EXCHANGE RATE VOLATILITY, FOREIGN DIRECT INVESTMENT AND MANUFACTURING SECTOR PERFORMANCE IN NIGERIA (1986 - 2014)

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BEING A THESIS SUBMITTED TO THE DEPARTMENT OF ECONOMICS, IN PARTIAL FULFILMENT OF THE REQUIREMENTS FOR THE AWARD OF THE MASTER OF SCIENCE (M.Sc.) DEGREE IN ECONOMICS OF OBAFEMI AWOLOWO UNIVERSITY, ILE-IFE

2016

CERTIFICATION

This is to certify that this research work is carried out under my supervision by Olusola Joseph DAHUNSI with the registration number SSP13/14/H/0094 in the Department of Economics, Faculty of Social Sciences, Obafemi Awolowo University, Ile-Ife, Nigeria.

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Title: **EXCHANGE RATE VOLATILITY, FOREIGN DIRECT INVESTMENT AND MANUFACTURING SECTOR PERFORMANCE IN NIGERIA (1986 – 2014)**

Degree: **M Sc. (Economics)**

Year: **2016**

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DEDICATION

To the only wise God our savior, be glory and majesty, dominion and power, both now and ever. Amen.

ACKNOWLEDGEMENTS

Should a horse be ridden upon in my heart, it will be a smooth ride without any obstacle for all that the Lord has done in my life and particularly for the successful completion of this research work. May His name alone be praised. I also appreciate my Supervisor, Dr. Omosola Arawomo, for all his time and efforts towards the completion of this study. I celebrate you sir. In the same vein, I acknowledge all the members of staff in Economics department, Obafemi Awolowo University Ile-Ife for being instrumental to making me a better person in life. May the good Lord bless you all.

I cannot but appreciate my parents, Late Pa. Micheal Ayodele Dahunsi and Dcns. D. O. Dahunsi for their parental love, provisions and care. May the Lord reward you bountifully. Also, I appreciate my Uncles, Anties and their families – Mr. & Mrs Tunji Augustus, Prof. & Mrs M. O. Adeoye, Mr. & Dr. (Mrs) I. A. Adeoye, Mr. & Mrs. Shanniyi and Mr. & Mrs Tunde Adeoye for their supports, provisions, care and love. I pray that the good Lord will reward every act of kindness you have shown to me. I appreciate you all.

Also, I am grateful to my Brothers, Sisters and their families – Mr. & Mrs. Olukayode Adunoye, Pst & Mrs. A. S. Dahunsi, Dr. and Mrs. Biodun Gbolahan, Revd & Mrs. Samuel Oladipupo for all the supports I have enjoyed in you. May the Lord shower His blessings upon you all in Jesus name. To all my cousins, friends and classmates that time and space will not permit me to mention, I say 'Thank You' from the depth of my heart.

How can I forget the Beulah family - Revd & Mrs. J. A. Abegunde and every member of the church for the enormous role that all of you have played throughout the period of my stay in school, a-five-letter word is not enough to express my profound gratitude to all of you and I pray that God will reward you abundantly. THANK you all. Olamide Ijinleifemi, a black, bold and beautiful woman, you are priceless. Thank you. To GOD be the Glory!

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ABSTRACT

The study established the long run relationship that exists among exchange rate volatility, foreign direct investment (FDI) and the manufacturing sector performance from 1986 to 2014 and examined the impacts of exchange rate volatility on FDI in Nigeria. It also analysed the interaction of exchange rate volatility and FDI inflow. These were with a view to providing information on the effects of exchange rate volatility and FDI on the manufacturing sector performance in Nigeria.

Secondary data covering the period between 1986 and 2014 were employed in the analysis. Annual data on manufacturing value added, real interest rate, inflation rate, degree of trade openness, gross fixed capital formation, total natural resources were sourced from World Development Indicators (WDI). Also, annual data on manufacturing FDI and monthly data on exchange rate were obtained from Central Bank of Nigeria (CBN) statistical bulletin. Data collected were analysed using appropriate descriptive statistics and Autoregressive Distribution Lag (ARDL) regression technique.

The bound test results showed that there exists a long run relationship among exchange rate volatility, FDI inflow and manufacturing sector performance. It was observed that the F-statistic (10.553) is greater than the upper bound (3.61) which connotes the existence of a long run relationship among the variables. The results also showed that in the long run, exchange rate volatility ($t = -55.413$; $p<0.05$) had negative and significant effect on FDI inflow. In the short run, exchange rate volatility ($t = 209.117$; $p<0.05$) had a significantly positive effect on manufacturing FDI inflow. The results of the interaction of exchange rate volatility and FDI inflow ($t = 3.348$; $p<0.05$) showed a positive and significant effect on the manufacturing sector performance.

The study concluded that exchange rate volatility and manufacturing FDI inflow had negative impact on the performance of the manufacturing sector performance in the long run. Also, the effect of the interactions between exchange rate volatility and manufacturing FDI inflow is positive on the manufacturing sector performance in Nigeria between 1986 and 2014

CHAPTER ONE

INTRODUCTION

1.1 Background to the study

The manufacturing sector is one that drives industrialisation which helps countries to develop. Developed countries of the world such as United Kingdom, United States, Germany, France, Russia, and China just to mention but a few have walked the path of industrialization to attain all-round development. In the early 1960s, countries like South Korea, Taiwan, Singapore and Hong Kong (the "Asian Tigers") were considered to be part of the third world but the rapid economic growth of the 'Tigers' through their industrialisation experience from the period between 1960s and 1990s has assisted them to successfully achieve development in a manner that no one could have predicted about fifty-five years earlier.

Since independence in 1960, Nigeria being one of the third world countries, has pursued industrialisation with the hope of transforming the economy from a monolithic, inefficient and import-dependent economy to a more dynamic and export-oriented economy, especially exporter of industrial outputs. This aspiration as contained in the successive development plans from the first national development plan (1962-1968) to the fourth national development plan (1981-1985) was further reinforced by the windfall gains from crude oil boom of the 1972/73 and 1979/80 periods (Adeoye, 2005). However, from 1990 till the present period, the only changes that have taken place was just a mere shift in exported products indicating a sign of export substitution from primary agro industry-based exports to primary mining industry-based exports (i.e. crude oil). As a result of this, the industrial sector performance is still far from being adequate and the manufacturing sector has continued to decline in growth and value-added.

In Europe, Japan and other developed countries, large share of foreign capital is concentrated in their manufacturing industries. Thus, capital flow plays a significant role in their developmental process by enhancing the manufacturing sector which serves as a great catalyst for economic growth and development (Akinlo, 2004). The reasons for the increased capital inflow in these countries can be traced to the adoption of liberal economic policies by many countries. However, since 1960s the explosion of capital flow across many developing countries particularly the Asian economies has been made possible through the official direct assistance, grants, soft loan facilities and foreign direct investment (Ghirmay and Cadet, 1998).

In Nigeria, favourable economic conditions like large domestic market, abundant natural resources and seemingly low unit labour cost have made the country to be positioned for large inflow of foreign direct investment (FDI). Generally, FDI flow to Nigeria are mostly in oil sector given the apprehension as regards the benefits from extractive FDI. Hence, since 1970, there has been a significant growth of FDI particularly into the manufacturing sector (MFDI) and the trend has grown from ₦224.8m in 1970 to ₦506.2m in 1975, to ₦1503.9m in 1980 to ₦2278.1m in 1985 and to ₦2810.2m in 1986. Since SAP in 1986, the trend of MFDI inflow that was hitherto noticed still continue to increase from ₦3122.3m in 1987 to ₦6339.0m in 1990 to ₦ 27668.8 in 1995 to ₦ 37333.6m in 2000 to ₦ 133894.5m in 2005 to ₦ 179275.2m in 2010 and to ₦ 194160.1m in 2014 (CBN Statistical Bulletin, 2015).

Given the significant roles which FDI inflow can play in the development of industrial sector of developing economies like Nigeria, one important factor that must be reckoned with is the exchange rate (Uwabanmwen and Ajao, 2012). Exchange rate plays an important role in transactions that involves transfers of funds, movement of goods and services and technology transfers from one country to another. Thus, the real and money shocks are responsible for exchange rate volatility in emerging countries (Caporale *et al.*, 2009). Exchange rate volatility therefore, influences the total amount of FDI inflows and also the allocation of this investment spending across a range of countries. Hence, it constitutes a major source of worry to both foreign investors and the host countries as it influence the volume of foreign investments that could be undertaken in an economy and subsequently the level of manufacturing activities that could be achieved.

In Nigeria, exchange rate witnessed a radical change from the long operated fixed system that was between the period of 1960s and the first half of the 1980s. During that period, it was observed that naira was relatively stable with respect to the dollar ranging from ₦0.7143 per dollar in 1960 to ₦0.89375 per dollar in 1985. Thereafter, exchange rate regime shifted drastically from the second half of 1986 when structural adjustment programme (SAP) policy was introduced to enhance export promotion thereby making locally made goods cheaper to the rest of the world.

With the introduction of SAP and the subsequent liberalisation of some aspects of Nigeria economy which was accompanied by flexible exchange rate system, the trend that was hitherto observed between naira and dollar was reversed. This is evident from the fact that the exchange rate drastically depreciated from ₦0.89375 per dollar in 1985 to ₦2.020575 per dollar in 1986 and since then, exchange rate has been unstabled and has continued to depreciate. As at 2014, the exchange rate stood at ₦158.5526 per dollar (CBN Statistical Bulletin, 2015) and is about ₦400.00 per dollar in 2016.

In conclusion, it cannot be overemphasised that exchange rate and its volatility play a critical role in the ability of the economy to attain optimal level of production in the manufacturing sector. Exchange rate is also an important variable that dictates how much of FDI goes into a country given its high sensitivity (volatility) to capital movements and market fundamentals. However, FDI inflow which is often accompanied by foreign technology, managerial expertise, and infrastructural development is inevitable for the development of industrial sector in developing countries judging by the role it played in the developmental