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Exploring the causality links between financial markets and foreign direct investment in Africa☆

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ABSTRACT

This paper sets out to explore the causality links between financial markets and foreign direct investment (FDI) in Africa. We use proxies for the banking sector and stock market to capture financial market development. We run separate estimations for the banking and stock market samples. Therefore, the sample size differs based on the sample being estimated. The banking sample is made up of 42 countries, whilst the stock market sample is made up of 16 countries. We use data covering the period 1970–2007 for the bank sample whilst for the stock market sample we use data covering the period 1990–2007. We use a 2SLS panel instrumental variable approach to obviate simultaneous causality bias. Our results suggest that a more advanced banking system can lead to more FDI flows. Also higher FDI flows can lead to the development of the domestic banking system. Countries with better-developed stock markets are likely to attract more FDI. We also find that FDI flows can lead to the development of the domestic stock market. Our results imply significant complementarities and feedback between financial markets and FDI in Africa.

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1. Introduction

Foreign direct investment (FDI) is defined as investment to obtain a lasting management interest (10% or more of voting stock) in an enterprise operating in an economy other than that of the investor (IMF, 1993). Several benefits of FDI have been identified in the literature. These include, but are not limited to, technological spillovers, introduction of improved management techniques, international trade integration, creation of forward and backwards linkages and the evolution of a more competitive business environment. Also through its effect on economic growth, FDI can lead to the reduction of poverty. The literature suggests that these benefits may depend on the absorptive capacity of the receiving economy. Some of the relevant absorptive capabilities identified in the literature include initial gross domestic product (Blomstrom et al., 1992), the level of human development (Borensztein et al., 1998), and the depth of financial markets (Alfaro et al., 2004; Adjasi et al., 2012; Durham, 2004; Hermes and Lensink, 2003).

In spite of these benefits and despite the fact that many more African countries are becoming more open to FDI, FDI on the continent remains low. Siphambe (2006) indicates that Africa received only US$10.9 of FDI per head in 1998, compared with an average for developing countries of US$35.4. In addition, the continent's share of FDI fell from 36% (during 1970–1974), to 10% (1980–1984) and finally to 3% (during 1995–1999) (Asiedu, 2002). Loans and official development assistance (ODA) to the continent have also been declining (see Bosworth and Collins, 1999; Asiedu, 2002).

Official development assistance (ODA) to sub-Saharan Africa was estimated at $22.5 billion in 2008. Also ODA is at the discretion of those giving the assistance and is therefore unreliable. The World Bank estimated remittances to sub-Saharan to reach $21.5 billion by the end of 2010. According to Musila and Sigue (2006) investment rates in Africa have on average, declined from 28.5% during 1974–1980 to 20.2% during 1991–1996. Musila and Sigue (2006) further note that the saving rate in sub-Saharan Africa declined from 10.3% during 1974–1980 to only 5.7% during 1991–1996. FDI has increased all over the world and the value of the worldwide stock of FDI more than quadrupled within ten years to reach a volume of more than US$15 trillion 2007 (Stiebale and Reize, 2011). Inward FDI as at 2008 to Africa and sub-Saharan Africa were $88 billion and 63.6 billion respectively. This shows the importance of FDI compared to other capital flows amidst the low savings and investment rates on the continent.

FDI has been identified to be more stable compared to other capital flows like portfolio investments and debt flows. Fernandez-Arias and Haussman (2000) note that a country must be doing something right to attract FDI flows. Also FDI may not have the explosive characteristics of other flows, as FDI is less subject to capital reversals and contagion that affect other flows, since the presence of large, fixed, illiquid assets makes rapid disinvestment more difficult than the withdrawal of short-term bank lending or the sale of stock holdings. This is very plausible in the face of incomplete markets and original sin (where the local currency cannot be used to borrow abroad or borrow long-term domestically). This is because equity related investments do not suffer from currency and maturity mismatches. Apart from being less prone to crisis, in terms of capital inflows, FDI ranks lowest in terms of constraining the options available to domestic policy makers (see Grabel, 1996).

Financial markets can play a vital role in influencing FDI flows into an economy. Financial market development involves improvements in the production of ex ante information about possible investments, monitoring of investments and implementation of corporate governance, trading, diversification and management of risk, mobilization and pooling of savings, and exchange of goods and services (Bertocco, 2008). Naceur et al. (2007) note that among others the existence of an equity market is important because it attracts foreign capital inflows. According to Wurgler (2000) financial markets and institutions do more than just provide a sideshow to the real economy; they perform a fundamental allocative function. That is, they allocate resources to the sectors that need them and can produce an adequate return on them.

Although the role of FDI on economic growth has been studied extensively, only a few studies systematically examine the causal relationship between FDI and the level of financial market development. Kholdy and Sohrabian (2005) note that economic literature is ambiguous on the effect of FDI on the economy of developing countries, on the direction of causality between economic growth and financial markets, and on causal links between FDI and financial development. Zakaria (2007) and Kholdy and Sohrabian (2008) investigate the causal link between FDI and financial markets for a