

Foreign Direct Investment and Monetary Union in ECOWAS Sub-Region: Lessons from Abroad

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Abstract

The paper examines the proposed Economic and Monetary Union for ECOWAS sub-region and provide a comprehensive evidence based on European Union experience of what ECOWAS common currency stand to gain in terms of both Intra and Inter flow of FDI. Evidence from the reviewed literature revealed that; single currency, research and development, trades and consequent exchange rate stability are the main factors that have been aiding FDI flows within the euro-zone.

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1 Introduction

The elimination of a national currency and its replacement by a common regional currency is presently a heated political debate in Britain. The UK government is considering the pros and cons of dropping the pound sterling, and joining the Euro zone. Similarly, the issues of regional solidarity and greater economic integration remain an important agenda in West Africa. Nigeria and Ghana are the main advocates of an Economic and Monetary Union (EMU) for the region. The quest for an ECOWAS common currency is encouraged by the successful story of European Monetary Union that adopted the Euro as its common currency starting from 1999. Thus the impact of the euro on international transactions turns out to be a major concern.

Recent empirical studies document a positive effect of EMU on trade (Micco et al, 2003, among others). On the other hand, the impact of EMU on Foreign Direct Investment (FDI) has rarely-been investigated. Nevertheless we provide a comprehensive evidence of what ECOWAS common currency stand to gain in term of both intra and inter flow of FDI to the participating countries base on the experience of European Union (EU). According to Lane (2006), monetary integration may affect FDI through different channels. First, EMU may have contributed to reduce macroeconomic instability, despite the loss of a policy instrument. The currency union may also help to avoid destabilizing speculation and increase transparency and credibility of rules and policies. These effects according to Dixit and Pindyck (1994) are important sine uncertainty about future returns may deter irreversible investments as there is an 'option value' of waiting.

Second, by removing intra-euro land exchange rate volatility, monetary integration increases the certainty-equivalence value of expected profits of risk averse firms and should foster intra-zone FDI. In the absence of a common currency the possibility of hedging against currency risk is reduced for FDI since hedging over long horizons is problematic. The removal also reduces trade costs and may favour vertical FDI in so far as firms fragment their production and locate their activities in different countries according to international differences in factor prices.

However, if foreign investment is a way to serve foreign markets, a removal of exchange rate volatility may decrease FDI and increase trade as a substitute. Also, a single currency could promote intra-zone FDI by easing comparison of international costs and price decision and by reducing transaction costs. Such as currency conversion costs and in-house costs of maintaining separate foreign currency expertise. In this paper, we provide an insight into the relationship between single currency as proposed by ECOWAS and the flow of FDI in and out of member countries. As a preliminary study, an in depth was made into literature and empirical works based on EU experience to offer a reasonable policy advice on the pros and cons of such decision as it affects FDI in these countries. The rest of paper is organized as follows in section 2 gives brief history of ECOWAS and its monetary union bids. Section 3 delves on both empirical and theoretical

literature of FDI and monetary union. Section 4 discusses the experience of FDI and European monetary union while section 5 concludes.

2 ECOWAS and Monetary Union

A common currency which has been one of the desire of ECOWAS since inception in 1975 sprang up with a heated debate in recent time on whether such policy is desirable and/or whether the region is ripe enough to take up such challenges especially when most of the criteria for optimum currency area (OCA) have not been met. However, the policy can be considered expedient given the fact that there exist in the sub region one of the oldest monetary union that has single currency (CFA Franc) for the French speaking west African countries know as “Union Economique et Monetaire Ouest Africaine (UEMOA). This is made up of Benin, Burkinafaso, Coted’ivoire Guinea Bissau, Mali, Niger, Senegal and Togo. Since 1994 when this was formerly launched, the intra-trade transactions have been enhanced Nnanna (2007). This informed the establishment of the West African Monetary Zone (WAMZ) and the proposed second monetary zone for non UEMOA (Basically made up of the English speaking countries in the region: Gambia, Ghana, Guinea, Nigeria and Sierra-Leone with Liberia and Cape Verde to join later). This according to Balogun (2008) serves as a prelude and fast track approach to ultimate unification and adoption of a common ECOWAS currency.

The same author Balogun (2008) also posited that, the quest for an ECOWAS common currency is further encouraged by the successful story of European Monetary Union (EMU) that adopted the Euro as its common currency starting from 1999. It is the general belief that Europe’s path to monetary union could be adopted to expedite the ECOWAS common currency project.

Meanwhile, the feasibility of a potential monetary union for a block of countries is usually evaluated by weighing the benefits and costs of joining a currency union (Mundell, 1961 and Mckinnon, 1963). Using a single currency leads to the elimination of transaction costs and uncertainties (Monitoring exchange rates and predicting their fluctuations, costs of currency conversion and keeping and managing reserves for intra-regional trade). On the other hand, participating in a monetary union involves loosing autonomy over monetary instruments such as interest rates and exchange rates that serve as stabilizers.

Going by OCA literatures, there are various benefits and costs a regional group such as ECOWAS can enjoy from participating in a currency area which cannot be judged statically as they can take different profiles over time. That is, in the early stages of a currency area especially when the new single currency can fully display its benefits both domestically and internationally. Most benefits and costs can also take a different profile across participating countries – between small and large countries, or for countries with a track record of relatively high inflation in the past. Admittedly, the perspective of these benefits and costs is “euro-centric”. The following according to Francesco (2002) can be classified as

some of the benefits a regional group such as ECOWAS can achieve from undergoing a common currency; Improvements in microeconomic efficiency resulting principally from the increased usefulness of money which means, the liquidity services provided by a single currency circulating over a wider area.

There will be a greater price transparency that will discourage price discrimination, decrease market segmentation and faster competition. Intra-area nominal exchange rate uncertainty will disappear leading to savings in transaction and hedging costs. The more concentrated trade in a currency area, the greater the saving in transaction costs are likely to be. This will strengthen the internal market for goods and services, foster trade, lower investment risks, and promote cross area Foreign Direct Investments (FDI) and enhance resource allocation.

Also, there will be increased macroeconomic stability and growth resulting from; improved overall price stability, the access to broader and more transparent financial markets, increasing the availability of external financing, reputation gains for those members with a history of higher inflation that benefit from an anti-inflationary anchor, reduction of some types of fluctuations of output and employment across the currency area due, possibly to different economic policies.

Lastly, benefits from positive external effects resulting principally from; savings on transaction costs results from a wider international circulation of the single currency, revenues from international seignorage, the reduced need for foreign exchange reserves, and simplified international co-ordination.

He (Francesco, 2002) classified some of the costs involved as follows: One, Costs from the deterioration in microeconomic efficiency, that is, the change over costs from switching to a new currency (administrative, legal, hardware costs etc). Two, the costs from decreased macroeconomic stability and the costs from negative external effects, such as if one or more member countries were to run sizeable and protracted budget deficits accumulating an unsustainable public debt, eventually some pecuniary externalities might ripple through the currency area.

However, adjudging the benefit or costs that may accrue to the region (West Africa) as a result of a single currency may be premature especially when most of the criteria for such policy have not been met as stated in Obaseki (2005) that “the inability of the member countries to implement policies towards the attainment of the ECOWAS single market objective and the West African Monetary Zone (WAMZ) convergence criteria led to the postponement of the launching of the WAMZ monetary union to 1st Dec. 2009. Also the need to change the strategy as stated by Ojo (2005) the objective of WAMZ is to merge with UEMOA to form a common currency for West Africa. But the historical antecedents of UEMOA which is not as robust as the EU and still have had a common currency in place for several years, one is inclined to agree with self validating theory of Fidrmuc (2001), that the best institutional device to guarantee a credible policy commitment to a monetary union is to have a monetary union itself in place (Confirming endogenous optimal currency area theory).

3 FDI and Monetary Union (Empirical and Theoretical Review)

This section delves extensively on the theoretical/empirical review in the work of Giovanna (2005). The effect of monetary union on FDI flows has been tested by different scholars. This is the main hypothesis tested by Molle and Morsink (1991b) which seems to be the first that specially considers the relation between foreign investment and monetary union. In a previous empirical analysis of the same issue (Molle and Morsink, 1991a), the authors concluded that exchange rate risk discourages direct investment abroad. Moreover, the EMU, by reducing the variability of exchange rates, was expected to increase the flows from the richer northern member states to those in the south. The subsequent study by Molla and Morsink (1991b) as discussed in Giovanna (2005) shows a more detail analysis of the empirical relation between FDI within the European Union and the variability in exchange rates using a gravity model. The results of the estimation indicate the importance of three variables for explaining FDI flows: research and development in the country of origin is identified as the most significant push factors; trade was identified as an important stimulus for FDI, indicating a considerable complementary relation between trade and FDI; the variability in the average monthly real bilateral exchange rates appears to be the most important friction factors, and distance and cultural difference result as additional frictions. The conclusion reached by the authors was that variability in exchange rates is of importance for direct investment flows. Consequently, monetary integration is likely to stimulate FDI between the countries joining the EMU.

In their work Jose and Julie (2006) using augmented gravity equation controlling for market size, transaction and production costs, exchange rate variables, skill endowments and merger and acquisitions determinants opined that the Economic and Monetary Union (EMU) plays an important role for stimulating FDI within the euro-zone, according to their results, the euro-zone, according to their results, the euro has increased intra-EMU FDI stocks by about 26% in the first four years of its adoption. The effect which is even larger for FDI flows.

In all, most literature on the impact of monetary union on FDI flows (See Froot and Stein, 1991; Klein and Rosengreen, 1992; Yannopoulos, 1990a and b among others) are of the opinion that the creation of the European Monetary Union and the consequent exchange rate stability are important factors behind FDI flows. Molle and Morsink (1991a and b) on their own concluded that monetary integration is likely to stimulate FDI between countries joining the EMU. This assertion the author intends to investigate empirically by undergoing a speculative study, using an augmented gravity model that will capture the specific nature of ECOWAS sub-region in Ibrahim (2008) forthcoming.

4 FDI and European Monetary Union

This section is similar to the preceding one but different as the focus will be on the performance of EU overtime in terms of FDI flows since the introduction of a common currency in 1999. The empirical literature on how European Union has been fairing in term of FDI flows is hard to come by but as far as we are aware, the Economist intelligence unit (2004) reports in its world investment prospect that the UK's share of EU in FDI inflows has decreased steadily from 29 percent in 1998 to 5 percent in 2003. The implication of which means that foreign investor has reduced their investments in the UK to EMU countries advantage. The work of Petroulas (2004) reveals an increase in intra-EMU FDI of 17 percent within the European Union region. Along the same line, but with different methodology, Jose and Julie (2006) concluded that other things being equal; the euro has increased intra EMU FDI stocks by about 26 percent on the first four years of its adoption. This effect which is even larger for FDI flows”.

If trade and FDI were to be complementary as demonstrated by Molle and Morsinbk (1991a) or a substitute as shown by Dunning and Robson (1987) and Yannopoulos (1990a), the empirical analysis of trade gains and monetary integration given by various authors will also be useful in this section. Rose (2000) demonstrated a significant positive effect of a currency union on international trade, using a gravity model on a panel that covers 186 countries during 1970-1990; He finds that countries sharing the same currency trade three times as much they would with different currencies. An extension of the work of Rose by Frankel and Rose (2000) to 200 countries plus dependencies, indicate that currency union increase trade more than triples among partner countries. Alesina et al (2002) using a different methodology than the gravity models and find that currency unions are likely to increase commencements of prices and perhaps, of output. Hence, in general, there are different views concerning the possible effect of common currency on FDI flows as well as the size of the possible trade gains following monetary unification. Whatever the case, the most importance thing is the additional gains for West African countries if per adventure the proposed monetary unification for the sub-region finally works out.

5 Conclusion

The empirical evidence on the impact of monetary unification on Foreign Direct Investment as reviewed by this paper indicates that the Economic and Monetary Union plays an important role for stimulating FDI. The paper observed further that, research and development, trade and the consequent exchange rate stability are important factors behind FDI flows.

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