

Financial Development: An Empirical Study of Foreign Direct Investment in Nigeria (1999-2021)

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Abstract

This study determined the effect of financial development on foreign direct investment in Nigeria. The study adopted Ex Post Facto research design. Data were obtained from Central Bank of Nigerian Statistical Bulletin from 1999 to 2021. The hypotheses were tested with regression analysis, and the result shows that credit to private sector and market capitalization were positively affected by foreign direct investment, though the effects were not statistically significant. Based on the findings, government should create enabling environment that will encourage foreign direct investment in the industrial production sector which will help to increase the nation gross domestic product.

Keywords: *Credit to private sector, Market capitalization, Foreign direct investment*

INTRODUCTION

The catastrophe of banking institutions to provide long-term finance, as well as the need for alternative sources of long-term finance for the dying real creative sectors, rekindled interest in the development of the stock market as an alternative source of finance for the real sector. The nations of the world are divided into three major income categories: low-income, middle-income, and high-income economies. Higher-income economies are already in a position to invest their funds in the development of their economies (Islam, Muhammad, Khan, Wlodzimierz & Judit 2020). Low-income countries are unable to attract significant foreign investment (Lee, Chi-Chuan & Chih-Yang, 2020). However, middle-income economies can attract an increasing level of foreign investment if they deliberate on open economy (Osei & Kim 2020). Financial development is a universal strategy used in middle-income countries to attract foreign investment (Yusuf, Waliu, Shittu, Akanbi, Umar, & Idris, 2020).

Foreign Direct Investment (FDI) inflow refers to a commercial purchase decision, a significant stake within a multinational entity, or the complete purchase of a multinational entity in order to expand its operations to a new territory (Zhao, 2003). Foreign direct investment has received significant attention from academic and policy-making experts in recent decades, and has thus become very important across a country, mostly in developing and less developed countries (Dal Bianco & Loan, 2017). FDI inflows are a significant source of foreign financing for many developing countries, and thus provide an effective component for achieving sustainability and private sector growth (Asongu, Uduak & Salisu, 2018). Global finance and skills are required

by developing-country businesses in order to expand, organize, and lead their global sales (Khan & Khan 2019). The significant increase in FDI over the last few years has had little impact on foreign capital in the industrial sector.

Previous research using cross-sectional and panel data found a positive relationship between financial development and economic growth. Outside of Nigeria, there is also conflicting evidence supporting either a positive or negative relationship between financial development and economic growth. It is widely assumed that the industrial sector is critical to growth of economy. The Nigerian economy is dominated by the oil and gas sector, which is followed by agriculture and then industry. Unlike previous studies, this one looked into the relationship between financial development and industrial sector performance, especially at a time when industries are rapidly going out of business due to poor working conditions and a lack of basic amenities.

This research has been conducted in Nigeria and around the world. However, most previous studies were limited in scope and used variables from only one dimension, particularly financial deepening. In some cases, the studies were limited in scope because they only looked at the industrial sector and financial institutions. This study will fill the gap left by previous studies by extending the study period to account for current economic realities. The study also expanded the variables used for measurement in previous studies to explain the independent and dependent variables. The researcher believes that by examining a diverse of proxies from both advanced and developing countries, this current study will provide more current work on the subject (1999-2021). As a result, this study investigates how credit to the private sector and market capitalization has influenced the variation in foreign direct investment in Nigeria.

LITERATURE REVIEW

Financial development

Over the years, financial development has appeared as a necessary condition for rapid economic growth (Chang, 2002). Financial development seems to be either supply leading or demand following in terms of its role. The supply-side role drives financial development as a growth catalyst, whereas the demand-side role explains financial development as a result of economic growth (Chen & Guariglia, 2013). The channelling of savings into productive investment areas is referred to as financial development. However, the speed and efficiency of savings transfers are more important for financial development (Hye & Dolgoplova, 2011). There are three types of financial development: (i) financial expansion (ii) financial diversification (iii) financial liberalization (Muhammad, Adeel & Muhammad, 2017). Financial development entails gathering information, enforcing contracts, and conducting transactions, all of which create incentives for the emergence of specific types of financial contracts, markets, and mediators (Mahmood, 2013). Different types and combinations of information, enforcement, and transaction costs, in combination with various legal, regulatory, and tax systems, have motivated distinct financial contracts, markets, and intermediaries across countries and throughout history (Udoh & Ogbuagu, 2012).

Financial development has been highlighted as one of the major determinants of macroeconomic performance, such as economic growth, stability, and savings, while empirical evidence of its impact has generated more debate and controversy (Hiroyuki & Masahiro, 2018). Simultaneously, different measures development of finance may have contributed to the mixed findings regarding the impact of financial development on relevant macroeconomic

variables. Financial development is frequently captured by a quantity measure that gauges the depth of financial markets, such as the stock of private credit created as a share of GDP, owing to the availability of this type of data series by country and over time (private credit data go back to as early as the 1960s for many countries). According to Beck (2015, 2013), high levels of credit to private sector as a share of GDP do not necessarily imply high levels of financial development. According to his argument, what is captured by private credit varies across the globe.

Credit to Private Sector

Credit to the private sector refers to financial capital provided to the private sector in the form of loans and advances, non-equity securities acquisition, accounts receivable, and trade credits. Credit can be viewed from two perspectives in this regard: trade or commercial credit and banking system credit. A survey of 48 countries was used in a study by Beck, Demirgüç-Kunt, and Maksimovic (2008), which found that on average 19.7% of all investment financed through external sources was done using trade credit; in fact, the authors discovered that in most countries, trade credit is the second most vital source of external finance, trailing only bank credit.

The other type of credit is banking system credit, which involves banks, financial institutions, and merchant banks providing loans and overdrafts to finance economic activities such as manufacturing, production, and commerce. The Central Bank of Nigeria recently stated that the flow of credit to priority sectors did not meet the prescribed targets and had no positive impact on investment, output, or the domestic price level. Certainly, these remarks have raised concerns about the strength, effectiveness, and productivity of bank credit in Nigeria. However, studies have revealed that a number of small and medium-sized manufacturers Loening, Rijkers and Soderbom (2008) firms in Africa are credit-constrained due to the underdeveloped nature of the continent's financial system, relative to those of more advanced nation. The global financial crisis has resulted in a worldwide slowdown of credit flows, which triggered a discussion about the factors driving sluggish lending activity. Although the decline in credit flows can be explained by the overall decline in economic activity, some critics contend that the slowdown in lending (despite generally low interest rates) can be attributed to credit rationing by financial institutions. Understanding whether slow credit activity is due to a lack of credit or a lack of demand is critical from a policy standpoint. One of the most important indicators of the financial sectors is the interest rate structure. It also has a significant impact on credit flow to the private sector and overall investment activity. Lower lending rates and a more liberal credit policy encourage more credit to flow to the private sector, whereas rising lending rates and tight monetary policy, which are essential tools for controlling inflationary pressures, discourage it (Economic Survey, 2007).

Market Capitalization

The deregulation of foreign exchange and interest rates, which were the pillars of SAP, encouraged many companies to seek out cheaper sources of long-term funds that only the capital market could provide (Dada, 2003). Some key stock market indices have revealed signs of improved performance in the capital market over the years. The number of listed domestic companies has increased dramatically, as has the value of traded shares (CBN, 2005).

Market capitalization has a significant impact on economic growth and development, and its importance is growing (Odogunde, Elumilade and Asaolu, 2006). Indeed, the capital market has grown significantly over the last few decades, and an increasing number of businesses are

turning to it for funding. The capital market is the market for accessing medium to long-term securities, both in the primary market for the issuance of new securities and in the secondary market for the trading of existing shares. Capital markets exist primarily to transfer funds from surplus (savings) to deficit (capital investment) sectors of the economy. According to Mary, Samson, Kayode, and Elizabeth (2012), the purpose of an active market includes promoting rapid formation, liquidity for investor(s), mobilizing savings for economic growth and development, and providing an alternative source of funding for government other than taxation. Previous studies in Nigeria used various methodologies but used the same data. The capital market is expected to play an active role in financing national and regional development, financing industries, and facilitating regional payments. Industrial growth stimulates market expansion and resource availability; gains in efficiency in production and allocation, particularly the resultant economies of scale, which should lead to a higher global rate of economic growth in the area of integration. Capital markets, according to Usman, Ahmed, and Yahaya (2014), are expected to have a positive impact on industrial development by providing an efficient framework for mobilizing and allocating funds for manufacturing purposes in order to accelerate industrialization and thus overall growth of economy.

Foreign Direct Investment

FDI is defined as any flow of lending to or acquisition of ownership in a foreign enterprise that is primarily owned by residents of the investing country. Foreign direct investment is defined as investment that gives foreign owners control over the businesses in which they invest (Oseni & Enilolobo, 2011). Foreign direct investment (FDI) is also defined as an investment involving the acquisition or creation of assets by foreigners or a joint venture with local governments in order to establish a long-term business relationship (Ibeanacho, 2019). FDI should actually serve to increase domestic investment because the net effect could be beneficial in releasing scarce domestic funds for other investment purposes, particularly in developing countries like Nigeria, where educational and technological standards are low and financial markets are weak.

Unfortunately, developing countries must achieve a certain level of development in education, technology, infrastructure, and health before they can benefit from foreign presence in their markets. FDI is an investment made by a domestic or foreign company to expand operations in a country, which can be horizontal, vertical, or platform (Ali, 2014). FDI could be achieved through the establishment of plants and factories, as well as the acquisition of equipment by foreign investors, in order to maintain long-term perpetual business interest (Idenyi Ifeyinwa, Obinna & Promise, 2016). FDI has also been defined as the establishment of, or acquisition of significant ownership in, a commercial enterprise in a foreign country, or the expansion of previously existing investment (Arikpo & Ogar, 2018). As a result, FDI could be defined as physical investment, business ownership, or the acquisition of a substantial ownership interest in a business for a long or perpetual period of time by investors in countries other than the home country. A theoretical relationship exists between FDI and the stock market. Economic theory, in particular, assumes a positive relationship between FDI and economic growth, and thus, indirectly, between FDI and the capital market. As a result, this suggests that the two variables may have a bidirectional relationship (Ali, 2014; Arcabic, Globan & Raguz, 2013).

Empirical Review

Gbenga (2020) used Dynamic Ordinary Least Squares (DOLS) and pairwise Granger causality techniques to determine the role of foreign direct investment (FDI) in stock market

development in Nigeria from 1981 to 2018. According to empirical findings, FDI plays a positive and significant role in the development of Nigeria's stock market. This study concludes that FDI is a catalyst for stock market development in Nigeria, implying that FDI plays a complementary role in the stock market. As a result, the Nigerian government should ensure an investor-friendly macroeconomic framework and implement policies to encourage FDI inflows into the country. In a comparative study of Ghana and Nigeria, Vitenu-Sackey, Barfi, and Oppong (2019) examined the impact of stock market capitalization and foreign direct investment on stock market performance from 1996 to 2017. To make statistical inferences, the study used both panel and time-series approaches and methodologies such as unit root tests, cointegration tests, vector error correction model, dynamic ordinary least square, generalized least square, multiple linear regression (random and fixed effects) models, and granger causality tests. In a panel study, stock market capitalization and foreign direct investment have a negative impact on stock market performance, but both have a positive impact on stock market performance in Ghana and Nigeria, respectively, according to the study. Samuel (2017) used time series data from 1961 to 2013 to investigate the long-run relationship between financial development and economic growth in South Korea. Unit root tests and cointegration analysis were used in the study. Granger causality tests using a vector error correction model (VECM) with one co-integrating vector revealed that financial development increased economic growth and that there was unidirectional causality from financial development to economic growth but not from economic growth to financial development. From 1970 to 2013, Frances, Chukwuedo, and Chukwunonso (2016) investigated the impact of financial deepening and domestic investment in Nigeria. To test the causality between the two variables, the Granger Causality test and OLS were used. A unidirectional causality between financial deepening and investment in Nigeria was discovered, with the causality running from the former to the latter. Furthermore, the report shows that financial deepening has a significant impact on Nigerian domestic investment. Bennett, Anyanwu, and Kalu (2015) examined the impact of industrial development on Nigeria's economic growth from 1973 to 2013. The model explained that the influence of industrial output on economic growth is not statistically significant, even though the sign obtained from its *à priori* expectation is positive but not strong enough. Savings have a positive relationship with the economy and have a significant impact on it. Inflation has a negative impact on economic growth, whereas net foreign direct investment has a positive impact. R-squared indicates a 76% increase in GDP. Jelilov, Enwerem, and Isik (2016) investigated the impact of industrialization on Nigerian economic growth from 2000 to 2013. The ordinary least squares method was used, and it was discovered that industrialisation has a negative long-run impact on economic growth. According to studies, all of the efforts made over the years to industrialize the Nigerian economy have not yielded the desired results. Afolabi and Laseinde (2019) investigated the impact of manufacturing sector production on Nigerian economic growth from 1981 to 2016. Data for the Autoregressive Distributed Lag (ARDL) model and the Granger causality techniques on were obtained from the Central Bank of Nigeria statistical bulletin. The findings revealed unidirectional causality between RGDP and MCU, LMO, and LM2. The findings revealed that MCU has a positive impact on RGDP, while LMO also has a positive impact on GDP. Akinmulegun and Akinde (2019) investigated Nigeria's financial deepening and manufacturing sector performance from 1981 to 2017. OLS was used to analyze time series data obtained from the Central Bank of Nigeria (CBN) statistical bulletin and the

World Bank Development Index. To assess the impact of the variables, the study used an error correction mechanism (ECM). The findings indicate that credit to the private sector has a positive effect on GDP, as does market capitalization. The study concluded that financial deepening had a significant impact on Nigeria's manufacturing sector performance.

METHODOLOGY

Ex-Post Facto research design was adopted for this research work, hence, the researcher cannot influence the variation in the variables/data under existence. The time frame covers a period of twenty three (23) years ranging from 1999 to 2021. This allows for a large number of observations on foreign direct investment from the inception of democracy in Nigeria.

The study obtained data from the Central Bank of Nigeria annual reports and statistical bulletin of 2021.

The dependent variable is foreign direct investment (FDI). The independent variables are Credit to Private Sector (CPS), and Market Capitalization (MKP).

Model Specification

This study adapted model of Adeusi and Aluko (2015) on the relevance of financial sector development. The modified model is expressed as:

$$FDI = \alpha_0 + \alpha_1 CPS_{it} + \alpha_2 MKP_{it} \dots\dots\dots i$$

Where:

FDI = Foreign Direct Investment

CPS = Credit to Private Sector

MKP = Market Capitalization

α_0 = constant coefficient

$\alpha_1 - \alpha_4$ = coefficients of the independent variables

u = error term

t = time trend

The hypotheses were tested with descriptive statistics and regression analysis technique via E-Views 9.0 to ascertain the significant effect between the independent variables and dependent variable.

DATA ANALYSIS AND RESULTS

Table 1: Descriptive Analysis

| | FDI | CPS | MKP |
|--------------|----------|----------|----------|
| Mean | 7029236. | 11693333 | 13322120 |
| Median | 875100.0 | 10157020 | 10275340 |
| Maximum | 32001041 | 32426350 | 51288940 |
| Minimum | 92800.00 | 431170.0 | 300000.0 |
| Std. Dev. | 12366109 | 10292325 | 12817019 |
| Skewness | 1.381771 | 0.452521 | 1.341014 |
| Kurtosis | 2.937010 | 1.929275 | 4.723124 |
| Jarque-Bera | 7.322748 | 1.883656 | 9.738992 |
| Probability | 0.025697 | 0.389914 | 0.007677 |
| Sum | 1.62E+08 | 2.69E+08 | 3.06E+08 |
| Sum Sq. Dev. | 3.36E+15 | 2.33E+15 | 3.61E+15 |

Observations 23 23 23

Source: E-view output, 2023

Interpretation

This research work measured descriptive analysis to examine its using mean, standard deviation, minimum and maximum for foreign direct investment (FDI), credit to private sector (CPS) and market capitalization (MKP) in Nigeria. Table 1 portrays FDI to have an average mean of 7029236.0 with a minimum of 92800.0, a maximum of 3200104.0 and at a standard deviation of 12366109.0. CPS has an average mean of 11693333.0 with A minimum of 431170.0, a maximum of 32426350.0 and a standard deviation of 10292325.0, moreover, MKP has a mean of 13322120. The minimum value is 300000.0 while the maximum value is 51288940.0 and standard deviation stood at 12817019.0.

Test of Hypotheses

Restatement of Research Hypothesis

H₀: There is no significant effect between credit to private sector and market capitalization and variation in foreign direct investment in Nigeria.

H₁: There is a significant effect between credit to private sector and market capitalization and variation in foreign direct investment in Nigeria.

Table 2: Regression Analysis between CPS, MKP and FDI

Dependent Variable: FDI

Method: Least Squares

Date: 03/20/23 Time: 10:54

Sample: 1999 2021

Included observations: 23

| Variable | Coefficient | Std. Error | t-Statistic | Prob. |
|--------------------|-------------|-----------------------|-------------|--------|
| C | -3921974. | 2414903. | -1.624071 | 0.1200 |
| CPS | 0.338323 | 0.430666 | 0.785580 | 0.4413 |
| MKP | 0.525074 | 0.345833 | 1.518285 | 0.1446 |
| R-squared | 0.661025 | Mean dependent var | 7029236. | |
| Adjusted R-squared | 0.627127 | S.D. dependent var | 12366109 | |
| S.E. of regression | 7551153. | Akaike info criterion | 29.99341 | |
| Sum squared resid | 1.14E+15 | Schwarz criterion | 30.99151 | |
| Log likelihood | -395.2842 | Hannan-Quinn criter. | 34.67066 | |
| F-statistic | 19.50070 | Durbin-Watson stat | 0.995370 | |
| Prob(F-statistic) | 0.000020 | | | |

Table 2 shows that R-squared and adjusted Squared values of (0.66) and (0.63) respectively. This implies that the independent variables, credit to private sector (CPS) and market capitalization (MKP) jointly explain about 66% of the systematic variations in dependent variable, foreign direct investment (FDI) over the twenty three years periods (1999-2021).

Test of Autocorrelation: using Durbin-Waston (DW) statistics which the study obtained from the regression result, it was observed that DW statistics is 0.995 and an Akaike Info Criterion and Schwarz Criterion which are 29.99 and 30.09 respectively also further confirmed that the

model is well specified. In addition to the above, the specific finding from the explanatory variables is provided below.

Credit to Private Sector: The Coefficient value of 0.338323, t-value shows 0.785580 and p-value of 0.441, this implies that credit to private sector has a positive effect on foreign direct investment, however this effect is not statistically significant, hence the p-value is higher than value (0.441 > 0.05). on this note, this study therefore reject alternative hypothesis and accept null hypothesis which stated that credit to private sector has not significantly affect foreign direct investment in Nigeria.

Market Capitalization: The Coefficient value of 0.525074, t-value shows 1.518285 and p-value of 0.145, this implies that credit to private sector has a positive effect on foreign direct investment, however this effect is not statistically significant, hence the p-value is higher than value (0.145 > 0.05). This study therefore reject alternative hypothesis and accept null hypothesis which stated that market capitalization has not significantly affect foreign direct investment in Nigeria.

Discussion of findings and Conclusion

This study determines the effect of financial development on foreign direct investment in Nigeria. *Ex Post Facto* research design adopted for the study. Data were obtained from Central Bank of Nigerian Statistical Bulletin for the year, 2021. The hypotheses were tested with regression analysis, and the result shows that credit to private sector and market capitalization were positively affected foreign direct investment, though the effects were not statistically significant. This result implies that credit to private sector and market capitalization can affect the foreign direct investment positively but cannot be used for policy making.

Finally, the findings indicate that financial development has only insignificantly explained and affected variation in Nigerian foreign direct investment. This finding is consistent with that of Garba (2014), who discovered that changes in financial sector variables, such as banking sector credits and total market capitalization, positively affect foreign direct investment.

According to the findings, the government should create an enabling environment to encourage foreign direct investment in the industrial production sector, which will aid in increasing the nation's GDP.

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