

What Determines Foreign Direct Investment Inflows To Nigeria?

JONATHAN D. DANLADI UWAIFO OSAMUEDE JENNIFER
Department of Economics, Afe Babalola University, Ado-Ekiti Nigeria

ABSTRACT

FDI flow is important to the development process of developing countries. FDI is necessary for supplementing domestic savings and encouraging investment. Despite this, FDI flow to Nigeria has been low. It then becomes pertinent to identify the determinants of FDI in the WAMZ so as to increase FDI flow to the country. The study covers the period 1980 to 2013. The unit root stationarity test was used to check for the presence of unit root among the variables; the cointegration test for examining Lon run relationship among the variables in the model and then the vector error correction model was used to identify short run equilibrium determinants of FDI in Nigeria. The findings of the study reveal that the significant determinants of FDI are GDP, FDI lag two, exports, exports lag two, exchange rate and inflation which have a positive relationship with FDI and interest rate lag two, imports lag one, exchange rate lag two which have a negative relationship with FDI. This study recommends that the Nigerian government should endeavour to create favourable environment and policies that can attract more FDI into the productive sectors of the economy.

Key words: Foreign Direct Investment (FDI), Nigeria, cointegration, error correction model.

1.0 Introduction

Globally, FDI flows have increased dramatically from \$13.3 billion in 1970 to \$2.1 trillion in 2007 before declining to \$1.1 trillion in 2009 due to the global financial crisis in 2008-2009. The 2012 value is \$7 trillion (World Bank, 2013). Observably, majority of these FDI flows have been to developed countries and Africa has benefitted relatively little from these FDI flows. Africa's share of global FDI inflows declined from 9.5 per cent in 1970 to 5.3 per cent in 2009 (UNCTAD, World Investment Report 2010) and according to World Investment report (2008), inflow of FDI into Africa was just about 3% of the FDI investment globally. Notably, in absolute terms, FDI flows to Africa have been low however the latest FDI flows to the WAMZ countries have been favourable compared to that of previous years. As at 2011, FDI as a percentage of GDP in Guinea was as much as 24.3% and in Ghana 8.4%, Nigeria 3.8%, Gambia 3.5% and Sierra Leone 2.0%. This compares favourably with the values in 1998, where none of the countries registered any share above 1%, except Nigeria 3.4% and Gambia 2.8% (UNCTAD, 2012).

It is more recently accepted that FDI plays a crucial role in industrial development of the developed and developing countries alike and can help in boosting economic growth through, for example, total factor productivity growth (UNIDO, 2009). The positive role of FDI to bridge the gap between savings and capital in low-income countries has also been recognised in several studies (e.g. Asiedu, 2002). Indeed FDI brings many advantages to the host countries such as the transfer of technology, an increase in employment and an increase in the standard of living of the host country.

In light of all these, the crux of the matter is that compared with the rest of the world, Africa and indeed Nigeria's share of world FDI flow remains low and on the decline. This is due to a variety of factors. According to Udo & Obiora (2006), these factors include dependence of these countries on export of primary goods, an underdeveloped financial sector and low credit ratings, absence of information and the prevalence of ignorance and persistent budget deficits emanating from a weak tax system. All these signify severe constraints on government resources and impede government's ability to address shocks and instability. Other factors include macroeconomic instability, corruption and sometimes, policies put in place by these countries for example the indigenisation policy of Nigeria in the 1970s that required that Nigerians own at least 60% shares in all companies.

Thus, by acquiring the knowledge on conditions that attract FDI inflows, Nigeria will endeavour to create favourable investment and economic environments so as to maximise their chances of being FDI recipients. This necessitates a study to establish the determinants of FDI in the country. Therefore, the broad objective of the study is to identify and examine the determinants of FDI in Nigeria. This is imperative as a careful understanding of the determinants of FDI inflows into the country can help to strategically position the country to direct the inflows into productive in order to enhance overall growth.

Following this introductory section, section two provides some stylised facts about FDI inflow into Nigeria. Section gives the review of relevant literature. Section four provides the theoretical framework and

methodology. Section five presents the analysis of data, results and interpretation while section five summarises and draws relevant conclusions.

2.0 FDI Trends in Nigeria

Countries in West Africa, receive inflows of less than \$0.2billion. Nigeria is the only West African country to receive inflows of over \$3.0 billion. Apart from Nigeria, the only other WAMZ country to receive favourable FDI flows is Ghana whose FDI inflow ranges between \$0.5 and \$1.9 billion. Gambia and Sierra Leone receive less than \$0.2billion (Fabyan, 2009).

Nigeria's position as highest receiver of FDI flows in the WAMZ and West African Region has remained unchanged for the past twenty years and this is as a result of the booming oil industry. Statistics (World Investment Report, 2008) indicate that between 1970 and mid 1990s, Nigeria's share of FDI as a percentage of the total FDI inflow to the continent accounted for more than 30%. In 1977, the Nigerian government adopted policies to restrict the inflows of FDI to the country e.g. the industrialization scheme which indicated that foreign participation in Nigeria remain only at 40% (NIPC & UNCTAD report, 2008).

In 1980 FDI dropped significantly to a negative value of \$739 million as a result of the major decline in oil prices. During the period between 1981 and 1988, there was some FDI growth but it was inconsistent and erratic. However in 1989, FDI rose to a high point of about \$1,884 million (OECD Report, 2008). This was as a result of the change in government policies such as the introduction of the Structural Adjustment Program of 1986 which adopted liberalization, commercialization, deregulation and privatization.

From thereon, FDI flow has been quite stable. Apart from periods between 1990 and 1992, inflows have been in four digits (in millions). Since 2000, FDI has been on a steady increase except in 2010 where FDI dropped to about \$6,048 million and this can be attributed to the banking crisis of 2009. It should be noted that despite this steady increase, Nigeria's percentage share of inflows to Africa declined significantly to 16%. This is attributed to competition faced from other oil rich countries like Angola and Sudan (OECD Report, 2008).

3.0 Literature Review

Mkenda & Mkenda (2004) in their paper Determinants of FDI Inflows to African Countries examine the key determinants of FDI inflows to African countries observed during 1982 to 1997. One of the key determinants investigated is related to the stance of governance in the African countries. A panel data estimation approach was used to estimate the determinants. The study found that governance is positively related to FDI inflows, although the coefficient was not significant. The stability of political regimes is also an important determinant of FDI inflows to African countries. Other important determinants are; population size, level of industrialization, and aid received per capita. Although the level of infrastructure as proxied by the number of telephones was positively related to FDI inflows, the coefficient was insignificant. The level of government involvement in the economy as proxied by government consumption as a percentage of GDP was negatively related to FDI inflows. Several policy implications are drawn from the study. Firstly, population size, which proxies the market size is important for attracting FDI. The practical and rational way of expanding the market size is to integrate economies of individual countries into regional blocks. It also seems that FDI inflows into a country are adversely affected by the government's over-involvement into the economy. Increasing the GDP share of the private sector seems to be good for attracting FDI.

Hussain & Kimuli (2012) investigate the determinants of foreign direct investment flows to developing countries. They explored the different factors responsible for variation in foreign direct investment to developing countries. They used a macro panel of 57 low and lower middle-income countries for a period of 10 years. The results from the study shows that market size is the most important determinant of foreign direct investment to developing countries. Demirhan & Masca (2008) investigate the Determinants of Foreign Direct Investment flows to developing countries in their paper. The aim of their paper was to explore, by estimating a cross-sectional econometric model, the determining factors of foreign direct investment (FDI) inflows in developing countries over the period of 2000-2004. The study is based on a sample of cross-sectional data on 38 developing countries. From the findings of the study, growth rate of per capita, telephone main lines and degree of openness have positive sign and are statistically significant determinants

Anyanwu (2011) in his paper investigated the Determinants of Foreign Direct Investment Inflows to Africa, 1980-2007. The central concern of his paper was to respond to the question: what determines FDI inflows to Africa? He used the Ordinary Least Squares and robust GLM in estimating his results. His estimation results from a panel of seven five-year non-overlapping windows for the period 1980-2007 indicated that there is a positive relationship between market size and FDI inflows; natural resource endowment and exploitation (especially for oil) attracts huge FDI into Africa; East and Southern African sub-regions appear positively disposed to obtain higher levels of inward FDI. The key policy implications are discussed.

Mottaleb & Kalirajan (2010) Investigated the Determinants of Foreign Direct Investment in Developing Countries. Using panel data from 68 low-income and lower-middle income developing countries from 2005 to 2007, the paper strove to identify the factors that determine FDI inflow to the developing countries. Based on a comparative discussion focusing on why some countries are successful in attracting FDI while others are not, the paper demonstrated that countries with larger GDP and high GDP growth rate, higher proportion of international trade and with more business friendly environment are more successful in attracting FDI.

4.0 Theoretical framework and methodology

Earlier theories on the determinants of FDI viewed FDI as a capital movement as visualized by Mundell (1957) and MacDougall (1960). Those theories postulated that FDI was motivated by the return on capital. That is FDI would go from capital abundant countries where the return on capital is low to capital scarce countries where return on capital is high. The rate of return is fundamentally dependent on the interest rate. That is from the investor's point of view, FDI would move from countries where the interest rate is low to countries where the interest rate is high. The theory goes on further to say that capital movements and trade are substitutes. This is because if there is capital movement to a country, the country has the necessary resources to invest in its own goods and services leading to a reduction in imports and an increase in exports. Based on the exposition of the theory above, foreign direct investment can be written as;

$$FDI_t = f(GDP_t, INT_t, IMP_t, EXPT_t, INF_t, EXCH_t) \quad (1)$$

Where the variables in the equation respectively are FDI as a percentage of GDP, GDP current US\$ prices, interest rate, imports as a percentage of GDP, exports as a percentage of GDP, inflation rate, the official exchange rate to the US\$.

Explicitly the above model is rewritten as follows

$$FDI_t = \beta_0 + \beta_1 GDP_t + \beta_2 INT_t + \beta_3 IMP_t + \beta_4 EXPT_t + \beta_5 INF_t + \beta_6 EXCH_t + \mu_t \quad (2)$$

Specifying the variables in their natural log form equation, we have

$$L_N FDI_t = \beta_0 + \beta_1 L_N GDP_t + \beta_2 L_N INT_t + \beta_3 L_N IMP_t + \beta_4 L_N EXPT_t + \beta_5 L_N INF_t + \beta_6 L_N EXCH_t + \mu_t \quad (3)$$

The general error correction model adopted for the study is specified as follows

$$LnFDI_t = \beta_0 + \Delta L_N GDP_t + \Delta L_N INT_t + \Delta L_N IMP_t + \Delta L_N EXPT_t + \Delta L_N INF_t + \Delta L_N EXCH_t + ECM_{t-1} + \mu_t \quad (4)$$

Based on previous studies done on the determinants of FDI, e.g. Anyanwu (2011), Fabyan (2009), the analysis is expected to yield the following results

$$\beta_0 > 0, \beta_1 > 0, \beta_2 > 0, \beta_3 < 0, \beta_4 > 0, \beta_5 < 0, \beta_6 > 0$$

The study will conduct the unit roots test for Stationarity, cointegration tests for long-run relationship as well as the vector error correction for the main analysis. An Error Correcting Mechanism (ECM) is a dynamical system that helps the deviation of the current state from its long-run relationship. It is a category of multiple time series models that directly estimate the speed at which a dependent variable returns to equilibrium after a change in an independent variable. That is ECMs directly estimate the speed at which a dependent variable Y returns to equilibrium after a change in an independent variable X. data are collected from the World Bank database.

5.0 Data Presentation And Analysis

This section deals with the presentation and interpretation of data. An economic regression is carried out, using the stationary (Unit Root) test in order to know the levels each variable are stationary, Cointegration test and The Vector Error Correction Model (VECM).

5.1 Stationary test

The unit root test is conducted mainly to establish whether the variables are stationary at level or not and to determine how many of such relationship exist. In addition an Augmented Dickey Fuller technique is adopted to test the unit root property of the time series data used.

Table 1: Augmented Dickey Fuller Unit Root Test

Variables	Augmented Dickey Fuller test statistics	Order of integration	Maximum lags
FDI	-11.56408	I(1)	8
INT	-4.709630	I(1)	8
IMP	-4.947507	I(1)	8
EXPT	-5.231478	I(1)	8
GDP	-4.546570	I(1)	8
INF	-5.815962	I(1)	8
EXCH	-4.878842	I(1)	8

Source: Author's computation

The results show that all the variables are integrated at order one. This indicates that all the variables are statistically significant at 1 percent, 5 percent and 10 percent critical values in the first difference.

For the unit root test, the null hypothesis states that there is an existence of unit root and for the results; this indicates that all the variables are non stationary at level. However, this null hypothesis is rejected at the first and second difference because as indicated by the results, all the variables are stationary at first difference.

5.2 Cointegration test

After it has been established that the variables are stationary, we can move on to the cointegration test. This is to test for equilibrium relationship among cointegrated variables and their dynamic behaviour.

Table 2

Sample (adjusted): 1982 2013
 Included observations: 31 after adjustments
 Trend assumption: Linear deterministic trend
 Series: LNEXCH LNGDP LNNINT LNEXPT LNIMP LNINF
 LNFDI
 Lags interval (in first differences): 1 to 1

Unrestricted Cointegration Rank Test (Trace)

Hypothesized No. of CE(s)	Eigenvalue	Trace Statistic	0.05 Critical Value	Prob.**
None *	0.894993	227.0202	125.6154	0.0000
At most 1 *	0.844874	157.1546	95.75366	0.0000
At most 2 *	0.748260	99.38566	69.81889	0.0000
At most 3 *	0.607150	56.62552	47.85613	0.0061
At most 4	0.496826	27.66135	29.79707	0.0865
At most 5	0.150415	6.369937	15.49471	0.6518
At most 6	0.041585	1.316701	3.841466	0.2512

Trace test indicates 4 cointegratingeqn(s) at the 0.05 level

* denotes rejection of the hypothesis at the 0.05 level

**MacKinnon-Haug-Michelis (1999) p-values

Unrestricted Cointegration Rank Test (Maximum Eigenvalue)

Hypothesized No. of CE(s)	Eigenvalue	Max-Eigen Statistic	0.05 Critical Value	Prob.**
None *	0.894993	69.86557	46.23142	0.0000
At most 1 *	0.844874	57.76896	40.07757	0.0002

At most 2 *	0.748260	42.76014	33.87687	0.0034
At most 3 *	0.607150	28.96417	27.58434	0.0331
At most 4 *	0.496826	21.29141	21.13162	0.0475
At most 5	0.150415	5.053236	14.26460	0.7351
At most 6	0.041585	1.316701	3.841466	0.2512

Max-eigenvalue test indicates 5 cointegrating eqn(s) at the 0.05 level

* denotes rejection of the hypothesis at the 0.05 level

**MacKinnon-Haug-Michelis (1999) p-values

It can be observed from the co integration test that the trace test statistic indicates four (4) co integrating equations at the 5% level of significance. Also, the maximum eigenvalue test indicates five (5) co integrating equations or vectors at 5% level of significance. Therefore, based on these evidences, it is safe to reject the null hypothesis of no co integrating vectors or no significant long run relationship between the variables, but rather accept that there is a presence of co integrating vectors among the time series variables of the model or that there is a long run relationship existing among the variables that have been included in the model.

5.3 Error correction model (ECM)

Table 3

Dependent Variable: LNFDI

Method: Least Squares

Sample (adjusted): 1982 2013

Included observations: 31 after adjustments

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-8.976803	4.146172	-2.165082	0.0441
LNFDI(-2)	0.216989	0.108110	2.007108	0.0600
LNEXCH	0.449802	0.147122	3.057345	0.0068
LNEXCH(-2)	-0.461010	0.161529	-2.854034	0.0105
LNEXPT	0.778935	0.365454	2.131419	0.0471
LNEXPT(-2)	0.655804	0.296578	2.211237	0.0402
LNIMP(-1)	-0.836982	0.294533	-2.841721	0.0108
LNGDP	0.995095	0.151389	6.573092	0.0000
LNNINT	0.088866	0.143702	0.618407	0.5441
LNNINT(-1)	-0.215774	0.121911	-1.769933	0.0937
LNNINT(-2)	-0.451667	0.106955	-4.222962	0.0005
LNINF	0.212045	0.111693	1.898471	0.0738
ECM(-1)	-0.283624	0.132669	-2.137829	0.0465

R-squared	0.969808	Mean dependent var	21.06108
Adjusted R-squared	0.949680	S.D. dependent var	1.046272
S.E. of regression	0.234700	Akaike info criterion	0.234078
Sum squared resid	0.991515	Schwarz criterion	0.835427
Log likelihood	9.371793	Hannan-Quinn criter.	0.430103
F-statistic	48.18237	Durbin-Watson stat	2.548337
Prob(F-statistic)	0.000000		

Source: authors own computation using E-views 7

From the ECM, coefficient of the intercept (C), of FDI when all other explanatory variables are held constant is obtained to be -8.976803. This is the value of the regression model when the independent variables, (LNFDI(-2), LNINT, LNINT(-1), LNINT(-2), LNGDP, LNIMP(-1), LNEXPT, LNEXPT(-2), LNEXCH, LNEXCH(-2), LNINF and ECM(-1)) are not statistically significant. It is the autonomous component of the regression model and it is not affected by changes in the explanatory variables.

The coefficient of the slope of FDI lag two is obtained as 0.216989. This indicates a positive relationship between FDI lag two and FDI. The magnitude of the coefficient indicates that with a unit increase in FDI lag two, FDI will increase by 0.216989 units. The coefficient of the slope of GDP is obtained as 0.995095. This indicates a positive relationship between GDP and FDI. The magnitude of the coefficient indicates that with a unit increase in GDP, FDI increases by 0.995095 units. This conforms to economic theory as GDP is used as a

representative for economic growth and a country experiencing economic growth would be seen by investors to be a viable market for their goods and services and so GDP is supposed to have a positive relationship with FDI.

The coefficient of interest rate is obtained to be 0.088866 which indicates a positive relationship between interest rate and FDI. The magnitude of the coefficient shows that when there is a unit increase in interest rate, FDI increases by 0.088866 units. This result conforms to economic theory. However this result is contradicted in lag one and lag two for interest rate. The both posit a negative relationship with FDI with the coefficients of their slope being -0.215774 and -0.451667 for lag one and lag two respectively. When interpreted this means that in lag one, for every one unit increase in interest rate, FDI reduces by 0.215774 units and in lag two when interest rate increases by a unit, FDI decreases by 0.451667 units. It therefore follows that in Nigeria, the effect of interest rate on FDI flows must not be significant. As stated in the background information of chapter 2, Nigeria is a country that attracts FDI mostly because of its natural resource (crude oil). So the investors interested in Nigeria must not consider interest rate to be a determining factor when they wish to invest in the country

Another variable that exhibits a negative relationship with FDI is import lag one. The coefficient of the variable is given as -0.836982 indicating that for every unit increase in imports lag one, FDI decreases by -0.836982 units. This result conforms to theory. The coefficient of export is obtained to be 0.778935 which indicates a positive relationship between export and FDI. The magnitude of the coefficient shows that when there is a unit increase in export, FDI increases by 0.778935 units. This result conforms to economic theory. This result is further confirmed by the relationship between FDI and exports in lag two. The relationship here is also positive. The coefficient of exports in lag two is obtained as 0.655804 showing that for every one unit increase in exports, FDI increases by 0.655804 units.

The coefficient of exchange rate is obtained to be 0.449802 which indicates a positive relationship between exchange rate and FDI. The magnitude of the coefficient shows that when there is a unit increase in exchange rate, FDI increases by 0.449802 units. This result conforms to economic theory. However in lag 2 for exchange rate, the coefficient of exchange rate is -0.461010 which indicates a negative relationship between FDI and exchange rate in lag 2. This shows that after some years, the relationship between exchange rate and FDI changes from a positive relationship to a negative relationship. This is because the exchange rate is highly volatile and as such cannot be expected to have a stable relationship with the dependent variable.

The coefficient of inflation is obtained to be 0.212045 which indicates a positive relationship between inflation and FDI. The magnitude of the coefficient shows that when there is a unit increase in inflation, FDI increases by 0.212045 units. This result does not conform to economic theory. Inflation is used as a proxy for macroeconomic stability and this shows that investors in Nigeria are not bothered by the macroeconomic climate of the country. This result is similar to that of Ezeoha & Cattaneo (2011) who in their study found out that their corruption index turned out significantly positive at different significant levels of testing.

The absolute value of the coefficient of the error-correction term is 0.283624 which implies that about 28% percent of the disequilibrium in the model is offset by short-run adjustment within a year. In this case, full adjustments are achieved, and take twelve months to complete the cycles.

The t-test is carried out to check for the individual significance of the variables. Statistically, the t-statistics of the variables under consideration is interpreted based on the following hypothesis.

1. H_0 : FDI lag two is not a significant determinant of FDI in Nigeria.
2. H_0 : GDP is not a significant determinant of FDI in Nigeria.
3. H_0 : Interest rate is not a significant determinant of FDI in Nigeria.
4. H_0 : Interest rate lag one is not a significant determinant of FDI in Nigeria.
5. H_0 : Interest rate lag two is not a significant determinant of FDI in Nigeria.
6. H_0 : Imports are not a significant determinant of FDI in Nigeria.
7. H_0 : Exports are not a significant determinant of FDI in Nigeria.
8. H_0 : Exports lag two is not a significant determinant of FDI in Nigeria.
9. H_0 : Inflation rate is not a significant determinant of FDI in Nigeria.
10. H_0 : Exchange rate is not a significant determinant of FDI in Nigeria.
11. H_0 : Exchange rate lag two is not a significant determinant of FDI in Nigeria.

Decision Rule:

If t -calculated $>$ t -tabulated, we reject the null hypothesis (H_0) and accept the alternative hypothesis (H_1) and if otherwise, we accept the null hypothesis (H_0) and reject the alternative hypothesis (H_1).

Level of significance is at $5\% = \frac{0.05}{2} = 0.025$

Degree of freedom: $n-k$

Where n = sample size

K = number of parameters.

6.0 Conclusion And Recommendations

This study showed the determinants that are significant and it also examined the type of relationship that the determinants have with FDI. The variables that turned out to be significant determinants of FDI using the ECM are, Gross Domestic Product, interest rate lag two, FDI lag two, imports lag one, exports, exports lag two, exchange rate, exchange rate lag two and inflation. GDP, FDI lag two, exports in the current period, exports lag two, exchange rate in the current period and inflation turned out to have a positive relationship with FDI in Nigeria while interest rate lag two, imports lag one, exchange rate lag two were found to have a negative relationship with FDI.

These determinants were identified to be GDP, imports exports, exchange rate and interest rate. It should be noted that many determinants other than those mentioned in this study attract foreign direct investment into a country but it would be difficult to capture all these determinants in our model so only few of them were used. The behaviour of the determinants in relation to FDI in Nigeria was greatly affected by the presence of oil reserves in Nigeria. The necessary monetary and fiscal policies should be put in place so as to keep the rate of inflation stable. Although my study shows that for Nigeria, inflation has a positive relationship with FDI, the reality is that increasing levels of inflation will eventually drive the economy into depression. Efforts should be made to make sure that financial institutions are in order because they are the ones that control the rate of interest in the economy. A stable interest rate is necessary for attracting FDI.

International experience show that countries which succeed in attracting FDI have been implementing policies that provide foreign investors with favourable environment and helps to conduct business activity without incurring unnecessary risk. However, it implies not only the provision of incentives such as tax exemption or reduction and financial subsidies but also implementation of general policy measures that ensure stable macroeconomic environment.

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