THE ROLE OF FINANCIAL DEVELOPMENT IN ATTRACTING FOREIGN DIRECT INVESTMENT (1980-2022)

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Abstract

This study examined the trend of financial development and foreign direct investment in Nigeria. It also investigated the impact of financial development on foreign direct investment in Nigeria. This is with the view of analyzing the impact of Foreign Direct Investment on Financial Market Development in Nigeria from the period 1980 to 2022. The study employed Auto-Regressive Distributive Lag (ARDL). Annual time series data for all the variables were sourced from the World Development Indicator (WDI) and Central Bank Statistical Bulletin 2020 edition. The result of the trend analysis observed that indicators of financial market development (that is, market capitalization and credit to the private sector as a ratio of real GDP) and foreign direct investment experienced increase but unstable performance over the period of study. The regression estimate showed that financial market development (measured by market capitalization and credit to private sector as a ratio of a real GDP) had significant and positive influence on the inflow of foreign direct investment during the study period. This study concluded that financial market development contributes significantly to the inflow of foreign direct investment in Nigeria. The study recommends the need for policymakers to implement policies capable of encouraging domestic investment and improve the performance of the stock market in order to maintain a strong link between stock market development and foreign direct investment in Nigeria.

Keywords: Financial development, FDI, Innovation, ARDL, Nigeria.

1. INTRODUCTION

The relationship between financial development and foreign direct investment seems to be one of the most important economic discussions. This is because a developed financial system triggers high investment by identifying golden investment opportunities, saving stocks, monitoring managers, increasing trade abilities, decreasing risk and facilitating business transactions (Motameni & Ariani, 2013). Similarly, financial

development is a process in which compulsory factors, policies and institutions are all constituted in order to create efficient mediators and markets and provide deeper and better access to financial services (Dutta & Roy, 2008).

Basically, The Nigeria financial system has experienced intensive restructuring and rapid market-oriented transformations since the adoption of the SAP in 1986. Prior to this time, the financial system was regulated as evidenced by ceiling on interest rates and credit expansion, high reserve requirements, selective credit policies and restriction of entry into the banking industry. Following deregulation, the bank and non-bank financial institutions witnessed unprecedented increase due to the incentives provided for growth and expansion of financial institutions. For example, the number of banks rose from 41 in 1986 to 115 in 1997.

Furthermore, the number of bank branches rose from 1,323 in 1986 to 2,551 in 1997. Similarly, the number of community banks (microfinance banks) increased from 169 in 1990 to 695 in 2009; and the number of specialized non-bank financial institutions increased from 84 in 1990 to 242 in 2008 **(**Fidelis & Salisu, 2017). This effort stems from monetary policies to adequate regulation and supervision of the Nigerian financial system. Foreign investors are always concerned about the development and stability of the financial sector of a country which affects the confidence of such foreign investors in investing in the domestic economy. The banking sector remains the key to the financial system and economy in developed and developing economies. It fosters economic growth and development through effective financial services required to propel the economic activities of industries, agriculture, and other economic agents. Banks as financial intermediaries connect surplus and deficit economic agents, thereby driving economic growth.

The need for financial systems stability can thus not be overemphasized (Olaniwun, 2018). Thus, the quest to boost the public and foreign investors' confidence on the Nigerian financial system has resulted in the initiation of various financial reforms such as the deregulation of the interest rate to reflect markets forces and ensure efficient allocation of financial resources; introduction of universal banking in 2001, recapitalization of banks capital base to N25 billion in 2005, the strengthening of corporate governance among financial institutions and the massive growth in the use of the Automated Teller Machines (ATM) among others (Nwosa & Emma-Ebere, 2017).

The financial sector has an important role to play in the mobilization of fund and flow of foreign capital investment into the country. Hence, well developed domestic banks and other financial institutions ensure an efficient and high-level contribution to business-friendly environment accordingly foreign investors rely on secure investment climate based on stock market development and banking institution's development of the host country.

In other to expedite the development of financial system in Nigeria; The Nigerian banking sector has been the life wire of the financial system and economy through its intermediation and developmental obligations. The valuable roles and efforts played by the sector have led to an increased number of banks and deposits creation, employment,

technological advancements, expansion of the economy, price stability, and achievement of other macroeconomic variables (Igweoji & Ekwunife, 2019). The impact of the internet economy and digitalization in the banking industry is seen in the increased move/trend towards retail banking and the use of e-banking channels, which has further led to improvements in financial inclusion. According to the Central Bank of Nigeria (CBN), the total value of electronic payment (e-payment) transactions recorded in 2017 rose by 32.5 percent to N83.1 trillion in 2017 from N62.7 trillion recorded in 2016 (Daily post, 2018). Mobile devices are the most promising way to reach the masses and to retain continued loyalty among customers, due to their ability to provide services anytime, anywhere with their high rate of penetration and potential for growth. With the introduction of 3G in the telecoms service, banks now offer more robust banking technologies.

The following are some of the services that can be offered through mobile banking: account information check, such as mini- statement and checking of account history, alerts on account activity, insurance policy management, pension plan management, status on a cheque, stop payment on a cheque, etc. Therefore, there is evidence that the new CBN policy on a cashless economy will thrive in the country (Awoleye *et al.,* 2013).

Foreign Direct Investment contributes immensely to the growth of an economy in filling the financial gaps of savings - investment, revenue - planned expenditure, terms of trade and Balance of Payment (BOP) differences, etc. The economic performance of a country is assessed based on the examination of key economic and social indicators such as; Real GDP growth, inflation rate, real interest rate, exchange rate, infrastructure, openness (export and import divided by GDP), investment and savings, total debt, etc. as these expresses the level of achievements of set macroeconomic objectives of the country which are sustainable growth, price stability, and full employment (Omowumi & Abel, 2014).

The main determinant of foreign direct investment flows is the degree of the financial development of the domestic or host economy (Korgaonkar, 2012). Therefore, having a secure and friendly climate for investments motivate FDIs. Therefore, if a country is expecting to attract more foreign direct investments the country must focus on high financial development. This explains the link between the financial development and FDI.

Nigeria as a country, given her vast natural resources base and large market size, qualifies to be a major recipient of FDI in Africa. Despite the increased flows of FDI to Nigeria in the recent time, the economy is still dwindling. It is characterized by high rate of poverty, low per-capita income, high rate of unemployment, unfavorable balance of payment as well as low and unstable growth rate of GDP Iyoha (1996, 1999); Osinubi and Amaghi (2010). Though Nigeria financial markets have not developed to expectations and the underdeveloped financial markets have further deteriorated the level of economic growth in Nigeria. Although the Nigerian financial system recorded some progress in the last few years, like the national economy, it has been faced with many challenges.

The problem of macroeconomic instability has continued to be a hindrance to the development of the financial sector in Nigeria. Frequent policy reversals have caused disinvestment in the financial and real sectors which have negatively affected

macroeconomic performance (Nnanna, Englama & Odoko 2004 as cited by Oriavwote & Eshenake 2014). Many countries especially developing countries now see FDI as an important element of economic development. FDI is seen as a combination of capital, technology, marketing and management. Many African countries are improving their business climate in order to attract FDI (Ayanwale 2007). In the case of Nigeria, investors have highlighted the poor state of financial development.

Nigeria attracted the third-largest foreign direct investment (FDI) inflows of any African country in 2019, but, as with the continent more broadly, it suffered a sharp yearly decline in inward investment. Data from the United Nations Conference on Trade and Development (UNCTAD) shows Nigeria received $3.3bn of FDI inflows in 2019, a yearly decline of 48.5%. Only Egypt ($9bn) and the Democratic Republic of the Congo ($3.4bn) received more inward FDI during a year that saw FDI inflows across the whole African continent fall 10.3% to $45.4bn. Though FDI inflows in Nigeria declined in 2019, FDI stock has grown over the past three years to reach $98.6bn in 2019. The number and value of Greenfield investments have been on a similar trajectory, steadily growing from 36 projects worth $4.8bn in 2017 to reach 76 projects worth $10.2bn in 2019.

Dampened global demand for commodities is a major headwind facing Nigeria, a commodity export-based economy. Depressed oil prices and the Covid-19 crisis in 2020 are continuing impediments to inward investment.

Schumpeter (1911) contended that the well-functioning financial system will spur technological innovation through efficiency of resource allocation from unproductive sector to the productive sector, Fama (1980) also argued that financial markets have two significant functions namely to channel excess funds from surplus units to deficit unit which will generate a higher income growth and to provide liquidity services.

Previous related studies have examined the link between Financial Development and foreign direct investment such as Waliu (2017); Desbordes and Wei (2014); Anyanwu and Yameogo (2015), Kinda (2008, 2010) and Deichmann*et al.* (2003) some others have looked at the extent to which financial development has impacted foreign direct investment positively which among others are Choong *et al.*, 2005, 2012; Ang 2009a, b; Lee & Chang 2009; Azman-Saini *et al.*, 2010a; Hosein 2015.

Besides, some others researchers have looked extensively to which financial development imparted foreign direct investment negatively among others are Dutta and Roy, 2011; Ang, 2009; Chun-Ping and Chien-Chang, 2009; Baker *et al.*, 2008; Rhee and Wang, 2009**.** Alfaro *et al.* (2009), Agbloyor *et al.* (2014) and Baharumshah *et al.* (2015) explored financial market, while playing a positive role of attractiveness of FDI, can also facilitate their contribution to economic growth in the host country.

2. LITERATURE REVIEW

The effectiveness of foreign direct investment inflows in enhancing the development of the recipients' country is one of the studies about determinants of foreign capital investments which belongs to Dunning (1981). The author revealed the importance of

foreign direct investment (FDI) inflow to the country by the size of the market, unit labour cost and service sector productivity and inflation on FDI. Other researchers like Root and Ahmed (1979) is accepted as another leading study. They analysed the effects of social status on FDI inflow to the country. Development of human capital, life quality, health system, and urbanization rate are effective factors on FDI inflow. FDI is one of the major issues in economic growth of developing countries and development of financial market plays main role in absorbing foreign direct investment. However, there is no consensus in the theoretical or empirical literature about any unique impact of financial development on foreign direct investment.

Empirical studies that examined the relationship between FDI and FD are quite ambiguous and inconclusive. There are two strands of studies linking foreign direct investment to financial development. The first strands of studies document positive relationship between FDI and FD. They suggest positive spill over effect between financial development and economic growth thereby supporting the complementary role of FDI in relation to financial development. The second strand of empirical studies supports the substitute role of FDI that posits negative relationship between FDI and FD (Dutta and Roy, 2011; Ang, 2009; Chun-Ping and Chien-Chang, 2009; Baker *et* al., 2008; Rhee and Wang, 2009).

Aluko and Ibrahim (2020) investigated 28 Sub Saharan African countries to find the threshold between institutions and finance-growth nexus. They found distinct behaviour of institutions in finance-growth relationship. They used different institutional proxies as threshold variable and found that when International Country Risk Guide (ICRG) data set was used the financial development does not spur economic growth below the optimal level of institutions and vice-versa. Surprisingly, they found that growth spurring effects of finance are higher for such countries having low institutional quality than high institutional quality. Similarly, Zhu, Asimakopoulos, and Kim (2020) investigated 50 countries to address the question of whether too much finance is effective in finance and innovation-led growth nexus. They found small or even insignificant impact of innovation in the countries having higher level of financial development. Besides, marginal effect of innovation on economic growth is found negatively related to financial development.

Furthermore, the research carried out by Imoagwu and Ezeanyeji (2019) investigated the relationship between financial development and economic growth in Nigeria during the period of 1986 – 2017. The study adopted recent econometric techniques such as Augmented Dickey-Fuller (ADF) and the Phillip-Perron (PP), Unit Root Tests, cointegration test as well as the Toda Yamamoto causality test was used to accomplish its objectives. The results revealed that financial development has significant positive relationship on economic growth in Nigeria only in the short-run while negative impact in the long-run and that causality runs from financial development to economic growth. Furthermore, the study revealed that the stock market capitalization has significant positive impact on economic growth in Nigeria in the short run while negative significant in long run. The interest rate has positive insignificant effect on economic growth in Nigeria only in the short run while negative significant effect in the long run.

The ratio of domestic credit to private sector to GDP have positive significant impact on economic growth in Nigeria only in the long run while positive insignificant in the short run. Causality also runs from stock market development, interest rate, banking sector development and recapitalization to financial development in Nigeria. In line with the above findings by different researchers, it can be deducing that Nwosa and Emma-Ebere (2017) examined the relationship between foreign direct investment and financial development in Nigeria for the period 1980 to 2015. Using the vector error correction model (VECM) technique, the study observed that there is a negative relationship between financial market development and foreign direct investment in the long run while in the short run, a positive relationship existed between financial market development and foreign direct investment. The study therefore recommended further development of the Nigerian financial market by the monetary authority given its positive influence on the inflows of foreign direct investment in the short run. There is also the need for more financial reform of the Nigerian financial system in order to bring more foreign direct investment into the country both in the long run and short run.

With respect to literatures review from above on the impact of financial development on foreign direct investment in Nigeria, it can be deducing that there exists an insufficient knowledge on relationship between financial development and foreign direct investment in Nigeria. Notably, extensive work in Nigeria focused on the impact on foreign direct investment on economic growth in Nigeria while other studies centered their studies on the impact of financial development on economic growth. None to the best knowledge of the authors focused on the impact of financial development on foreign direct investment. It was also observed from the literature review most of the studies on financial development and foreign direct investment were cross - sectional or panel studies rather than country specific studies. The results obtained by such cross country or panel studies have been brought into serious doubt due to the implicit assumption of a common economic structure and similar production technology across different countries, which is unlikely to be true (Cuadros *et al.*, 2001). Base on the above literatures, the study seeks to fill the gap in literature by carrying out a country specific study on the relative impact of financial development on foreign direct investment in Nigeria.

3. METHODOLOGY

The model

This study adopts Beck Model (2008) which stated that measures of financial market development (FMD) determine the inflow of foreign capital. Other control variables as cited in Nwosa and Emma-Ebere (2017) are inflation rate (INF), exchange rate (EXR) and trade openness (OPNX).

FDI= F (FMD, INF, OPNX, EXR) …………………….……….......…..   (1)

FDI= β_0+ β_1FMD+ β_2INF+ β_3OPNX+ β_4EXR+ μ…………………............ (2)

Measurement of Variables

In measuring the impact of financial development on foreign direct investment in Nigeria, we adopted the conventional method of using their proxies. Thus FDI would be measured by the volume of net FDI flows as a ratio of GDP (FDI/RGDP), financial development (FD) is measured with the ratio of credit in private sector to GDP and market capitalization, Trade openness (OPNX) is measured with the addition of import and export divided by the GDP. Gross Domestic Product is measured by real gross domestic product, and the exchange rate (EXR) is measured by the official naira/dollars exchange rate.

Estimating Techniques

Method of data analysis simply means the statistical total or technique utilized in processing the data collected, with a view to arriving at valid conclusions. This research work will adopt descriptive tools to achieve the first objective and ARDL econometric techniques to achieve the second objective with the view of examining the impact of Financial Market Development on Foreign Direct Investment in Nigeria from 1980 to 2020.

Sources of Data

The study makes use secondary data obtained from Central Bank of Nigeria (CBN) Statistical Bulletin 2020 edition between (1980 to 2020) and World Development Indicator (WDI) Data Base. The study investigates the impact of financial development on foreign direct investment. All the data were sourced from the download facility of the Central Bank of Nigeria (CBN) Statistical Bulletin 2020 Annual edition and World Development Indicator (WDI) Data Base.

4. EMPIRICAL RESULTS AND DISCUSSION

This chapter deals with data analysis and interpretation which involves descriptive statistics, unit-root test and regression estimates on financial market development and foreign direct investment in Nigeria. The following were the main summary of findings of this study.

Table 1: Descriptive Analysis

Variable	LFDI	LEXR	LINF	LFMD	LOPNX	LMCAP
Mean	0.116794	4.786772	2.679167	2.304410	25.37952	6.102155
Median	0.147618	4.610346	2.530116	2.090425	25.15595	6.157614
Std. Dev.	0.819374	0.611664	0.692793	0.443270	0.515305	3.111099
Skewness	-0.169826	0.999244	0.869334	0.660595	0.364620	-0.145984
Kurtosis	2.480980	3.008863	2.867816	1.776917	1.606629	1.496393
Jarque-Bera	0.625211	6.490302	4.940708	5.267394	4.019070	3.812380
Probability	0.731538	0.038963	0.084555	0.071812	0.134051	0.148646
Sum	4.554974	186.6841	104.4875	89.87197	989.8011	237.9841
Sum Sq. Dev.	25.51220	14.21706	18.23856	7.466569	10.09050	367.7995
Observations	39	39	39	39	39	39

Source: Authors' Computation 2021 using E-Views 10, 2021

From the descriptive statistics on Table 1 above, it is noted that the mean values of foreign direct investment (LFDI), exchange rate (LEXR), inflation (LINF) are 0.12, 4.78 and 2.68 respectively while the average values of financial development (FMD), trade openness (LOPNX) and market capitalization (LMCAP) are 2.30, 25.40 and 6.10 respectively.

The median of foreign direct investment (LFDI), exchange rate (LEXR), inflation (LINF) are 0.14, 4.61 and 2.1 respectively while the median value of financial development (FMD), trade openness (LOPNX) and market capitalization (LMCAP) are 2.1, 25.2 and 6.15 respectively.

The standard deviation showed that trade openness is the most volatile variable (3.11) while financial market development is the least volatile variable. The skewness statistics showed that foreign direct investment and market capitalization is negatively skewed while the remaining variables were positively skewed.

The kurtosis statistics showed that foreign direct investment, inflation rate, financial market development, trade openness and market capitalization were platykurtic, indicating that the distribution of the variables were flat relative to normal distribution while exchange rate is leptokurtic because is distribution were peaked relative to normal distribution.

The Jarque-Bera statistics rejected the null hypothesis of normal distribution for exchange rate while the null hypothesis of normal distribution for the remaining variables were accepted at the same critical value (that is five percent).

Table 2: Correlation Analysis

	LFDI	LEXR	LINF	LFMD	LOPNX	LMCAP
LFDI	1	-0.701546	0.256842	0.035873	0.0748943	0.192687
LEXR	-0.701546	1	-0.152162	-0.210307	-0.319005	-0.361338
LINF	0.256842	-0.152162	1	-0.241181	-0.295446	-0.299144
LFMD	0.035873	-0.210307	-0.241181	1	0.875488	0.778083
LOPNX	0.0748943	-0.319005	-0.295445	0.875487	1	0.955998
LMCAP	0.192687	-0.361338	-0.299144	0.778083	0.955999	1

Source: Authors' Computation 2021 using E-Views 10, 2021

The Table above depict the correlation coefficients between the variables included in the model in table 4 above. The correlation results show that the variable under consideration, exchange rate (LEXR) has a significant negative relationship with foreign direct investment (LFDI) while the remaining variables has a positive significant with foreign direct investment.

Base on the result presented on table 4, this suggest that exchange rate (LEXR) has an inverse relationship with foreign direct investment while inflation rate (LINF), financial market development (LFMD), trade openness (LOPNX) and market capitalization (LMCAP) have a positive and direct relationship with foreign direct investment.

Table 3: Unit Root Test

Augmented Dickey-Fuller (ADF) Test						
Variables	Level			After Differencing		
	t-stats	Prob	Status	t-stats	Prob	Status
Lfdi	-3.034952	0.0034	I(0)			
Lexr				-4.795047	0.0022	I(1)
Linf	-3.494088	0.0134	I(0)			
Lfmd				-5.253324	0.0007	I(1)
Lopnx				-3.764123	0.0302	I(1)
Lmcap				-4.721683	0.0027	I(1)

Source: Authors' Computation 2021 using E-views 10, 2021.

From the above table it can be observed that the unit root test was carried out using the Augmented Dickey Fuller test and the result presented on table 2. The unit root test showed that foreign direct investment and inflation were significant at level I(0) while financial market development, exchange rate, trade openness and market capitalization were significant at first difference I(1). This result presented above suggests the need for co-integration test among the variables to be estimated and base on the result from above Auto-regressive distributive lag (ARDL) will be use.

Table 4: F-Bounds Test

Test Statistic	Value	Significant	I(0)	I(1)
F-statistic	4.029906	10%	2.08	3
K	5	5%	2.39	3.38
		2.5%	2.7	3.73
		1%	3.06	4.15

Source: Authors' Computation 2021 using E-Views 10, 2021

From the table above shows the result of Auto-Regressive Distribution Lag (ARDL) bounds test. The result above shows that the value of F-statistics 4.029906 is greater than lower and upper bound respectively at 5% level of significant at I(0) 2.39 and I(1) 3.38. Thus, this shows the existence of short-run and long-run relationship between the variables under study. This shows that the variables are normally distributed.

Table 5: ARDL Long Run

Variable	Coefficient	Std. Error	t-Statistic	Prob.*
LFDI(-1)	0.116238	0.153586	0.756829	0.4568
LEXR	-0.525446	0.216816	-2.423469	0.0236
LINF(-1)	0.531129	0.186526	2.847476	0.0091
LFMD(-2)	-1.224461	0.541946	-2.259380	0.0336
LOPNX(-2)	-5.581150	2.527752	-2.207950	0.0375
LMCAP	0.073934	0.151967	0.486518	0.6312
C	24.62408	28.79905	0.855031	0.4014

Source: Authors' Computation 2021 using E-Views 10, 2021

The table above showed the long run relationship that exist between the variables under study. It could be observed from the results presented in the above table that exchange

rate (EXR), financial market development (FMD) and trade openness (OPNX) had a negative and significant impact on foreign direct investment while market capitalization (MCAP) had a positive and insignificant impact on foreign direct investment. Also, the result above shows that inflation rate (INF) had a positive and statistical significant impact on foreign direct investment.

Table 6: Auto-Regressive Distributive Lag (ARDL) ECM Estimate on Foreign Direct Investment and Financial Market Development.

Variable	Coefficient	Std. Error	t-Statistic	Prob.
D(LFDI(-1))	-0.314784	0.106670	-2.951015	0.0072
D(LINF(-1))	0.365418	0.106310	3.437297	0.0022
D(LFMD)	0.460665	0.394101	1.168902	0.0061
D(LOPNX)	-4.903218	1.881786	-2.605620	0.4158
C	24.62408	28.79905	0.855031	0.4014
CointEq(-1)*	-0.568978	0.095403	-5.963917	0.0000
R-squared 0.783061		**Adjusted R-squared 0.683134**		
F-statistic (Prob) 6.386(p<0.05)		**Durbin-Watson stat 2.445690**		

Source: Authors' Computation 2021 using E-Views 10, 2021.

The above table represent the regression estimate on the relationship between financial development and foreign direct investment between the periods of study (1980-2020). From the table presented above, it could be observed that financial market development had positive and significant impact on foreign direct investment, indicating that a unit increase in financial sector would promote financial development by 0.46 units in the long run. This finding is in line with Nwosa and Emma-Ebere (2017) and Korgaonkar (2012). Also, from the above, inflation rate positively influenced foreign direct investment in Nigeria. A unit increase in inflation rate is expected to enhance the inflow of foreign direct investment by 0.36 per cent.

Apart from the variables, trade openness had insignificant impact on foreign direct investment, implying that this variable did not influence the inflow of foreign direct investment over the study period. In addition to the above, the error correction term (ECM-term) from the short run estimate is expected to be negatively signed and statistically significant. From the estimate, the coefficient of the error correction term was correctly-negatively signed (-0.57) and statistically significant. The coefficient estimate of the error correction term of -0.57 implied that the model corrects its short-run disequilibrium by about 57 percent speed of adjustment in order to return to the long-run equilibrium.

Discussion of Regression Estimates

From the view of regression estimates presented above, it is obvious that positive relationship exists between financial market development and foreign direct investment and thus suggests that development of the sector over the years has promoted the flows of foreign direct investment.

5. CONCLUSION AND POLICY RECOMMENDATION

The focus of this study is on the relationship between financial market development and foreign direct investment in Nigeria over the period 1980 to 2020. Based on the regression estimates, the study concluded that financial market development is a key determinant of foreign direct investment in Nigeria. Thus, the relationship between financial market development and foreign direct investment depends on the measures or indicators of financial market development.

In order to boost the level of inflow of foreign direct investment in Nigeria, there is need for the policymakers to implement policies capable of encouraging domestic investment. Similarly, the findings of the study also showed that, trade openness was insignificant in influencing foreign direct investment in Nigeria, thus there is the need for commercial banks to direct their stocks in the development of productive investment that would encourage foreign investors in investing in Nigeria. Also, there is the need for the monetary authority to increase depositors' confidence by ensuring the healthiness of the financial institutions. Such increase in depositors' confidence will lead to increase in the volume of savings in Nigeria which ultimately would enhance the flow of credit from the commercial back to the private sector.

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