

Determinants of Foreign Direct Investment in Nigeria: An Empirical Analysis

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Abstract: The role of foreign direct investment in the development of Nigerian economy cannot be over emphasized. Foreign direct investment provides capital for investment, it enhances job creation and managerial skills, and possibly technology transfer. This paper investigates the determinants of foreign direct investment in Nigeria. The error correction technique was employed to analyze the relationship between foreign direct investment and its determinants. The results reveal that the market size of the host country, deregulation, political instability, and exchange rate depreciation are the main determinants of foreign direct investment in Nigeria. The authors recommend the following policies among others: expansion of the country's GDP via production incentives; further deregulation of the economy through privatization and reduction of government interference in economic activities; strengthening of the political institutions to sustain the ongoing democratic process; gradual depreciation of the exchange rate; and increased investment in the development of the nation's infrastructure.

Keywords: Foreign direct investment, deregulation, unit root, co integration.

I. INTRODUCTION

Foreign direct investment (FDI) not only provides developing countries (including Nigeria) with the much needed capital for investment, it also enhances job creation, managerial skills as well as transfer of technology. All of these contribute to economic growth and development. To this end, Nigerian authorities have been trying to attract FDI via various reforms. The reforms included the deregulation of the economy, the new industrial policy of 1989, the establishment of the Nigeria Investment Promotion Commission (NIPC) in early 1990s, and the signing of Bilateral Investment Treaties (BITs) in the late 1990s. Others were the establishment of the Economic and Financial Crime Commission (EFCC) and the Independent Corrupt Practices Commission (ICPC). However, FDI inflows to Nigeria have remained low compared to other developing countries (see appendix 1). For instance, FDI inflows increased from N786.40 million in 1980 to N2, 193.40 million in 1982, but soon dropped to N1, 423.50 million in 1985. The value of FDI rose from N6, 236.70 million in 1988 to N10, 450.0 million and N55, 999.30million in 1990 and 1995, respectively. However, the value of FDI fell drastically to N5, 672.90 million in 1996 and further to N4, 035.50million in 1999. The inflows of FDI has continued to rise since the year 2001, moving from

N4,937.0million to N13,531.20million in 2003 and N20,064.40million in 2004. The FDI inflows stood at N41,734.0million in 2006 (CBN, 2006).

In terms of growth rate, FDI inflows dropped from 95.6 percent in 1971 to -31.20 percent and -17.23 percent in 1976 and 1984, respectively. Although the growth of FDI increased by 182.68 percent in 1986, the value soon fell by -24.76 percent in 1989 and further to -89.87 percent in 1996. Since the year 2000 the growth of FDI has remained positive except in 2001 when the value was -70.00 percent. The recent surge in FDI inflows to the country is attributable to the reduction in the nation's debt profile (through debt arrangements with London club and Paris club) and the renewed confidence of foreign investors in the Nigerian economy (CBN, 2006).

This study is important because Nigeria (before the year 2003) had experienced declining and fluctuating foreign investment inflows. Besides, Nigeria alone cannot provide all the funds needed to invest in various sectors of the economy, to make it one of the twenty largest economies in the world by 2020 and to meet the Millennium Development Goals (MDGs) in 2015. The objective of this study therefore, is to identify the determinants of FDI inflows to Nigeria.

The departure of this study from other studies on the determinants of FDI in Nigeria is the inclusion of deregulation as an important determinant of FDI. This paper is organized into five sections, with review of relevant literature and theoretical background following the introduction. The methodology of the study is presented in section 3, while section 4 provides data analysis and discussion of results. Section 5 is for policy recommendation and section 6 concludes the paper.

II. REVIEW OF RELEVANT LITERATURE AND THEORETICAL BACKGROUND

Many studies have cited the host country's market size (measured by the Gross Domestic Product, GDP) as an important determinant of FDI inflows (Raggazi, 1973; Moore, 1993; Wang and Swain, 1995; Chakrabarti, 2001 and Masayuki and Ivohasina, 2005). However, if the host country is only used as a production base due to low production costs in order to export their products to another or home market, then the market size may be less influential or insignificant (Agarwal,1980). Bajo-Rubia and Sosvilla-Rivero (1994) and Yin Yun Yang et al. (2000) discovered that rising prices (inflation) also influences FDI. Another factor that determines FDI inflows is the exchange rate. If the exchange rate of a country depreciates, it attracts FDI since foreign firms may merge with or acquire domestic

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industries (Masayuki and Ivohasina, 2005). However, Benassy-Quere et al. (2001) disclosed that the effects of the level of exchange rates on FDI inflows are rather ambiguous. According to Harvey (1990), in the long-run the negative effects of exchange rate volatility are more than the positive effects in attracting FDI. Similarly, Goldberg and Kolstad (1994) found high exchange rate variability to be impediments to FDI inflows between United States and Canada, and Japan and United Kingdom. Some authors have concentrated more on locational factors as important determinants of FDI (Blomstrom et al., 2000). Masayuki and Ivohasina (2005) found that the price of land was a major determinant of FDI inflows into Japan. This is consistent with the work of Blomstrom et al (2000).

Study by Loungani (2003) employ a gravity model of bilateral FDI and portfolio capital flow in order to explain determinants of the mobility of financial capital across countries. The study revealed that the industry specialization in the source countries, the ease of communications between the source country and the destination country (as measured by the telephone densities in each country), and debt equity ratios of publicly traded companies affect the flow of FDI. According to Ahmet (1996), the movement in the exchange rate between the Turkish lira and the Deutsche mark, and interest rate affects inflows of Deutsche mark into the Turkish economy. Focusing on Kenya, Elijah (2006) employed an econometric model to regress FDI on exogenous variables that include human capital, real exchange rate, annual inflation and openness of the economy. The author found that economic openness and human capital affect FDI inflows positively in the short-run. But inflation and real exchange were negatively related to FDI inflows in the short-run and long-run respectively. A similar econometric model of FDI was used by Fuat and Ekrem (2002) to examine location related factors that influence FDI inflows into the Turkish economy. They discovered that the size of the host country's market, infrastructure (proxied by share of transportation, energy and communication expenditures in GDP) and the openness of the economy (as measured by the ratio of exports to imports) are positively related to FDI inflows. The results further revealed that both exchange rate instability and economic instability (measured by interest rate) have negative effects on FDI. As pointed out by Masayuki and Ivohasina (2005), other determinants of FDI inflows are cost of establishing Greenfield plants and the cost of acquiring firms established inside the host country, and the price of land (measured as stock price).

In Nigeria, Ekpo (1997) examined the relationship(s) between FDI and some macroeconomic variables for the period 1970-1994. The author's results showed that the political regime, real income per capita, rate of inflation, world interest rate, credit rating, and debt service explained the variance of FDI inflows to Nigeria. Obadan (1982) in his study argued that market size, trade policies and raw materials are very important determinants of FDI in Nigeria. Anyanwu (1998) maintained that domestic investment, openness and indigenization policy are very important determinants of FDI in Nigeria. According to Ajakaiye

(1995), the high bank lending rate that existed during the early days of deregulation (1987-1990) has affected internal rate of return (IRR) on investment negatively, thereby boosting investment inflows. However Aremu (1997) opined that the host country's FDI make credit available to investors in a form of subsidized loans, loan guarantees as well as guaranteed export credits. He noted that these credits are provided directly to foreign investors for their operations particularly to defray some inevitable costs which invariably have an immediate impact on cash flow and liquidity.

Olatunji (2001) in another development argued that despite government efforts to provide incentives to many investors, many investors are still adamant to come to Nigeria. He noted that this might not be unconnected with the lingering problems that still persist on ground. For example, poor infrastructure, general insecurity, sectarian violence, the arm revolt in the Delta region and the pervasive indiscipline that is becoming the order of the day in the Nigerian economy. Apart from the issues mentioned above, one important issue that deters many investors to come to Nigeria is the issue of the stock exchange market, how developed is the market in terms of its structure, duties, methods and its personnel. On his part, Soludo (1998) maintained that it is not profitability of investment today that attracts investors to invest, but how long will the profit remain fairly stable overtime. Whenever the socio-political and economic environment is highly volatile, an investor is better off exercising his option to wait. On the other hand, he might decide to invest on those projects whose cycles are very short and can be easily undone. He also asserted that while the maintenance of the macro economic stability, avoidance of over-valued exchange rates and export orientation are critical for the resurgence of investment they are necessary but not sufficient conditions.

Ekpo and Egwaikhide (1998) observed that public investment directly influences private investment. As such the public (government) should invest in infrastructures which give an enabling environment for private investors, consequently it will help in attracting foreign direct investment to Nigeria. Having survey the relevant literature, we select the variables that could affect FDI inflows into Nigeria. This study is very important because empirical studies that consider deregulation as an important determinant of foreign direct investment in Nigeria are almost non existent.

III. METHODOLOGY

In this study we employ a multiple regression model to estimate the relationship between foreign direct investment and its potential determinants. The model expresses foreign direct investment (FDI) has a function of the market size of the host country (GDP), Deregulation (DEREGU), political regime (POLINS), Openness of the economy to foreign trade (EXPIMP), rate of inflation (INFLATIO), Exchange rate of the host country's currency (EXCHRAT) and infrastructural development (FRAS). Our model is thus presented below:

$$\text{LnFDI} = \beta_0 + \beta_1\text{LnGDP} + \beta_2\text{DEREGU} + \beta_3\text{POLINS} + \beta_4\text{EXPIMP} + \beta_5\text{INFLATIO} + \beta_6\text{EXCHRAT} + \beta_7\text{LnFRAS} + U_t \dots\dots\dots(1)$$

Where $\beta_0, \beta_1, \beta_2, \beta_3, \beta_4, \beta_5, \beta_6,$ and β_7 are coefficients of elasticities, Ln represents the natural logarithm of variables, and U the disturbance term. We expect FDI to be positively related to the host country's market size, deregulation, openness of the economy to foreign trade and infrastructural development. However, FDI is expected to be negatively related to political instability, inflation and exchange rate. The E-view 4.1 software is used to estimate the model above.

IV. DATA ANALYSIS AND DISCUSSION OF RESULTS

Annual (secondary) data of the variables are used, and they were collected from the Central Bank of Nigeria statistical bulletin (various issues) for the period 1977 to 2006. The variables are measured as follows: foreign direct investment is captured by the total inflows of FDI into Nigeria. The host country's market size is a measure of the Gross Domestic Product (GDP). The ratio of exports to imports captures the country's openness to foreign trade, and it is denoted as

EXPIMP. Exchange rate (EXCHRAT) refers to the rate at which the naira is converted to the US dollar, while the political regime (POLINS) captures both military rule and civilian rule. Thus, we assign D=0, for civilian rule and D=1 for military rule. The rate of inflation (INFLATIO) refers to the changes in the general price level, while deregulation (DEREGU) of the economy which started in 1986, is captured by dummy variable. That is, D=1 for period of deregulation and D=0 for the era of regulation. Lastly, infrastructural development (FRAS) is a measure of capital expenditure on both transportation and communication. Foreign direct investment, gross domestic product and infrastructure are in natural logarithm.

Before estimation, we performed a stationarity (unit root) test that excludes the intercept and trend. The result of the unit root test is presented below:

Table 4.1: Stationarity (unit root) test for variables

Variables	T-ADF Statistics	Critical values	Decision
LnFDI	-5.385638 (0.0000)	1%=-2.669359 5%=-1.956406 10%=-1.608495	Stationary at 2nd difference
LnGDP	-4.798739 (0.0000)	1%=-2.653401 5%=-1.953858 10%=-1.609571	Stationary at 1st difference
DEREGU	-5.099020 (0.0000)	1%=-2.653401 5%=-1.953858 10%=-1.609571	Stationary at 1st difference
POLINS	-5.099020 (0.0000)	1%=-2.653401 5%=-1.953858 10%=-1.609571	Stationary at 1st difference
EXPIMP	-6.195226 (0.0000)	1%=-2.656915 5%=-1.954414 10%=-1.609329	Stationary at 1st difference
INFLATIO	-5.062606 (0.0000)	1%=-2.656915 5%=-1.954414 10%=-1.609329	Stationary at 1st difference
EXCHRAT	-4.230409 (0.0001)	1%=-2.653401 5%=-1.953858 10%=-1.609571	Stationary at 1st difference
LnFRAS	-5.130995 (0.0000)	1%=-2.653401 5%=-1.953858 10%=-1.609571	Stationary at 1st difference

The results of the unit root test reveal that the market size, deregulation, political regime, openness of the economy, inflation, exchange rate and infrastructure are stationary at first difference. However, foreign direct investment is

stationary at second difference. Next we run the regression exercise using the error correction approach. The result of the regression exercise is presented in the table below:

Table 4.2: Results of the regression exercise
Dependent Variable: LNFDI

Method: Least Squares

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Included observations: 28 after adjusting endpoints

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-66.78827	18.56166	-3.598184	0.0019
LNGDP(-1)	6.533206	1.673624	3.903628	0.0010
DEREGU(-2)	3.622192	0.577354	6.273775	0.0000
POLINS	1.604399	0.602659	2.662201	0.0154
EXPIMP(-1)	0.083057	0.378259	0.219577	0.8285
INFLATIO(-1)	0.012179	0.009765	1.247193	0.2275
EXCHRAT(-1)	-0.016734	0.007180	-2.330798	0.0309
LNFRAS(-1)	-0.305542	0.209387	-1.459217	0.1608
ECM(-1)	-0.337272	0.200986	-1.678090	0.1097
R-squared	0.864829	Mean dependent var		8.099433
Adjusted R-squared	0.807915	S.D. dependent var		1.478881
S.E. of regression	0.648156	Akaike info criterion		2.225720
Sum squared resid	7.982012	Schwarz criterion		2.653929
Log likelihood	-22.16008	F-statistic		15.19538
Durbin-Watson stat	1.883202	Prob(F-statistic)		0.000001

1. Discussion of results

The regression results show that the explanatory variables explained approximately 86 percent variations in foreign direct investment in Nigeria. The value of the F-statistic shows that the equation has a good fit, that is, the explanatory variables are good explainer of changes in FDI in Nigeria. The Durbin Watson statistic indicates the absence of autocorrelation among the variables.

The market size of the host country was found to be significant in attracting FDI into Nigeria, and the variable has the correct sign. For example, a 1 percentage increase in the market size of the host country in the previous one year causes the inflow of FDI to increase by approximately 6.53 percent. This is consistent with the findings of Obadan (1982), Chakrabarti (2001), and Masayuki and Ivohasina (2005). Another discovery from the estimation is that deregulation of the economy is positively related to FDI inflows, and the variable is significant. If the economy is deregulated by 1 percentage in the previous two years, FDI inflows will rise by 3.62 percent. The estimation also reveals that political instability in the previous one year has a significant positive effect on foreign direct investment. A 1 percentage increase in political instability leads to a 1.60 percentage increase in FDI. The positive impact of political instability on FDI reflects the situation in the Nigeria's oil sector that has continued to attract more foreign investment regardless of the political situation in the country. Furthermore, the results reveal that exchange rate is significant in explaining changes in FDI. A 1 percent depreciation in exchange rate causes FDI to increase by approximately 0.02. This finding is in line with Masayuki and Ivohasina (2005) that exchange rate depreciation may encourage the inflow of foreign direct investment to the host country.

However, the results illustrate that openness of the economy and inflation are statistically insignificant but positively related to foreign direct investment. Similarly, the results show that infrastructural development has an insignificant effect on foreign direct investment in Nigeria. Lastly, error correction parameter is significant and correctly signed, implying that the variables are con-integrated, and that a long run relationship exists among the variables.

2. POLICY RECOMMENDATION

The above findings have important policy implications. Firstly, since the market size of the host country has significant effect on FDI, there is need for continuous increase and growth of the nation's Gross Domestic Product. Foreign investors will be motivated and attracted when they are certain that the host country creates the needed market for their products. This can be achieved if government creates an enabling environment (or incentives) for production activities. Secondly, government should make efforts to further deregulate the economy (with caution) in order to attract more FDI into Nigeria. This is true because, the inflow of FDI has been on the increase since the introduction of the Structural Adjustment Programme (SAP)

in 1986. In addition, the deregulation policies pursued by the immediate past administration (particularly through reduction in government intervention or interferences in economic activities) have further encouraged and boost foreign investment in various sectors of the economy. Thirdly, government should strengthened the political institutions and adopt democratic principles that will ensure stability within the polity. The current crisis in the Niger-Delta region has been a major obstacle to crude oil production. The restoration of peace in the region will in turn woo more foreign investment to Nigeria. The surge in FDI to Nigeria since 1999 has partly been attributed to the democratic rule and relative peace within the system. Fourthly, government should allow the exchange rate to depreciate further since it will reduce the dollar price of some ailing indigenous industries, thereby attracting more foreign investment in the form acquisition or mergers. Finally, government should invest more in infrastructure (like power, energy, transportation, telecommunication, etc.) so as to enhance the competitiveness of the environment of investment and ultimately increase FDI inflows. All of these should be complemented with the on-going war on corruption.

V. CONCLUSION

The low level (and fluctuation) of FDI to Nigeria, the significance of FDI in a developing economy, and the recent surge in FDI inflows to Nigeria motivated this study. The ordinary least squares regression technique was employed to estimate the relationship between FDI and its potential determinants. The regression results showed that the principal determinants of FDI are the market size of the host country, deregulation, exchange rate depreciation and political instability.

VI. REFERENCES

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Appendix 1: Foreign direct investment inflows into selected countries in 2002

Country	FDI inflows (million dollars)
Nigeria	1,005.0
Malaysia	23,823.0
Indonesia	11,641.0
Tunisia	14,060.0
Turkey	18,846.0
Venezuela	38,080.0
Morocco	12,481.0
Kazakhstan	15,464.3
Hungary	35,890.0
India	20,326.0
Thailand	38,180.0
Argentina	32,394.0
Brazil	100,847.0
South Africa	29,611.0

Source: International Financial Statistics (2005)

Appendix 2: FDI and growth of FDI in Nigeria

Year	Foreign direct investment (Nm)	Growth of FDI (%)
1970	251	-
1971	489.6	95.05976
1972	432.8	-11.6013
1973	577.8	33.50277
1974	507.1	-12.2361
1975	757.4	49.3591
1976	521.1	-31.1988
1977	717.3	37.65112
1978	664.7	-7.33305
1979	704	5.912442
1980	786.4	11.70455
1981	584.9	-25.6231
1982	2,193.40	275.0043
1983	1,673.60	-23.6984
1984	1,385.30	-17.2263
1985	1,423.50	2.757525
1986	4,024.00	182.6835
1987	5,110.80	27.00795
1988	6,236.70	22.02982
1989	4,692.70	-24.7567
1990	10,450.20	122.6906
1991	5,610.20	-46.3149
1992	11,730.70	109.0959
1993	42,624.90	263.3619
1994	7,825.50	-81.641
1995	55,999.30	615.6003
1996	5,672.90	-89.8697
1997	10,004.00	76.34719
1998	32,434.50	224.2153
1999	4,035.50	-87.558
2000	16,453.60	307.7215
2001	4,937.00	-69.9944
2002	8,988.50	82.06401
2003	13,531.20	50.53902
2004	20,064.40	48.28249
2005	26,083.70	29.9999
2006	41,734.00	60.00030

Source: Central Bank of Nigeria (2005, 2006).

Appendix 3: Data used for regression.

YEAR	FDI (Nm)	GDP (Nm)	EXPT(Nm)	IMPT(Nm)	INFLATI (%)	EXCHRAT (N/\$)	FRAS(Nm)
1977	717.3	96,100	7,630.70	7,093.70	15.4	0.6466	2,300.40
1978	664.7	89,000	6,064.40	8,211.70	16.6	0.606	1,331.10
1979	704	91,200	10,836.00	7,472.50	11.8	0.5957	1,865.70
1980	786.4	96,200	14,186.70	9,095.60	9.9	0.5464	2,349.30
1981	584.9	70,400	11,023.30	12,839.60	20.9	0.61	1,625.70
1982	2,193.40	70,200	8,206.40	10,770.50	7.7	0.6729	1,283.90
1983	1,673.60	66,400	7,502.50	8,903.70	23.2	0.7241	1,094.40
1984	1,385.30	63,000	9,088.00	7,178.30	39.6	0.7649	261.90
1985	1,423.50	68,900	11,720.80	7,062.60	5.5	0.8938	240.90
1986	4,024.00	71,100	8,920.60	5,983.60	5.4	2.0206	516.10
1987	5,110.80	70,700	30,360.60	17,861.70	10.2	4.0179	375.10
1988	6,236.70	77,800	31,192.80	21,445.70	38.3	4.5367	703.70
1989	4,692.70	83,500	57,971.20	30,860.20	40.9	7.3916	683.80
1990	10,450.20	90,300	109,886.10	45,717.90	7.5	8.0378	877.40
1991	5,610.20	96,600	121,535.40	89,488.20	13	9.9095	353.40
1992	11,730.70	97,000	205,611.70	143,151.20	44.5	17.2984	625.30
1993	42,624.90	100,000	218,770.10	165,629.40	57.2	22.0511	1,436.70
1994	7,825.50	101,300	206,059.20	162,788.80	57	21.8861	1,293.50
1995	55,999.30	103,500	950,611.40	755,127.70	72.8	21.8861	3,800.30
1996	5,672.90	107,000	1,309,543.40	562,626.60	29.3	21.8861	8,819.70
1997	10,004.00	110,400	1,241,662.70	845,716.60	8.5	21.8861	7,147.70
1998	32,434.50	113,000	751,856.70	837,418.70	10	21.8861	6,227.50
1999	4,035.50	117,000	1,188,969.80	862,515.70	6.6	92.6934	3,313.70
2000	16,453.60	121,000	1,945,723.30	985,022.40	6.9	102.1052	3,020.90
2001	4,937.00	126,000	1,867,953.90	1,358,180.30	18.9	111.9433	19,241.00
2002	8,988.50	131,000	1,867,953.90	1,669,485.20	12.9	120.9702	17,083.20
2003	13,531.20	136,000	1,867,953.90	2,295,890.50	14	129.3565	6,639.60
2004	20,064.40	145,400	1,867,953.90	2,193,967.00	15	133.5004	9,750.70
2005	26,083.70	156,000	1,867,953.90	2,496,423.70	11.6	131.6619	19,982.50
2006	41,734.00	169,304	5,752,747.70	2,528,086.00	8.2	128.6516	6,513.1

Source: Central Bank of Nigeria (2005, 2006).

Dependent Variable: LNFDI

Method: Least Squares

Date: 12/18/09 Time: 15:49

Sample(adjusted): 1979 2006

Included observations: 28 after adjusting endpoints

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-66.78827	18.56166	-3.598184	0.0019
LNGDP(-1)	6.533206	1.673624	3.903628	0.0010
DEREGU(-2)	3.622192	0.577354	6.273775	0.0000
POLINS	1.604399	0.602659	2.662201	0.0154
EXPIMP(-1)	0.083057	0.378259	0.219577	0.8285
INFLATIO(-1)	0.012179	0.009765	1.247193	0.2275
EXCHRAT(-1)	-0.016734	0.007180	-2.330798	0.0309
LNFRAS(-1)	-0.305542	0.209387	-1.459217	0.1608
ECM(-1)	-0.337272	0.200986	-1.678090	0.1097
R-squared	0.864829	Mean dependent var		8.099433
Adjusted R-squared	0.807915	S.D. dependent var		1.478881
S.E. of regression	0.648156	Akaike info criterion		2.225720
Sum squared resid	7.982012	Schwarz criterion		2.653929
Log likelihood	-22.16008	F-statistic		15.19538
Durbin-Watson stat	1.883202	Prob(F-statistic)		0.000001