Trade Policy and Private Investment Behaviour in Nigeria: 1980-2013

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Abstract

The study empirically examined Private investment behavior in eras of trade policy reforms in the country using secondary data. Dummy variable of 1 was used to represent trade policy reforms from 1986-2003 and 0 to represent other years. The stationary status of the data series was investigated. The ordinary least square regression was used to determine the impact of trade policy on private investment behavior. The response of private investment to trade policy was very slow about 0.35 percent. This could be as a result lack of credibility and sustainability of trade policies experienced by investors over the years. Investors may prefer a ''wait and look attitude''. Causality runs unidirectional from Trade policy to Private investment. It is recommended that consistency and lasting of government trade policy should be strengthened to build more confidence by investors.

Keywords: Trade policy, Private investment, behavior

Introduction

Trade reforms have virtually being carried out by all countries in the world at one time in their history. This is because of its close association to the macroeconomic objectives of economic growth and development. Rodrik (1992) posits that trade reforms are mostly carried out in periods of macroeconomic instability and are intended to work by reducing the distortions in the structure of relative price and direct resources to sectors that can make the best use of them.

Surveys of trade reforms and how they set into the economic environment seem to agree with this notion as it suggests that a time of crisis enables radical reforms that may not had occurred in periods of economic growth. As illustrated by Rodrik (1992), all the trade reforms made in the eastern bloc economies (Bolivia in 1985), Mexico (Since 1987), Poland (1990) and Peru (1990); occurred in periods of severe macroeconomic instability.

The 1980's witnessed the rise in the use of economic reform policies by countries to influence and shape macroeconomic expectations, no thanks to the twin evils of a huge external debt and economic instability in most developing countries in Africa, Latin America, Eastern Europe and the Middle East. According to the World Bank (1996), 42 countries received loans during this decade alone from the institution with a desire for trade reforms. Hence, it is not ironic to note that the texture of most of the reforms bore the imprints of foreign creditors and lacked local content to make it sustainable.

By trade reform it is meant creative incentives that lead to the abolition of quantitative restrictions; engender a competitive exchange rate regime and a reduction in tariff to stimulate investment, employment and economic growth. That is trade reforms directly impacts on relative prices Abebefe (1995). Also it has been asserted by the CBN (1993) that trade reform policy in developing countries which are mostly import dependent is necessary to streamline external trade transaction to conform with the desired goal of economic development.

This paper is set to examine trade reform policies and their relation to private investment behavior in Nigeria. Towards this end, the paper is divided into nine (9) parts. Part II following the introduction presents a brief historical overview of trade reform policies in Nigeria since independence, Part III reviews relevant literature, while Part IV analyses some of the fundamental theoretical issues.

In Part V, materials and method of analysis is presented, and Part VI is model estimation. Data analysis and interpretation are in Part VII, we finally present our conclusions and recommendations in parts VIII and IX respectively.

Part II: Historical Overview of Trade Reform Policies in Nigeria

Trade policies in Nigeria can aptly be categorized according to the era of their formulation. In this mode we have the Pre-Structural Adjustment Program (SAP) Policies, SAP Policies and Post SAP Policies. It should however be emphasized that these three modes represent different time lines but were closely geared towards the same goal of economic growth and had similar macroeconomic objectives as balance of payment viability and export promotion, and complemented other economic policies such as the industrial policy, employment generation and self sufficiency initiatives of government. CBN (1993)

A. **The Pre-Sap Trade Policy Regime (1960-1986)**

This regime saw the plan and execution of three National Development Plans that where intended by the government to guide the Nigeria economy in the right direction. At the attainment of independence in 1960, the texture of the Nigeria economy was largely agrarian with cash crops such as cocoa, palm rubber, groundnut, ginger and a few solid minerals like coal and tin forming the bulk of exportable commodities. Therefore, the first development plan of 1962-1968 had the primary theme of its trade policy geared toward the export of these cash crops. In line with this, government established marketing boards and encouraged farmers to expand their production of these cash crops with guaranteed external markets by the boards in each region.

In this era, the policy of import substitution was in the limelight, and government embarked on various policy initiatives to fasten the pace of industrialization, control import and protect domestic industries which produce import substitutes (CBN 2002). In fact, the character of the exports and imports was concentrated in the Western Hemisphere, with Great Britain as a matter of historical inheritance, the largest trade partner. (CBN 2002)

The end of the Nigeria civil war in 1970 saw the need for a quick intervention to restore infrastructure and the economy. The need to quickly place the economy on the part of recovery necessitated the Second National Development plan (1970-1974). The plan was designed to incorporate the priority areas of the first plan which was to enhance agricultural and industrial production, as well as create a pool of intermediate level manpower for the country.

The Second National Development Plan retained protectionist trade policies, stringent control mechanism and saw the introduction of foreign exchange budgeting to relate aggregate foreign exchange expenditure to national income (CBN 2002). Furthermore, import licensing strategies and tariffs were introduced with specific import bans placed on a number of non essential items, while import quotas also meant the restriction of certain items. The main goal of the Second National Development Plan was to ensure the country was able to produce its own goods and services, develop its labour and finance its own development (CBN, 2002)

However, the change in the structure of the export basket of the country dramatically changed the balance of payments, affected macroeconomic variables and impacted on the implementation of the development plans. The sudden and unexpected increase in the oil price in 1973 coupled with a country low absorptive capacity and the existence of various productive bottlenecks in the economy meant that by 1974, the country was faced with surfeit of funds for which it had no immediate investment outlet internally. Consequently, protectionist restrictions on import payments were eliminated in 1974.

Indeed the oil boom of 1973 precipitated the very ambitious Third National Development Plan (1975-1980) and signaled the official change in the structure of export commodities depended upon by the economy. The Third National Plan saw a relaxation of most of the restrictive trade policies of prior plans.

However, by 1981 when the Fourth National Development Plan (1981- 1985) was launched, the oil price had fallen. This meant two things for the country. First, foreign exchange needed for plan execution fell short of targets and second, with loosed import restrictions, there was an increase in import demand and consequently, balance of payment deficits. According to the CBN (2002), the inability of control measures to effectively secure downward adjustments to imports demand against the backdrop of decreasing foreign earnings impacted on the balance of payment of the country.

B. Sap Era Trade Policies

The huge macroeconomic distortions in the economy as orchestrated by the protectionist trade policies of the previous National Development Plans made it imperative for the government to take drastic remedial measures to address the situation. Hence, the World Bank induced Structural Adjustment Program (SAP) was introduced in July, 1986. The key objectives of SAP noted by the CBN (2002) were:

- Restructure and diversify the productive base of the economy and lessen dependence on the oil sector and imports.
- Lay the basis for sustainable non inflationary economic growth.
- Lessen the dominance of unproductive investments in the public sector, improve sector efficiency and intensify the growth potentials of the private sector.

A prominent feature of the SAP reform included the reform of the exchange rate regime which was before then administratively fixed by the relevant authority and viewed as highly overvalued. (See Abebefe 1995;). As noted by Philip (1979), the SAP era witnessed a series of currency devaluation with the expectation that reform measures would raise the prices of exports in domestic currency. Hence, the naira plummeted from an exchange rate of a dollar per unit in 1985 to 130 naira per unit of a dollar in 2004.

In addition, the second tier foreign exchange market (SFEM) was established in September, 1986 as a mechanism for a competitive market determined exchanged rate regime. In 1995, the policy of "guided deregulation" was introduced by the government and this led to the establishment of the Autonomous Foreign Exchange Market (AFEM), which was later transformed to a daily two way quote Inter-bank Foreign Exchange market (IFEM) in October 25th, 1999. More so, the SAP era witnessed the introduction of trade liberalization and deregulation policies as the government tries to free up the space for private business participation in the real sector of the economy. The liberalization and deregulation policies saw a gradual reduction of government participation in business administration and import prohibition. There was also a shift towards using tariffs as protectionist measures for local industries.

In fact, the SAP era saw the abolition of the marketing boards, elimination of exports and imports prohibitions for most durable and non durable items, introduction of market oriented exchange rate policy, and the abolition of import licensing and exchange controls.

C: Current Trade Reform Initiatives

Current government efforts at initiating trade reforms and attracting private investment has seen several incentives added to trade policies. In order to encourage private sector participation and investment, the Nigeria government established a Free Export Processing Zone (EPZ) in Calabar, Cross River State in 1991 with the primal aim of encouraging the setup of industries and services that are export oriented.

In addition, tax concessions of up to 25% investment tax credit for capital expenditure has been earmarked for companies wholly in tool fabrication, spare parts and simple machinery for local consumption and export; 120% tax concession for expenses in research and development and a tax concession for local raw material utilization ranked 80% for agro-industries, 70% for agro-allied industries, 65% for engineering, chemical industries 60% and 70% for petro-chemical industries. Further, a development plan termed the Medium Term Expenditure Framework (MTEF) is currently implemented. The MTEF is an annual three year plan that sets out the medium term expenditure priorities and budget constraints against which sector plans can be developed and refined.

Part III: Literature Review

According to the World Bank (1991), the main problem confronting developing economies is the level of savings and investment which are inadequate and insufficient to fuel the growth needed to raise living standards and attain full capacity utilization of resources.

Private investment is a catalyst for economic growth and stimulates activities which lead to capital formation. In recognition of this fact, the policy focus in Nigeria has shifted from heavy public sector participation to private sector led economic development (Kalu .E, 2012). In this regard all countries are desirous of using suitable frameworks in form of economic policies to boost private investment. Trade reforms are intended to attract private participation in the economy and ease the mobility of capital for investment, job creation, mobilize domestic savings and economic growth.

Frankel and Romer (1999) using cross country evidence have been able to show that trade liberalization; deregulation and openness are determinants of capital accumulation, income growth and output. Rodrik (1992) however argues that though tariff and non tariff barriers determine economic openness, but not the trade balance as the latter is determined by the balance between national income and expenditure, especially the rate of exchange.

Corden (1974) posits that protectionism could reduce the rate of capital accumulation because, investment without capital inflows is determined by the amount of domestic savings the economy can mobilize out of total capital. However, as shown by Rodrik (1992), protectionist commercial regimes may have external balance and prompt debt service as compared to liberalized regimes.

Aizmenman (1992) maintains that countries that take advantage of international trade might enjoy higher growth rates as a result of faster absorption of foreign technical knowledge. Moreover, if investment is linked to changes in output as (outlined in the accelerator principle), any policy measure that promotes growth will be a stimulus for an increase in capital accumulation.

Furthermore, issues of trade credibility and its impact on investor and consumer confidence have been extensively explored. (see Rodrik, 1992). The lack of credibility in reforms set in motion forces of skepticism which might render the reform inefficient, harmful and difficult to sustain, especially when such reforms are perceived as only temporal.

Busari and Fashumu (1998), examined the impact of trade policy on private investment in Nigeria using 67 firms from 1980 -2003. The study observed that trade policy practice in Nigeria has deterred investment by raising the cost of import, thus affecting import dependent firms. This is in addition to the uncertainty in the real exchange rate especially as it concerns firms which are import intensive.

Luintel and Mavrotas (2005), using panel data sets investigated domestic private behavior in 24 low and middle income countries from 1981 – 2000. The results showed cross country heterogeneity in private investment behavior. Furthermore, using co-integration and error correction techniques, Frimpong and Marbuah (2010), investigated factors that either stimulated or dampened private sector investment in Ghana. Their result shows that in the short run, private investment is determined by public expenditure; inflation, real interest rate, openness, real exchange rate and a regime of constitutional rule, while inflation, external debt, real interest rate significantly impact on private sector investment in the long-run.

Part IV: Theoretical Framework

Theories of capital accumulation in the economy have been given primary importance in economic literature ever since the time of Keynes. In contemporary analysis of investment, the neoclassical school of thought have witness several refinement from the accelerator theory, flexible accelerator theory and Jorgensen neoclassical approach to investment.

The flexible accelerator theory is based on the idea that the larger the gap (lag) between existing stock of capital and the desired stock of capital, the larger would firms investment be. This neoclassical model is expressed as $I_{nt} = \alpha k^{*} - k_{-1}$ where I_{nt} is net investment, k^{*} stands for desired capital stock and k_{-1} is stock of capital in previous period.

Jorgensen (1971) neoclassical approach to investment posits that desired capital stock K* is proportional to output and the user cost of capital. Other models of investment include Tobin's Q theory published in 1969 and the cash flow theory of investment.

Part V: Materials and Methods

This study adopts the flexible accelerator model which states that there are adjustment between the level of output and the level of investment in the economy. This model satisfies the apriori expectation that trade reforms would take some time for its impact to be felt in the economy. Hence, utilizing a distributed lagged model and forming dummy variables for trade reforms, the bilateral causality between trade reforms and private investment behavior is expressed as:

$$INV_t = \alpha TR_{t-i} + \beta_j INV_{t-j} + \mu_{it}$$

Where:

INV_t = Private investment in period t
TR_{t-i} = Dummy variables for trade reforms in period $_{t-I}$ set as 1986-2013=1, others = 0
INV_{t-j} = lag variables of investment for period $_{t-j}$
μ_i = uncorrelated error term

Economic theories suggest an increase in real GDP as a result of a rise in private investment which impacts positively on employment, output and national income. However, trade policy may either have a positive or negative relationship with private investment. If a negative term of trade is recorded, this may worsen the current deficit and exert a negative effect on private investment. Conversely, a positive relation may be expected if the terms of trade turn positive. Therefore, the relation between trade policy and private investment is ambiguous.

Data sources utilized in this study spans from 1980 – 2013. The data is drawn from the World Bank's World Economic Outlook Database. Other data sources include books and journals.

Part VI: Model Estimation

A distributed lag model is formed to capture the effect of trade reforms on investment as empirically expressed thus:

$$INV_t = \alpha_i TR_{t-I} + \beta_j INV_{t-j} + \mu_{it} \quad . \quad . \quad . \ 1$$

$$TR_t = \lambda_i INV_{t-I} + \mathcal{E}_j TR_{t-j} + \mu_{it} \quad . \quad . \quad . \quad 2$$

The hypothesis is set as:

Ho: $\alpha_i = 0$, i=1,2,…,n. i.e lagged T.R terms has no significant impact on private investment in Nigeria during the period under consideration.

First, we account for stationarity in the values of the parameters by finding their first difference. After which we regress investment on its lag (1 period is used). Next, is the regression of investment on the lagged dummy of trade reforms and investment.

Applying the F test at 5% level of significance, we use the Granger Causality test to examine if there is a bilateral causality in the hypothesis so modeled. We reject the null hypothesis if the computed F statistic is greater than the critical F statistics, but accept the null hypothesis if otherwise.

The F test is given as:

$$F = \frac{RSS_R - RSS_{UR}/M}{RSS_{UR}/n - k}$$

Where:

RSS_R: Restricted sum of squares
RSS_{UR}: Unrestricted sum of squares
N = no. of variables
K = no. of parameters
M = no of restrictions.

Part VII: Data Analysis and Interpretation of Result

Growth Rate of Investment

Using a Lin log model, the growth rate of investment is given as :

$$\begin{array}{lll} InInv = 2.7209 & + 0.00346607_t & . \quad . \quad . \ 4 \\ se= (0.511) & (0.00255) & \\ t = 5.324 & 1.360 & \end{array}$$

Where InInv stands for log of private investment, se denotes standard error and t is t-statistics

The result shows that over the period 1980-81 to 2012-13, private investment increased at the yearly rate of 0.35%.

Granger Causality Test

Restricted Residual Sum of Squares **(RSS_R)**	Unrestricted Residual Sum of Squares **(RSS_{UR})**	No. of Parameters **(k)**	No. of restrictions **(m)**	No. of variables **(n)**
303.7445	2.961538	2	1	33

Using the F statistics:

$$F = \frac{RSS_R - RSS_{UR}/M}{RSS_{UR}/n - k}$$

$$= \frac{303.744.5 - 2.961538/1}{2.9615638/33 - 2}$$

$$= \mathbf{314.9}$$

At 5% significance level (1=numerator and 31=denominator), the F calculated is above the critical value 2.94. This suggest that the Granger causality is in the direction TR $\longrightarrow$INV.

We therefore reject the null hypothesis and accept the alternative hypothesis which states that trade reforms cause growth in private investment. This establishes a unidirectional causality.

Part VIII

Conclusion

The study empirically examine private investors response to government trade policies in Nigeria from 1980-2013. It was observed that the response of private investment to trade policy reforms was positive but not significant. This means low investment growth because of skepticism of private investors for possible policy reversal by government that would dampen their investment. This is because investment requires sunk cost of entry and exit. Any trade policy that is not sustained over time cripple private investment.

Part IX

Recommendation

To ensure the viability and sustenance of gains in private investment, the following policy measures are required. First future reforms should be targeted at deepening private participation with a more open economic space. Secondly, is the need to ensure consistency in trade reforms as frequent alterations may stifle its impact on economic growth and development.

Thirdly, there is the need for Policy Impact Assessment (PIA) by policy makers to evaluate the effect of trade reforms on investment; and allow for flexibility in policy terms so as to achieve the desired result.

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