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Impact of political stability on foreign direct investment: Evidence from Nigeria

Social Sciences Research

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Abstract

Foreign direct investment is considered as a major driver of economic growth. FDI is seen as the acquisition of 10% or more of foreign company and its attraction depend largely on the stability of the political environment in the host country. The paper therefore examined the impact of political stability on foreign direct investment in Nigeria. The study employed a set of macroeconomic variables as independent variables and used annual time series data from 1970Q1 to 2015Q4 sourced from Central Bank of Nigeria Statistical Bulletin. The model of the study for analysis of its data was estimated with ordinary least squares (OLS) method and the empirical result from the Auto Regressive Distributed Lag (ARDL). Both R-squared and Adjusted R-squared stood at approximately 0.99 which shows that the explanatory variables exchange rate, quarterly inflation rate, interest rate and political stability explained about 97% variation in the dependent variable (foreign direct investment). This implies that political stability in line with other variables of interest impacts significantly on foreign direct investment in Nigeria.

Keywords: ARDL, foreign direct investment, political stability.

Introduction

Foreign direct investment is considered a major ingredient of economic stimulation. Foreign direct investment is when an individual or business owns 10% or more of a foreign company, although 10% ownership doesn't give the investor a controlling interest, but does allow influence over the company's management, operations and

policies. It also reduces the effect of politics, cronyism, bribery and the recipient business receive best management and operational practices that raises the standard of living for more people in the recipient country and create a boom-bust cycle that leaves permanent foot print in a country. The Nigerian Investment Promotion Commission Act No16 of 1995 was established and given mandate for the promotion of foreign

private investment in the country to complement the works of the Foreign Exchange Monitoring and Miscellaneous Act No 17. Obidike and Uma (2013), see foreign direct investment as a sure path for Nigeria to expand and develop her infrastructural and technological base to achieve the above stated target. Ajayi (2006) observed that foreign direct investment contributes to growth in a substantial manner because it is more stable than other forms of capital flows., provides developing countries (including Nigeria) with the much needed capital for investment, it also enhances job creation, managerial skills as well as transfer of technology. But the extent of its attraction and retain are hinged on the political stability of any nation seeking to use it as an option.

Political instability is considered by economists a serious threat which is harmful to the economic performance of a country. Political instability is defined as the tendency of a government collapse (Alesina, Özler, Roubini & Swagel, 1996). This may be either due to the conflicts or extensive competition between various political parties. Political instability is likely to shorten policymakers' horizons leading to suboptimal short term macroeconomic policies. It may also lead to a more frequent switch of policies, creating volatility and thus, negatively affecting macroeconomic performance (Aisen & Veiga, 2013).

Khan & Akbar (2013) argue that uncertainty in the economic environment is directly related to political instability, which in turn negatively affects the foreign investors' decisions.

Nigeria is part of the NEKS countries; an acronym for Nigeria, Egypt, Kenya and South Africa, described by analysts as nations with huge untapped markets for foreign direct investment (FDI) in Africa (Adebakin & Raimi, 2012). At independence and several years after, the country that was perceived as one of the destination markets for FDI is nowhere to be found on the FDI inflow growth ladder amongst her peers. In addition, according to a report on the ease of doing business published by World Bank (2015) shows that political instability is among the top three greatest constraints faced by companies when investing in Africa. The report also shows the increasing degradation of foreign direct investment in the recent years. Hence the motivation for this study.

The unsatisfactory inflow of (FDI) into Nigeria when compared with that of some selected nations as analyzed in appendix 1 is a source of worry to policy makers. Olatunji (2001) argued that despite government efforts to provide incentives to investors, many investors are still adamant to come to Nigeria, hence this endeavor to study the impact of political stability on (FDI) inflow to Nigeria.

The main objective of this study is to investigate the role of political stability in attracting and retaining foreign direct investment (FDI) inflows to Nigeria. The specific objectives of this study include:

Literature Review

Alesina et al (1996), defined political instability as the propensity for a power change in a country, it may be legitimate (constitutional) or otherwise (e.g., military coups). Such changes affect growth because they foster uncertainty and Multinationals may decide not to invest in a country that does not have a stable political environment. And there is a consensus that political instability adds a layer of uncertainty on

economic activity, thereby disrupting production and reducing foreign investors' incentives to invest in a country.

Mankiw (2008) posits that foreign direct investment is capital investment that is owned and operated by a foreign entity. Agbonifob (2005,) situated the enormous benefits of foreign direct investment to the economic prospect of Nigeria in numerous ways: first, foreign direct investment can greatly make better the industrialization and development goals of Nigeria, by contributing to finance investment. While UNCTAD (2017), viewed FDI is as "(an investment involving a long-term relationship and reflecting a lasting interest and control by a resident entity in one economy (foreign direct investor or parent enterprise) in an enterprise resident in an economy other than that of the foreign direct investor (FDI enterprise, affiliate enterprise or foreign affiliate). FDI implies that the investor exerts a significant degree of influence on the management of the enterprise resident in the other economy. Such investment involves both the initial transaction between the two entities and all subsequent transactions between them and

among foreign affiliates, both incorporated and unincorporated. FDI may be undertaken by individuals as well as business entities". Dunning (1988, 2000) believed that firms invest internationally for three reasons: ownership, location and internalization (OLI). The OLI framework is considered the bases of the international trade theories concerning the decision of multinational enterprises (MNEs) to invest in other countries.

Ownership advantages are related to assets and processes that firm possess which provide some advantage over the existing firms in the foreign markets. These advantages can be tangible, for example patents, design or others; or can be intangible like a brand or organization efficiency. MNEs invest in other countries to explore these firm-specific advantages in other markets so they can enhance the chances of success. Location advantages can also ignite firms interest to invest in a particular market there by tapping into the low transportation costs to be profitable

which would have cost higher in relation with particular conditions of the host country like natural resources endowment or labor costs.

Internalization advantages reflect in the interest for a firm choosing to produce in a foreign market instead of licensing for example, while exploring the core competencies of a firm.

Dunning's assertion above confirms in strong terms the reasons for firms to invest internationally. As important and reasonable as they seems to be, it is believed that political stability of the host nation will ensure exchange rate stability, repatriation of profits at the discretion of the firm without difficulty, corruption free processes and transparency of the legal system which are some of the ingredients of the political stability lubricant that will make way for the realization of the targeted reasons above.

It is assumed by many economists that one of the objectives of industrialization is to provide employment for the inhabitants and make goods available for consumers. Hence, if foreign direct investment is wooed into the country it will help provide employment, training, and development of talents, technical or managerial skills to the citizens. It will also bring about advancement in technology. Moreover, it can also impact on the country's balance of payment by promoting export, also helping in integrating the country's economy into a global market. Foreign Direct Investment serves as an important engine for economic development which will result in the increase of the standard of living of the people.

The empirical relationship between political stability and FDI inflows was investigated by several scholars. Asif, Yasir & Chaudhry (2018) employed ARDL model to posit that government stability and low external conflict encourage FDI in the Long run in Pakistan. In the view of Abdul Kahlik and Masih (2017) used Autoregressive distributed lag (ARDL) approach to co-integration to reveal that there is a long run and short run relationship between political instability and FDI.

While Kurecic and Kokotovic (2017) used Granger Causality test and Vector Autoregressive framework (VAR) to reveal a long-term relation between political instability and FDI for a panel of small economies, but revealed that such relationship was found for larger economies.

Goswami & Haider (2014) employed data from 146 developed and developing countries between 1984 and 2009 to interrogate the nexus between political stability and FDI. Political stability was proxied by the 12 ICRG political risk indicators, which were grouped into three categories by using factor analysis. After eliminating multicollinearity between the political risk components, they ran a regression using pooled OLS and the fixed-effect approach. They found that market size, economic growth, openness to trade, and infrastructure have positive effects, while cultural conflict and partners' attitude showed negative relations with FDI. Governance failure showed inconsistent results.

Asiedu (2006), posits that the perception that FDI in African countries is mainly propelled by natural resources and market size. So, given the importance of FDI in the region, he used a panel of 22 SSA countries over the period of 16 years (1984-2000) to explore the impact of natural resources and market size vis-à-vis government policy, institutional quality and political instability in attracting FDI. Results show that SSA countries with more natural resources or larger markets are more likely to attract FDI. In turn, smaller countries, or those without natural resources, can also attract FDI by improving their institutions and policy environment. In furtherance of the study, Lemi & Asefa (2003), did a panel study for 29 African countries between 1987 and 1999 to interrogate the relationship between economic and political instability in these countries using a Generalized Autoregressive Heteroscedastic (GARCH) model to generate economic uncertainty indicators. They conclude that the impact of uncertainty is insignificant, but political instability and government policy commitment have significant

impact. Other economic factors like market size, trade and labor are also significant in affecting FDI inflows.

Jensen (2003) interrogated the correlation between FDI and democratic regimes, the results revealed a positive relationship between democracy and FDI as they can attract higher levels of FDI; even when other factors of economic or political nature are also present, democratic political institutions attract as much as 70% more FDI (% of GDP) than authoritarian regimes. But, according to Root (1994) a detailed analysis was revealed, concluding that the success of any contractual business arrangement is systematically related to the transition of political constraints. While Fosu (1992) interrogated the correlation between FDI and instability of government regimes within a nation, and growth in sub-saharan African countries and found adverse impact of political instability on economic growth and Barro (1991) from his research concluded that political instability and growth are negatively correlated.

METHODOLOGY

This research examines the impact of a set of macroeconomic variables as independent variables (the determinants of FDI) on FDI inflows in Nigeria for the period between 1970Q1 to 2015Q4 . The study employed time series data sourced from the Central Bank of Nigeria Statistical Bulletin and National Bureau of Statistics and utilized the model of multiple regression analysis, thus;

$$FDI_t = \beta_0 + \beta_1 GROWTH_t + \beta_2 OPENNESS_t + \beta_3 INF_t + \beta_4 INF_t + \beta_5 INT_t + \beta_6 PSTB_t + \mu_t \quad (3.1)$$

Where: **FDI:** foreign direct investment measured in millions of USD, **GROWTH:** Economic growth, growth rate of real GDP, **OPENNESS:** Trade openness (the ratio of the sum of imports and exports to GDP) , **EXR:** Exchange rate, **INF:** Quarterly inflation rate, **INT:** Interest rate, **PSTB:** Political stability, μ_t : Error term, β_0 : Intercept term and $\beta_1, \beta_2, \beta_3, \beta_4, \beta_5, \beta_6$: Partial slopes, **t:** Time

Estimation Procedure

The study employs E-views 9.0 software for the tests and estimation of the model. The ordinary least squares (OLS) estimation was used to estimate the parameters of the model owing to its desirable properties (i.e., the BLUE properties). Employing Auto Regressive Distributed Lag (ARDL) of the multiple regression model at (4 lags) and Auto Regressive Distributed Lag (ARDL) cointegration and Long Run Form as in the appendix 2, and 3 below:

Analysis and Interpretation of Results

From the Auto Regressive Distributed Lag (ARDL) of the multiple regression model, it was shown that both the R-squared and Adjusted R-squared stood at approximately 0.99 which shows that the explanatory variables (growth, openness, exchange rate, quarterly inflation rate, interest rate and political stability) explain about 97% variation in the dependent variable (foreign direct investment), we reject the null hypothesis and accept the alternative. This implies that there is a long-run relationship existing between FDI and the set of macroeconomic variables in Nigeria. Thus, fluctuations in the macroeconomic variables will always determine the level of FDI in Nigeria. To confirm the strong relationship between FDI and macroeconomic variables in Nigeria, the prob.(F-stat) value of 0.000000 shows that the overall test is statistically significance at 5% level.

Conclusion and Recommendation

In conclusion, from the literature reviewed and the result of our analysis, we can concretely posit that political instability has a negative effect on FDI, but the effects are measured through divergent components of political instability that lead to different results depending on both economic variables and political component.

The result from the OLS regression analysis also showed that; macroeconomic variables, political stability inclusive have strong influence on the inflow and retention of FDI in Nigeria. The implication of these results is that for sustainable inflow of FDI into Nigeria, there is need for Government to deliberately stabilize the political environment in addition to the adoption of sound and promising macroeconomic policies in the economy, so as to encourage meaningful inflow of FDI into Nigeria that will stimulate economic growth and create job opportunities.

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Appendix 1:

Political Stability and FDI

Dependent Variable: LFDI				
Method: ARDL				
Date: 06/28/17 Time: 06:14				
Sample (adjusted): 1970Q3 2015Q1				
Included observations: 179 after adjustments				
Maximum dependent lags: 4 (Automatic selection)				
Model selection method: Akaike info criterion (AIC)				
Dynamic regressors (4 lags, automatic): LGDP LOPN LEXR INF INT PSTB				
Fixed regressors: C				
Number of models evaluated: 62500				
Selected Model: ARDL(2, 2, 1, 0, 0, 0, 0)				
Note: final equation sample is larger than selection sample				
Variable	Coefficient	Std. Error	t-Statistic	Prob.*
LFDI(-1)	1.497902	0.061916	24.19253	0.0000
LFDI(-2)	-0.616187	0.061906	-9.953543	0.0000
LGDP	0.389176	0.121036	3.215377	0.0016
LGDP(-1)	-0.578150	0.202502	-2.855037	0.0048
LGDP(-2)	0.210975	0.120401	1.752262	0.0816
LOPN	0.136807	0.087744	1.559157	0.1209
LOPN(-1)	-0.137417	0.086355	-1.591312	0.1134
LEXR	0.020146	0.024702	0.815570	0.4159
INF	-0.000194	0.000692	-0.280328	0.7796
INT	0.002036	0.003492	0.582858	0.5608
PSTB	0.115176	0.046224	2.491703	0.0137
C	1.018627	0.282297	3.608348	0.0004
R-squared	0.991754	Mean dependent var	11.90143	
Adjusted R-squared	0.991211	S.D. dependent var	1.140720	
S.E. of regression	0.106944	Akaike info criterion	-1.568335	
Sum squared resid	1.909985	Schwarz criterion	-1.354656	
Log likelihood	152.3660	Hannan-Quinn criter.	-1.481690	
F-statistic	1825.894	Durbin-Watson stat	2.043568	
Prob(F-statistic)	0.000000			
*Note: p-values and any subsequent tests do not account for model selection.				

ARDL Cointegrating And Long Run Form				
Dependent Variable: LFDI				
Selected Model: ARDL(2, 2, 1, 0, 0, 0)				
Date: 06/28/17 Time: 06:15				
Sample: 1970Q1 2015Q4				
Included observations: 179				
Cointegrating Form				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
D(LFDI(-1))	0.616187	0.061906	9.953543	0.0000
D(LGDP)	0.389176	0.121036	3.215377	0.0016
D(LGDP(-1))	-0.210975	0.120401	-1.752262	0.0816
D(LOPN)	0.136807	0.087744	1.559157	0.1209
D(LEXR)	0.020146	0.024702	0.815570	0.4159
D(INF)	-0.000194	0.000692	-0.280328	0.7796
D(INT)	0.002036	0.003492	0.582858	0.5608
D(PSTB)	0.115176	0.046224	2.491703	0.0137
CointEq(-1)	-0.118285	0.024472	-4.833454	0.0000
Cointeq = LFDI - (0.1860*LGDP +0.052*LOPN + 0.1703*LEXR -0.0016 *INF + 0.072*INT + 0.9737*PSTB + 8.6116)				
Long Run Coefficients				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
LGDP	0.185993	0.092563	2.009366	0.0456
LOPN	0.051557	0.022395	2.302166	0.0265
LEXR	0.170320	0.199508	0.853698	0.3945
INF	-0.001640	0.005816	-0.282039	0.7783
INT	0.072089	0.029780	2.420719	0.0204
PSTB	0.973715	0.373761	2.605179	0.0100
C	8.611608	1.170479	7.357339	0.0000