

Monetary Policy and Foreign Direct Investment in Nigeria: Moderating Role of Institutional Quality

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Abstract: - Foreign Direct Investment (FDI) has consistently been acknowledged as an important contributor to capital transfer, technology diffusion, job creation, and overall economic development, particularly for emerging and developing economies like Nigeria. The extent to which a country can attract FDI depends on its macroeconomic environment as well as the strength of its institutional framework. Among the macroeconomic factors, monetary policy variables such as the liquidity ratio, monetary policy rate (MPR), and money supply play a significant role in shaping the decisions of foreign investors. However, studies on the actual extent and direction of the impact these variables have on FDI inflows are rather scarce, particularly when moderated by the quality of institutions in the host country. This study therefore, examined the effect of monetary policy variables, liquidity ratio, monetary policy rate, and money supply on FDI, while introducing institutional quality as a moderating variable. This study adopted the Error Correction Mechanism (ECM) approach to analyze annual time series data spanning 27 years (1994 – 2024). ECM results of monetary policy variables and foreign direct investment showed the error correction term (CointEq (-1)) is -0.7370 and significant ($p = 0.0006$); $R^2 = 0.5470$, confirming a strong long-run equilibrium. About 73.7% of FDI deviations from long-run trends are corrected in the next period. Furthermore, the ECM results of monetary policy variables, institutional quality, and foreign direct investment, the error correction term (CointEq (-1)) is - 0.7193 and significant ($p = 0.0023$); $R^2 = 0.5553$. Results revealed that 71.9% of FDI deviations from the long-run are adjusted to the equilibrium. Specifically, the ECM results for both the short-run and long-run models produced similar outcomes since both models showed a wide, negative, and statistically significant error correction term. The model of institutional quality indicates a marginal slow speed of adjustments, implying that while long-run effects appeared in both models, institutional quality slightly moderated the speed at which FDI returned to equilibrium. The study recommended that monetary authorities consider long-term monetary policy outcomes in conjunction with institutional frameworks in order to attract more FDI inflows.

Key-Words: - CBN, ECM, FDI, institutional quality, Monetary policy, Monetary policy rate, Liquidity ratio, Inflation rate.

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1 Introduction

Foreign capital inflows, FDI in particular, can actually be a key catalyst for economic advancement, especially in emerging economies, through increased investment, employment opportunities, and the transfer of technology. Prior studies by [1] and [2] underscore that a nation's capacity to attract FDI is shaped by both its monetary policies and the quality of its institutions. Important monetary policy variables such as policy interest rates, liquidity ratio, and money supply play crucial roles in shaping investment decisions. However, their actual effects on the magnitude of FDI inflows are still a subject of debate in academic literature, particularly when the role of institutional quality is considered.

Monetary policy instruments are formulated to maintain macroeconomic stability, moderate inflation, and influence interest rates, all of which also determine FDI. For example, a higher liquidity ratio, which raises banks' reserve requirement, may restrict credit and discourage investors, whereas a lower liquidity ratio may spur economic output but may heighten inflationary trends. Similarly, a high MPR increases borrowing costs, potentially discouraging FDI, whereas a lower MPR can enhance investment by reducing capital costs. Yet, according to [3], in economies with persistent inflation, a high MPR serves as a sign of policy commitment, which may bolster investor confidence.

Money supply is also an important variable: a steadily growing and well-managed money supply can stimulate investment, whereas uncontrolled expansion may trigger inflation and undermine macroeconomic stability. Despite these theoretical postulations, empirical evidence remains mixed. Some find that tight monetary policies reduce FDI due to rising financing costs, while others argue that policy predictability, regardless of being tight or loose, encourages investment by reducing uncertainty. [4] noted that the unstable transmission of monetary policy creates uncertainty for investors, leading to inconsistent empirical outcomes across countries.

These changes underscore the potential capability of institutional quality variables such as governance standards, regulatory efficiency, and rule of law to moderate the effect of monetary policy on FDI inflows. When institutions are strong, policy implementation becomes more effective, investment risk drops, and capital inflows are enhanced. Conversely, weak institutional frameworks could

undermine monetary policy efficacy and discourage foreign investors. Empirical evidence indicates that institutional quality influences investors response to policy changes. Where institutions function properly, investors trust the system to tackle inflation and policy adjustments, but where institutions are weak, even favorable monetary policies may fail to attract the much-needed FDI.

In the case of Nigeria, despite numerous monetary reforms, FDI inflows remain low and unstable. The persistent underperformance can be attributed to institutional challenges such as corruption, poor governance structures, and weak regulatory oversight, all of which weaken the efficacy of policy measures. On the global scale, the post-COVID environment, rising geopolitical tensions, and climate-related risks have further exacerbated investors' reaction to both macroeconomic signals and institutional credibility.

Therefore, understanding how monetary policy interacts with institutional quality has become essential for explaining variations in FDI inflows. Existing research often isolates these variables, neglecting their combined influence. This study addresses that gap by examining how liquidity ratio, MPR, and money supply impact FDI when moderated by institutional quality. The findings aim to guide policymakers, central banks, and investors in creating strategies that effectively attract and sustain foreign investment.

1.1 Objectives of the Study

- i. To examine the effect of monetary policy on foreign direct investment inflows in Nigeria
- ii. Determine the moderating role of institutional quality on the effect of monetary policy on foreign direct investment inflows in Nigeria..

1.2 Research Questions

- i. In what ways do key monetary variables influence the flow of FDI into Nigeria?
- ii. To what extent does institutional quality moderate the relationship between monetary policy variables and foreign direct investment inflows in Nigeria?

2 Literature Review

2.1 Theoretical Framework

The Interest Rate Parity (IRP) Theory by [5] links interest rate differentials between countries to expected exchange rate movements. It suggests that, in the absence of arbitrage, capital flows toward higher interest rate economies. This theory helps explain investor behavior in response to global monetary policy shifts.

Institutional Theory, introduced by [6], highlights the influence of formal rules and informal norms on economic outcomes. Strong institutions enhance the effectiveness of policy implementation, build investor confidence, and reduce uncertainty, key factors in attracting FDI.

According to Keynes' monetary policy theory of investment [7], investment outcomes are strongly influenced by prevailing interest rates and overall liquidity in the economy. Reduced interest rates stimulate borrowing and promote capital formation, whereas elevated interest rates tend to dampen investment. The theory also posits that expectations about future economic conditions and levels of uncertainty significantly shape how investors respond. Consequently, monetary policy becomes an important consideration for guiding investment decisions and stabilizing economic performance.

The Eclectic (OLI) Theory by [8] explains FDI through Ownership, Location, and Internalization advantages. Although developing economies like Nigeria may possess robust location advantages, a weak institutional system dampens foreign investment. Consequently, strengthening institutional frameworks and promoting macroeconomic stability are vital steps for harnessing the full FDI potential envisioned by this model.

2.2 Empirical Literature

[9] explored the link between macroeconomic variables and FDI in Nigeria using VAR analysis (1986–2016). They found that interest rate, inflation, and real GDP had significant positive effects on FDI, despite low inflows over the years.

[10] examined the effect of post-2008 expansionary monetary policies on FDI in Brazil, China, Turkey, and Poland (2008–2021) using ARDL. They found that low global interest rates boosted FDI, but warned that post-pandemic

tightening could reverse gains, urging stronger FDI strategies in developing economies.

[11] analyzed the impact of monetary policy on Nigeria's foreign trade (1981–2017) using ECM. The study found a long-term relationship, with money supply and exchange rate positively influencing net imports, while interest rate had an insignificant negative effect.

[12] studied exchange rate effects on FDI in Nigeria (1981–2018) using ECM and Granger causality tests. Both real and nominal exchange rates were positively linked to FDI, affirming their influence.

[13] investigated how interest rate, inflation, and exchange rate affected FDI in Iraq (2004–2018). ARDL results showed that interest and inflation positively impacted FDI, while the exchange rate had a negative effect. However, no causal link was found between policy variables and FDI.

[14] assessed monetary policy's effect on FDI in Southeast Asia (1997–2020). Using OLS, FEM, and REM, the study showed that contractionary policies promoted FDI, while expansionary ones reduced inflows. Trade liberalization and skilled labor also enhanced FDI, but urbanization and tourism did not.

[15] analyzed the asymmetric effect of monetary policy on FDI in Nigeria (1981–2022) using ARDL and NARDL. Real exchange rate had a negative impact, while monetary contraction (via MPR) influenced FDI in both the short and long term. A stable exchange rate was more effective than currency appreciation.

[16] found that monetary policy and financial development positively affected FDI in Nigeria in the long run but had negative effects in the short run, suggesting both factors are key for sustained FDI growth

[17] examined the impact of institutional quality and investor motivations on foreign direct investment (FDI) inflows into African economies. Using panel data from 1997–2022 and applying the System Generalized Method of Moments (SGMM), the findings show a negative interaction between governance and investor motivations. Poor governance and adverse investor sentiment reduce FDI inflows by about 7.5 points, supporting Dunning's Eclectic Paradigm and highlighting the need for regulatory and market reforms.

3 Data and Methodology

3.1 Model Specification and Definition of Variables

Long-Run Model Specification (Cointegration Equation):

The first step in ECM modeling is to estimate the long-run relationship using the levels of the variables:

$$FDI_t = \beta_0 + \beta_1 LIQ_t + \beta_2 MPR_t + \beta_3 MS_t + \beta_4 INF_t + \varepsilon_t \quad (1)$$

where:

FDI_t : Foreign Direct Investment at time t (dependent variable)

LIQ_t , MPR_t , MS_t , INF_t : Explanatory variables at time t

β_0 : Constant term

β_1 , β_2 , β_3 , β_4 : Long-run coefficients

ε_t : Error term

3.2 Error Correction Model (Short-Run Dynamics):

After confirming cointegration, as indicated by the stationarity of the residual term μ_t , the ECM is developed to model the short-run fluctuations and the mechanism through which the system navigates backward toward the long-run equilibrium.

$$\Delta FDI_t = \alpha_0 + \alpha_1 \Delta LIQ_t + \alpha_2 \Delta MPR_t + \alpha_3 \Delta MS_t + \alpha_4 \Delta INF_t + \lambda EC_{t-1} + \mu_t \quad (2)$$

where:

Δ denotes the first difference (e.g., $\Delta FDI_t = FDI_t - FDI_{t-1}$)

$EC_{t-1} = \varepsilon_{t-1}$: The lagged residual from the long-run equation (error correction term)

λ : Speed of adjustment coefficient (expected to be negative and significant)

μ_t : White noise error term

Table 1 (Appendix) presents the variables used for the study, description, measurement and sources of data. The variables include foreign direct investment, liquidity ratio, monetary policy rate, money supply, interaction of money supply and institutional quality, and interaction of monetary policy rate and institutional quality.

4 Results and Analysis

Table 2 (Appendix) presents the unit root test results using the Augmented Dickey–Fuller and Phillips–Perron statistics, [20]. In time-series econometrics, stationarity is a fundamental property that must be tested before proceeding to regression analysis, especially in models involving macroeconomic variables over time.

Stationary time series usually maintain a constant mean, variance, and autocovariance, while non-stationary series exhibit changing statistical properties, potentially producing spurious regression results. To determine the stationarity properties of the series, we employed unit root tests such as the ADF and PP tests. Depending on the properties, variables may be stationary in levels $I(0)$, or at first differencing $I(1)$.

FDI is typically $I(1)$, influenced by policy shifts and external shocks. Liquidity ratio (LIQ), derived from stable banking ratios, is often stationary at a level. The monetary policy rate (MPR) may be $I(0)$ if stable, but in volatile settings, it may be $I(1)$. Money supply (MS), which trends upward due to inflation and growth, is generally non-stationary and becomes $I(1)$ after differencing. Inflation may vary stably in stable economies, but often $I(1)$ in developing ones.

Interaction terms like $IQMS$ and $IQMPR$ tend to be non-stationary due to the behavior of MS and MPR , and often require differencing. Overall, most macro variables, including FDI , MS , INF , $IQMS$, and $IQMPR$, are $I(1)$, while LIQ and sometimes MPR may be $I(0)$. This combination calls for cointegration testing before estimating long-run relationships in regression models

Table 3 (Appendix) presents the Cointegration Results of Monetary Policy Variables and Foreign Direct Investment. The Johansen Cointegration Test assesses whether a long-term relationship exists among FDI , monetary policy variables (LIQ , MPR , MS , INF), and their interactions with institutional quality ($IQMS$, $IQMPR$), [21].

Results as presented in Table 3 (Appendix) showed that both Trace and Max-Eigen statistics confirm two cointegrating equations at the 5% level (p -values: 0.0000, 0.0007; 0.0045, 0.0022), indicating a stable long-run equilibrium among the variables.

This suggests that changes in monetary policy and institutional quality are closely tied to FDI over time, despite short-term fluctuations. The interaction terms show that institutional quality moderates the

effect of money supply and interest rate on FDI. For example, strong institutions can enhance the positive effect of money supply and reduce the adverse impact of high interest rates, highlighting the critical role of governance in FDI outcomes.

Table 4 (Appendix) presents the result of error correction mechanism (ECM) of Monetary Policy Variables and Foreign Direct Investment. The ARDL Error Correction Model as shown in table evaluates short- and long-run relationships between FDI and variables including LIQ, MPR, MS, INF, and interaction terms (IQMS, IQMPR) from 1998 to 2024 (26 observations), [22]

In the short run, none of the variables or interaction terms were statistically significant at conventional levels, suggesting a limited immediate impact of macroeconomic factors or institutional quality on FDI inflows. This may indicate delayed investor responses or structural rigidities.

However, the error correction term (CointEq (-1)) is -0.7370 and significant ($p = 0.0006$), confirming a strong long-run equilibrium. About 73.7% of FDI deviations from long-run trends are corrected in the next period. While short-run effects are weak, the significant adjustment rate points to a robust long-term relationship between FDI and macroeconomic conditions, with institutional quality playing a more prominent role over time.

Table 5 (Appendix) presents the result of the ARDL Error Correction Model of the short- and long-run relationship between FDI and macroeconomic variables such as LIQ, MPR, MS, INF and their interactions with institutional quality (IQMS, IQMPR), using annual data from 1998 to 2024 (26 observations), [23]. In the short run, none of these variables or their interactions significantly affect FDI, suggesting limited immediate influence of policy or institutional quality on investment flows.

However, the error correction term (CointEq (-1)) is negative and statistically significant, confirming a valid long-run equilibrium. Annually, around 71.9% of FDI disequilibrium is correlated, indicating a pronounced movement toward long-run equilibrium. This underscores that while short-run macroeconomic variations may exert minimal influence on FDI, sustained policy consistency and strong institutional frameworks are crucial for drawing FDI.

4.1 Discussion of Results

The study finds that while short-run impacts of MPR, MS, LIQ, and INF on FDI in Nigeria are insignificant, a strong long-run relationship exists. This supports [8], emphasizing macroeconomic and institutional stability as key long-term drivers of FDI. The significant negative error correction term confirms that FDI adjusts toward the long-run equilibrium rather than short-term changes. Aligned with findings by [24] and [25], the results highlight that investors prioritize long-term conditions, with institutional quality showing little short-run influence.

5.1 Conclusion

The ECM findings indicate that both models share comparable adjustment dynamics, each showing a sizeable, negative, and statistically significant error-correction term. However, the inclusion of institutional quality in one model slightly slows the adjustment process, implying that while long-term equilibrium is strong in both cases, institutional factors have a subtle moderating effect on the speed at which FDI converges to stability.

5.2 Recommendations

To attract sustained FDI inflows, policymakers need to focus on maintaining long-term macroeconomic stability and enhancing institutional quality. Although short-term economic variations may not immediately influence investor behavior, consistent and positive long-term trends are crucial for fostering investor confidence and drawing capital into the economy.

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APPENDIX

Table 1. Variable description, measurement, and source of data

Variable	Description	Measurement	Source of data
Foreign direct investment inflows(fdi)	Foreign Direct Investment (FDI) inflow refers to the movement of capital from a foreign entity into a domestic economy to establish or expand business operations.	Ratio of foreign direct investment as a ratio of gross domestic product expressed in percentage terms	[18]
Liquidity ratio (liq)	Liquidity ratio requirement is a regulatory mandate that compels commercial banks to maintain a minimum percentage of their liabilities in liquid assets to ensure financial stability and meet short-term obligations.	Ratio of CBN prescribed liquidity requirement as a ratio of gross domestic product expressed in percentage terms	[18]
Monetary policy rate(mpr)	The monetary policy rate requirement is the benchmark interest rate set by the central bank to influence borrowing, lending, inflation, and overall economic activity within the country.	Ratio of CBN prescribed monetary policy rate as a ratio of gross domestic product expressed in percentage terms	[18]
Money supply (ms)	Broad money supply refers to the total amount of money in an economy, including physical currency, demand deposits, and easily accessible financial assets like savings and time deposits.	Ratio of the total amount of money in circulation as a ratio of gross domestic product expressed in percentage terms	[18]
Money supply and Institutional quality (iqms)	Institutional Quality and Money Supply (IQMS) refers to the interplay between the strength of a country's institutions such as governance, regulatory frameworks, and legal systems and the effectiveness and stability of its money supply management.	Multiplication of institutional quality data and the ratio of total amount of money in circulation as a ratio of gross domestic product expressed in percentage term	[18] and [19]
Monetary policy rate and Institutional quality(iqmpr)	Institutional Quality and Monetary Policy Rate (IQMS) refers to how the effectiveness, transparency, and credibility of a country's institutions influence the formulation, implementation, and impact of the central bank's monetary policy rate on the economy	Multiplication of institutional quality data and the ratio of CBN prescribed monetary policy rate as a ratio of gross domestic product expressed in percentage term	[18] and [19]

Source: Author's compilation, 2025

Table 2. Unit root test results

ADF statistics				PP statistics		
Variable	@level	@first difference	Remark	@level	@first difference	Remark
Fdi	-2.1321	-6.8696	I(1)	-2.0558	-7.1152	I(1)
Liq	-3.9788	X	I(0)	-3.8871	X	I(0)
Mpr	-2.3525	-7.1282	I(1)	-2.2733	-7.3942	I(1)
Ms	0.1201	-5.3142	I(1)	0.4574	-5.3138	I(1)
Inf	-0.9826	-5.4666	I(1)	-1.0084	-5.8000	I(1)
Iqms	0.1616	-3.6220	I(1)	0.1793	-3.6032	I(1)
Iqmpr	-3.0250	-3.0250	I(1)	-2.8177	-16.1720	I(1)

Source: Author's computation from e-view

Table 3. Cointegration Results

Date: 07/06/25 Time: 10:15
Sample (adjusted): 2000 2024
Included observations: 25 after adjustments
Trend assumption: Linear deterministic trend
Series: FDI LIQ MPR MS INF
Lags interval (in first differences): 1 to 1

Unrestricted Cointegration Rank Test (Trace)

Hypothesized No. of CE(s)	Eigenvalue	Trace Statistic	0.05 Critical Value	Prob.**
None *	0.812982	106.4310	69.81889	0.0000
At most 1 *	0.773947	64.51725	47.85613	0.0007
At most 2	0.542766	27.34266	29.79707	0.0935
At most 3	0.218010	7.778666	15.49471	0.4894
At most 4	0.063151	1.630820	3.841465	0.2016

Trace test indicates 2 cointegrating eqn(s) at the 0.05 level

* denotes rejection of the hypothesis at the 0.05 level

**MacKinnon-Haug-Michelis (1999) p-values

Unrestricted Cointegration Rank Test (Maximum Eigenvalue)

Hypothesized No. of CE(s)	Eigenvalue	Max-Eigen Statistic	0.05 Critical Value	Prob.**
None *	0.812982	41.91376	33.87687	0.0045
At most 1 *	0.773947	37.17459	27.58434	0.0022
At most 2	0.542766	19.56399	21.13162	0.0816
At most 3	0.218010	6.147846	14.26460	0.5943
At most 4	0.063151	1.630820	3.841465	0.2016

Max-eigenvalue test indicates 2 cointegrating eqn(s) at the 0.05 level

* denotes rejection of the hypothesis at the 0.05 level

**MacKinnon-Haug-Michelis (1999) p-values

Source: Authors Computation from E-view, 2025

Table 4. ECM Results

ARDL Error Correction Regression
Dependent Variable: D(FDI)
Selected Model: ARDL(1, 1, 1, 1, 1)
Case 2: Restricted Constant and No Trend
Date: 07/07/25 Time: 08:55
Sample: 1998 2024
Included observations: 26

ECM Regression Case 2: Restricted Constant and No Trend				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
D(LIQ)	-0.003305	0.006408	-0.515770	0.6131
D(MPR)	-0.040701	0.034971	-1.163846	0.2615
D(MS)	0.004406	0.021442	0.205491	0.8398
D(INF)	-0.010704	0.020733	-0.516302	0.6127
CointEq(-1)*	-0.737000	0.173655	-4.244055	0.0006
R-squared	0.547028	Mean dependent var		0.029231
Adjusted R-squared	0.460748	S.D. dependent var		0.603536
S.E. of regression	0.443199	Akaike info criterion		1.381447
Sum squared resid	4.124938	Schwarz criterion		1.623388
Log likelihood	-12.95881	Hannan-Quinn criter.		1.451117
Durbin-Watson stat	2.131362			

Source: Authors' Computation from E-view, 2025

Table 5. ECM Results of Monetary Policy Variables, Institutional Quality, and Foreign Direct Investment

ARDL Error Correction Regression
Dependent Variable: D(FDI)
Selected Model: ARDL(1, 1, 1, 1, 1, 1, 1)
Case 2: Restricted Constant and No Trend
Date: 07/07/25 Time: 08:59
Sample: 1998 2024
Included observations: 26

ECM Regression Case 2: Restricted Constant and No Trend				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
D(LIQ)	-0.005841	0.008460	-0.690390	0.5031
D(MPR)	-0.036253	0.040052	-0.905146	0.3832
D(MS)	0.005968	0.029711	0.200858	0.8442
D(INF)	-0.020362	0.022337	-0.911616	0.3799
D(IQMS)	0.000168	0.000613	0.273715	0.7890
D(IQMPR)	6.10E-05	0.000366	0.166448	0.8706
CointEq(-1)*	-0.719345	0.186613	-3.854745	0.0023
R-squared	0.555376	Mean dependent var		0.029231
Adjusted R-squared	0.414968	S.D. dependent var		0.603536
S.E. of regression	0.461629	Akaike info criterion		1.516692
Sum squared resid	4.048917	Schwarz criterion		1.855410
Log likelihood	-12.71699	Hannan-Quinn criter.		1.614230
Durbin-Watson stat	2.224776			

Source: Authors' Computation from E-view, 2025