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Macroeconomic uncertainty, foreign direct investment and institutional quality: Evidence from Sub-Saharan Africa

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A B S T R A C T

This study examines how institutional quality moderates the relationship between macroeconomic volatility and foreign direct investment (FDI) in 40 countries in the Sub-Saharan African region over the period from 1996 to 2011. The GARCH models of Engle (1982) and Bollerslev (1986) are employed to model the volatility of macroeconomic uncertainty. The dynamic panel model estimation of Arellano and Bond (1991) and Blundell and Bond (1998) is used to analyze the relationship between foreign direct investment and the volatility of the macroeconomic variables. We find that macroeconomic uncertainty adversely affects the flow of FDI, while institutional quality also increases the flow of FDI in the presence of other control variables. The interaction between institutional quality and macroeconomic uncertainty reduces the initial negative effect exerted on the flow of FDI by economic uncertainty. Policy implications are drawn from the findings.

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1. Introduction

Over the past decade, African leaders have sought to position their countries to better attract large volumes of foreign direct investment. The urge to attract FDI to the continent and retain it has led to a lot of reforms and agreements. In a recent development, World Development Indicators (2013) noted that by the end of the year, 2011 several developing countries continued to implement policy changes to further liberalize and facilitate FDI entry and operations and to regulate FDI. Among the numerous reforms with the aim of increasing FDI that have taken place over the decade are economic partnership agreements, structural adjustment programmes, financial sector adjustment programmes and economic recovery programmes. Notable trade agreements include the African Growth and Opportunities Act and the New Partnership for Africa's Development. The benefits of such reforms are confirmed by Dupasquier and Osakwe (2006) to be that countries that hitherto received less FDI are likely to experience an increase in their receipt of FDI largely due to the improvement in economic policies.

Much has been said on the determinants of FDI as well as the benefits foreign direct investment brings to a country. Thus, recent studies have sought to find out how the quantum of foreign direct investment can be increased. In line with

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the above, academics have focused their attention on how to mitigate the factors that threaten the flow of FDI. Among these threatening factors is macroeconomic uncertainty. Given the benefits of FDI as echoed by agencies such as the World Bank and the United Nations[1] and the fact that most African countries have unstable economic variables, how can this be curtailed? One way academics have sought to mitigate deterring factors of FDI is to advocate for strong and effective institutions. This paper thus assesses the association between FDI, macroeconomic uncertainty and institutional quality. This is essential because of the beneficial effects of FDI on economic growth as well as the negative impact economic uncertainty exerts on foreign direct investment. Therefore, the critical questions are: (i) Does economic uncertainty undermine the flow of FDI? (ii) Does institutional quality accelerate FDI? (iii) Can institutional quality mitigate the adverse effect of economic uncertainty on FDI?

Among the nine theories of FDI (Faeth, 2009) is the theoretical model (Corden, 1990; Barrell and Pain, 1996), which looks at the effect of policy variables such as the interest rate, inflation and the exchange rate on FDI flow. A few studies have recently turned their attention to macroeconomic variables and the uncertainty of these variables on investment, notably FDI. The empirical literature is still limited, although in the light of the above questions, only empirical studies can find answers. For instance, it has not been conclusively shown whether volatility deters FDI. According to Kosteletou and Liargovas (2000), there is no clear direction between, for instance, exchange rate volatility and foreign direct investment. This might be because the effect of volatility on investment could be positive as well as negative. Cordon (1990) documents a positive association between exchange rate volatility and FDI flow, suggesting that investors will invest only when the exchange rate is favourable. However, Qin (2002) also suggests that in cases where low differential purchasing power parity exists between countries, two-way FDI occurs. When this happens, local producers will hedge their risk against FDI risk in an environment of volatile economic variables, in this case the exchange rate.

On a broader note, the literature shows that the amount of investment is inversely correlated with most measures of volatility. Empirical studies suggest a negative impact of the exchange rate on foreign direct investment (Kyereboah-Coleman and Agyire-Tettey, 2008; Udoh and Egwaikhide, 2008). In addition, Cavallari and D'Addona (2011) found interest rate volatility to be a deterrent factor for foreign direct investment. While Akinboade et al. (2006) and Lipsey and Chrystal (2006) found hyperinflation to deter the inflow of foreign direct investment, Bell (2004) sums up the two sides of the debate and suggests that the directional effect of volatile economic variables (exchange rate) on FDI is uncertain. Hence, it could have either a positive or negative effect on the investors' net worth.

Just as the set of macroeconomic variables (exchange rate, inflation, GDP growth, interest rate, etc.) is known to empirically impede the inward flow of FDI, various measures of institutional quality are also known to empirically impact the flow of foreign direct investment. Using democracy as a proxy for institutional quality, and in the presence of natural resources, Asiedu and Lien (2011) noted an inverse association between democracy and FDI inflow into Africa. Within the BRICS region, Jadhav (2012) found a positive correlation between measures of institutional quality (rule of law and voice and accountability) and FDI inflows. Javorcik and Shang-Jin (2009) showed corruption, among other things, to discourage the partnering of local firms by foreign firms, thereby reducing inward FDI. Countries with strong and good quality governance have been found to be preferred by foreign institutional investors (Li et al., 2006; Ferreira and Matos, 2008)

Using the government's level of corruption and the investment profile as measures of institutional quality, Mohamed and Sidiropoulos (2010) finds the variables to be major determinants of FDI in MENA countries. Rammi and Zurbruegg (2006) showed that a deterioration in the effectiveness and enforcement of investment regulations (such as price controls and excessive regulation in foreign trade and business development) has an adverse effect on intra-ASEAN FDI. Using governance as a measure of institutional quality for a panel of 164 countries for a ten-year period from 1996 to 2006, Buchanan (2012) concluded that institutional quality greatly influences the flow of FDI. These findings are not statistically different from Globerman and Shapiro (2002), who also found a positive association between governance and foreign direct investment. Employing numerous measures of institutional quality, Gani (2007) found that the rule of law, regulatory quality, control of corruption, effective government and political stability all impact the flow of FDI positively. In fact, numerous empirical studies have concluded that poor or inefficient institutions discourage foreign investment (Asiedu, 2006; Huang, 2003; Asiedu and Villamil, 2000; World Development Indicators, 2013). Using various measures of institutional quality for a sample of 141 countries over a 25-year period, Elgin and Oztunali (2014) found institutional quality to be a moderating factor between economic development and the size of a country's informal sector. Specifically, they conclude that higher GDP per capita is associated with a larger informal sector size in countries where the level of institutional quality is deemed to be low. Studying the impact of institutional quality, economic freedom and entrepreneurship on foreign direct investment in emerging markets, with data from 87 countries over a five-year period from 2004 to 2009, Echeverri et al. (2013) found the various measures of institutional quality to attract FDI. However, the magnitude of the attraction depends on whether a country is high income, emerging or low income.

The above review of the literature has shown that there is an abundance of studies on the determining factors of FDI across various countries and time periods. Some have concluded that macroeconomic uncertainties hamper the flow of FDI, while at the same time institutional quality promotes FDI inflow. However, to the best of the authors' knowledge, no

[1] UNCTAD's new FDI Contribution Index shows relatively higher contributions by foreign affiliates to host economies in developing countries, especially Africa, in terms of value added, employment and wage generation, tax revenues, export generation and capital formation. The rankings also show countries with less than expected FDI contributions, confirming that policy matters for maximizing positive and minimizing negative effects of FDI (WIR, 2012).

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