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The Effect of Foreign Direct Investment (fdi) on the Current Account Balance (cab) of Selected West Africa Countries

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Abstract

As opposed to a current account surplus, majority of developing economies experience current account deficits. It is gradually preferable to use foreign direct investment (FDI) rather than other foreign capital inflows to alleviate the current account imbalance. It may, nevertheless, also be a factor in a current account deficit. This study uses the pooled Ordinary Least Squares (OLS) regression technique to investigate the influence of foreign direct investment on the current account balances of four West African countries: Nigeria, Ghana, Cote d'Ivoire, and Senegal. The study spans from 1990 to 2019. The findings indicate that trade openness, real effective exchange rates, and FDI inflows have a negative influence on the current account balance. The study recommends that policymakers prioritize investments that come with value addition, employ the skilled labor force of the host economy, target an economy's productive sector, as opposed to its consumption sector and promote exports.

Keywords: *Foreign Direct Investment, West Africa, current account, Exports, Imports.*

Type of Paper: Research Paper

Introduction

There is a connection between other foreign capital inflows, the current account balance, and FDI. (Margeirsson, 2015). An economy's ability to grow and develop is greatly aided by FDI through various avenues. For instance, firms in recipient economies can access new and improved technology, gain access to new foreign markets, and provide diversified products for exports (Kahouli & Maktouf, 2015; Kusek & Silva, 2018). FDI is a catalyst for accumulating physical capital stock, boosting domestic savings, enhancing job creation, and a source of knowledge spill over in the host economy (Farkas, 2012; Sunde, 2017). The presence of FDI in an economy is usually associated with importing new technologies, which benefits other firms in the host economy. As production commences, the host economy can benefit from exports and improve its current account balance. An economy's macroeconomic status is significantly influenced by its current account balance. Recurrent deficits in the current account negatively affect the external sector of the economy, which often translates into imbalances in the internal sector, a phenomenon known as 'twin deficit' (Ali et al., 2019). Most developing countries that experience a saving-investment gap resort to foreign capital inflows to bridge the gap. This study investigates the influence of foreign direct investment (FDI) on the current accounts of the chosen West African states.

Regardless of the role of FDI in the development and growth of an economy, it can negatively impact the current account balance and foreign exchange reserves of an economy. Over time, rising FDI inflows lead to high import volumes and higher profit repatriation, among other consequences like worsening current account balances and exchange rate appreciation, particularly in developing nations. (Jaffri et al., 2012; Sahoo et al., 2016). This occurs when significant FDI inflows cause the host nation's currency to appreciate, which in turn promotes imports and discourages exports and worsens the economy's current account balances. (Kim et al., 2006; Hobza & Zeugner, 2014; Ali et al., 2019). In other words, foreign direct investment (FDI) inflows depress the current account because they increase the host economy's currency rate and cause consumers to switch from buying local goods to buying imported goods. (Margeirsson, 2015).

Empirically speaking, research on how FDI affects host economies' current account balances has yielded a range of findings. The impact could be positive (Siddiqui & Ahmad, 2012; Kaur et al., 2012; Ehimare, 2011), negative (Strauss, 2017; Sahoo et al., 2016; Rahman & Bristy, 2015; Jaffri et al., 2012), or no impact (Nguku, 2013). These studies cut across individual economies to regions and economic groups or unions. However, these studies have yet to consider the West African sub-region. Consequently, by concentrating on this sub-region, this study adds to the body of previous knowledge. Irrespective of the benefits associated with FDI inflows, policymakers must know the potential demerits associated with it in order to maximize the benefits and reduce the demerits. This study looked at the effects of FDI on the current accounts of four West African countries: Senegal, Ghana, Nigeria, and Cote d'Ivoire. The goal was to ascertain how rising FDI inflows affect these economies' current accounts. These countries were chosen because of the volume of inflows of FDI into their economies in recent years and the similarities in their policies meant to attract FDI.

Literature Review

2.1 Theoretical Review

The difference between savings and investments causes deficits in the current account. Low levels of savings in developing economies make them rely primarily on foreign capital inflows for investment activities (Ali et al., 2019) and other needs. The current account deficit is expected to persist because most developing economies concentrate on increasing investment through foreign capital inflows rather than increasing domestic savings (Nguku, 2013). Capital inflows, therefore, play a vital part in the savings, investments, and current account discourse and have become an important financing option for most developing economies. However, an increased inflow of foreign capital into an economy may have negative macroeconomic implications (Ali et al., 2019). Although loans, portfolio investments, and other capital inflows are essential sources of foreign capital, increasing inflows of FDI into developing economies over time and recurring current account deficits provide reasonable grounds to investigate its effects on the current account balance.

According to the literature, imports, exports, and profit repatriation can all be used to assess how foreign direct investment (FDI) has an

impact on the balance of payments. Generally speaking, FDI can affect an economy's current account directly or indirectly. when the use of FDI is the only option in funding current account deficit, the deficit may get worse. (Bedir & Soydan, 2016). FDI is mainly preferred in financing current account deficits because investors remain committed and rarely abandon their investments in the recipient country in the face of economic instability or distress, making it a stable and safer financing alternative (Bedir & Soydan, 2016). Portfolio investment and other short-term capital inflows are usually volatile and threaten the stability of the country's international investment position. They are often not encouraged to finance the current account deficit (Li et al., 2018).

2.2 Empirical Review

2.2.1 Foreign Direct Investment and the Current Account Balance

FDI's detrimental effects on the current account balance could happen through multinational corporations (MNCs) accessing new markets for their products. MNCs sometimes strategically set up their operations in a central location to produce large quantities and capitalize on economies of scale. They establish affiliates in other countries where their products become essential inputs for the affiliates. In the end, the affiliates resort to importing their inputs from the central location of the MNC, even though there may be domestic firms producing such inputs. The affiliate's import operations cause the host economy's current account balance to worsen. (Bedir and Soydan, 2016). Rahman and Bristy (2015), with a panel of SAARC (South Asian Association of Regional Cooperation) countries used ordinary linear regression to show that FDI causes a deficit in the receiving nations' current account balance.

Menincer (2008) provides further evidence of the above as he analyzed data on the EU's new member states employing the panel least square method on data from 1996 to 2006. He observed that in the short run, high volumes of FDI drive domestic firms out of business, increase imports, and cause affiliates of MNCs to be less efficient due to the removal of competition. Oke and Adigun (2020) analysed data from 1981 to 2017 using the error-correction model (ECM) and an autoregressive distributed lags (ARDL) bound testing technique. They found that FDI and Nigeria's current account balance had a negative relationship in both the short and long terms. According to the study, there is a need to encourage exports and discourage imports to address the deficit. Zaman

and Vasile (2012) employed descriptive data analysis from 1991 to 2011. They concluded that in Romania, there is a decline in the current account balance due to increased FDI inflows. A study by Sahoo et al. (2016) analyzed 23 Asian countries with data covering 1998 to 2013. The findings of the panel regression show that the current account balances of the selected countries are significantly impacted negatively by foreign direct investment (FDI). According to them, policies must ensure that inflows are channeled toward the economy's productive rather than consumption sectors.

Positively, Siddiqui and Ahmad (2012) found evidence of the long-term positive impact of FDI on the current account balance after analysing quarterly data on Pakistan from 1976 to 2005 using the Granger causality test and the Johansen-Juselius cointegration technique. However, there was no evidence of causality in both directions in the short run. Similarly, Kaur et al. (2012) discovered that FDI and current account balance are causally related in just one way after analyzing data on India using cointegration and causality analysis techniques. Popovici and Cantemir (2017) noted that FDI and imports and exports had a complementary relationship in analyzing data on Middle Eastern and North African countries. The dynamic panel data model was employed on data from 1999 to 2013. From their research, where affiliates are located in economies that possess cheap labor, the production generated raises the host economy's overall output and, eventually, the output that is available for export. This is one channel through which FDI inflows increase exports in the host economy (Ali et al., 2019). Another channel can also be through MNCs exposing affiliates to highly developed markets, which allows the host country to increase its exports (Gerlach & Lui, 2010). Ehimare (2011) analysed data from 1980 to 2009 using a basic ordinary least square (OLS) regression technique on the Nigerian economy and found that FDI had a positive effect on the current account.

Hailu (2010), in his study of FDI on the trade performance of African countries, observed a positive impact of FDI on exports and imports. The study employed the Least Squared Dummy Variable (LSDV) regression method on data from 1980 to 2007. However, the overall effect on the trade balance was negative, as imports are known to outweigh exports among the countries considered. The higher imports from the study are explained by low human capital development and low technological levels on the African continent, which causes MNCs to import production inputs. An important recommendation made by the

study is the encouragement of MNCs that are focused on exporting and controlling those MNCs that are import-focused. Similarly, using panel data from 1970 to 2009, Mijiyawa (2017) found that FDI had a positive and significant influence on exports of commodities and services among 53 African countries. FDI's export spillover effect was an important factor in realizing this effect. The study recommended implementing policies and strategies that will attract export-focused FDI and measures to encourage domestic firms to be efficient and actively involved in production for exports.

Regarding FDI and outflow of profit (repatriation of profit), Faheem and Siddiqui (2020) analyzed the impact of FDI and institutional quality on profit repatriation in developed and developing countries. A total of hundred (100) countries were considered for developing and developed countries, and the Causal research design was used in analyzing data from 2008 to 2017. The results indicate that investors are usually attracted to countries with strong institutions as these economies provide efficient tax systems and stable political and economic systems and are seen as friendly and conducive environments for their investment activities as opposed to those with weak institutions, which encourage corrupt practices and increase the cost of business operations.

Woodward (2005) sees FDI inflows as a significant contributor to current account deficits. He observed from an analysis of six economies that repatriation of profits as a result of FDI from the recipient country to the country of the MNC had the same effect as loan repayments and, therefore, contributed to the balance of payments deficit. Strauss (2017) found that increasing FDI inflows result in current account deficits as the inflows come with more income outflows (repatriated profits). This observation was made by analyzing data on the South African economy from 1994 to 2013.

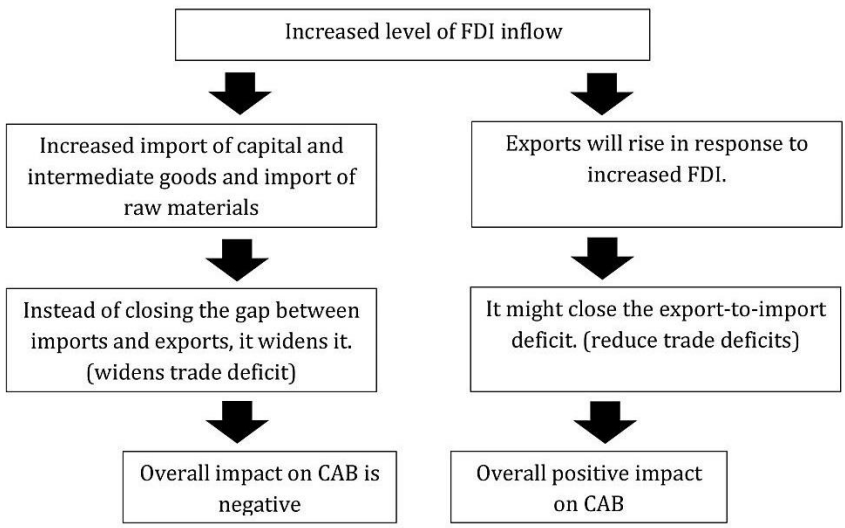
Castillo and Perezyera (2013) analyzed the effects of profit repatriation by United States FDI on the economic performance of some selected Latin American countries. The method of panel cointegration was used on data from 1980 to 2011. Major determinants identified were the profitability of the subsidiary's operations, government incentives, and volatility in the exchange rate. It was observed that repatriation of profits from FDI by United States investors adversely affects not only the productive capacity of the Latin American countries but also their standard of living. This could be explained by the fact that FDI from the United States takes up a chunk of the total foreign investment in the economies analyzed. A recommendation by the study was the need for

policymakers to establish regulatory frameworks that discourage repatriation through, for instance, well-developed human capital and efficient institutions. Also, the profitability of subsidiaries in the respective economies is critical in making repatriation or reinvestment decisions.

Previous reviewed studies present mixed results on the foreign direct investment and current account balance discourse. While most regions or economies considered for the studies have characteristics and economic conditions different from those of the West African subregion, others must be updated. To close the knowledge gap, this study examines how foreign direct investment (FDI) impacts the selected West African countries' current account balance (CAB).

The flow chart below summarizes how FDI affects the current account balance. An important observation is that the overall effect depends on the relative elasticities of imports and exports arising from FDI (Hossain, 2008).

Figure 1: How FDI affects the Current Account



Source: *Hossain, (2008)*

Most of the economies in West Africa (region considered for discussion) are usually engaged in exporting primary products (for instance, cocoa, coffee, oil seeds, pulses) whose prices are determined on the international

market and are therefore exposed to price fluctuations which affect their export receipts (Gebremariam & Ying, 2022). These primary products are traded without any value addition and are mostly imported back into the country after being refined and processed into consumable components. This results in low export receipts and high import payments, usually resulting in a deficit in the current account (Gebremariam & Ying, 2022). Another challenge is the low volume of exported goods and limited diversification of exported goods due to over-reliance on traditional export products. As a result of the above challenges, the presence of MNCs in these economies from the perspective of policymakers is to correct these shortcomings and ensure they get many returns from exports. For instance, MNCs that focus on production for export are usually welcome as their activities generate returns for these economies and help the economies move away from dependence on primary traditional exports to value-added exports.

Hypothesis

H_{01}: A negative relationship exists between foreign direct investment (FDI) and the current account balance (CAB) of the selected West African countries.
H_{A1}: No significant relationship exists between foreign direct investment (FDI) and the current account balance (CAB) of the selected West African countries.

Methodology and Data

This study employs the pooled Ordinary Least Square technique using secondary data for 4 West African countries from 1990 to 2019. The World Development Indicators (WDI) database served as the source of data for each variable.

FDI inflows can result in either import payments or export receipts. The amount of receipts and payments determines how it affects the current account; hence, a positive or negative sign can be expected. Investors need information on the growth prospects of an economy. This can be obtained from the growth rate of the real GDP of an economy. A higher growth rate attracts investment, which leads to increased productivity. Increased productivity increases the export base; a positive sign is expected. A real exchange rate appreciation favors imports at the expense of exports. Excess of imports over exports negatively affects the current

account. Therefore, it is anticipated that the real effective exchange rate and the current account will have a negative relationship. Openness to trade attracts and impacts both imports and exports. The magnitude of import payments and export receipts determines the net effect on the current account; hence, a positive or negative sign is expected. Inflation causes the price of domestic goods to be expensive. This encourages imports and discourages exports as lower prices will be sought in other trading countries. Hence, a negative sign is expected.

3.1 Empirical Model

According to the model by Hossain (2008) and Sahoo et al. (2016), trade openness, inflation, GDP growth rate, real effective exchange rate, and FDI inflows all have an impact on the current account balance. This gives rise to:

$$Current\ account\ balance = f(FDI\ Inflows, GDP\ Growth\ Rate, Real\ Effective\ Exchange\ Rate, Trade\ Opennes, Inflation).$$

For an empirical investigation, the estimation is as follows:

$$cab_{it} = \beta_0 + \beta_1 fdi_{it} + \beta_2 gdpgr_{it} + \beta_3 reer_{it} + \beta_4 open_{it} + \beta_5 inf_{it} + \mu_{it} \quad (1)$$

4. Data Analysis and Findings

4.1 Descriptive Analysis

Table 1 summarizes the data for the countries considered for the study, showing the mean and standard deviation.

Table 1: Descriptive Results

Variable	Mean	Std. Dev.	Minimum	Maximum
CAB	-1.7918	5.3281	-10.9200	20.7400
FDI	2.0190	1.6562	-0.1000	8.4300
REER	102.2400	32.2933	49.7498	273.0089
GDPGR	4.6088	3.7671	-2.2200	16.2100
OPEN	59.7765	20.5253	20.7225	116.0484
INF	11.0559	13.9268	-2.2480	72.8355

Six variables (one dependent and five independent) were considered for the study. The mean displays each variable's average value throughout

the course of the study's years. The standard deviation is helpful for comparison as it shows how the values spread from the mean. On the other hand, the range of values for the variables is shown by the maximum and minimum values. CAB has a mean of -1.7918 and a standard deviation of 5.3281. FDI has a mean of 2.0190 and a standard deviation of 1.6562. The mean (102.2400) and standard (32.2933) were used to determine REER. GDPGR has a standard deviation of 3.7671 and a mean of 4.6088. A mean of 59.7765 with a standard deviation of 20.5253 relates to OPEN. The standard deviation was 13.9268 and the mean was 11.0559 for INF.

4.2 Diagnostic tests

To guarantee the estimation's results are unbiased and consistent, two important diagnostic tests were conducted - heteroscedasticity and a test for multicollinearity. The test results are shown in Tables 2 and 3, respectively.

4.2.1 Heteroskedasticity Test

Table 2: Heteroskedasticity Test Results

Type of Test	**DF**	**Prob. Chi-Square**
Heteroskedasticity	20	0.3125

From Table 2, the p-value (0.3125) exceeds the significance level of 0.05. Since the p-value exceeded 0.05, the null hypothesis results showed that the error variance was not heteroscedastic. It was discovered that there was no heteroscedasticity in the data.

4.2.2 Test for Multicollinearity

Table 3: Multicollinearity Test Results

Variable	**VIF**	**1/VIF**
INF	1.08	0.924647
REER	1.08	0.926991
FDI	1.07	0.935201
GDPGR	1.06	0.943727
OPEN	1.05	0.951357
Mean VIF	1.07	

The variance inflation factor for variables INF (1.08), REER (1.08), FDI (1,07), GDPGR (1.06), and OPEN (1.05) had values less than 5, an indication that the variables did not highly correlate; hence no existence of multicollinearity.

4.3 Pooled OLS Regression Test Results

Table 4: Pooled OLS Regression Test Results

Variables	Coefficient	Std. error	t-statistic	p-value
FDI	-0.7237***	0.3087	-2.34	0.021
REER	-0.0364***	0.0171	3.48	0.001
GDPGR	0.1280	0.1367	0.94	0.352
OPEN	-0.0782***	0.0238	-3.29	0.001
INF	-0.0250	0.0376	-0.66	0.508
constant	9.4118	2.8360	3.32	0.001

Note: CAB is the dependent variable for the 1990–2019 sample period. The asterisks ***, **, and *, respectively, denote the statistical significance of the coefficients at the 1, 5, and 10% significance levels.

The pooled OLS regression was initially run, as shown in Table 4. The pooled OLS does not care for countries' unobserved effects and, therefore, necessitates running the panel model of random effect. Nonetheless, either the pooled OLS or random effect model must be chosen for this study. The Breusch and Pagan Lagrangian multiplier test for random effect can be used to overcome this issue. The results from the Breusch and Pagan test conducted showed Prob > chi2 = 1.000. This value is compared to 0.05 (the level of significance). Since 1.000 > 0.05, the appropriate output for this analysis is the pooled OLS regression. This is presented in Table 4.

At the 5% level of significance, trade openness (OPEN), real effective exchange rate (REER), and foreign direct investment (FDI) all have a statistically significant impact on the current account balance (CAB). However, the growth rates of real gross domestic product (GDPGR) and inflation (INF) do not account for the current account balance analysis as they are not statistically significant.

Discussion of Results

The study looks at the current account balance (CAB), foreign direct investment (FDI), and other factors that impact the CAB for four West African countries. Here, the findings from table 4 are examined. Inflation

(INF) and the real gross domestic product growth rate (GDPGR) are not statistically significant. They are not discussed because they are unrelated to the current account balance in this study. The next section discusses the statistically significant variables; real effective exchange rate (REER), foreign direct investment (FDI), and trade openness (OPEN): When all other factors remain constant, there is a 0.72% fall in the current account balance for every 1% rise in inward FDI. This is consistent with research by Oke and Adigun (2020), Sahoo et al. (2016), and Jaffri et al. (2012) on the negative effects of FDI on the current account balance. One common reason for this phenomenon is that increased FDI inflows usually result in an appreciation of the native currency's real value. The real appreciation creates a current account balance deficit by encouraging imports while inhibiting exports.

There is a statistically significant negative real effective exchange rate (REER) coefficient. This implies that for every 1% increase in the REER, the current account balance falls by 0.04 percent. This is consistent with economic theory, that a real appreciation causes an increase in import expenditure and a reduction in export receipts, leading to a current account deficit. Calderon et al. (2007) and Aristovnik (2006) lend support to the notion that the current account balance decreases as REER increases.

Trade openness (OPEN) has a statistically significant negative coefficient. This suggests that the current account balance decreases by about 0.08 percent for every 1% rise in trade openness. This can be explained by the region's over-reliance on imports and dependence on a few traditional products for export whose prices are determined on the world market and, therefore, subject to fluctuations. This result is consistent with the studies of Gebremariam and Ying (2022) and Hailu (2010), where the effects of imports on the current account balance outweigh that of exports, leading to a deficit.

Conclusion

The purpose of this study is to investigate how FDI inflows affected the current account balances of four West African nations. The findings demonstrate that while real GDP and inflation growth rate has no effect on the current account balance, FDI inflows, trade openness, and the real effective exchange rate all had a negative impact. An observation from this study is that the result reflects the region's unique features. For instance, imports are usually greater than exports, and inflation is usually

high. The high inflation makes domestic prices expensive and creates an enabling environment for imports. This provides a different perspective from what is generally known in the literature and what is observed among developed economies.

Recommendation and suggested further research

This study's key conclusion is that, despite all of the positive effects of foreign direct investment (FDI) on the economy—such as improved employment, technological transfer, competitive pressure to boost domestic producers' efficiency, and many others—there is a chance that, if poorly managed, FDI inflows could have a negative impact on the current account balance. Policymakers must thus identify appropriate investment channels and concentrate on initiatives that will strengthen the host economy while they work to promote inflows. Value-added investments, for example, that target an economy's productive sector rather than its consumption sector, employ the skilled labour force of the host economy, and promote exports must be given priority. Also, policies that encourage domestic savings must be enhanced as a means of bringing an end to external borrowings in the long run.

As the study concentrated on four West African countries, further research could be done on individual countries to understand their specific conditions and help develop country-specific measures and solutions to address the challenges. This study can also be helpful for research on other regions, such as East, Central, or Northern Africa.

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