

# Attracting foreign direct investment (fdi) in africa



The developing economies of Africa must on their part make deliberate and sustained efforts to attract the much needed inflows of foreign investments. To achieve this, the enabling economic, financial and political environment for such inflows must be created. An economy that is exposed to higher levels of political instability, economic uncertainties and financial risk will not be able to gain the confidence of investors. These risk factors if not well mitigated with a great degree of transparency and accountability could serve as barriers to both local and foreign investments. According to Banz and Clough (2002), the major reasons among many others for not investing in developing economies are the lack of transparency and poor governance policies. Therefore, Nigeria and other developing economies of Africa must work towards an environment that has a relatively reasonable economic risk, ensure political stability and demonstrate moderate financial risk to attract foreign capital inflows especially in the form of equity investment.

The Economic Community of West African States (ECOWAS) markets to which Nigeria belong have of recent experienced some legal, regulatory and supervisory changes resulting into increased transparency in the operation of their markets. The liquidity of the markets have increased and operations also liberalized to attract more foreign investors. The Nigerian economy is the largest of the 15 member body and has a lot of political and economic influence over the other members. Conscious efforts have been made by the various member countries to partially open up their economies, through systematic privatization programs, overhauling of their legal and financial institutional infrastructures and use of modern trading platforms have

resulted in real development of their markets and manage to attract some foreign direct investments (FDI) to them.

Nigeria is currently the biggest economy in Africa after the recent rebasement of its GDP, thereby beating South Africa to the second place ((Magnowski, 2014). The petroleum sector accounts for roughly 80% of fiscal revenues and 90% of export earnings (World Fact book). The country is also one of the major exporters of petroleum, and plays a significant role in OPEC (OPECAnnual Statistical Bulletin 2013). To diversify its economy Nigeria is encouraging the growth of their private sector by offering some incentives to private sector equity investors who are willing to invest in the country.

The country has an increasing GDP of \$422. 6billion, \$450. 4billion and \$502 billion for the years 2011, 2012 and 2013 respectively, and diminishing foreign debt stock of \$15. 73 billion and \$13. 4 billion for 2012 and 2013 respectively. There is also an increasing Foreign Direct Investment of \$7. 444 billion and \$9. 212 billion for 2012 and 2013 respectively (World Fact book: World Bank).

The Nigerian Stock Exchange (NSE) is the second largest exchange in Africa; it was established in 1960 to provide listing and trading services among others. Its activities are regulated by the Securities and Exchange Commission (SEC) of the country. The value of publicly traded shares stood at \$50. 88 billion, \$39. 27 billion and \$56. 39 billion for 2011, 2012 and 2013 respectively.

Despite all the above mentioned strong economic fundamentals or good indicators, Nigeria has been plagued by several daunting challenges, notable <https://assignbuster.com/attracting-foreign-direct-investment-fdi-in-africa/>

among them are the issues epileptic power supply, inadequate infrastructures, insecurity, endemic corruption, increasing rate of unemployment and its heavy reliance on petroleum products (Global edge, 2014; World fact book). These factors pose some uncertainties about the Nigerian economic and stock market outlook.

Nevertheless, the Nigerian economy is still growing. Fortunately, the government is also conscious of some of these teething problems. Programs are initiated to diversify the economy in the areas of agriculture, power, telecommunication, transport and other services. These efforts seem to be yielding the desired results as evidenced in the country's 6-8% per annum pre-rebasing growth rate. With these measures a seemingly conducive economic environment is created which could be exploited by investors. This therefore, presents reasonable economic risk. There is also institutionalized democracy leading to political stability in its own form in terms of the country's ability to carry out declared programs. Nigeria is also able to finance its commercial and trade debt obligations and has at no time defaulted in payment of its external financial commitments; thus demonstrating relatively moderate financial risks.

These indices send strong signals in terms of information content about Nigeria's overall economic health to domestic, international investors and rating agencies among others. Therefore, it will be of interest to empirically explore how these factors (economic, financial and political risks) when taken together or separately can affect the country's stock market performance and vice versa. Country risk ratings assess the probability of a country's default on its debt from a variety of perspectives: from socio-

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economic condition to growth in the real gross domestic product (GDP), government stability to corruption, to exchange rate stability among others.

The objective of this paper is to empirically investigate the short and long-run relationships between Nigeria's country risk ratings; political, economic, and financial components and its stock market in order to provide further information for current and potential investors to enable them make better informed investment decisions. In our knowledge this is the first few studies of this nature conducted on an emerging economy like Nigeria.

Our main instrument of investigation is the Autoregressive Distributed Lag (ARDL) approach formulated by Pesaran and Pesaran (2009) and Pesaran et al. (2001), to empirically investigate the relationships. The ARDL method is adopted because of its econometrics techniques. One important advantage of the ARDL model over other traditional approaches is that it can be used in time-series data irrespective of their order of integration, whether  $I(0)$ ,  $I(1)$  and/or fractionally integrated (Pesaran and Pesaran, 2009). The ARDL approach can also test for cointegration by the bounds testing procedure and can estimate the short-run dynamics and long-run relationships.

The rest of the paper is organized as follows; section two discusses related literature. Section three explains the methodology adopted in this paper. Section four presents the ARDL procedure and discusses its empirical findings. Conclusion and implications are given in section five.

The globalization of trade and financial markets in the past years has created huge investment opportunities and its attendant risks. It has therefore, becomes inevitable to know the credit worthiness of participating players.

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The motive behind such an assessment of the economic and financial condition and sometimes political stability of a country is to be able to evaluate the country credit risks involved in doing business or investing in such a country. Any event in a country that will affect not only the prospect of profitability but also restrict the movement of capital in the form of profits, dividend etc is worth evaluating.

The need for such critical evaluation of credit worthiness of countries has resulted in the establishment of several rating agencies such as Fitch, Moody's and Standard & Poor among many others. These risk ratings are considered as indicative of possible future default. A higher rating is seen as a lower risk of default, while a lower score indicates a higher risk of default. Though the primary significance of ratings is due to their impact on interest rates at which countries source for funds in the international financial markets, studies have also shown its influence on stock market movements. This argument is linked to the influence of country credit risk ratings on the inflows of Foreign Direct Investments (FDI), into the host's economy, especially through equity shares investments.

There is no scarcity of research papers on sovereign ratings and their critical roles for encouraging and facilitating investment flows especially in developed economies, but there is paucity of studies conducted on the impact of these ratings on movements of national stock markets, particularly for emerging markets such as Nigeria. Some of the early studies by Erb et al (1995, 1996a, 1996b) show that there is association or relationship between country credit risk (i. e. the risk of a country's inability to service its external debts) and returns on equity investments.

The existence of relationship between country credit ratings and stock market returns was confirmed in the early work of Erb et al. (1996a) using data that cut across boundaries. As a follow up to their earlier work, Erb et al. (1996b) investigated the influence of economic, financial and political risks on expected fixed income returns. They show that there is relation between the country risk measures and world bond market expected returns. For the ICRG economic variable, they find positive and significant signs in unhedged, local, and foreign exchange portfolio returns. They also show that the country risk attributes are significant to the real yields of fixed income securities.

Kaminsky and Schmukler (2001) also examine the influence of sovereign ratings and outlook changes on the sensitivity of emerging financial markets. They find that these variables have substantial influence on both bond and stock markets. A domestic downgrade is associated with an average increase change rate of two percentage points in bond yield spreads and a decrease of one percentage point in stock returns. SubaÅÿÄ± (2008) expressed a contrary view, stating that in most cases news of a downgrade is often anticipate earlier before its announcement; therefore the potential negative effect of such information on stocks and exchange rate returns is diluted.

The impacts of rating changes on both bond yield and sovereign debt have been tested severally by many authors. Reisen and Maltzan (1999) using the three main rating agencies, find that there is mutual interdependencies among rating changes and changes in bond yield spread. The study by Cantor and Packer (1996) also reported similar findings. Among several authors that have provided valuable insight into the influence of rating <https://assignbuster.com/attracting-foreign-direct-investment-fdi-in-africa/>

changes on sovereign debt and corporate securities are Hand et al. (1992) and Richards and Deddouche (1999). The degrees of sensitivity in all these studies tend to vary probably because of the methods used for the country risk analysis.

Hammoudey et al. (2011) using emerging economies; Brazil, Russia, India, China and South Africa (commonly referred to as the BRICS countries) establish various degrees of sensitivities of these countries' stock markets to their respective country risk ratings. China is most sensitive to all the risk variables, followed by Russia, while all the BRICS countries show moderate economic risk sensitivity.

The spillover effect of sovereign debt rating changes on national stock markets and international debts is also confirmed by various authors, among them are Ferreira and Gama 2007; Li et al 2008. This situation is common among countries that share common economic features and unrestricted Evidence of flow of information. Common border also suspected to play a significant role.

Regional stock market movements are also influenced by country credit risk rating news. This development is consistent with the study by Christopher et al. (2008), stating that there is a positive relationship between the two factors. While Brooks et al. (2004) in their study, though under a different setting did not find any sensitive association among the two variables. Turkey's stock market index also seems to have association with its economic, financial and political risk ratings. Using Autoregressive



Distributed Lag (ARDL) model, Sari et al. (2013) established a steady long-run relationship among the stock market and some of the risk variables.

There are many leading commercial publishers of country and political risk analysis, but data for this study is sourced from the International Country Risk Guide (ICRG) economic, financial and political risk ratings for Nigeria covering the period 2001 to 2013. The ICRG rating system is made up of 22 variables representing three major components of country risk, namely economic, financial and political. These variables essentially represent risk-free measures. There are 5 variables representing each of the economic and financial components of risk, while the political component is based on 12 variables (Hoti, 2003). The specified allowable range for each factor reflects the weight attributed to each factor. A higher score indicates a lower risk and vice versa. The stock market returns variable is obtained by taking the first logarithm difference of the monthly stock of the Nigerian Stock Exchange (NSE) for the period earlier specified. s