IMPACT OF EXCHANGE RATE ON THE INFLOW OF FOREIGN DIRECT INVESTMENTS IN NIGERIA FROM 1986-2020

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Abstract
This paper analyzed the impact of the exchange rate on the inflow of foreign direct investment in Nigeria for the period from 1986 to 2020 making use of annual time series data sourced from the database of the World Development Indicator (WDI) and Central Bank of Nigeria (CBN) 2021 Statistical Bulletin. The method employed for this investigation was the Autoregressive Distributed Lag (ARDL) approach of estimation, the data analysis began with the finding out the unit root properties of the variables. The Philips-Perron (PP) unit root test was employed and the test reveals that the variables were either integrated of order I(0) or order I(1). This necessitated the use of the Bounds testing approach in finding out the cointegration among the variables. Analysis using the Bounds testing approach to co-integration revealed the existence of long-run relation among the variables of the models. In determining the impact of the exchange rate on foreign direct investment inflow in Nigeria, the study estimated an ARDL model and the finding revealed that the exchange rate affects FDI in both the long and short run. The study recommends that government should make the exchange rate stable to increase the inflow of foreign direct investment for desired economic growth in the country.
Keywords: Autoregressive Distributed Lag, Economic growth, Exchange Rate, Foreign Direct Investment

1.1 Introduction

The exchange rate is the price of a particular currency with the other. It can also be regarded as a means by which the prices of goods in two different countries are linked together. According to Obansa et al (2013), the exchange rate shows the extent of involvement of the external sector in international trade. The issue of the exchange rate system has been a key topic of debates in international finance especially in developing economies, with many economies trying to liberalize trade as means of achieving economic growth. The exchange rate can also be regarded as one of the vital and helpful macroeconomic variables that a country makes use of to achieve its macroeconomic objectives of economic growth.

The conventional school is of the view that depreciation of currencies will revamp trade balance; resolve the problems of balance of payment and increase output and employment if the Marshall–Lerner conditions are satisfied. The condition is that currency depreciation will result in the growth of output if the total sum of the price elasticity of demand for exports and the price elasticity of import demand is more than one. The basis of driving the direct effects is to boost the local production of tradable goods, strengthen the competitiveness of export firms in international markets and encourage local firms towards the utilization of more local raw materials (Iyoboyi & Muftau, 2014). One of the vital objectives of macroeconomic policy is significant growth in the economy of a country which is determined in terms of incessant growth in gross domestic product.

Growth is truly considered to have occurred when the productive capacity of a nation progresses (Akpan, 2008). Genuine production of goods and services enhances exports and sometimes requires the importation of inputs which involves transactions in foreign currencies (Oyovwi, 2012). Jin (2008) revealed that Nigeria's over-reliance on oil exportation implies that the economy is extremely prone to external shocks since in the event of any significant drop in oil price, foreign exchange earnings will fall and that will destabilize the exchange rate as there will not be sufficient stock of

foreign currencies to defend the local currency at the foreign exchange market. This major change in relative prices (exchange rate) would trigger a near-equal adjustment in the distribution of a country's local resources and eventually move the economic structure away from the production of commodities for exports especially agriculture into possibly the services sectors.
The structural adjustment program (SAP) was introduced due to the critical economic situation in the 1980s which gave rise to implementing the devaluation policy as part of the IMF conditions. This policy was introduced principally to discourage imports and encourage exports by rising the nations' productivity and income thereof; however, there has not been a visible increase in export since. The exchange rate between the naira and the United States dollar for instance continues to increase and imports also continue to increase which was not the original reason for implementing the devaluation policy. In addition, according to Nwosu (2016), exchange rates that come into view after the fall down of the Bretton Wood System have been unstable and have made academics and professionals to be cynical about its efficiency in stimulating economic growth. For example, the naira to US dollar exchange rate was N4 in 1987 whereas the real GDP was about N204.8 billion. In 1995, it depreciated to N21 to one US dollar whereas the real GDP was N281.4B. As of 2014, the exchange rate was N168 to one USD and the exchange rate depreciated to N365 in 2017.
Given the above, it is imperative to develop research whose objective is to evaluate the fundamental linkage between the exchange rate and the inflow of FDI in Nigeria. This study bridges the literature gap by answering the relevant research question of "How does exchange rate affects the inflow of FDI in Nigeria" making use of the latest available data. Results from the study will be helpful for policy-making aimed at attracting FDI from the exchange rate point of view.

2.1 Literature Review

The fluctuations and uncertainty in exchange rates appear to be significant factors investors consider in their decision to invest in a foreign country. Much of the scholarly writings on exchange rate and FDI focus on two issues: the level of the exchange rate, and the volatility of the exchange rate. Froot and Stein (1991) argued that the level of the exchange rate may influence FDI. This is due to the fact depreciation of the currency of the host country against that of the home currency raises the relative wealth of foreigners thereby increasing the investment climate of the host country as foreign investors can be able to acquire assets in the host country relatively cheaper. Therefore, the depreciation of the currency of the host country would increase the inflow of FDI into the host country, and on the contrary, an appreciation of the currency of the host country would decrease the inflow of FDI. However, it is often opined that the price of assets should not matter but only their rate of return. When the currency of a host country depreciates relative to the foreign investors' country, the price and nominal return of the assets in the currency of the host country go down. Since the prices of assets and returns on assets both go down exchange rate fluctuations should not impact on FDI.

Froot and Stein (1991) oppose this argument with the assertion that when capital markets are subject to information asymmetries, movements of exchange rates do affect foreign investment. Information asymmetry triggers a deviation between internal and external financing, making the external financing more expensive than the internal, because the lenders incur monitoring costs and therefore lend less than the full value of the asset. In this situation, should foreign investors hold their wealth in foreign currency; the local currency depreciation will increase the wealth of foreign agents concerning domestic agents, thus leading foreign investors to bid more aggressively for domestic assets. Froot and Stein (1991) made use of industry level data on the inward FDI of US for the 1970s and 1980s to justify their hypothesis (Jayaratnam, 2003).

Campa (1993), on the other hand, has a dissimilar argument for the linkage between level of exchange rate and inflow of FDI. In his assertion, the firm's resolution whether or not to invest in a foreign country depends on the expectations of profitability prospect. In such a situation, the higher the level of the exchange rate (that is calculated in terms of units of foreign currency per host

currency) and the more it is rising, the higher will be expectations of future profits from entering a foreign market. Hence, Campa's model projects that an appreciation of the host currency will enhance FDI in the host country, all things being equal, which is different from the prediction of Froot and Stein (1991). Campa's empirical findings that examine the number of foreign entrants entering the US confirm support his assertion according (Gorg and Wakelin 2001). Gorg and Wakelin (2001) made an important contribution. Contrary to other studies that have considered either inward or outward FDI, it considered both. The paper empirically examined both direct investments from the US to 12 countries and investments from these 12 countries to the US. The empirical findings revealed different results for US outward and inward FDI, which appear opposing. The study found a positive linkage between US outward investment and appreciation in the host country currency while there is a negative linkage between US inward investment and appreciation in the dollar.

Blonigen (1997), making use of data on Japanese acquisitions in the US from 1975 to 1992, recommended that exchange rates can impact the acquisition of FDI as this involves buying specific assets in the foreign currency that will generate returns in another currency. The assertion that the fall in the value of the real dollar increases foreign acquisitions that are asserted by Blonigen is different from the argument put forward by Froot and Stein (1991), though they both have the same outcome. Froot and Stein reveal that exchange rate movements are significant because capital markets are imperfect. However, Blonigen reveals that exchange rate movements matter since domestic and foreign firms may have the same opportunities to buy firm-specific assets in the domestic market, but domestic and foreign firms do not have the same opportunities to generate returns on such assets in foreign markets. As a result of uneven levels of access to markets, exchange rate movements may influence the relative level of foreign firm acquisitions.

2.2 Empirical Review

Robinson (2007) established good evidence of weak countries' currency rising foreign direct investment. This is in the context of the model in imperfect capital markets as currency depreciation (downward change in the exchange rate) makes goods in a host country less expensive than countries of export. Thapa (2002) opined that depreciation in exchange rate in host countries tends to increase inflows of foreign direct investment; also a strong exchange rate stimulates the incentives of foreign firms to make production at home for export instead of investing in a host country for export. Scholars such as Adeniran, Yusuf, and Ademeyi (2014) point out that the exchange rate system has not sustained an efficient policy that will increase the inflow of foreign investment and foreign exchange. Regrettably, in Nigeria, foreign exchange has witnessed inelastic supply both in the foreign exchange and domestic market with its attendant destabilizing speculative activities when compared with her counterparts in Asia and America where Nigeria was ranked ahead in the 70s in terms of exchange rate stability.

Mahmood, Ehsanullah & Ahmed (2011) argued that instability in the exchange rate of a country can influence investment in that country negatively, creating an unfavorable atmosphere for investment in that country and requiring that resources in that country should be reallocated among various sectors of the economy of that country. In another relevant investigation Benson, Eya, and Yunusa (2019) studied the impact of exchange and interest rates on foreign direct investment in Nigeria 2006-2018. Annual time series data was employed for the study from the period 2006-2018. The unit root property of the data was tested using the Augmented Dickey-Fuller and the variables were all stationary after taking the first difference. In addition, Johansen Co-integration test statistics were employed to test the co-integrating nature of the variables while the short-run and long-run linkage between the variables under study were analyzed using the error correction model. The data were tested for normality using the Jarque-Bera test statistics. The findings of the study reveal that a positive relationship exists between exchange rates and foreign direct investment.

Eregha (2017) examined the influence of exchange rate policies and inflationary expectations on the flow of foreign direct investment to the West African Monetary Zone (WAMZ). The investigation made use of the Arellano Panel Correction for Serial Correlation and Heteroscedaticity option of the within estimator for five of the WAMZ countries chosen based on the availability of data for the period 1980-2014. Findings revealed that exchange rate uncertainty hindered the flow of FDI while inflation expectation had an insignificant impact on the flow of FDI to WAMZ. The fixed exchange rate policy regime was found to hinder the flow of FDI in the zone while the intermediate policy regime had a significantly positive effect in stimulating the flow of FDI with periods of current account imbalances and variations in foreign exchange reserves as the channels since most of these countries use their reserves from the limited export earnings to interfere in the foreign exchange market to preserve the official rate.

Morrissey and Udomkerdmongkol (2014) analyzed the effect of exchange rates on US inflows of foreign direct investment (FDI) to a sample of 16 emerging market countries making use of panel data for the period 1990-2002. Three variables were made use of to capture separate exchange rate effects. The bilateral exchange rate to the US dollar captures the value of the local currency (a higher value signifies a cheaper currency and enhances FDI). Fluctuations in the real effective exchange rate index (REER) proxy for expected changes in the exchange rate: an increasing (decreasing) REER is interpreted as devaluation (appreciation) being expected so that FDI is postponed (encouraged). The transitory part of bilateral exchange rates is a proxy for the volatility of the local currency, which does not attract FDI. The findings affirm the 'Chakrabarti and Scholnick hypothesis that, all things being equal, there is a negative linkage between the expectation of local currency depreciation and inflows of FDI. Cheaper local currency (devaluation) enhances FDI as volatile exchange rates don't encourage FDI.

Jaratin et al (2014) examined the exchange rate fluctuations and foreign direct investment (FDI) linkage making use of annual data on ASEAN economies, that is, Thailand, Malaysia, Singapore, and the Philippines. By making use of the ARDL bounds test approach, the empirical findings reveal the existence of significant long-run co-integration between exchange rate and FDI for the case of Malaysia, Singapore, and the Philippines with all countries recording negative coefficient implying that the appreciation of the Malaysian ringgit, Singapore dollar, and the Philippine peso has a positive effect on FDI inflows. Making use of the ECM-based ARDL approach for the causality test, both Philippines and the Singapore reveal long-run bidirectional causality between the exchange rate and FDI while long-run unidirectional causality runs from the exchange rate to FDI in Malaysia. In addition, this study also revealed the short-run unidirectional causality running from the exchange rate to FDI in Singapore.

Cambazoğlu and Güneş (2016) study examined the nexus between FDI inflows in Turkey and the real exchange rate level. Annual time series data for the period from January 2007 to January 2015 were used to examine the effect of the real exchange rate on foreign direct investment in Turkey in the long run. For this reason, the study made use of a bound test co-integration approach that is based on the Autoregressive Distributed Lag Model (ARDL). The findings obtained from a long-term static analysis of the estimated ARDL model showed that there is a co-integration linkage between the exchange rate level and inflows of FDI in Turkey.

3.0 Methodology

This paper made use of annual time series data from 1986 to 2020. The data were sourced from the database of World Development Indicators and the Central Bank of Nigeria (CBN), 2021 Statistical Bulletin. The study employed the ARDL model to find out the impact of the exchange rate on foreign direct investment in Nigeria.

3.1 Empirical Model Specification

To analyze the impact of the exchange rate on foreign direct investment in Nigeria, a multivariate model is adopted from the empirical work of Morrissey and Udomkerdmongkol (2014) for this investigation, whereas the authors used FDI as a function of bilateral exchange rate and real effective exchange rate, this study expressed FDI as a function of the exchange rate, inflation, economic growth, and trade.

$$FDI_t = \alpha_0 + \beta_1 EX_t + \beta_2 INF_t + \beta_3 GDP_t + \beta_4 TRD_t + \mu_t \ldots\ldots(1)$$

Where FDI_t is the foreign direct investment at time t; EX is the exchange rate at time t; INF stands for inflation; GDP is the gross domestic product; TRD is the trade and μ_t is the error term at time t. Expanding Equation 1 and expressing the variables in the semi-logarithmic form leads to a baseline model of Equation 2.

$$LFDI_t = \beta_0 + +\beta_1 EX_t + \beta_2 INF_t + \beta_3 LGDP_t + \beta_4 TRD_t + \mu_t \ldots(2)$$

Where L is the natural log; β_0 is intercept term; β_1 to β_4 are the slope coefficients. The equation above assumes that FDI at a time depends on the current exchange rate, current inflation rate, current GDP, and current level of trade. This study, therefore argues that the impact of the exchange rate (EX); inflation (INF); gross domestic product (GDP), and trade (TRD) on foreign direct investment (FDI) may persist beyond the current period. Taking account of this fact, the study renders the model dynamic and obtains the estimable equation in semi-log linear form as follows:

$$LFDI_t = \beta_0 + \beta_1 LFDI_{t-1} + \beta_2 EX_t + \beta_3 EX_{t-1} + \beta_4 INF_t + \beta_5 LGDP_t + \beta_6 TRD_t + \mu_t \ldots(3)$$

3.2 Estimation Techniques

This paper adopted Auto Regressive Distributed Lag (ARDL) as an estimation technique. This technique is used for both co-integration test parameter estimation (long-run and short-run estimates). But the order of integration of the variables employed is estimated using the Philips – Perron (PP) unit root test approach. If the variables are found to be integrated of the same order say I(0) or different order I (0) and I(I), the study then proceed to apply the ARDL approach to co-integration.

3.3 Co-integration Test

The Autoregressive Distributed Lag (ARDL) model which employs the bounds testing approach to co-integration as proposed by Pesaran and Shin (1999) and Pesaran et al. (2001) is employed in the data analysis. This method has some features that many researchers give some advantages over the method suggested by Engel-Granger (1987) and the maximum likelihood-based method proposed by Johansen and Juselius (1990) and Johansen (1991). In the first place, the approach can be used with a mixed order of I(0) and I(1) data, that is, it can be used whether the variables are mutually co-integrated or not. In the second place, it involves just a single-equation setup, making it simple to implement and interpret. In the third place, different variables can be assigned different lag lengths as they enter the model. And, the model can be tested by using the OLS (ordinary least square) once the order of ARDL has been acknowledged (Pesaran & Shin 1999; Pesaran et al. 2001).

4.0 Results and Discussions

4.1 Descriptive Statistics

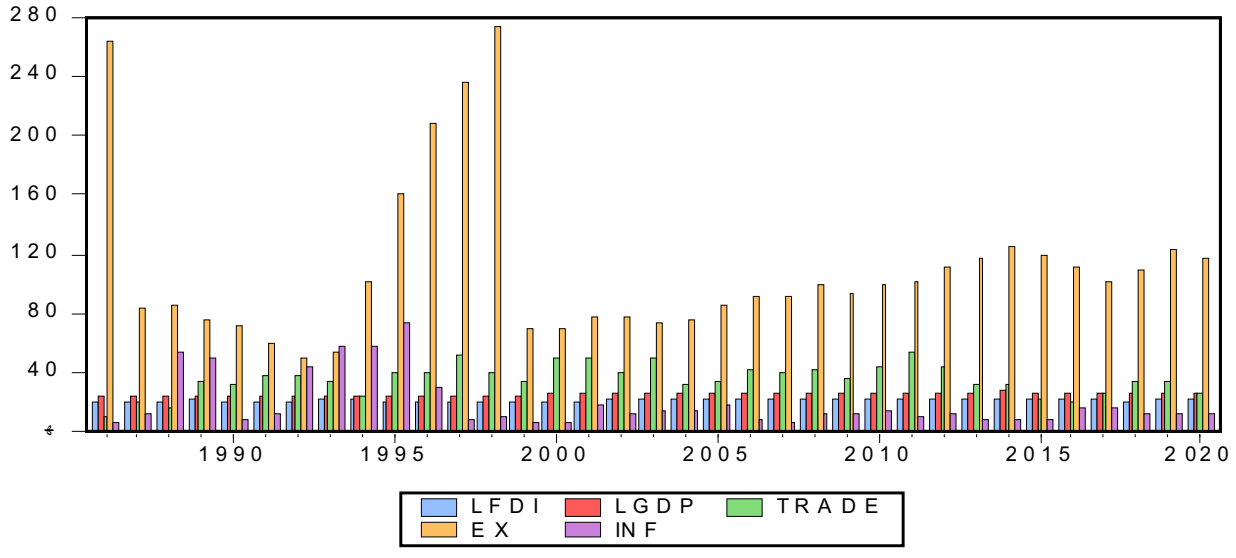
Table 1 below depicted the descriptive statistics of the variables under investigation. The variables statistics were presented in terms of their mean value, maximum value, minimum value as well as standard deviation. The maximum value of log (FDI) over the period under study is $22.90267 which was recorded in 2011, while the minimum value is $19.07931 which was recorded in 1986. The mean value log (FDI) is $ 21.27034. Likewise, the maximum value of log (GDP) is $27.02712 which was recorded in 2014 while the minimum value is $24.04658 which was recorded in 1993. The mean value of log (GDP) over the period under study is $25.61821. For the value of the exchange rate (EX), the maximum value stands at N273.0110 which was recorded in 1998 while the minimum value is N49.74991 which was recorded in 1992. The mean value of the exchange rate over the period under study is N110.2833

Table 1. *Descriptive Statistics of the Variables*

	LFDI	LGDP	TRADE	EX	INF
Mean	21.27034	25.61821	34.95288	110.2833	19.46086
Median	21.35680	25.37639	34.45783	99.56663	12.21778
Maximum	22.90267	27.02712	53.27796	273.0110	72.83550
Minimum	19.07931	24.04658	9.135846	49.74991	5.388008
Std. Dev.	1.075711	1.005781	10.29688	54.68121	17.84792
Skewness	-0.18405	0.078023	-0.36351	1.819858	1.704270
Kurtosis	1.991853	1.332982	2.836300	5.575783	4.546375
Jarque-Bera	1.679795	4.088146	0.809906	28.99485	20.43041
Probability	0.431755	0.129500	0.667008	0.000001	0.000037
Sum	744.4618	896.6374	1223.351	3859.917	681.1300
Sum Sq. Dev.	39.34323	34.39424	3604.874	101661.2	10830.64
Observations	35	35	35	35	35

Source: Author's Computation using E-view 9. LFDI= Log Foreign Direct Investment, LGDP= Log Gross Domestic Product, EX= Exchange Rate, INF= Inflation, TRADE= Trade

Figure 1: Chart showing the descriptive statistics of the variables



4.2 Unit Root Test

The unit root test as depicted in Table 2 below indicated that log (FDI), and log (GDP) were not stationary at the level until after taking the first difference at a 5% level of significance. Exchange rate (EX), trade (TRADE), and inflation (INF) were stationary at the level at a 5% level of significance even before taking the first difference. Consequently, the variables under this study were all stationary and therefore integrated into order I(I) and I(0).

Table 2. *Summary of Phillip Perron Unit Roots Test.*

Variables	Test Statistic at Level	5% Critical Value at Level	P-Value at Level	Test Statistic at First Diff	5% Critical Value at First Diff	P-Value at First Diff	Order of Integration
LFDI	-2.542906	-2.951125	0.1205	-8.806810	-2.954021	0.0000	I(I)
LGDP	0.176221	-2.951125	0.8612	-4.615437	-2.954021	0.0001	I(I)
EX	4.101034	-2.951125	0.0003	-6.982819	-2.954021	0.0000	I(0) I(I)
TRADE	-3.537843	-2.951125	0.0013	-7.084322	-2.954021	0.0000	I(0) I(I)
INF	-4.535808	-2.976263	0.0003	-5.130472	-2.954021	0.0000	I(0) I(I)

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

Table 3. *Autoregressive Distributed Lag Bounds Test*

Computed F Statistic	K	5% critical bound test value Lower Bound	Upper Bound
2.185749	4	2.56	3.49

4.3 Bounds Test to Cointegration

The variables employed for this study are integrated of order I(0) and I(I) as indicated by the result of the unit root test in Table 2 above. The study resolved to apply the bounds test to co-integration to find out whether the variables have a long-run relationship as depicted in Table 3 above. The F statistic value of 2.185749 from the result of the ARDL bound test depicted in Table 3 above is less than the lower bound value of 2.56 at a 5 percent level of significance. Hence, based on this, the null hypothesis that states no long-run relationship is therefore accepted and concludes that log (FDI) (foreign direct investment), log(GDP), (EX) Exchange Rate, (INF) inflation, and trade do not have a long run relationship over the period under study.

4.4. Autoregressive Distributed Lags (ARDL) Short-Run Estimate

To study made use of the 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 into the order one of as revealed by the unit root test in Table 2 above. This method was applied based on 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 (1, 0, 0, 0, 0,) as the result depicted in Table 4 below.

Table 4. *Autoregressive Distributed Lag Result*

D/Variable: LFDI	**ARDL**	(1,0,0,0,0)		
Variable	Coefficient	Std. Error	t-Statitic	Prob.*
LOG (FDI (-1))	0.334008	0.165903	2.013266	0.0538
LOG(GDP)	0.509893	0.210985	2.416731	0.0224
EX	-0.006089	0.002061	1.355452	0.0063
INF	0.002016	0.007439	-2.953884	0.7884
TRADE	0.015858	0.011700	1.355452	0.1861
C	1.195243	3.410473	0.350462	0.7286
R-squared	0.757346			
Adj R-squared	0.714015			
Durbin Watson st	2.227962			
Prob (F-Statistic)	0.000000			

Source: Author's Computation making use of Eview 9.

Table 4 depicted above, has shown that the ARDL estimation has a good fit with an R-square value of 75 percent. It indicated that about 75 percent of the variation in FDI is explained by exchange rate, gross domestic product, trade, and inflation over the period under study while the remaining 25 percent is explained by other variables not captured by the model. The result also indicated that the explanatory variables are mutually significant to explain the impact on FDI being the dependent variable as shown by the significant probability value of the F statistic which is 0.00000 less than 5 percent.

Furthermore, results revealed that gross domestic product (GDP) has a significant positive relationship with foreign direct investment. Precisely, a unit increase in the log (GDP) will bring about a 0.509893 percent significant increase in FDI at a 5 percent level of significance. Furthermore, the results indicated that the exchange rate (EX) has a significant negative relationship with FDI. Precisely, a unit increase in the value of the exchange rate will bring about a -0.006089 percent decrease in FDI over the period under study. Also, the results showed that inflation (INF) has an insignificant positive relationship with FDI. Specifically, a unit increase in (INF) will bring about a 0.002016 percent increase in FDI. Similarly, trade (Trade) has an insignificant positive relationship with FDI. Specifically, a unit increases in log (Trade) will bring about a 0.015858 increase in FDI over the period under study.

5.0 Conclusion and Policy Suggestions

5.1 Conclusion

The study examines the impact of the exchange rate on foreign direct investment in Nigeria from the period 1986 to 2020. The study reveals that the exchange rate has a significant negative impact on foreign direct investment implying that when the exchange rate for the dollar increases, there will be a decrease in FDI. On the other hand, GDP shows a significant positive effect on foreign direct investment. The study also argues that inflation and trade have an insignificant positive impact on FDI over the period under study.

Given that the exchange rate has a significant negative linkage with foreign direct investment, it means that changes in monetary policy by the Central Bank of Nigeria (CBN) concerning the

exchange rate have influenced the inflow of FDI and further changes to these policies would likely translate into changes in the value of FDI in Nigeria.

5.2 Policy Suggestions

The findings from the study suggest for possible consideration by policymakers: that the Central Bank of Nigeria should maintain an adequate flow of foreign exchange in the foreign exchange market and ensure exchange rate stability to attract foreign investors for increased inflow of foreign direct investment. This study has shown that the exchange rate has an effect on attracting FDIs into Nigeria.

Therefore, exchange rate policy measures should focus on addressing Nigeria's exchange rate challenges. Efforts to reinforce the value of the naira should be made by focusing on the market forces rather than using measures that would only overstate the value of the naira. Rather than shielding the overstated value of the naira, certain issues like dependence on imports, low production, and non-oil exports should be addressed. This will translate in to increase in demand for the naira, and the exchange rate would thus reflect the realistic value of the country's economic performance, and foreign investors would be attracted to invest in Nigeria.

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