Chapter 9
Exploring the Role of Local Financial Markets in the Portfolio Investment–Growth Nexus:
Insights From Selected Countries in Sub-Saharan Africa

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ABSTRACT

In recent times, foreign portfolio investment inflows have been considered pivotal to sub-Saharan Africa's growth (SSA) as they help enhance liquidity and make a substantial fund available for investment. However, some scholars have stressed that the sustainable inflows of portfolio investments and their impact on growth depend on the extent to which the recipient country can develop its local financial markets. As a result, this chapter aims to determine the moderating role of local financial markets in facilitating the effects of portfolio investments on economic growth in 28 SSA between the period 1995-2018. The study employed the system generalized method of moments (SGMM) and found that portfolio investments positively and significantly impact economic growth. However, the study observes that the interaction between portfolio investments and financial market development is negative and significant, presupposing that the relationship between portfolio investment and economic growth is not contingent on local financial markets.

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INTRODUCTION

Globalization has no doubt resulted in structural change in the global economy; thus, bringing about changes in the political, economic, cultural, and spiritual development strategies; and create a continuous interdependence of the world (Rode & de Viteri, 2018; Van Neuss, 2018). The growing interdependence due to globalization has, however, caused countries to pay more attention to developing competitive advantages in cross-border trade, investments, and income flow in relation to GDP (Glushkova, Lomakina & Sakulyeva, 2019).

Contemporary studies on globalization focus more on the economic aspect of globalization (such as the foreign direct investment and foreign portfolio investment) and analyze the indicators that most closely reflect the development of countries in the globalizing world economy. It is assumed that foreign direct investment has a significant impact on the development of an economy because is often considered as the main source of capital inflows (Sarkodie & Strezov, 2019). However, this is no longer the case as foreign portfolio investments are increasingly replacing foreign direct investments as a source of capital inflow in many developing countries (Shabbir & Muhammad, 2019). The surge in foreign portfolio investments in the developing nations, according to Shabbir and Muhammad (2019), is due to the liberalization of these nations, high returns on investment, trade openness, and improved communication and technology globally. Foreign portfolio investments are cross-border investments, which involve the purchase of securities such as bonds, notes, money market instruments, and financial derivatives in a bid to make a profit (Baghebo & Apere, 2014).

Foreign portfolio investments are beneficial to developing and emerging countries, as they help to fill the saving-investment gaps, finance innovation, and increase capital productivity by insuring against liquidity risk (Bayar & Sasmaz, 2019; Debbiche, 2020). Despite the benefits of portfolio investment inflows to a host economy, they can, however, have an adverse effect on the economy due to its volatile nature. For instance, it is argued that portfolio investment volatility majorly accounted for the financial market distress, which resulted in the financial crisis of 1997-1998 (Duasa & Kassim, 2009). The volatile nature of portfolio investment inflows makes the execution of macroeconomic stabilization policies difficult.

Existing empirical literature on the growth effect of portfolio investment inflows remains inconclusive. While some empirical studies reported a positive impact of portfolio investments on economic growth (e.g., Ezeanyeji & Maureen, 2019; Albulescu, 2015; Ehigiamusoe & Lean, 2019), others found a negative or no significant relationship (e.g., Anetor, 2020a; Sawalha, Elian & Suliman, 2016; Kuzucu, 2018). Despite the debate on the growth effect of portfolio investments, some scholars are of the notion that there must be a developed financial market before portfolio investment inflows could exert a significant impact on growth (e.g., Adeniyi, Ajide & Salisu, 2015; Mlachila et al., 2016). Unfortunately, existing studies on globalization and cross-border investments pay less attention to investigate whether the impact of foreign portfolio investments on economic growth is contingent on the development of financial institutions of the recipient country.

To this end, this study aims to proffer answers to the following cogent research questions: what is the economic growth effect of portfolio investments in sub-Saharan Africa (SSA)? To what extent does the interaction between portfolio investments and financial market development influence economic growth in SSA? In other words, is the relationship between portfolio investments and economic growth contingent on financial market development in SSA? This study center on SSA because the frontier markets economies of the region have received an increasing volume of portfolio capital inflows in the last decade (Anetor, 2020b; Gueye et al., 2014; Korkpoe & Howard, 2019).

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