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Foreign Capital Inflows and Growth: An Empirical Analysis of WAMZ Experience

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ABSTRACT : Using the Seemingly Unrelated Regression Estimation (SURE) technique, we examine the implications of four different types of foreign capital inflows, namely; Foreign Direct Investment (FDI), Official Development Assistance (ODA), Foreign Private Investment (FPI) and Remittances (REM) on output growth of the West Africa Monetary Zone (WAMZ) economies over the period 1981-2010. Our results show that there are differences in the growth impact of the various forms of foreign capital inflows in the WAMZ countries. The result also shows that more than one form of capital inflow contributed positively to output growth in Nigeria. Again, we find that ODA positively contributes more to output growth in Sierra Leone and Ghana, whereas, FDI foster more output growth in Nigeria and Gambia. Remittances have the highest contribution in Liberia and finally none of the inflows has positively impacted on Guinea's economic growth. We therefore recommend that WAMZ countries should endeavor to create competitive economic environments that will be attractive to foreign investors since promoting trade and investment through sound economic policies and strengthened institutions are essential in maximizing the benefits from Foreign Capital Inflows in the region.

Keywords: Foreign Capital Inflows; Investment; WAMZ; Economic Growth.
JEL Classifications: B22; C23; O11; O55; F35; F43

1. Introduction

The need for foreign capital to supplement domestic resources is being felt by the developing economies, in view of the growing mismatch between their domestic capital stock and capital requirements. This is evidenced by the attention given to the drive for foreign capital especially in developing countries. Foreign capital inflow has been identified as an important vehicle for augmenting the supply of funds for domestic investment (Fosu and Magnus, 2006). African countries and other emerging economies need substantial inflow of capital to fill their savings and foreign exchange gaps, enhance capital accumulation and growth needed to overcome widespread poverty in these countries. Thus, the relative advantage (s) of foreign capital inflow as a productivity-enhancing package is now widely acknowledged especially since the recent financial crises. Increasingly, economic development literature shows that there is a robust link between foreign capital flow (FCF) and economic growth (Alfaro and Chanda, 2003; Borensztein et al., 1998; Levine, 2001).

FCF – economic growth nexus may be explained in two ways: the direct and indirect channels. Direct channel of foreign capital flow – growth link is transmitted through: transfer of

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technology; lower cost of capital due to better risk allocation; financial sector development of the capital market; and augmentation of domestic savings. The indirect channels' stand on the premise that financial flow promotes specialization; induces better policies and enhances capital inflows by signaling better policies (Prasad et al., 2003). Hence, West Africa Monetary Zone countries have encouraged inflows of capital by dismantling restrictions and controls against capital inflows within the region. However, South Africa attracted the vast majority of the foreign inflows being directed to Africa as a result of its proximity, sophistication and market size which have given it strong comparative advantage in the Sub-Saharan Africa (SSA) region while West African sub-region received a minimal percentage. For instance, South Africa attracted an average of 54.4% of total foreign direct investment (FDI) inflow to Africa in 2005 while an average of about 45.6% was distributed among the other Sub-region and this pattern of distribution has not altered till date.

In view of this, efforts are being made by different national authorities to attract more foreign capital to Africa. One of these efforts is symbolized by successful integration of African countries in large regional blocs such as the Economic Community of West African States (ECOWAS), The Common Market of East and Southern African (COMESA), Bourse Regional De Valeurs Mobilieres (BRVM), South Africa Development Community (SADC), West Africa Economic and Monetary Union (WAEMU) which is the first monetary integration in the ECOWAS sub-region. The consolidation of these regional blocs combined with a relatively conducive investment environment has helped African countries to achieve greater integration with the global economy.

Consequently, the second monetary zone in the sub-region within ECOWAS besides Union Economique et Monetaire Ouest Africaine (UEMOE) was established in 2000, when Gambia, Ghana, Guinea, Liberia, Nigeria and Sierra Leone signed the Accra declaration establishing the West African Monetary Zone (WAMZ). The objective of the WAMZ is to facilitate the monetary integration of the sub-region and to ensure the achievement of ECOWAS monetary cooperation programme through sound management of the economies and the establishment of a single currency for these countries. But, there has been perceptible pattern of inflows to sub- Saharan Africa. The bulk of capital inflows go to South Africa whereas the West Africa sub-region is left with a limited amount of the inflows. Even, among the West Africa sub-region, Nigeria seem to receive substantial part of the inflows of capital against other WAMZ countries. However, even as Nigeria looks more financially viable when compared to other WAMZ countries, its share of inflow is still incomparable to South Africa. To this end, we consider it interesting to undertake this study in order to unravel the cause (s) of this trend, understand what actually determines the attraction of inflows to WAMZ countries, empirically elucidate what type (s) of capital inflows foster more growth in specific WAMZ countries and how WAMZ countries can exploit the benefit of such inflow (s). These issues, among others, are the factors motivating this research.

The theory of the two-gap model had acknowledged that capital inflow was needed to provide the required growth that would make economic take-off possible in developing countries (Chenery & Strout, 1966). This implies that the development of emerging economies is imbedded in their ability to embrace the global production web through capital inflow which brings increase productivity, technology transfer, effective competition and economic growth. Hence, over the decades, private capital inflow had taken off, driven by a number of domestic and external factors that contributed towards enhancing the regions (ECOWAS) attractiveness for foreign investors. In April 2000, the WAMZ countries agreed to move towards monetary integration. Such proposal has been argued to provide much needed exchange rate and price stability in the WAMZ region. Above all, the agenda is expected to stimulate capital flows and investment that enhances growth and development in the WAMZ economies.

In spite of the possible benefits of the foreign capital in the host economy, it is worrisome that Africa sub-region has not attracted sufficient dose of it that will launch them into economic development. Table 1 shows that only 1.6% on the average of the total capital inflow was directed to Africa between 1970 and 1990. 21.8% to other developing countries, whereas 77.2% was flowed to developed world.