



International Journal of Banking, Finance, Management & Development Studies

Vol. 1, No. 2

December, 2015

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**A Publication of the Department of Banking and Finance, Economics and Management Studies,
College of Social and Management Sciences, Afe Babalola University, Ado-Ekiti, Nigeria.**

**International Journal of Banking, Finance,
Management & Development Studies.**
Vol. 1, No. 2, December, 2015

A Publication of
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Assessment of Foreign Direct Investment and Economic Growth in Nigeria

¹Olaniyi, T.A, PhD, ACA

Abstract

The expected benefit of Foreign Direct Investment (FDI) was inhibited by imported inflation, persistent technology gap and capital flight. As such, its impact on economic growth had remained unresolved. The study examines the impact of foreign direct investment on Nigeria Gross Domestic Product and capital formation for the period of 1980- 2012. It investigate the relationship between gross domestic product (GDP) and Foreign Direct Investment on one hand and between capital formation and FDI on the other hand while factoring in some macro- economic variables such as, total trade, manufacturing index, prime interest rate, inflation rate, exchange rate, balance of payment and external reserve. The secondary data used was analyzed using linear regression which was interpreted using R, adjusted R², standard error estimate, Durbin Watson statistics, F-statistics, and T-statistics. The result shows that FDI has a negative but insignificant impact on economic growth and on capital formation as well in Nigeria. The study recommends that government should continually promote the inflow of FDI by providing appropriate infrastructures, transparency, reduce corruption as well as appropriate incentive effective regulatory framework and sustainable security in order to induce FDI positively towards economic growth in Nigeria.

Keywords: Foreign Direct Investment, Economic Growth and Capital Formation

Introduction

The impact of capital availability to economic growth cannot be overemphasized in terms providing working capital for the day to day activities as well as huge sums for developmental purposes. Capital is made available by borrowing or through Foreign Direct Investment. Foreign Direct Investment (FDI) is an investment in a foreign country where the investing party usually a multi-national, retains control over the investment. It is acquired in an enterprise operating in another country

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other than that of investor's country (Nunnenkamp and Spatz, 2003). Indeed, it is form of foreign portfolio investment consisting of acquisition of assets by foreign national of company in a domestic stock market (Odozi, 1995).

Policymakers believe that foreign direct investment (FDI) produces positive effect on host economies in the form of externalises and adaptation of foreign technology through licensing agreement, imitation, employee training and the introduction of new process by the foreign firms (Alfaro, 2006). This in part may be responsible for Nigeria despite its huge resource base to be one of the top three African countries that consistently received FDI (IMF, 2005).

The literature is replete with studies on FDI and economic growth yet, the empirical linkage between FDI and economics growth in Nigeria has remained unclear especially with accompanied imported inflation, capital flight and continuous underdevelopment (Taylor and Sarno, 1997)

Specifically, Aitken and Harrison, (1999), Germidis (1997) do not find strong link between FDI and economic growth while Dutta, (1997) found a negative connectivity between the two, hence the need to examine the relationship between FDI and growth in different economic dissensions following the increased resistance to further liberation within the economy. This is because Nigeria populace believe it also causes imported inflation and retardation of local industries. More so that FDI is meant to create more capital for more investment expansion, establishing the linkage between FDI and capital formation is a justifiable exercise which has not been captured by any study except in combination with other variables (See Ehimare, 2011).

Basically, the study is aimed at providing answers of the following questions

- i. Does foreign direct investment promote economic growth in Nigeria?
- ii. Does foreign direct investment impact on capital formation?

In a bid to provide answers to the above research questions, this study examines the impact of foreign direct investment on economic growth in Nigeria. Specifically, this study:

- (i) assesses the effect of foreign direct investment on Nigeria's gross Domestic Products.
- (ii) examines of the impact of foreign direct investment on capital formation in Nigeria.

These objectives are supported by these hypotheses:

- i. H_0 : Foreign Direct Investment does not significantly promote Economic Growth.
- ii H_0 : Foreign Direct Investment does not significantly influence Capital formation.

The study covers the period 1980-2010 which coincides with when the federal government initiated a number of economic reforms (including Structural Adjustment Programme, Banking Sector Reform, debt rescheduling, public sector reform/ personality rebranding, financial sector/ capitalisation and change reform) all aimed at increasing the inflow of foreign direct investment in the form of public cooperation, restoration and maintenance of macro -economic reforms, improving regulatory frameworks for FDI by permitting profit repatriation and providing incentives to attract FDI. Period beyond 2012 in Nigeria were characterised by market distortions from global financial crisis, manipulated forex trading and other forms of corruption which might render the result invalid and as were excluded from the study.

Review of Relevant Literature

FDI is an investment made to acquire a lasting management interest (normally 10% of voting stock) in a business enterprise operating in a country other than that of the investor defined according to residency (World Bank, 1996). Thirlwall (1994) defined Foreign direct investment (FDI) as investment by multinational companies with headquarters in developed countries. This investment involves not only a transfer of funds (including the reinvestment of profits) but also a whole package of physical capital, techniques of production managerial and marketing expertise products, adverting and business practice for the maximization of global profits.

Economic growth as defined by Jhingan (2002) was the process whereby the real per capital income of a country increase over a long period of time. It is measured by increase in the amount of goods and services in each successive time period. Thus, growth occurs when an economy's productive capacity increase in turn is used to produce more goods and services. It is in view of this that foreign direct investment (FDI) is seen as being potent instrument for growth (Penilescu and Radulescu, 2009).

Capital formation as a concept used in macroeconomics, national accounts and financial economics or corporate accounts means a measure of the *net additions* to the (physical) capital stock of a country (or an economic sector) in an accounting interval, or, a measure of the amount by

which the total physical capital stock *increased* during an accounting period.

Gross Fixed Capital Formation (GFCF) according to Ruggles and Ruggles (1956) is a component of the expenditure on gross domestic product (GDP), and thus shows something about how much of the new value added in the economy is invested rather than consumed

GFCF is *not* a measure of *total* investment, because only the value of net additions to fixed assets is measured, and all kinds of *financial* assets are excluded, as well as stocks of inventories and other operating costs (the latter included in intermediate consumption).

Fluctuations in this indicator often reflect the nature of future business activity, business confidence and the pattern of economic growth. In times of economic uncertainty or recession, typically business investment in fixed assets will be reduced, since it ties up additional capital for a longer interval of time, with a risk that it will not pay itself off (and fixed assets may therefore also be scrapped faster). Conversely, in times of robust economic growth, fixed investment will increase across the board, because the observed market expansion makes it likely that such investment will be profitable in the future.

The ability of a nation to generate employment opportunities and thus increase its per capital income depends on how much of the capital created is reinvested (Gross Fixed Capital Formation (GFCF)).

The need to accelerate the pace of economic growth by many countries, especially the less developed counties (LDC) Nigeria inclusive has propelled them to make deliberate effort to attract foreign direct investment (FDI), as they are held as buffer stock absorbers for insurance of the economy against external shocks in exchange and inflation rates management among others (Onuorah and Aluko, 2013). Additionally, the ability to sustain growth in Nigeria and meets its external obligations depends on adequate inflow of foreign investment resources given low level of per capital real income, high average and marginal consumption propensities, low savings and restricted new productive capital formation (Omoniyi and Omobitan, 2011). Unfortunately, the level of FDI attracted by Nigeria is mediocre compared with the resource base and potential needs (Asiedu, 2003).

Theoretical Framework

Most of the studies on the connection between FDI and economic growth lack the theoretical underpinnings which renders their conclusions

although valid but baseless. This is because any variable in any form behave in conformance to established theory. The theories of FDI are those of the pull factor theory and eclectic theory which were discussed by Ogbanje *et al* (2010) and Ayadi (2009) respectively. The pull-factor theory explains the concept of FDI as investment opportunities which are attracted by existing socio-economic and political factors including availability of natural resources, infrastructure, market size, human capital development, labour cost, openness of the economy to international trade as well as fiscal and other non-tax incentives. This is otherwise called Market Size Hypothesis or Endogenous theory.

On the other hand, eclectic theory posits ownership advantages in the form of intangible assets possessed by a firm are optimized if used by the firm or combined with factor input from abroad (the basis for FDI) rather than selling or leasing those assets. Thus, these two theories are in support of FDI and form the foundations of this study

Empirical Studies

As good as FDI is as an instrument of development, it is influenced by inflation, exchange rate, uncertainty, credibility, government expenditure as well as institutional and political factors, per capital income and political stability (Ekpo (1997) while Iyoha (1998) added macro economic instability, macroeconomic policy (Monetary, Fiscal, Exchange rate) and credit policy reforms. These mentioned factors are called economic growth variables and FDI is designed to address some of these indices/ factors. What then is the practical connectivity between FDI and economic growth with specific emphasis on Nigeria?.

Although FDI- Growth linkage cannot and ought not to contradict economic theory and empirical evidence that purports a positive relationship between the two (Oyeranti, 2003), but there is ambiguity in the literature as regards such relationship (Okon *et al*, 2012).

In theory, FDI is expected to bring benefits to the host country in the form of employment opportunity, technology transfer and overall economic growth but in reality researches have shown contradictory evidences. For instance Romer, (1993), Findlay (1978), Dee Gregorio and Lee (1998) emphasized the positive impact of FDI on the growth of the recipient country in terms of needed physical capital, new technology, diffusion of knowledge, marketing and managerial talents and expertise. The dimension of these contrasting results is not limited to the link between FDI and growth but also to the signs of the relationships.

Egwaikhide (2012) investigates the relationship between foreign direct investment (FDI) and economic growth in Nigeria between 1980-2009 through the application of Johansen Cointegration technique and Vector Error Correction Methodology. The study finds that the impact of the disaggregated FDI on real growth in Nigeria namely: agriculture, mining, manufacturing and petroleum sectors is very little with the exception of the telecom sector which has a good and promising future, especially in the long run.

Technology transfer which Muchlinski (1997) refer to as the process by which commercial technology is disseminated has being the bane of FDI. It comes as a result of FDI spillovers to the host country (Ikiara, 2003). The studies of Blomstrom and Sjöholm (1999) supports the view that FDI contributes to economic growth via technology transfer while Girma *et al* (2001) and Saggi, (2003) are of the view that technology transfer enhances higher productivity and growth in the developed and developing economies.

While Leathy and Neary (2004) find negative impact of FDI on economic growth, Hein, (1992) finds no relationship at all. The results in other studies are both positive and negative depending on the level of development of the recipient country. This is because the spill over effects of FDI depends on the various country specific factors.

In Nigeria Ariyo (1998) evaluates the impact of FDI on economic growth between 1970-1995 and found that only private domestic investment contribute to economic growth over the period but Adelegan (2000) concludes that FDI is pro-consumption and pro-import and is negatively related to economic growth.

Jerome and Ogunkola (2004) found out an improved economy during the era of FDI but left behind unresolved deficiencies in terms of corporate environment, institution uncertainty and the rule of law.

While Ogbanje (2011) concentrated on the agricultural sector with a positive correlation with FDI, Ayanwale (2007) evaluated the linkage between FDI and economic growth in Nigeria using non-extractive industries and derives a positive relationship. Among the determinants of FDI mentioned including market size, infrastructure facilities and stable macroeconomic policy, only market size is available. Thus, the study of Akinlo (2004) was in line with the market size hypothesis as he established a positive and significant impact of export on growth. Precisely, Oyatoye *et al* (2011) reveals that one naira (₦1) increase in the value of FDI will lead to ₦104.749 increase in GDP. Contrary to the general belief and theoretical propositions, the study of Omoniyi and Omobitan (2011) shows a negative

relationship between FDI and economic growth. This he said might be due to locational factors. This result also agrees with Obadan (2004) who posits that foreign private capital flows do not constitute economic aid, as they do not provide resources to developing countries on concessionary terms even though they may yield substantial benefits. He said FDI is just a means of providing fund of lending or finance in the area of equity participation. The mixed results of Anyadi (2009) shows that FDI has not contributed significantly to output growth but has been found to exert some level of influence on export of goods and services.

Methodology of the study

This study employs the use of secondary data obtained from Central Bank of Nigeria bulletin and Stock Exchange Facts book. These data related to gross domestic products, inflation rates, index of industrial production, index of manufacturing production, interest rate as well as external reserve, exchange rate and balance of payments. These variables were transformed into two models that are similar to those used by Peniscu and Radulescu (2009) and Ehimare (2011) except that the former study relates FDI to GDP and Export Growth while the latter relates FDI to GDP and Current account balance. However, this study differs from these two as it emphasises GDP and Capital formation with differing variables since modern growth theory purports that economic growth results from capital accumulation which transform to further investment. Justifiably thus is this study and the model adopted which expands the previous studies by determining the extent to which FDI in Nigeria has led to capital accumulation. This is yet to be found in Nigerian literature.

The study models are Economic Growth Model and Capital formation Models I and II respectively as follows:

MODEL 1: $GDP = F(TT, FDI, IIP, GFCF, IMP, IR, PIR)$

MODEL II: $GFCF = F(FDI, BOT, GDP, PIR, ER)$

These were specified as:

MODEL 1: $GDP = \beta_0 + \beta_1 TT + \beta_2 FDI + \beta_3 IMP + \beta_4 GFCF + \beta_5 IIP + \beta_6 IR + \beta_7 PR + \mu_t$

MODEL II: $GFCF = \beta_0 + \beta_1 FDI + \beta_2 BOT + \beta_3 IMP + \beta_4 PIR + \beta_5 ER + \mu_t$

Where

TT = Total trade (Summation of import, export and re-export)

GDP = Gross Domestic Product

IIP = Index of Industrial Production

GFCF = Gross Fixed Capital formation

IMP = Index of Manufacturing Production

IR = Inflation Rate

BOT = Balance of Trade
ER = External Reserve
PIR = Prime Interest Rate

A prior expectation is in form of a positive relationship between FDI and economic Growth on one hand and between FDI and Capital formation on the other hand while the reliability and validity of these models are based on economic, statistical and econometric criteria. The economic criterion is based on economic theory which is used to confirm whether a priori expectation conform to theoretical analysis while the statistical Criteria is based on statistical theory of first order test involving covariance, correlation and standard error.

Econometric Criteria used is the second order test which is used to determine whether estimates of our parameter are unbiased, efficient, consistent and sufficient. It is used to test the violation of the assumption of ordinary least squares. Also, the regression statistics show the values and signs attached to each of the parameters whether it conforms to theory or not and they include correlation co-efficient, coefficient of determination, adjusted R square.

Thirdly, t-test was carried out in order to ascertain the significance of the parameters while f-test reveals the significance of the overall regression equation for further prediction and the Durbin - Watson statistics test for the presence of auto correlation distribution terms. Here,

$H_0: P \neq 0$ $\longrightarrow$ No auto correlation
 $H_1: P \neq 0$ $\longrightarrow$ Auto correlation

The two boundaries for the Durbin Watson test are:

Du $\longrightarrow$ Upper Boundary
Dl $\longrightarrow$ Lower boundary

Presentation and Discussion of Results

MODEL 1

The result of model I analysis reveals:

$GDP = \beta_0 + \beta_1 FDI + \beta_2 GFCF + \beta_3 IMP + \beta_4 IR + \beta_5 PIR + \beta_6 TT + \mu_t$. From this, the equation becomes:

$GDP = 191460.619 + 3.179FDI + 23.970GFCF - 24512.064IMP - 17064.52IR + 107045.132PIR + 1.749TT$

SE= (1.681) (1.675) (10836.248) (12536.129) (40882.696) (1.45)

t ratio= (165) (1.891) (14.311) (-2.262) (-1.361) (2.618) (12.064)

F ratio= 136.517 and F table= 2.4741

$R^2 = 0.972$, $R = 0.986$ and $D = 1.829$

MODEL 2

$$\text{GFCF} = \beta_0 + \beta_1 \text{FDI} + \beta_2 \text{BOT} + \beta_3 \text{GDP} + \beta_4 \text{PIR} + \beta_5 \text{ER} + \mu_t$$
$$\text{GFCF} = 68196.439 - 0.422 \text{ FDI} + 0.052 \text{ BOT} + 0.033 \text{ GDP} - 1825.812 \text{ PIR} - 0.127 \text{ ER}$$
$$\text{SE} = (28259.486) (0.159) (0.022) (0.033) (1433.584) (0.014)$$
$$t \text{ ratio} = (2.413) (-2.657) (2.364) (10.409) (-1.274) (-8.842)$$
$$F \text{ ratio} = 35.785 \text{ while } F \text{ table} = 2.7426$$
$$R = 0.937, R^2 = 0.877 \text{ and } DW = 1.376$$

Model 1 results show that, holding other variables constant, the impact of FDI on GDP is 3.179% indicating a positive but insignificant impact while gross fixed capital formation has a positive contribution of 23.9% and manufacturing intensity (IMP) and inflation rate (IR) serve as disincentives to GDP (reducing Economic Growth by -24.5% and -17% respectively). Prime interest rate has a significant positive impact but the impact of total trade of the country on its economic growth is insignificant.

The values of $R = 0.986$ and $(R^2) = 0.972$ reflects a strong predictive capability of the dependent variables while 97% of the variation in gross domestic product (GDP) is explained by the independent variable. The remaining 3% is due to stochastic disturbance term. Hence, the model has the goodness of fit required. The test of statistical significance reveals that GCFC, IMP, PIR and TT are statistically significant at 1% and 5% significance level while FDI and IR are not at the same levels.

When taking in isolation, the impact of FDI on economic growth reveals F -calculated of 136.517 which is greater than F -table 2.474. Thus, the null hypothesis is rejected for the acceptance of alternative hypothesis meaning that foreign direct investment significantly influences economic growth in Nigeria. However, since a country works in a macroeconomic framework, only FDI- GDP relationship may be misleading therefore other variables that may influence economic growth were factored in which reveals insignificant contribution of FDI to economic growth in Nigeria. This result is in consonance with Penilescu and Radulescu (2009), (Ehimare, 2011) and at variance with those of Awe (2013), Omoniyi and Omobitan (2011) and Ayadi (2009). More so it is agreement with the literature where the relationship between FDI and economic growth had generated varying results and conclusions

Interpretation of Model II

Model II tried capturing the importance of capital in enhancing economic growth. This is because all productive activities depend on capital, the absence and/or inadequacy of which hampers economic development. This assessment indicates a positive relationship between gross fixed capital

formations (GFCF) and balance of payment, gross domestic product and external reserve but is negatively related to Foreign Direct Investment and prime interest rate.

The correlation co-efficient (R) = 0.877 while coefficient of determination (R^2) = 77% and the remaining 22.3% is due to stochastic error term. When captured in isolation, the relationship between capital formation and FDI shows F calculated (35.787) to be greater than F -table (2.7426) at 5% significance level. By inference therefore, the null hypothesis is accepted while alternative hypothesis is rejected meaning that Foreign Direct Investment significantly influences capital formation.

However and more justifiably, at a macro level, FDI reveals negative but insignificantly impact (0.422) on Capital formation. This is in like manner with interest rate and exchange rates that have negative impact on capital formation. The Durbin Watson statistical value of 1.376 suggest the existence of no serial correlation in the residual.

It can be said therefore that the varying conclusions reached in different earlier studies are a product of the prevailing economic conditions in each country as well as the approach in terms of variables in the model adopted.

Conclusion and Recommendations

From the analysis carried out it can be concluded that there is negative but insignificant relationship between foreign direct investment and economic growth and there is negative relationship between foreign direct investment and capital formation in Nigeria.

The results of this study shows negative co-efficient of independent variable which shows that as foreign direct investment increases economic growth decreases but at an insignificant rate and vice-versa. Additionally, the growth of foreign direct investment has negative but insignificant impact on capital formation in Nigeria. This may be due to the practice of capital flight by foreign counterparts, high inflation, interest rates and exchange rate levels.

In line with these conclusions, for fruitful attraction of FDI into the country with a view to have desirable positive impact on economic growth and capital formation, it is thereby recommended that appropriate infrastructure and skills should be provided as well as maintenance of political stability and reduction in corruption. To provide a transparent and appropriate incentive and regulatory framework, (FDI) policies should be applied consistently in line with the pros and cons of international investment agreements that will facilitate trade.

Thus, in order to boost manufacturing output, more efforts are required at building essential infrastructures, with emphasis placed on raising the comprehensive capacity of the energy industry, transportation, telecommunication, industrial estates, accommodation, public health undertakings, water supply and municipal works and the services industry with a view to reduce the information gaps in the international investment process as well as technologies which limit the possibilities for Multi - National Corporation to upgrade and finally, capture possible externalities. More importantly, adequate and sustainable security should be provided with a view to getting rid of civil unrest caused by book- haram and Niger Delta Militants

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