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Original Paper

Effect of Foreign Direct Investment on Economic Growth in Nigeria: Does Exchange Rate Matter?

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Abstract

This study investigates the effect of foreign direct investment on economic growth in Nigeria for the period from 1986 to 2020; a particular attention is also given on the role of exchange rate in the relationship between foreign direct investment and economic growth using annual time series data sourced from the database of World Development Indicator (WDI) of the World Bank and Central Bank of Nigeria (CBN) 2021 Statistical Bulletin. Autoregressive Distributed Lag (ARDL) model was employed for the analysis. The study found that FDI has positive and significant effect on economic growth. Exchange rate also has a positive and significant effect on the economic growth. Findings also show that the regression is significant at 5% level of significance as F-statistic is less than 0.05. This entails that the growth effect of FDI is enhanced in the presence of a stable exchange rate. Based on the findings, the study suggests an improvement in the institutional quality so as to attract the further inflow of foreign direct investment in Nigeria. The study also suggests that government should make exchange rate stable so that more foreign investment can be attracted for desired economic growth and development in the country.

Keywords

Exchange Rate, Foreign Direct Investment, Economic Growth, Autoregressive Distributed Lag.

1. Introduction

The growth effect of foreign direct investment has been rigorously debated in the literature. Some researchers are of the opinion that foreign direct investment impacts positively to the growth of an economy while some are of the opinion that FDI has an insignificant impact depending on the market size and other institutional variables in the country. Foreign direct investment (FDI) is termed as an investment made by an investor either individuals or corporate bodies in a country other than the investor's home country in creating business or buying an asset in the country The academics, industry

experts, international community all over the globe do concur that the developing countries in general need tremendous inflows of foreign capital to stimulate economic activities.

Nigeria is an import based economy with heavy dependence on oil as the major export commodity and source of foreign exchange. The inflow of foreign direct investment has been largely from the extractive sector due to lack of productive capacity that could fully integrate the economy in to global market. FDI in Nigeria has its origin from the period of colonial masters who came with the purpose of utilizing Nigeria's oil resource. World Bank, (1996) considered Nigeria as the second most largest foreign direct investment host country in Africa due to the nation's large oil endowment. Appreciation in the value of Naira during the period of oil boom was also responsible for the large amount of FDI in the country. Korna, Tagher and Idyu (2013) argued that the exchange rate during the oil boom was $1.49 to ₦1 and the resultant FDI activities was $2414.8 million. With the coming of new government in 1999 and subsequent fall in oil prices, there was a change in focus from extractive industries to manufacturing and other productive enterprises and also from import substitution to export promotion strategy. That was largely due to the understanding of the significance of foreign direct investment in bridging the savings-investment gap that would trigger export activities. A variety of policies relating to incentive measures were taken by the government to attract more inflows of FDI in Nigeria such as the promulgation of the Foreign Exchange (Monitoring and Miscellaneous Provisions) Act and Nigerian Investment Promotion Commission Act in 1995 as well as the privatization of some enterprises which include electricity, telecommunication, transportation and manufacturing.

The inflow of foreign direct investment in Nigeria has been decreasing according to National Bureau of Statistics, from $2,277.04 million in 2014 to $1,446.62 million in 2015, also from $1,044.02 in 2016 to $981.75 in 2017 with United Kingdom as the major source of the capital investment in the country. It is expected that FDI to enhance economic growth in Nigeria through the accumulation of capital for productive activities into the economy. On the other hand, capital accumulation depends upon certain level of institutional and macroeconomic variables (Jude & Levieuge, 2013). Some authors such as Esew and Yaroson (2014) have regarded the level of development index as markets size, human capital, political risks, and business environment among others. This has been the concern and a problem to Nigerian economy due to the deficiencies in such institutional quality.

Net inflows of investment in a Nigerian economy are expected to serve as a means of balancing the country's domestic resources in order to ensure speedy economic growth. Regrettably, despite of all the effort to attracting foreign direct investment, the growth of FDI in Nigeria becomes an issue of concern to the country. Nsofor (2016) argued that level of terrorism in the country; such as *Boko Haram* terrorism constitutes a major impediment to multinational companies' influx with serious hindrance to the inflow of FDI. The inflow is also stalled by other forms of factors, such as weak governance, bureaucratic bottleneck, inefficient policy implementation and regulatory burden. Consequently, foreign investments which could have accrued to the country in form of technical skills and transfer of technology were discouraged.

Due to Nigeria's resource endowment and market size, the country has been one of the most attractive countries for investors. Therefore, Nigeria accounts for a great proportion of FDI inflow in Africa. On the other hand, the amount of foreign direct investment attracted by Nigeria has started decreasing (Trading Economics, 2015). This could be attributed to the macroeconomic environment of the nation or certain policies which may support the inflow of foreign direct investment. Based on the available statistics, the inflow of foreign direct investment during the period of the recession improved greatly but decreased to about 30% at the onset of recovery in the second quarter of 2017(Trading Economics). This indicates a negative linkage between FDI and economic growth and not the positive effect as often found. Furthermore, in the first quarter of 2018, statistics reveal that the inflow of FDI increased but the growth rate of GDP of the country dropped.

In general, after comparing these variations for a decade, available statistics reveal that in periods where the economy was in downturn, the FDI inflow was rising while in periods or moments where FDI inflow was falling, the growth rate of real GDP was increasing. There is an urgent need for a new and more comprehensive analysis on the effect of foreign direct investment on the economic growth of Nigeria. The country is significantly changing and there are new policies in motion as each government strives to move the country to the path of growth and development thus making the macroeconomic features of the country to change as well. Thus, there is a need for further investigation on the nexus between foreign direct investment and economic growth in the country.

2. Literature Review

2.1 Theoretical Background

Many theories exist in an effort to rationalize the resolution or choice for multinational corporations to invest in a foreign economy; they range from Vernon's (1966) economic theories, to the internationalization theories advanced by Rugman (1981). However, Dunning (1988, 1993) is prominent for his clarification on the determinants of investment in foreign markets as well as the reasons for such investments. Accordingly, firm's decision to invest in a foreign country is based on one or all of these major reasons; resources seeking; firms seek to invest in countries that are rich in human and natural resources not available in their home country; market seeking: also termed as horizontal FDI. The main reason of firms here is to serve the host market through replicating their production facilities locally, while market size in terms of the nation's population, the growth of the economy and high tariffs or transportation cost plays important roles in this type of FDI; Efficiency-seeking: corporations can benefit from the common governance of geographically dispersed activities in the presence of economies of scale and scope, they may seek to invest in such countries. This study therefore employs and adopts the fundamental theory as laid down by Dunning (1993).

2.2 Empirical Review

In spite of the findings and evidences gathered on the positive effects of foreign direct investment (FDI) on growth, some empirical literature suggests the contrary. Carkovic and Levine (2005) made use of the

Generalized Method of Moment (GMM) dynamic panel data estimator using data from 1960 to 1995 for 68 countries as sample to study the impact of FDI to economic growth. Findings reveal that foreign direct investment does not have a significant and positive impact on economic growth. Findings that showed FDI positive effect to economic growth comprise the study of Trojette (2016) on whether the effect of foreign direct investment on economic growth depends upon institutional quality. A generalized method of moment (GMM) panel estimator of the period from 1984-2013 found that with stability in government and the respect of rule of law FDI enhances economic growth.

Nduba (2015) investigated whether eighty percent of all FDI flowed to the mining sector, could have an effect on the magnitude of effect exerted by FDI on economic growth in Zambia. Making use of annual time series data from 1990 to 2013, the study reveals that FDI impacted to increasing productivity in the mining sector due to the injection of new capital but this in turn has not impacted in active growth for the entire economy. The study opines that FDI has not impacted to dynamic economic growth but has reinforced dependence on the mining sector.

Adeleke, et al. (2014) examined the effect of foreign direct investment on economic growth in Nigeria from the period 1990-2013. Making use of regression analysis of the Ordinary Least Square (OLS), results found that economic growth is directly linked to inflow of foreign direct investment (FDI) and it also found that economic growth is directly linked to inflow of foreign direct investment and it is also statistically significant at 5% level of significance which portrays that a good economic performance is a positive indicator for the inflow of foreign direct investment.

Louzi and Abadi (2011) investigated the FDI-growth effect postulation of Jordan economy. The research was based on annual time series data from 1990-2009. The method of co-integration and error correction mechanism was employed to accommodate two way relationships between variables. Result revealed that the inflows of FDI do not exert an independent effect on economic growth.

Adigwe, Ezeagba and Udeh (2015) made study of Pearson Correlation on the relationship between FDI, exchange rate and gross domestic product in Nigeria from 2008-2015. Results revealed that there was a strong linkage between FDI, EXR and GDP. It shows that economic growth in Nigeria is directly linked to foreign direct investment and exchange rate. The study suggests that there is need for formulating investment policies by the government that will be favorable to local investors so as to compete with the inflow of investment from foreign countries.

Antwi and Zhao (2013) conducted a study on the linkage between FDI and economic growth in Ghana from the period from 1980-2010. Making use of annual time series data sourced from the database of world development indicators. Co-integration methodology was used to analyze data. Results found that a long-run equilibrium and causal linkage exist between the GDP and Gross National Income.

Sohail, Sohail and Azeem (2014) analyzed the effect of foreign direct investment on economic growth in Pakistan. The investigation made use of annual time series data from 2000-2010 by using two-stage least square method of simultaneous equations estimation. The findings revealed that there is a positive linkage between FDI and economic growth in Pakistan. Ur Rahman (2014) made use of multiple regression

technique to investigate the effect of foreign direct investment on economic growth of Pakistan with data from 1981-2010. Consumer Price Index (CPI) and FDI were used as independent variables. The finding shows that there is a positive linkage between the FDI and GDP while there is negative linkage with CPI. Gul and Imran (2015) analyzed the effect of FDI and trade openness on economic growth of Pakistan making use of annual time series data for the period of 2008-2013. To find out the long run linkage and relationship among variables, regression analysis, co integration technique, correlation and Durbin Watson test were used. It was revealed that FDI, trade openness and domestic capital positively affect the economic growth.

Nketiah-amponsah and Sarpong (2019) analyzed the effect of infrastructure and foreign direct investment on economic growth in SSA. Making use of system GMM, the results reveal that foreign direct investment has a positive effect on economic growth after interacting with the host country's infrastructure. Makiela and Ouattara (2018) also undertook a study with the sample of developed and developing countries over the period 1970-2007. Making use of system GMM, the result reveals that foreign direct investment has a positive impact on the economic growth of the host countries.

Dinh et al. (2019) undertook an investigation on developing countries from 2000 to 2014 by making use of VECM and FMOLS. The short-run finding reveals that foreign direct investment negatively affects economic growth, but it has a positive impact in the long run. Khobai et al. (2018) examine the FDI-growth linkage in South Africa from a period 1970-2016 by making use of quantile regressions. The results show that foreign direct investment has a negative and significant effect at the lower quantiles but has no significant effect at the higher quantiles. Likewise, Nguyen (2020) undertook a survey on a specific country in Vietnam over a period 1997-2018, and the result reveals that foreign direct investment has a significant and positive and impact on economic growth.

Mohd and Muse (2021) performed an investigation in Ethiopia on the impact of FDI on economic growth over the period from 1981 to 2017. Making use of the VAR model, the results reveal that, foreign direct investment has a positive and significant impact on economic growth both in the short and long run.

3. Data Collection and Methodology

This study made use of annual time series data from 2000 to 2021. The data were sourced from the database of World Development Indicators and Central Bank of Nigeria (CBN), 2021 Statistical Bulletin.

3.1 Model Specifications

In order to find out the effect of foreign direct investment and economic growth, a multivariate model is adopted from the empirical work of Aminu, Y and Batat E (2019) who investigated whether foreign aid triggers economic growth in Nigeria.

$$GDP = f(ODA, GCF, EXPT, IMP) \quad \ldots\ldots\ldots\ldots (1)$$

Where:

GDP stands for a proxy for Economic Growth (Gross Domestic Product)

f stands for a functional relationship

ODA stands for Official Development Assistance

GCF stands for a proxy for Domestic Investment (Gross Capital Formation)

EXP stands for Exports

IMP stands for Imports

For the use of this investigation, the model in equation (1) above was adopted and then substitutes Official Development Assistance (ODA), Gross Capital Formation (GCF), Imports and Exports with Foreign Direct Investment (FDI), Exchange Rate (EXR) and Trade respectively which translate in to a new model as follows:

$$GDP = f(FDI, EXR, TRD) \ldots\ldots\ldots\ldots\ldots\ldots (2)$$

The econometric equation takes the following dynamic form:

$$GDP_t = \propto_o + \beta_1 GDP_{t-1} + \beta_2 FDI_t + \beta_3 FDI_{t-1} + \beta_4 EXR_t + \beta_5 EXR_{t-1} + \beta_6 TRD_t \ldots + \mu_t \ldots \quad (3)$$

Where:

α_o $stands\ for$ Intercept, β_1-β_6 = Slope parameters or coefficients of the independent variables

GDP = Gross Domestic Product (Proxy for Economic Growth), FDI= Foreign Direct Investment, EXR = Exchange Rate, TRD = Trade, μ_t = Error term, t = time period

Additionally, for linearity and normality of data, natural logarithm was applied into the model in equation (3) above in order to find out the influence of exchange rate on the effect of foreign direct investment on economic growth which also takes the following form:

$$LogGDP_t = \alpha_0 + \beta_1 \log(FDI)t + \beta_2 \log(EXR)t + \beta_3 \log(TRD)t + \ldots . + \mu_t \ldots .. (4)$$

3.2 Estimation Technique

3.2.1 Unit Root Test

The paper made use of unit root test to confirm whether the series is stationary or not using Phillips Peron Unit Root Test method.

3.2.2 Bounds Test for Co integration

The study conducted co integration test to find out whether the dependent and independent variables have a long run association using ARDL Bounds Test to co integration method.

3.2.3 Autoregressive Distributed Lags (ARDL) Model

The paper made use of Autoregressive Distributed Lags (ARDL) model estimation technique to analyze the data based on the fact that the variables are at first difference and at level.

4. Results and Discussion

4.1 Descriptive Statistics

Table 1 below revealed the descriptive statistics of the dependent and independent variables of the study. The variables statistics were put forward in terms of their mean value, maximum value, minimum value as well as standard deviation. The maximum value of log (GDP) over the period under investigation is $27.02712 which was recorded in 2014, while the minimum value is $24.04658 which was recorded in 1993. The mean value log (GDP) is $ 25.61821. Likewise, the maximum value of log (FDI) is $22.90267

which was recorded in 2011 while the minimum value is $19.07931 which was recorded in 1986. The mean value of log (FDI) over the period under study is $21.27034. For the log value of exchange rate (log EX), the maximum value stands at 5.609512 which were recorded in 1998 while the minimum value is 3.907009 which was recorded in 1992. The mean of the log value exchange rate over the period under study is 4.613161.

Table 1. Descriptive Statistics of the Variables

	LGDP	LFDI	LEX	LINF	LTRADE
Mean	25.61821	21.27034	4.613161	2.680374	3.500035
Medium	25.37639	21.35680	4.600827	2.502892	3.539736
Maximum	27.02712	22.90267	5.609512	4.288204	3.975523
Minimum	24.04658	19.07931	3.907009	1.684176	2.212206
Std. Dev.	1.005781	1.075711	0.405917	0.708241	0.361463
Skewness	0.078023	-0.184051	0.894596	0.938820	-1.494023
Kurtosis	1.332982	1.991853	3.611977	2.884935	5.908844
Jarque-Bera	4.088146	1.679795	5.214595	5.160708	25.36010
Probability	0.129500	0.431755	0.073734	0.075747	0.000003
Sum	896.6374	744.4618	161.4606	93.81308	122.5012
Sum Sq. Dev	34.39424	39.34323	5.602142	17.05457	4.442285
Observations	35	35	35	35	35

Source: Author's Computation using Eview 9. LGDP = Log Gross Domestic Product, LFDI = Log Foreign Direct Investment, LEX = Log Exchange Rate, LINF = Log Inflation, LTRADE = Log Trade

4.2 Unit Root Test

The unit root test as depicted in Table 2 below revealed that log(FDI), log(GDP) and log(EX), were not stationary at level but were converted to stationary after taking the first difference at 5 percent level of significance. As a result, the variables under this study are integrated of order one that is I(1).

Table 2. Summary of Unit Roots Test (Phillip Perron).

Variables	Test statistics at level	5% critical value at level	P-value at level	Test statistics at first diff	5% critical value at first diff	P-value at first diff	Order of Integration
Log(GDP)	-0.176221	-2.951125	0.8612	-4.615437	-2.954021	0.0001	I(I)
Log(FDI)	-	-	0.0160	-	-	0.0000	I(0), I(I)

	2.542906	2.951125		8.806810	2.954021		
Log(EX)	-	-	0.0086	-	-	0.0000	I(0), I(I)
	3.486215	2.951125		6.223041	2.954021		
Log(INF)	-	-	0.0322	-	-	0.0000	I(0), I(I)
	3.149278	2.951125		5.192265	2.954021		
Log(Trade)	-	-	0.0001	-	-	0.0000	
	4.624040	2.951125		7.668475	2.954021		

Source: Author's Computation using Eview 9. GDP = Gross Domestic Product, FDI = Foreign Direct Investment, EX = Exchange Rate, INF = Inflation, Trade = Trade, Log = Natural Logarithms

4.3 Bounds Test to Co Integration

Consequent upon that the variables employed for this study are integrated of order one as revealed by the unit root test in Table 2 above. The study decided to apply the bounds test to co integration to find out whether the variables have long run relationship as depicted in Table 3 above. The F statistic value of 1.719625 from the result of ARDL bound test depicted in Table 3 above is less than the lower bound value of 2.56 at 5 percent level of significance. Hence, on the basis of this, the null hypothesis that states no long run relationship is therefore accepted and conclude that log(GDP) (indicator for economic growth), log(FDI), log(EX) Exchange Rate, Log(INF) inflation and log(trade) do not have long run relationship over the period under study.

4.4 Autoregressive Distributed Lags (ARDL) Short-Run Estimate

To study made use of Autoregressive Distribution lag (ARDL) model as formulated by Pesaran and Shin (1998) for the data analysis because of its fitness and the fact that the variables employed for this study are integrated of the order one of as revealed by the unit root test in Table 2 above. This method was applied based of its applicability irrespective of whether the repressors in the model are purely I(0) or I(1) or mixed. In addition, to estimate the variables in the model, the study selected ARDL (4, 0, 0, 0, 0,) as the result depicted in Table 4 below.

The ARDL estimation depicted in Table 4 above has a good fit with an Adjusted R-square value of 97 percent. It revealed that about 97 percent of the variation in economic growth proxy by GDP is explained by foreign direct investment, exchange rate, inflation and trade over the period under study while the remaining 3 percent is explained by other variables not captured by the model. The result also showed that the independent variables are mutually significant to explain economic growth being the dependent variables as showed by the significant probability value of the F statistic which is 0.00000 less than 5 percent.

The results further revealed that Foreign Direct Investment (FDI) has significant positive relationship with economic growth which is also similar to the work of Adeleke, Olowe and Fasesin (2014) as well as Alexander, Joshua and Tauhid (2013) on the nexus between foreign direct investment and economic

growth in Nigeria. Precisely, a unit increase in the log (FDI) will bring about 0.161401 percent significant increase in economic growth at 5 percent level of significance. Moreover, the results showed that exchange rate log (EX) has insignificant positive relationship with economic growth. Specifically, a unit increase in the log value exchange rate will bring about 0.174999 percent increase in economic growth over the period under study. In addition, the results also revealed that inflation (INF) has significant negative relationship with economic growth. Specifically, a unit increase in log (INF) will bring about -0.145965 percent decrease in economic growth. Similarly, trade (Trade) has insignificant positive relationship with economic growth. Specifically, a unit increases in log (Trade) will bring about 0.109603 increase in economic growth over the period under study.

5. Conclusion and Recommendation

5.1 Conclusion

This study examines the effect of foreign direct investment and economic growth in Nigeria from the period 1986 to 2020 taking into account the role of exchange rate. The study reveals that foreign direct investment has significant positive effect on with economic growth. However, exchange rate shows insignificant positive effect on the economic growth. The study also argues that inflation has a significant negative effect with economic growth while trade reveals insignificant positive relationship with economic growth over the period under study.

5.2 Recommendations

Based on the results, the following recommendations were made:

i. The depreciation of Nigeria's currency should be encourage so as to allow more inflow of foreign direct investment considering its positive impact on economic growth.

ii. The right and enabling environment should be created in order to attract foreign investors in terms of ensuring security and provision of infrastructure.

iii. The Nigerian government should put in place policies that will encourage exports and discourage Import. Stringent excise duties should be eliminated while importation that does not lead to economic growth should be discouraged.

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