditure. This is because when a nation has excess in production, she engages in international trade, furthermore, this is also made possible as countries face different opportunity costs in their production choices while the excess mainly flow from the contributions of the micro activities in the country. It is also opined that technology poses a threat to the full participation of the micro variable. Solow (1956) model also pointed it out that production is a function of three things which technology is one of them. Lopez (2005) opined that an increase in production is as a result of openness. Gries and Redlin (2010) strived to examine the dynamics of the

relationship between GDP growth and trade openness. Their Findings confirmed a long run relationship between the variables as well as a short run adjustment to equilibrium. In the long-term causality was found to be bi-directional moving from trade openness to growth and vice versa while a negative adjustment was found in the short term. Edoumiekumo and Opukri (2013) is of the opinion that the benefits of international trade are that it has a robust impact on her economic growth. Tan and Tang (2012) also opined that technology is a factor that helps in explaining growth in the country. Ismaila and Imoughele (2015) discovered that foreign trade has no robust impact on a country. They noted that the cost of doing business in the country was very high in as much as the infrastructure and business environment are not friendly. The country witnessed deficit in her balance of trade as at early in the year. This has led regulatory bodies to place restrictions and bans on goods imported. On the long run, goods in the country became scarce and there was shortage in the availability of raw materials which automatically led to few goods pursuing much profits in the market. Aurangzeb and Ul Haq (2012) asserted that investment plays an important role in driving growth through increase in productivity levels. They also discovered that foreign direct investment brings technology and creates employment. FDI helps to adopt new methods of production and enhances productivity by bringing competition in the economy. Ullah and Rauf (2013) evaluate the impacts of macroeconomic variables on economic growth, they found out that there is a positive relationship between foreign direct investment and saving rate while exports have negative impacts on economic growth but labour force and tax rates have no impact on economic growth for some selected countries.

3. Research Methodology

3.1. Estimation Methods and Analytical Techniques

The model below was built and anchored on Ezirim *et al.* (2006) and Ogunbiyi and Abina (2017). Before arriving at a conclusive decision about a particular technique to be used, stationarity test was first conducted to ascertain the linearity of the trend and reliability of the data and if the data can be used or not for estimation or forecasting in the long run. This stationarity test was conducted using Philip Perron (PP) unit root tests, the data for the study was compiled and computed from the annual statistical bulletin of the central bank of Nigeria, while the time scope for the study is between the period 1981-2018.

3.2. Model Specification

3.2.1. Functional Model

$$RXDE = F(FIVT, EXHR, EXRE, IOP) \tag{1}$$

3.2.2. Econometric Model

Thus, the econometric form of the Equation 1 is stated as follows:

The Equation 1 was further transformed to Equation 2 by taking the log value in model one:

$$LnRXDE = b_0 + b_1 LnFIVT_t + b_2 LnEXHR_{t+1} + b_3 LnEXRE_{t+1} + b_4 IOP_{t+1} + Y_t \tag{2}$$

Apriori = $b_1 > 0, b_2 > 0, b_3 > 0, b_4 < 0$.

Where:

RXDE = External debt to total exports ratio (Percentage of export that are being financed by external debt).

FIVT = Foreign investment to total exports ratio (Percentage of export that are being financed by foreign investment).

EXHR = Real exchange rate.

EXRE = Ratio of external reserve to export (Percentage of external reserve that are being financed by export).

IOP = Inflationary pressure.

Ln = Log.

t_{+1} = Lag period.

Y_t = Stochastic error term.

On the basis of the results gotten from the unit root test, the autoregressive distributive lag (ARDL) could be designed thus;

The Equation 3 represents the ARDL model which is a statistical tool used when stationarity level is missed.

$$y_t = \beta_0 + \beta_1 t \sum_{i=1}^p \phi_i y_{t-i} + \beta_2 x_t + \sum_{i=0}^p \beta_{i+1} \Delta x_{t-i} + \pi t \tag{3}$$

Where:

x_t = Dimension of 1(1) variable which are not stationary.

β_1 = Represent the matrix which makes autoregressive process stable.

πt = Error term.

4. Presentation and Analysis of Result

Table-1. Unit root test output.

Variables	PP stat	Critical val. at 5%	P-value	Order of integration
RXDE	-4.316377	-3.557759	0.0090	1(0)
FIVT	-5.382512	-3.557759	0.0006	1(0)
EXHR	-3.562882	-3.562882	0.0501	1(1)
EXRE	-8.086545	-3.562882	0.0000	1(1)
IOP	-6.627304	-3.562882	0.0000	1(0)

Source: Extraction from E-views Output.

The condition for autoregressive distributive lag (ARDL) as stated in the model above is validated from the result above, since the result in Table 1 from the stationarity test is mixed stationarity was identified in this order;

in the order of 1(1) and 1(0) integration, that is the variables under investigation were stationary at EXRE and EXHR were stationary at the order of 1(1) while RXDE, FIVT and IOP became stationary at level 1(0).

Table-2. Heteroskedasticity test.

Heteroskedasticity test: Harvey			
F-statistic	7.377041	Prob. F(4,25)	0.3715
Obs*R-squared	16.24059	Prob. Chi-square(4)	0.6827
Scaled explained SS	14.36647	Prob. Chi-square(4)	0.9462

Source: Extraction from E-Views Output.

The residual and normality in the model will be checked via the result of the heteroskedasticity test Table 2, with an estimated sample of 25 shows a probability level of 0.3715 which is greater than the 0.05 significance level, the observed R² exhibit a coefficient of (16.24059) which is greater than 0.05%, this leads to the acceptance of the null hypothesis which shows that there is an existence of heteroskedasticity in the employed study model showing that variables are influenced from the error term more than internally and it also validates the CLRMA assumption.

Table-3. Presentation of bound test co-integration output.

ARDL bounds test		
Date: 04/03/19 Time: 13:37		
Sample: 1981 2018		
Included observations: 38		
Null hypothesis: No long-run relationships exist		
Test statistic	Value	k
F-statistic	7.986137	4
Critical Value Bounds		
Significance	Io Bound	I1 Bound
10%	2.45	3.52
5%	2.86	4.01
2.5%	3.25	4.49
1%	3.74	5.06

Source: Extraction from E-Views Output.

From the result of Table 3, since the F-statistics of 7.986137 is greater than the upper and lower bound statistics at all levels (1%-10%), the null hypothesis will further be rejected, therefore we can conclude that there is a long run association between the variable under investigation.

Table-4. Autoregressive distributive lag (ARDL).

Dependent variable: RXDE				
Method: ARDL				
Date: 04/03/19 Time: 23:05				
Sample (adjusted): 1981 2018				
Included observations: 48 after adjustments				
Maximum dependent lags: 3 (Automatic selection)				
Model selection method: Akaike info criterion (AIC)				
Dynamic regressors (1 lag, automatic): FIVT EXHR EXRE IOP				
Fixed regressors: C				
Number of models evaluated: 48				
Selected model: ARDL(1, 0, 1, 1, 0)				
Note: final equation sample is larger than selection sample				
Variable	Coefficient	Std. error	t-statistic	Prob.*
RXDE(-1)	0.605073	0.141164	4.286324	0.0003
FIVT	0.002181	0.002493	0.874698	0.3904
EXHR	0.013822	0.006224	2.220799	0.0361
EXHR(-1)	-0.017429	0.007012	-2.485383	0.0203
EXRE	0.012507	0.003093	4.043870	0.0005
EXRE(-1)	-0.006861	0.003557	-1.929126	0.0656
IOP	-0.005597	0.007618	-0.734636	0.4697
C	0.264099	0.474778	0.556258	0.5832
R-squared	0.859961	Mean dependent var		1.417000
Adjusted R-squared	0.819116	S.D. dependent var		1.444972
S.E. of regression	0.614553	Akaike info criterion		2.076474
Sum squared resid	9.064202	Schwarz criterion		2.442908
Log likelihood	-25.22358	Hannan-Quinn criter		2.197937
F-statistic	21.05441	Durbin-Watson stat		1.942748
Prob (F-statistic)	0.000000			

*Note: p-values and any subsequent tests do not account for model selection.

Source: Extraction from E-views Output.

4.1. Global and Relative Analysis

The long run dynamic relationship is shown in the Table 4, it was discovered from the result above that two of the indicators used above (FIVT and IOP) at level has positive but insignificant relationship with RXDE while EXHR (-1) has negative but significant relationship with RXDE, EXRE (-1) has negative and an insignificant

relationship with RXDE. EXHR and EXRE has positive and significant relationship with RXDE. The Global statistics has it that the co-efficient of determination which is the (R^2) R-squared is 86% which means the model is fit and the variable jointly account for about 86% while the remaining 14% is not accounted for in the model. The F-statistics (21.05441) alongside the P-value 0.000000 established that inter-relationship exist between external debt, exchange rate, foreign investments and economic growth in Nigeria. The implication of this result will be further analyzed below so as to cushion the effect of debt crises in the country.

Foreign investment to total exports ratio (FIVT) was revealed to have a positive (co-efficient of 0.002181) and an insignificant relationship (p-value 0.3904) with external debt to total exports ratio (RXDE), this means for every one percent increase in FIVT, (percentage of export that is been financed by foreign investment) there will be about 0.002181% increase in the percentage of export that is been used to finance external debt these result agrees with our apriori expectation stated in the model. This means the more foreigners invest in the economy the more their funds will be used to finance production of goods and services produced in the country for export purpose and part of the proceed that is gotten from the exportation of goods and services that will be used to finance debt taking from international financial institutions. Foreigner's invest their foreign currency which is to be converted to domestic currency this will also improve and boost the foreign exchange market of the home country.

As expected Naira real exchange rate (EXHR) has a positive (co-efficient of 0.013822) and a statistical significant relationship (p-value of 0.0361) with RXDE in the short run, this means for every one percent increase in EXHR it will lead to an increase of about 0.013822% to (RXDE) the percentage of exports that are being financed by external debt, but in the long run EXHR (-1) has a negative (co-efficient of -0.017429) and an insignificant relationship with percentage of exports that are being financed by external debt (RXDE), this means the fluctuation in the value of exchange rate negatively affects the prices of goods and services but since the probability shows that it's significant that means there is every possibility that exchange rate if properly managed and attain stability it will boost export and in turn help to increase the percentage of exports that are being financed by external debt.

The ratio of external reserve to export (EXRE), it can be seen that the percentage of external reserve that are being financed by export had a positive (co-efficient of 0.012507) and a significant relationship (p-value 0.0005) with RXDE, this means for every one percent increase in EXRE there will be a corresponding increase of about 0.012507% in the proportion of external debt to total exports ratio, this agrees with the apriori expectation stated above, while in the long run EXRE(-1) has a negative (co-efficient of -0.006861) and an insignificant relationship (with a p-value of 0.0656), this means for every one percent increase in the proportion of external reserve that are being financed by export there will be a reduction of -0.006861% in the percentage of export that is being financed by external debt. It can be deduced that in the short run proportion of external reserve that are being financed by export will contribute positively and significantly to the proportion of export that are being financed by external debt, while in the long run it was discovered that the external reserve is weak and does not have the capability to finance production of goods and services as well as reduce the percentage of exports that are being financed by external debt.

Inflationary pressure (IOP) has a negative (-0.005597) and insignificant relationship (P-value 0.4697) with RXDE, this means for every one percent increase in IOP it will lead to a reduction of about -0.005597 in the percentage of export that is used to finance external debt. This implies that inflationary pressure affects the volume of goods and services that are to be produced for export purpose, it also affects naira exchange rate between two countries.

5. Concluding Remarks and Policy Recommendations

This paper investigates external debt, exchange rate, foreign investments and economic growth inter-relationships. Further empirical evidence from Nigeria. The data for the study was compiled and computed from the annual statistical bulletin of the central bank of Nigeria, within the period 1981-2018, the data for the study attained stationarity at mixed level after applying the Phillips Perron unit root tests, after carrying out various diagnostic tests to ascertain how reliable and useful the data generated will be for analytical purposes. The paper further made use of autoregressive distributive lag bond test was then used as the statistical technique for decision making, it was revealed that foreign investment to total exports ratio has a positive and an insignificant relationship with external debt to total exports ratio. As expected Naira real exchange rate has a positive and a significant relationship with external debt to total exports ratio in the short run, but in the long run Naira real exchange rate (-1) has a negative and an insignificant relationship with percentage of export that are being financed by external debt. The percentage of external reserve that are being financed by export had a positive and a significant relationship with percentage of exports that are being financed by external debt, while in the long run, the ratio of external reserve to export (-1) has a negative and insignificant relationship with external debt to total exports ratio. Finally, inflationary pressure (IOP) has a negative and insignificant relationship with percentage of export that are being financed by external debt, the result accepts the Harrod Domar growth model discussed above on how investment increase the capital stock of nations. Based on the result of the ARDL it does appear that there is need for foreign investors to participate in the country and for this to take place policies on investment friendly environment will need to be reviewed and corrective measures that will improve the policy will need to be put in place this environment will stimulate and boost foreign participants which will in the long run boost the value of the local currency and make the foreign market of the country to be competitive. There is also need for policies on how the local industries will be protected against foreign multinationals this will also reduce the consequence that might arise from depending on them as earlier discussed in the dependency theory above.

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