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Does monetary integration lead to an increase in FDI flows? An empirical investigation from the West African Monetary Zone (WAMZ)

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Abstract

This paper investigates the relationship between monetary integration, foreign direct investment (FDI) and trade in the West African Monetary Zone (WAMZ) using annual time series for the period 1980−2013. It also examines whether trade and FDI are complement or substitute. Several econometric models are applied including Ordinary Least Squares (OLS) and fully-modified OLS (FMOLS). Our empirical results revealed that FDI flows into the WAMZ is influence positively by monetary integration. The findings also suggest that while real GDP, large population size and greater distance positively influence FDI flows, weak economic freedom index negatively impact FDI flows into the zone. The results support the argument that monetary union positively affect trade. Our empirical finding support the hypothesis that FDI and trade flows are complementary. The results are in line with earlier research findings. Therefore, any policy that promotes trade such as monetary integration enhances FDI inflows as well. The findings offer perspectives and insight for a new policy in WAMZ economies in their drive to attain sustainable economic growth.

JEL classification: F1; F140; F230; F330

Keywords: Foreign direct investment; Trade; Gravity model; Integration

1. Introduction

In an integrated region, barriers that formerly confront investors are not only removed but investors have the ease to move around within the zone. These characteristics could lead to an increased inflow of Foreign Direct Investment (FDI). In theory, capital moves from places where it exists in abundance to places where it is limited. Because capital is relatively limited in most West African countries, it is argued that a monetary integration can attract a great amount of capital into the zone.[2] From the host country perspective, FDI inflows are usually regarded as openly beneficial. They finance substantial amount of domestic investment in host countries. FDIs create employment opportunities, boost domestic demand and enhance growth. In addition, they are less volatile than other forms of capital flows, because investors have long-term orientation schedules. They also bring a huge package of managerial and technological know-how that the host country welcomes. The source country could benefit from low cost of production due to lower wage rate in host country. It is well documented that foreign direct investment is an important factor in the economic development of any country particularly least developing nations. It has also been argued that trade has been the energy of economic growth. Studies have shown that integration in the form of monetary integration enhances trade by more than three folds (see Rose & Glick (2001)). It also been argued that trade and FDI to larger

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[2] West Africa Monetary Zone members are Gambia, Ghana, Guinea, Nigeria and Sierra Leone. Liberia and Cape Verde are considered new joiners.

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extent exhibits similar characteristic (see Brenton, Di Mauro, and Lucke, 1999).

The motivation for the study is the low and uneven level of economic growth in the economies of the region. In order to overcome this, there is need to formulate policies that will enhance FDI and trade flows into the region. One possible channel to release the benefits of FDI and trade is through more integration. Hence, monetary integration is a possible catalyst to sustainable economic growth. Integration impact on trade flows and FDI will help convince policy makers to consider joining a monetary union.

In this paper, we assess the impact of deepening integration within West Africa paying more attention to the second monetary zone on FDI flows to zone member countries. Consequently, we seek to answer the question: is there an increase in FDI flows to West African Monetary Zone, and how has it been evolving over the years?

In a host country, the following factors positively attract foreign direct investment and trade flows: large market base, income level, population size, low cost of production, political stability, good governance, institutional quality, level of infrastructure, quality of labor force, and common colony. FDIs drive growth positively when the host country is well developed. Foreign direct investment may also be a vehicle for transfer of technological knowledge from source to host country. These influencing factors justify the use of traditional gravity model and Ordinary Least Squares (OLS) methodology in estimating FDI and trade flows. These estimation techniques will help us establish a relationship between FDI and integration, trade and integration and trade and foreign direct investment. The findings will offer policy recommendations.

To the best of our knowledge, this is the first study that clearly considers the impact of monetary integration in the West African region on FDI inflows to the region; and the complementarity or substitutability of trade and FDI flows in the region. This is the first paper to establish a link between FDI and trade via integration channel using West African countries. Although Brenton et al. (1999) looked at Economic Integration and FDI but their study covered the European Union only.

This paper is organized as follows: literature review on FDI flows and regional integration is discussed in Section 2, which is followed by data and methodology for the empirical work in Section 3. Section 4 discusses the empirical findings. Summary and conclusion are discussed in Section 5.

2. Literature review

The initial research carried by Mundell (1961) and McKinnon (1963), the pioneers of Optimum Currency Area (OCA) have triggered further research in the field. these the studies include the suitability of a region as an optimum currency area and its economic impact (see Alesina & Barro, 2002; Alesina, Barro, & Tenreyro, 2002; Alesina, Spolaore, & Wacziarg, 2000; Casella, 1992). Masson and Pattillo (2004a, 2004b) and Devarajan and De Melo (1987) have done substantial work on monetary integration in the African continent. However, prior to the European Monetary Integration, few studies looked into the impact of regional integration on FDI flows. A number of researches have been carried out on monetary integration and its impact on trade flows (see Frankel & Rose, 1998, 2000, 2002; Rose & Glick, 2001; Rose & Van Wincoop, 2001). Since the Euro came into existence, more studies on trade, monetary integration and FDI began to surface. Brenton et al. (1999) study on the impact of European Union (EU) on investment flows revealed that EU single market program led to significant increases in investment by EU firms in other EU countries in the late 1980's. Markusen (2000) also surveyed the literature, and he developed a model that takes into account both vertical and horizontal multinational activity with intra and inter industry trade. In his model, he incorporated economic size as one of the explanatory variables for the level of bilateral FDI. There are two forms of FDIs namely horizontal and vertical FDI. In a horizontal FDI, firms duplicate almost the same activities in different countries. Unlike horizontal FDI, in a vertical FDI different stages of production for a firm are located in different countries. Majority of FDIs are influenced by market rather than low cost of production.

In a horizontal FDI, there is a trade-off between plant fixed cost and trade cost. In a relatively small host country, the savings from trade cost is much lower than the fixed costs in setting up a production. Therefore, exports will be preferred over FDI. However, when the host country in a relatively large, and the fixed cost of the plant is overcomed by trade costs savings, FDI will be preferred over exports. The implication of this is that a choice between FDI and exports results in a trade-off between trade cost and fixed costs. It implies that in this FDI framework, firms cannot be involved in both exports and FDI.

In practice, however, firms engage in both FDI and exports. A typical setting for a vertical FDI is where home country is much bigger than host country. A vertical FDI framework is like a developed country as the source country and developing countries as the host country. Subsequently, other researchers followed and the empirical research of the bilateral distribution of FDI using the gravity model began to gain much attention. Brainard (1997), Eaton and Tamura (1996) surveyed the literature and employed the gravity model to investigate bilateral FDI flows. Brenton et al. (1999), using simulation models with certain choice of parameter specifications, assessed the impact of deepening integration between the EU and Central and Eastern European Countries (CEECs) on FDI. They addressed the following: the expected long-term level of FDI flows in the CEEC; whether FDI and trade are either complements or substitutes; and whether an increase in integration in the region will lead to a reduction of FDI inflows from the CEEC to other European countries. According to their findings, FDI diverges from the normal pattern in the CEEC, that is, there is no substantial evidence of a surge in FDI inflows in the CEEC. They found trade and FDI are complementary. They also found no evidence that an inflow of FDI going to the CEEC region has a clear negative impact on