Regulatory Framework and Foreign Direct Investment in West African Monetary Zone (WAMZ) Countries

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Abstract

FDI has been regarded as an essential part of a liberal and functional global economic system; more especially in developing countries such as WAMZ countries. But these countries even with their liberalized foreign policies and regulations kept having low FDI inflow. Due to the evidence of risks and uncertainties associated with market failure inherent in the WAMZ countries, there is need for government regulation, since right institutional framework such as policies and regulations have positive influence on the inflow of FDI into a recipient country. Drawing from the Institution FDI Fitness Theory and employing Fixed Effect Model and time series data from 1975 to 2019; this work examined the significant impact of regulatory quality on FDI inflow into the WAMZ countries. The findings from the result of this study revealed that regulatory quality has positive significant impacts on FDI inflow into the zone; and therefore recommended that governments in WAMZ should also encourage good regulatory quality in the form of favourable, flexible rules and regulation that guide the operation of both persons and businesses, favourable investments environments and/or climates, among others, so as to attract high FDI into the zone.

Key words: Regulatory quality, FDI, Fixed Effect, Institutional FDI Fitness, WAMZ

GEL: F15, O11, O24, O55

1. Introduction

Liberals orthodoxy suggested that less regulation is very crucial in determining foreign direct investment (FDI) inflow into a country since globalization has created a "borderless world" thereby supporting "FDI liberalization"; that countries that liberalized their trade attract high level of FDI inflow, hence trade openness is considered the most significant factor in attracting FDI inflow into host country (Lipsey, 2000; Cham, 2016). FDI is of benefit to both home country and host county since is a vital and effective way of transferring technology and

innovation into the host country and benefit the home country through increase in the inflow of foreign earnings, which has positive implication on the country's balance of payment (Siklar & Kocaman, 2018).

FDI inflow is a response to global financial integration call to promote global allocation of capital; hence reducing global risk distribution, improving specialization in production, more especially in developing countries that are capital deficit and depend majorly on foreign capital inflow to fill the savings and the foreign exchange gaps (Gehringer, 2015; Cham, 2016; Ehigiamusoe & Lean, 2019; Eregha, 2019; Adebayo et al., 2020).

Owing to this, many national governments went into one form of integration or another leading to the creation of the West African Monetary Zone (WAMZ); consists of six member countries: Ghana, Gambia, Guinea, Liberia, Nigeria and Sierra Leone. It has been argued that monetary integrations such as WAMZ could attract more FDI inflow into the Zone (Orji, Akachukwu & Ilori, 2014; Cham, 2016).

Evidence has shown that a positive relationship exists between FDI inflow and a country's quality of government institutions, since right institutional framework (such as sound policies and quality regulations; and also ensuring the administration of government procedure for investment, including incentives) can lead to higher attraction of FDI (Heilbron & Whyte, 2019); Hence, effective government regulations could have a positive influence on the FDI inflow by eliminating some uncertainty and risks due to market failure, but unnecessary regulations could also lead to negative impact by creating huge agreement costs, barrier and bottleneck but this depends on lots of economic factors operating in the recipient economy (Aderemi, Olubunmi, Awomailo & Omotayo, 2019).

Rooted in the liberal ideology is the idea that free trade and liberalized foreign investment regulation attract FDI, for this reason proposed host country should pursuit policies targeted at international trade openness, so as to benefit from FDI inflow and be integrated into the global economy, as restrictions and regulations could limit the capacity of the country to attract inflow of FDI (OECD, 2002; Chang, 2007). On the contrary, the WAMZ countries with their trade liberalization policies kept having low inflow of FDI.

Owing to the low attraction of FDI in WAMZ, the idea that liberalized foreign investment regulations attract FDI has been questioned by scholars. Little wonder, World Bank in Chang (2007) admitted that regulations and explicit incentives (such as tax incentives) controlling FDI do not have much effect on the investment inflow into a recipient country, as to the country's general political and economic environment.

In recent times the failure of the market forces has necessitated government intervention in economic activities and public enterprises in most developing countries, notwithstanding the success stories of some developed economies through free market operations and stories of government failure in some advanced economies (Aderemi et al., 2019). Hence in the case of market failure evident in the developing economies, there is therefore the need for strong government regulations (Stiglitz cited in Aderemi et al., 2019).

There have been evidence of low level of regulatory quality in developing countries; and WAMZ countries precisely have very poor (negative) regulatory quality; revealed by the World Governance Indicator (2021). They have failed to formulate and implement quality regulations that were needed to attract high FDI inflow into the zone; and leverage on the benefits that

comes with FDI. This work would therefore examine the significant impact regulatory quality has on the inflow of FDI into WAMZ countries.

2. Review of relevant Literature

Previous studies had tried to explain the behaviour of FDI; some had seen it as an effective tool for economic integration. Cham (2016) studied the relationship between monetary integration and FDI, and how FDI and trade could go together or alternate each other in the WAMZ. Using annual time series data from 1980 to 2013 and employing several econometric models such as fully-modified OLS (FMOLS), Ordinary Least Squares (OLS), and gravity model, the results of empirical analyses showed that monetary integration positively impact the flow of FDI into the WAMZ. The results are in line with the proposition that economic integration affect trade positively and that FDI and trade could go together. The study therefore recommended insight and standpoint for new policies in WAMZ countries in their quest to achieve economic growth that is sustainable.

Also, Jaiblai & Shenai (2019) studied the factors that determine FDI in ten (10) Sub-Saharan African economies using a cross-sectional data from 1990 to 2017. Employing panel unit root test and cointegration test; and subsequently the ARDL model, the result revealed that FDI is a vital means of finance for the developing countries, hence recommended the formulation of policy guidelines for attraction of FDI and advancement of development in the sub-region. In a similar cross-country study, Appiah-Kubi et al. (2020) studied effect corporate governance structures has on FDI, using selected panel time series data of 17 countries in West African (2009-2018), and employing system generalized method of moment (GMM), the result revealed that countries that seems to protect the interest of the non-ruling party are likely to attract more

FDIs, countries with firms showing high ethical values also generated increasing FDI, the existence of effective governing boards also promote high inflow of FDI into the country, their result also established that regulations in the security and stock exchange significantly impact on the FDI. They recommended that countries in the West Africa set up corporate governance a structure that is entirely independent of political factors so as to fully leverage on the FDI inflow to alleviate poverty.

In a comparative study on both rich and developing nations, Busse et al. (2010) looked at how the exchange rate regime affected FDI flows from 1980 to 2004. They employed dummy variable to account for the various exchange rate regimes, and controlled for inflation. The fixed effect model was employed and result showed a negative effect of macroeconomic distortions (using inflation as a proxy), while for developing nations, the level of the exchange rate has a negative effect; and a positive but not significant effect for developed countries. The exchange rate volatility variable was also found to be not significant but positive, while for rich countries, the fixed exchange rate regimes dummies were significantly positive, but not significantly so for developing nations. The study therefore recommended the use of the exchange rate as a more useful tool for policy making, if both rich and developing countries are to encourage high FDI inflows.

Eli & Isitua (2016) analyzed the contending factors that determine FDI in WAMZ, and the causal link between FDI and growth. A simultaneous-equation method of "Weighted Two-Stage Least Squares (WTSLS)" was used on panel data set from 1980 to 2002, and found zero evidence of two-way causal relationship between economic growth and FDI. The result also established that high income per capita, political stability and good infrastructure attracts FDI inflow into host country. The study recommended that governments should take cognizance of these determinants

(high income per capita, political stability and good infrastructure) if any significant attempts are made in drawing FDI into the WAMZ

Some other works examined FDI in individual host country; such works like Aderemi et al., (2019) studied the empirical relationship between FDI and regulation in Nigeria. Using data from UNCTAD, World Bank database, CBN Statistical Bulletin from 1996 to 2014 and employing DOLS, cointegration and granger causality models, the result established a long-run significantly positive relationship between FDI inflows and government effectiveness, rule of law and inflation rate in Nigeria, but regulatory quality was not significant. The result also revealed a one-way causal relationship from FDI to regulatory quality and also from rule of law to government effectiveness. The study, therefore recommended that investors, researchers and policy makers should improve the rule of law, government effectiveness and regulatory quality in order to attract high FDI inflow in Nigeria, if their policy target is FDI attraction in the long-run. Also, the Nigerian government should ensure sound investment climate in the form of effective public regulations in order to attract larger inflow of FDI.

Similarly, Adenyuma & Oga (2019) conducted a descriptive study of the effect of statutory framework in attracting FDI in Nigeria. The study found a negative impact of uncompetitive investment laws on the inflow of FDI in Nigeria, and recommended the review of foreign investment laws in Nigeria especially in the areas of implementation, conformity and supervision so as to become competitive, accommodate dispute resolution and restore investor confidence.

Enu et al. (2013) studied the factors that determine FDI in Ghana from 1980 to 2012. This study employed Johansen's test of cointegration cum vector autoregressive model; and the result revealed statistically significance of the first past year FDI, the last two years of exchange rate

and openness to trade, and hence recommended the implementation of policies that encourage FDI, moderate exchange rate and openness to trade. A Similar study by Barthel et al. (2008) studied the determinants of FDI and their characteristics in Ghana, using both quantitative and qualitative techniques of empirical investigation based on the data from 2007 to 2008, and an enterprise survey data from 54 multinational corporations in Ghana. The result of the analysis revealed that for foreign companies presently doing business in Ghana, a market-seeking goal is critical, hence recommended that for Ghana to draw more FDI inflow, they need to accelerate land administration and property registration reforms. With respect to .manufacturing sector, attention should be focused on few key industries for attracting FDI rather than trying to capture many heterogeneous industries in Ghana along.

Also, Olawale & Agbede (2020) examined factors that determine FDI in Nigeria during the periods 1981 to 2017 using data from CBN Statistical Bulletin and World Bank Report (2017). Employing ARDL model and bound test approach to cointegration Test, the result showed that GDP, infrastructure development, inflation, deregulation and openness have significant positive impact on FDI in Nigeria, while political stability and exchange rate are not effective in attracting FDI. Cointegration test revealed that all variable are cointegrated, hence recommended improvement in GDP, infrastructure development, and openness so as to attract more FDI in Nigeria.

3. Data and Methodology

This study adopted the Institutional FDI Fitness Theory associated with the work of Wilhelms & Witter (1998) as theoretical framework. The theory assumes that the capacity of a country to draw large inflow FDI is dependent on its fitness into the expectations of her investors, thereby

providing explanations for the unequal FDI inflows between countries and the theory anchors on four basic and inter-related fitness pillars, namely: socio-cultural, educational, market and government fitness.

The fourth pillar, government fitness, according to this theory plays an important part in attracting FDI since it has to do with formulating and implementing protective regulations to ensure market fitness (Popovici & Calin, 2014; Makoni, 2015). This theory had been tested empirically especially in African case; works like the country-specific study by Muthoga (2003) on Kenya (cited in Popovici & Calin (2014), and cross-country study by Musonera, Nyamulinda & Karuranga (2010) on Kenya, Tanzania and Uganda (as cited in Makoni, 2015). The study utilized the time series data from each individual countries of WAMZ from1975 to 2019.

Specification of Model

The study adopted the Fixed Effect Model in line with the work of Busse et al. (2010) that also used the model. The choice of this model was based on the fact that it takes care of country-specific variations in utilizing data on the individual countries in WAMZ. First, the descriptive statistics was carried out to investigate the data characteristics and nature of the variables of the model; second, the fixed effect and random models were examined, and then the Hausman test applied to choose the most appropriate model.

In this study FDI was measured as inward FDI (Alguacil et al, 2008; Kiat in Siklar & Kocaman, 2018); regulatory quality measured by regulatory quality index (Issever, 2014; Aderemi et al. 2019). Other factors such as political stability and exchange rate were controlled for since they are all risk factors within the government fitness (Popovici & Calin, 2014; Makoni, 2015). While

Political stability was measured as political stability and absence of violence/ terrorism (Shahzad & Al-Swidi, 2013), exchange rate was capture as exchange rate.

The model takes inward FDI as the dependent variable; regulatory quality index is taken as the regressor; while Political stability and exchange rate volatility were the control variables. The specific linear form of the model as it relates to the objectives of the study was given as:

$$F_{it} = \beta_0 + \beta_1 RQ_{it} + \beta_2 PS_{it} + \beta_3 EXT_{it} + \mu_{it} \dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots 1$$

Where;

F = inward foreign direct investment

RQ = regulatory quality index

PS = political stability and absence of violence/ terrorism

EXT =exchange rate

β_0 = the intercept

$\beta_{i's}$ = the parameters of the model

Variable that had larger values than other variables was rescaled in this study by putting the variable exchange rate (ext) to its logarithm forms in the model as can be seen in equation (2) below:

$$F_{it} = \beta_0 + \beta_1 RQ_{it} + \beta_2 PS_{it} + \beta_{3\ln\_EXT_{it}} + \mu_{it} \dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots 2$$

Table 1: Data source

Factor	Variable	Symbol	Source
FDI	Inward FDI	*F*	World Development Indicators
Regulatory Quality	Regulatory quality index	*RQ*	World Governance Indicators
Political Stability	Political stability and absence of violence/ terrorism	*PS*	World Governance Indicators
Exchange rate	Exchange rate	EXT	World Development Indicators

Source: Author's Compilation

4. Result Findings

Descriptive Statistics

The study examined the descriptive statistics of the model variables in order to investigate the data characteristics and nature of the variables in the model. Therefore, the result presented as shown in table 2 below:

Table 2: Descriptive Statistics of the Model Variables

Variables		Mean	Std. Dev.	Min	Max	Observations
f	overall	4.012253	11.28941	-28.62426	103.3374	N = 270
	between		4.042134	1.409599	12.17803	n = 6
	within		10.66698	-27.51666	95.17161	T = 45
rq	overall	-.8809474	.5060462	-2.112312	.1281278	N = 270
	between		.4844505	-1.591747	-.1940873	n = 6

	within		.2444971	-1.401513	-.1524329	T = 45
Ps	overall	-.884321	.876481	-2.557359	.8262815	N = 270
	between		.7785874	-1.611395	.3045226	n = 6
	within		.5110535	-2.084811	.515363	T = 45
ext	overall	782.6946	1859	.0001149	9088.319	N = 270
	between		1182.079	.9103069	2693.532	n = 6
	within		1512.324	-1891.869	7177.482	T = 45

Source: Author's computation from available data using STATA 13

The descriptive statistics results shown in table 2 indicated that all the variables of the model showed sufficient variations in their mean, standard deviations values and their associated minimum and maximum values. Table 2 further revealed that the overall number of observation for the study (N) is 270 (that is, from 1975– 2019 for each of the six (6) WAMZ member countries). The between panel group (n) has six (6) observations (that is; the number of WAMZ member countries).Within group panel (T) has 45 observations, corresponding to each country's number of time period (that is; from 1975 – 2019 in each WAMZ member country).

It was observed from the descriptive statistics results, that the model variables have extremely varied scales, and so resorted to rescaling exchange rate (ext) due to its extreme large values compared to the other variables of the model. This was done by putting exchange rate (ext) in its logarithm forms in all the preceding tests conducted.

The Result of the Panel Random and Fixed Effect models

The study examined the random and the fixed effect models and applied the Hausman test to select the appropriate model that best analyses the objective. Hence the summary results presented in Table 3 as given below:

Table 3: The Summary of the Results of the Random Effect Model (The Dependent Variable = f)

Variables	Coef.	Std. Err.	z	P>|z|
rq	-7.957638	2.680079	-2.97	0.003
ps	3.861774	1.201557	3.21	0.001
ln_ext	.3001859	.2006641	1.50	0.135
_cons	-30.93323	13.11457	-2.36	0.018
sigma_u	0			
sigma_e	9.7554735			
rho	0 (fraction of variance due to u_i)			

corr(u_i, X) = 0, Wald chi2(5) = 21.85, Prob> chi2 = 0.0006
Source: Author's computation from available data using STATA 13

Table 3 revealed that the errors term, u_i, are uncorrelated with the regressors, X, in the random effect model (that is; corr(u_i, X) = 0). Wald chi2 test indicates that all the coefficients in the model are statistically significantly different from zero (that is; Wald chi2(4) = 21.85 hence, suggesting that it is statistically significant). The probability of Chi2 also revealed that it is less than 0.05 (that is; Prob> chi2 = 0.0006< 0.05) thereby, showing that the model is good and as such, has a good fit. The intra-class correlation (rho) revealed that about 0% of the variance is due to differences across panels or across WAMZ.

In order to choose the preferred or appropriate model that best analyses the study objectives, the study examined the fixed effect model before employing the Hausman test. Hence, the fixed effect model is summarily presented in Table 4 below:

Table 4: The Summary of the Results of Fixed Effect Model (Dependent Variable = f)

Variables	Coef.	Std. Err.	t	P>|t|
rq	10.64476	3.931052	2.71	0.007
ps	4.183894	1.655715	2.53	0.012
ln_ext	.5054073	.1296368	3.89	0.000
_cons	7.729836	13.23537	0.58	0.560
sigma_u	10.771495			
sigma_e	9.7554735			
rho	.54937594 (fraction of variance due to u_i)			

F test that all u_i = 0: F(5, 259) = 14.74, Prob> F = 0.0000, corr(u_i, Xb) = -0.7969
Source: Author's computation from available data using STATA 13

Table 4 suggested that the errors, ui, are correlated with the regressors, Xb, in the fixed effects model (i.e. Corr(u_i, Xb) = -0.7969). Result on F-test indicates that all the coefficients in the model are statistically significantly different from zero (i.e. F test that all u_i = 0: F(5, 259) = 14.74). Result on the probability of F, also confirmed that all it is less than 0.05 (i.e. Prob> F = 0.0000, is < 0.05). This therefore implies that the model is good; and as a result, has a good fit. In another vein, the intra-class correlation (rho) suggests that about 54.9376% of the variances are due to differences across panels and/or across individual WAMZ member countries.

On this ground, the study applied the Hausman test to choose the best and/or the preferred model (the random or fixed effect model) that would be interpreted based on study objective. Econometrically, whenever the Hausman test results is significant (statistically different from

zero), then fixed effects model is more preferred and/or appropriate. Hence presented summarily, the Hausman test as shown in Table 5 below:

Table 5: Summary Results of the Hausman Test

---- Coefficients ----				
Variables	**(b)**	**(B)**	**(b-B)**	**sqrt(diag(V_b-V_B))**
	fixed	**random**	**Difference**	**S.E.**
rq	10.64476	-7.957638	18.6024	2.87582
ps	4.183894	3.861774	.3221204	1.139145
ln_ext	.5054073	.3001859	.2052214	.2180923

chi2(5) = (b-B)'[(V_b-V_B)^(-1)](b-B)=121.25, Prob>chi2 = 0.0000
Source: Author's computation from available data using STATA 13

Table 5 suggested that Prob>chi2 is less than 0.05 (Prob>chi2 = 0.0000 < 0.05), hence, suggesting that it is statistically significant. Based on this observation, the study applied the fixed effect model as the best and/or appropriate model for the analyses of the study objective; and therefore, interprets the fixed effect model.

Table 4, which is the fixed effect model results, in line with the study objective (which examines whether regulatory quality has significant impact on the inflow of FDI into WAMZ countries), suggested that that when regulatory quality (rq) is improved by one percent, the inflow of FDI (f) into WAMZ countries would significantly rise by about USD 10.64476 billion. The implication of this result is that whenever regulatory quality (rq) is improved upon by 1%, it would lead to a significant positive impact on FDI inflow into WAMZ countries by about USD 10.64476 billion. Its p-value is less than 0.05 (that is; 0.007 < 0.05) thereby, indicating that it is statistically very significant at 5% level of significance. This finding disagrees with the study by Aderemi *et al.,* (2019), who found that regulatory quality has positive, but insignificant impact on FDI inflows in Nigeria. In another vein,

this finding agrees with Olawale & Agbede (2020) and others, who found that good regulatory framework has positive significant impact on FDI inflow in developing countries.

The result also showed that whenever there is an improvement in political stability in WAMZ countries by one percent, FDI inflows (f) in WAMZ countries would significantly rise by about USD 4.183894 billion. The implication of this result is that a percentage improvement in political stability (ps) would significantly increase FDI inflow (f) in the individual WAMZ countries. Also the p-value is also less than 0.05 (that is; 0.012< 0.05) thus, signifying that it is statistically significant in affecting FDI inflow in the individual WAMZ member countries at 5% level of significance. This finding agreed with the findings of Eli & Isitua (2016), and others, who found that political stability attracts FDI inflow into host country. This finding however, did not agree with the findings of Olawale & Agbede (2020) who revealed that political stability is not effective in attracting FDI in Nigeria.

The results of the fixed effect model with respect to exchange rate effect on FDI inflow, suggested that whenever there is a devaluation and/or depreciation of exchange rate (ln_ext) by one percent, FDI inflows (f) in WAMZ member countries would significantly rise by about USD 0.5054073 billion. Also judging from the p-value which is less than 0.05 (that is; 0.000 < 0.05) hence, meaning that it is statistically significant at 5% level of significance. This finding agreed with the findings of Jaiblai & Shenai (2019), and others, who revealed that exchange rate significantly encourages FDI inflows. But disagreed with Busse *et al.* (2010) and others; who showed that exchange rate significantly hinder the inflow of FDI.

5. Conclusion and Recommendations

Drawing from the findings, the study concluded that regulatory quality has positive significant impact on the inflow of FDI in WAMZ countries. This is also expected since any improvement in

regulatory quality of any economy would on the average bring about favourable rules and regulation (both on humans and businesses), fair, efficient and convenient taxes, good and patriotic citizens, rise in government revenues, rise in infrastructural development, increase in domestic investments, rise in production within the WAMZ, rise in export of goods and services, stable economy, and significant rise in the inflows of foreign direct investment. The study also concluded that political stability and exchange rate within these countries of WAMZ have positive significant effect and/or impact on FDI inflow. This is because with increased percentage and/or higher levels of political stability, absence of violence and terrorism, more FDI inflows would be attracted. Also, anytime a country's currency depreciates, that country's currency would becomes weaker when compared to other countries' currencies, and as such, bring about arise in FDI inflows into the recipient country.

The study therefore recommended that government of the countries within WAMZ should encourage good regulatory quality in the form of favourable, flexible rules and regulation that guide the operation of both persons and businesses, fair, efficient and convenient tax administration, favourable business and investments environments and/or climates in the form of political stability and stabilized exchange rate, among others, to help improve the quality of institutions in WAMZ countries. This would no doubt lead to increased infrastructural development, increase in domestic investments, rise in production within the WAMZ, increase in export of goods and services, stable economy, and a significant rise in the inflows of foreign direct investment to WAMZ countries.

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