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Financial Development and FDI in Nigeria: Investigating the Moderating Effect of Institutional Quality

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Abstract: This study investigates the impact of financial development, represented by Total Stock Market Capitalization (TSC), on Foreign Direct Investment (FDI) inflows in Nigeria, while examining the moderating role of institutional quality, indicated by Regulatory Quality (RQ), in this relationship. Using data from the World Bank's World Development Indicators (1996-2023), the Fully Modified Ordinary Least Squares (FMOLS) estimation technique was employed, controlling for trade openness and the real effective exchange rate. The study's findings revealed no statistically significant direct effect of TSC or RQ on FDI. Moreover, the moderating effect of regulatory quality on the relationship between financial development and FDI was also not statistically significant. However, the findings emphasize that improved control of corruption and enhanced political stability are significant positive determinants of FDI inflows in Nigeria. Additionally, trade openness significantly promotes FDI, while exchange rate appreciation notably deters it. The study concludes that attracting FDI to Nigeria largely depends on strengthening enforcement and regulation within the investment landscape, maintaining exchange rate stability, promoting trade openness, and implementing adequate institutional reforms.

Keywords: Financial Development, Foreign Direct Investment, Nigeria, Institutional Quality, Financial Institutions, Capital Markets.

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1. Introduction

Nigeria is endowed with national wealth in terms of natural and human resources, which positions the country well to enter the global market. However, in recent years, Nigeria has become significantly less attractive to foreign direct investment (FDI). Figure 1.1 (see Appendix) illustrates that the contribution of FDI to Nigeria's GDP has declined over the past decade. In analyzing the causes of this FDI decline, Islam, FCMA, and Hassan (2021) emphasized that a country's financial development is crucial for attracting FDI, as it facilitates a smooth and cost-effective flow of international transactions and promotes economic diversification. Yet, the ability of financial development to attract investment does not exist in isolation; it heavily depends on the prevailing institutional framework. As highlighted by Bouchoucha and Benammou (2020), strong institutions enhance FDI attractiveness, while weak ones – often plagued by corruption – increase business costs and deter investors. Moreover, weak institutions can also impede the effectiveness of financial development and further complicate efforts to attract FDI. This complex interplay raises a pressing question: how can Nigeria, a nation rich in resources, reconcile its potential with the ongoing decline in FDI? To address this question, this study examines the moderating role of institutional quality in the complex relationship between financial development and FDI inflows in Nigeria.

There is no denying that the world has become interconnected through a web of commerce and investment. Developed and developing countries engage in cross-border transactions that facilitate the free flow of information, technology, energy resources, capital, and assets. In this global landscape, foreign direct investment (FDI) serves as a catalyst for the transfer of capital across borders, particularly from developed to developing countries (World Bank, 2024). According to the Organization for Economic Cooperation and Development (OECD) (2024), FDI involves a long-term commitment to the management of a foreign enterprise, directly contributing to the economy's sustained growth. In contrast, other forms of capital flows such as equity trading, and debt financing, involve seeking financial returns through less direct influence on the development of these enterprises. Loungani and Razin (2001) noted that as opposed to domestic capital flows, which experienced large reversals, FDI demonstrated notable resilience during the global financial crises of the late 1990s. The study further highlighted that FDI is likely to become even more attractive to developing countries, a pattern that has been noticeable for a considerable period. As reported by the United Nations Conference on Trade and Development (UNCTAD), there was a notable expansion in FDI between 1990 and 2019. Global FDI increased

from $204.8 billion in 1990 to $1539.9 billion in 2019 (Lee *et al.,* 2024). The surge in developing countries was even more remarkable, experiencing a 20-fold increase from $34.65 billion to $684.7 billion (Lee *et al*., 2024).

FDI offers distinct advantages, including unique technology transfer, enhanced competition, human capital development, and increased tax revenues for host countries. However, a nation's ability to fully capitalize on these benefits, and thus its appeal to these investment flows, critically depends on the efficiency of its financial system (Desbordes and Wei, 2017; Mahmood *et al*., 2018; Islam *et al.,* 2020). Hence, a well-developed financial sector is a prerequisite for attracting and leveraging FDI for sustainable economic growth. Financial development refers to the evolution and improvement of a country's financial institutions, markets, and instruments that enhance the flow of capital (Gizaw *et al.,* 2024). A sophisticated financial sector characterized by transparent capital markets allows host countries to effectively absorb and integrate foreign direct investment into the development of their economies.

Economists have noted that the effectiveness of an economy's financial system in utilizing FDI for sustainable growth is rooted in its underlying rules, norms and legal framework (Islam *et al., 2020*; Fernández *et al.,* 2019; Trevino *et al*., 2008). This is because the rules, norms, legal rights, and governmental system of a country – collectively referred to as Institutional Quality – directly influence the formulation and execution of financial regulations needed for the smooth flow of the financial sector. Therefore, while the effectiveness of a nation's financial system is a critical factor in attracting potential investors, the reality is that the foundation supporting this financial system—the strength and quality of its institutions—may serve as a significant barrier.

To stimulate economic expansion, Nigeria has historically promoted the inflow of foreign direct investment. For instance, The Structural Adjustment Programme (SAP) in the 1980s aimed to liberalize the economy, successfully driving FDI from $200 million in 1970 to $2 billion by 1994 (World Bank, 2025). However, political instability following the 1993 elections led to a sharp decline in FDI inflows during the late 1990s (Rufai, 2018). The return to democratic governance in 1999, coupled with subsequent economic reforms, revitalized FDI, culminating in $8 billion by 2008, according to the National Bureau of Statistics (NBS) (2011). In 2016, the NBS reported that FDI inflows in Nigeria fell to $1 billion and have been declining ever since. Figure 1.1 (see appendix) indicates the trend of FDI in Nigeria over the years. FDI has been on a steady downward trend after slightly increasing in 2011. This can be attributed to major multinational divestments over the years. The mass exodus of various multinational firms, as a result of economic downturns, unfavourable business

environment and exchange rate volatility, left a detrimental effect on the growth of Nigeria's financial sector.

Meanwhile, Figure 1.2 illustrates Nigeria's total stock market capitalization (TSC), a key indicator of financial development in Nigeria. It measures the total value of securities listed in the capital market as a percentage of the GDP. The graph reveals significant volatility, with a dramatic spike around 2007. The Securities and Exchange Commission (SEC) (2012) attributed this surge to "inorganic growth" driven by the recapitalization of Banks, which catapulted equities capitalization, thus leading to a deviation from the market's natural growth pattern. Crucially, risk management and corporate governance did not keep pace with this fast growth. The resulting capital was largely used for speculative lending in the oil and gas sector and unregulated margin finance, creating an asset bubble. Banks artificially inflated their stock values before raising capital. When the global financial crisis hit, international investors withdrew, triggering a market collapse and local investor panic, which further depressed prices. This is why, after the 2007 peak, TSC significantly declined, with the market losing over 70% of its value between 2007 and 2009 and has been fluctuating ever since. The inability to effectively enforce existing regulations to ensure the stability of the market and promote sustainable finance highlights a critical deficiency in Nigeria's institutional framework.

Against this backdrop, the empirical analysis presented in Section 4 of this study provides key insights into Nigeria's FDI and financial development landscape. From the results of the Fully Modified Ordinary Least Squares estimation technique (FMOLS), the core hypothesis exploring the moderating role of institutional quality (specifically regulatory quality, RQ) on the relationship between financial development (represented by total stock market capitalization, TSC) and FDI was not statistically significant in this study; as the interaction term (RQ*TSC) was found to be insignificant. Similarly, neither TSC nor RQ demonstrated a statistically significant direct impact on FDI inflows within this model's framework. This lack of significance, further explored in Section 4, potentially reflects the institutional bottlenecks in Nigeria's financial sector, such as enforcement challenges and inconsistent regulatory mechanisms. Notably, different dimensions of institutional quality proved highly significant: control of corruption and political stability were both found to be statistically significant positive drivers of FDI. Furthermore, consistent with economic theory, trade openness significantly boosts FDI inflows, while exchange rate appreciation significantly hinders them.

The remainder of this study is organized as follows: Section 2 – The literature review, which explores the underlying conceptual, theoretical and empirical literature,

as well as the literature gap and value addition; Section 3, outlining the methodology, data description and estimation technique; The fourth section is the Interpretation and Evaluation of Empirical Results, while the conclusion in Section 5 summarizes the study's findings, the policy recommendations, limitations to the study and areas of further research.

2. Literature Review

2.1. Conceptual Literature

The principles underpinning this study include FDI, financial development, and institutional quality. FDI, based on existing literature, simply involves long-term investment of different forms in expectation of returns or interest. North (1994) perceived institutional quality as the incentive structure of a country that lays the foundation for economic performance geared towards improving the overall well-being of its citizens. Whereas financial development is viewed as the process of increasing the economic efficiency and effectiveness of a country's financial system (World Bank, 2016).

2.2. Theoretical Literature

Tausch (2011), in his view of the Dependency Theory, implied that developing countries rely heavily on investments, loans, and foreign capital to finance their development, which brings about economic stagnation and underdevelopment contrary to expectations. Moreover, according to Schularick, and Steger (2008) "*the quality of institutions, such as the protection of creditors and the enforcement of property rights across international borders, is a necessary condition for net investment flows and the buildup of sizeable net foreign asset positions.*" This reinforces the postulates of institutional economics, which highlight the specific role of institutions in shaping economic behaviours and outcomes. In light of these postulates, there is a need to review recent studies and their findings to determine the relationship between financial development and foreign direct investment, as well as the role of institutional quality in this regard, be they detrimental or beneficial.

2.3. Empirical Literature

Nwosa and Emma-Ebere (2017) examined the relationship between FDI and financial development in Nigeria (1980-2015) using VECM, finding a long-run negative and a short-run positive relationship. Similarly, Azolibe (2021) empirically evaluated the relationship between public capital expenditure, economic growth, and FDI in Nigeria

(1986-2018), employing ECM, variance decomposition, and Granger causality tests. The study found a positive and significant short-run effect of capital expenditure on FDI, while economic growth had a negative and insignificant relationship with FDI, suggesting Nigeria's resource abundance attracts FDI despite lower growth rates. In another study, Alshubiri (2021) analyzed the relationship between stock market capitalization and financial growth in Western Europe (1989-2018) and found that stock market capitalization and stock trading positively impact financial growth, while GDP per capita growth and inflation negatively impact growth.

Ndugbu, Po, and Felix (2023), employing the Autoregressive Distributed Lag (ARDL) model in his study on the nexus between institutional quality and FDI in Nigeria, established that institutional quality acts as a positive driver of FDI inflows. In addition, Olanrewaju, Tella, and Adesoye (2019), using the Granger non-causality test, found that institutional quality positively affects inclusive growth in Nigeria. Similarly, Islam *et al*. (2020), utilizing panel regression in Belt and Road Initiative countries, demonstrated that institutional quality positively moderates the impact of financial development on FDI inflows.

In addition, research has explored the specific determinants and moderating factors influencing FDI. Lee et al. (2024), investigating developed and developing economies from 1996 to 2019 using Principal Component Analysis (PCA), found that developing economies are largely dependent on economic indicators to attract FDI, while developed economies prioritize social indicators. Notably, they found a weak and statistically insignificant linkage between institutional indicators and FDI inflows in both groups. Chengying et al. (2023), analyzing 113 developing countries from 2000 to 2019 with Hausman fixed and random effects models, concluded that national absorptive capacity moderates the relationship between FDI inflows and institutional quality, thereby creating an FDI-friendly policy environment. Chen and Jiang (2023), examining 42 G20 countries from 2005 to 2020 using panel data, revealed a positive association between institutional quality and FDI inflows. They also found that financial development and natural resource abundance strengthen the promoting role of institutional quality in attracting FDI, while tax levels weaken it.

Conversely, Khan et al. (2024), employing a two-step system GMM model for global, developed, developing, and Asian panels from 2002 to 2019, presented varied results. They found that globally, only regulatory quality significantly increases FDI inflows, while other institutional indicators are negatively associated. In developed countries, control of corruption and regulatory quality negatively affect FDI inflows, and in developing countries, control of corruption, political stability, and voice and

accountability significantly attract FDI inflows, while government effectiveness, regulatory quality, political system, and institutional quality index significantly reduce FDI inflows. In Asian countries, all institutional quality indicators except control of corruption positively impact FDI inflows. Furthermore, Iddrisu et al. (2023), investigating the moderating role of institutions/governance on the foreign bank presence-financial development nexus in 28 African economies from 2000 to 2018 using a two-step system GMM, found that foreign bank presence positively affects financial development and that quality institutions strengthen this relationship.

Furthermore, Adegoriola and Emmanuel (2022) studied the nexus between exchange rate fluctuations and FDI in Nigeria (1986-2020), using unit root, co-integration, and ARDL models, and found a significant negative long-run relationship between exchange rates and FDI, with persistent negative effects from exchange rate shocks. In a different study, Korsah et al. (2025) studied macroeconomic drivers of FDI in 16 West African countries (1989-2018), using fixed and random-effects regression models, revealing that natural resources, market size, trade openness, and exchange rate strength are significant FDI drivers, with French-speaking countries attracting more FDI, and infrastructure, inflation, tax, and political stability being insignificant.

2.4. Literature Gap and Value Addition

While numerous studies have explored the individual and combined effects of financial development (FD) and institutional quality on Foreign Direct Investment (FDI) inflows, a significant gap exists concerning the specific moderating role of institutional quality on the FD-FDI relationship, particularly within the context of Nigeria. This gap is particularly critical given Nigeria's recent decline in FDI inflows, as highlighted in the introductory section of this study. Understanding this moderating effect is essential for formulating effective policies to attract and leverage FDI for Nigeria's sustainable development.

Studies show varied results regarding the impact of institutional quality on FDI. Some find positive relationships (Chen and Jiang, 2023), while others find mixed or even negative impacts (Khan *et al.*, 2024; Lee *et al.*, 2024). This inconsistency highlights the need for a more nuanced understanding of the institutional factors at play. Also, while studies examine the direct relationship between institutional quality and FDI in Nigeria (Ndugbu *et al.*, 2023; Olanrewaju *et al.,* 2019), there is less emphasis on the moderating effect of institutional quality on the relationship between financial development (specifically Total Stock Market Capitalization) and FDI in Nigeria. As earlier illustrated in Figure 1, there have been significant bottlenecks in Nigeria's

financial sector, and weak institutions were a contributing factor. This presents a unique case of how weak institutions can destabilize financial markets. Existing literature does not fully explore this major downturn. Hence, there is a need for an empirical analysis of the role of institutional quality in this context.

To address this research gap, this study provides insight into the moderating role of institutional quality (IQ) on the relationship between financial development (FD) and Foreign Direct Investment (FDI) inflows in Nigeria. The study quantifies and describes the historical patterns and fluctuations of Foreign Direct Investment, financial development (represented as the Total Stock Market Capitalization), and measures of Institutional Quality. The Fully Modified Ordinary Least Squares (FMOLS) estimation technique will be employed for the empirical analysis, which little to no study has attempted in this context. The use of the FMOLS estimation technique is particularly relevant due to its ability to address potential endogeneity issues and produce consistent estimates in long-run relationships. This is crucial for accurately analyzing the complex and dynamic interactions between FDI, financial development (TSMC), and institutional quality, where variables are often interconnected and influenced by unobserved factors over extended periods.

3. Methodology

3.1. Theoretical Framework

This study is grounded on the framework of Institutional Economics, which provides a broad foundation for understanding the interplay between institutions (rules, norms, and enforcement mechanisms) and the economic structure within a system. Institutional economics explores how these institutions evolve and how they could be improved (Raudla, 2014). Institutions establish the "rules of the game" for economic actors, influencing their investment decisions and interactions. A well-defined and enforced set of rules is essential for creating a stable and predictable investment environment, which is crucial for attracting FDI (Shepsle, 2014). This study thus hinges on this framework to analyze how the quality of Nigeria's institutions influences the effectiveness of its financial markets in attracting and absorbing FDI.

3.2. Model Specification

$$FDI_t = \alpha_0 + \beta_1 COC_t + \beta_2 PSAVT_t + \beta_3 RQ_t + \beta_4 TSC_t + \beta_5 INT_t + \beta_6 REXCH_t + \beta_7 TOP_t + \varepsilon_t$$

Where:

FDI: Foreign Direct Investment

COC: Control of corruption

PSAVT: Political stability and absence of violence and terrorism

RQ: Regularity Quality

TSC: Total Stock Market Capitalization.

INT: The interaction term between TSC and RQ (TSC*RQ)

REXCH: Real Effective Exchange Rate.

TRO: Trade Openness.

α_0: The constant term.

$\beta_1, \beta_2, \beta_3, \beta_4, \beta_5, \beta_6, \beta_7$: The coefficients for each independent variable.

ε_t: The error term.

t: The time series component

3.3. Sources and Description of Data

This study employs time series data ranging from 1996Q1 to 2021Q3 in Nigeria. Data on Foreign direct investment inflows, Total stock market capitalization, Control of corruption, Political stability and absence of violence/terrorism, Regularity Quality, and Real Effective exchange rate were sourced from the World Bank's World Development Indicators while Trade Openness was sourced from the World Trade Organization database.

The dependent variable, FDI, represents foreign direct investment inflows into Nigeria. FDI refers to investments made by foreign entities to acquire a lasting interest in enterprises, measured as a percentage of the GDP. Total Stock Market Capitalization (TSC) refers to the total value of all publicly traded shares in the Nigerian Stock Exchange market, measured as a percentage of GDP. This serves as a proxy for financial development. A well-functioning stock market facilitates the mobilization of capital from savers to investors. The stock market plays a crucial role in financial intermediation, attracting both domestic and foreign investors. Institutional quality represents the overall quality of Nigeria's institutions, including factors such as control of corruption, political stability and absence of violence/terrorism, and regulatory quality. Trade openness measures the degree to which an economy is open to international trade, often calculated as the sum of exports and imports as a percentage of GDP. Finally, the Real effective exchange rate refers to the nominal effective exchange rate (a measure of the value of a currency against a weighted average of several foreign currencies) divided by a price deflator or index of costs.

3.4. Estimation Technique

To obtain the long-run estimates, this study employs the Fully Modified Ordinary Least Square (FMOLS) model, which was first proposed by Phillips and Hansen (1990). FMOLS helps in estimating the long-run relationship between variables while dealing with the issue of serial correlation and endogeneity by adding the lags and leads in the model. FMOLS is suitable when dealing with non-stationarity and when co-integration exists between the variables employed. The FMOLS model is well known for its robust features since it can be applied when the sample size is small.

4. Interpretation and Evaluation of Estimation Results

4.1. Pre-Estimation Tests

4.1.1. Unit Root Test

This test determines whether a variable's mean and variance have remained stable throughout time. That is, to determine whether or not the variable is stationary. The Augmented Dickey-Fuller test will be applied to find the unit root in this study. The proposed hypothesis will be:

H_0: the variable is not stationary.

H_1: the variable is stationary.

If the augmented dickey-fuller statistics are greater than 5% critical values, we must fail to accept the null hypothesis.

Table 1: Augmented Dickey-Fuller Test for Unit Root

Variables	*ADF test statistic*	*t-Statistic*	*P-value*	*Order of integration*	*Decision*
FDI	-2.209667	-1.944248	0.0268	I(1)	Stationary
COC	-2.864338	-1.943974	0.0045	I(1)	Stationary
PSAVT	-3.597817	-1.944105	0.0004	I(1)	Stationary
RQ	-3.254688	-1.943974	0.0014	I(1)	Stationary
TSC	-3.349903	-1.944105	0.0010	I(1)	Stationary
INT	-3.137770	-1.944105	0.0020	I(1)	Stationary
REXCH	-4.221568	-1.943853	0.0000	I(1)	Stationary
TOP	-2.956521	-1.944105	0.0035	I(1)	Stationary

Source: Author's construct using E-Views' output Note: Test critical values at a 5% level of significance

The results of the ADF's unit root test, shown in Table 1 above, show that all variables became stationary after differencing them once, i.e., I(1).

4.1.2. Cointegration Test

The co-integration test is a vital econometric tool used to assess the existence of long-term relationships between variables in a regression model. It helps to ascertain whether these variables move together in the long run, indicating a stable equilibrium relationship rather than short-term fluctuations. The Johansen co-integration will be deployed to examine if a long-run relationship exists between the variables. The proposed hypothesis is as follows:

H_0 = No Co-integration (There is no stable long-run relationship)

H_1 = Co-integration (There is a stable long-run relationship)

If the Trace and Max-eigenvalue tests indicate a cointegrating equation at the 0.05 level, we must fail to accept the null hypothesis.

Table 2: Johansen Cointegration Test Results (Trace-Statistic)

Hypothesized No. of Co-Integrating Equation	*Eigenvalue*	*Trace Statistic*	*0.05 Critical Value*	*P.Value*
None *	0.865865	487.0227	143.6691	0.0000
At most 1*	0.597364	278.0959	111.7805	0.0000
At most 2*	0.472845	183.4848	83.93712	0.0000
At most 3*	0.391773	116.8976	60.06141	0.0000
At most 4*	0.293461	65.18809	40.17493	0.0000
At most 5*	0.159872	29.06090	24.27596	0.0116

Trace test indicates 6 cointegrating eqn(s) at the 0.05 level

* denotes rejection of the hypothesis at the 0.05 level

Table 3: Johansen Cointegration Test Results (Trace-Statistic)

Hypothesized No. of Co-Integrating Equation	*Eigenvalue*	*Max-Eigen Statistic*	*0.05 Critical Value*	*P.Value*
None *	0.865865	208.9268	48.87720	0.0000
At most 1*	0.597364	94.61112	42.77219	0.0000
At most 2*	0.472845	66.58720	36.63019	0.0000
At most 3*	0.391773	51.70948	30.43961	0.0000
At most 4*	0.293461	36.12718	24.15921	0.0008
At most 5*	0.159872	18.11695	17.79730	0.0447

Max-eigenvalue test indicates 6 cointegrating eqn(s) at the 0.05 level

* denotes rejection of the hypothesis at the 0.05 level

Based on the results in Tables 2 and 3, we can conclude that there is at least one co-integrating equation since there is at least one instance where the Trace and Max-eigenvalue statistic is below the critical value. Therefore, we fail to accept the null

hypothesis at a 0.05 level of significance and conclude that there exists a long-run relationship among the variables.

4.2. Estimation Result

Table 4: FMOLS Regression Result

Variable	*Coefficient*	*Std. Error*	*t-Statistic*	*Prob.*
COC	0.057126	0.024911	2.293182	0.0239
PSAVT	0.084029	0.029998	2.801170	0.0061
RQ	-0.070742	0.079334	-0.891698	0.3747
TSC	-0.144886	0.123086	-1.177109	0.2419
INT	0.009894	0.006543	1.512224	0.1336
REXCH	-0.019453	0.002979	-6.530043	0.0000
TOP	0.036349	0.009723	3.738590	0.0003
C	1.769773	1.325979	1.334692	0.1850
R-squared	0.773317	**Adjusted R-squared**		0.757449
F-statistic	18.95052	**Prob(F-statistic)**		0.00000

POST-ESTIMATION TEST			
Test Type	**Test Statistic**	**P-value**	**Decision Rule**
Normality Test (Jarque-Bera)	1.553777	**0.459835**	Normally Distributed

Source: Researcher's construct from EViews' output

The results in Table 4 indicate a clear link between controlling corruption and attracting foreign direct investment (FDI). Specifically, holding other factors constant, a one-unit increase in the control of corruption is associated with a 0.057126 increase in FDI, and this result is statistically significant with a p-value of 0.0239. This underscores the importance of transparent governance and strong institutions in creating a favorable investment climate. From an economic perspective, this implies that nations prioritizing anti-corruption measures are likely to experience increased capital inflows, fostering economic growth and development.

Furthermore, Political stability and the absence of violence/terrorism (PSVAT) exhibit a positive and statistically significant relationship, with a coefficient of 0.084029 and a p-value of 0.0061. This implies that a one-unit increase in political stability and the absence of violence is associated with a 0.084029 increase in FDI, assuming other factors remain unchanged. Economically, this suggests that maintaining peace, security, and political stability is paramount for attracting long-term investment and promoting sustainable economic development.

From Table 4, there is a negative relationship between regulatory quality (RQ) and FDI, with a coefficient of -0.070742. However, this result is not statistically significant, given that the p-value (0.3747) is less than the 5% level of significance. This suggests that, within this model, regulatory quality may not be a primary driver of FDI. However, this doesn't rule out its potential importance. Further investigation is needed to understand the nuances of this relationship.

Table 4 further indicates that total stock market capitalization has a negative coefficient of -0.144886. As a result, if other variables remain unchanged, an increase in TSC may lead to a 14% increase in FDI inflows in Nigeria. However, this result is not statistically significant, implying that there is not enough statistical evidence to back up the nature of this relationship. This implies that the size of the stock market, as measured here, does not appear to have a direct, measurable influence on FDI within this context. This result opposes the findings of Alshubiri (2021), who observed a positive relationship between stock market capitalization and financial growth, suggesting that a developed stock market can attract foreign investment.

The interaction term (INT), representing the combined effect of regulatory quality (RQ) and total stock market capitalization (TSMC), shows a positive coefficient of 0.009894. However, this result is statistically insignificant (p-value = 0.1336). Therefore, the analysis does not provide strong statistical evidence to confirm that institutional quality (specifically regulatory quality) significantly moderates the relationship between financial development (TSC) and FDI inflows in Nigeria. This result does not strongly support the hypothesis that institutional quality plays a pivotal role in shaping how financial development influences FDI in Nigeria, at least not in the manner captured by this particular interaction term. It contrasts with findings such as Islam et al. (2020), who demonstrated a moderating effect of institutional quality on financial development's impact on FDI in BRI nations. However, it's crucial to acknowledge that the lack of significance here does not necessarily imply the absence of such an effect. The Nigerian context presents unique challenges that might explain this result. Intuitively, it is possible that even with perceived improvements in institutional quality (as measured by RQ), underlying issues like weak enforcement and inconsistent application of regulations could diminish any potential moderating influence on the TSC-FDI relationship. To put this into perspective, as previously discussed in this study, the Nigerian stock market has experienced periods of rapid, 'inorganic' growth, such as the 2007 surge driven by bank recapitalization. This growth, while increasing TSC, was not accompanied by commensurate improvements in risk management and corporate governance, as acknowledged by the Securities and Exchange Commission (SEC). The lack of robust enforcement mechanisms allowed for speculative lending, stock manipulation, and unregulated margin finance, creating an

environment of uncertainty. The subsequent collapse of the Nigerian stock market during the 2008 global financial crisis, with a loss of over 70% of market value, underscores the fragility of the market. This episode highlights that even with a nominally 'well-developed' stock market, inadequate enforcement can undermine investor confidence and deter FDI. Therefore, the insignificant positive coefficient of the interaction term (INT) may reflect the complex interplay between financial development, institutional quality, and enforcement challenges in Nigeria. It suggests that while there might be a theoretical positive moderating effect of regulatory quality on the TSC-FDI relationship, this effect is not robustly evident in the data, potentially due to underlying weaknesses in enforcement and governance that counteract the intended positive influence. This result calls for a deeper examination of how institutional quality is measured and implemented in the Nigerian context and whether it effectively translates into a stable and attractive environment for foreign investment.

Meanwhile, Table 4 shows that exchange rate appreciation reduces foreign direct investment inflow in Nigeria and vice versa. The result shows that, on average, a percentage increase in the exchange rate will decrease FDI by about 0.19%, holding other variables constant. In the presence of insecurity, which limits the ability to secure locally sourced raw materials, Nigeria practiced a fixed exchange rate system for a long time, which resulted in the misrepresentation of the true value of the naira in the form of appreciation. Intuitively, exchange rate uncertainty can discourage foreign investors. Furthermore, the significant negative coefficient on Exchange Rate is consistent with the findings of Adegoriola and Emmanuel (2022), who found a negative relationship between exchange rate fluctuations and FDI in Nigeria

Also, trade openness has a long-run coefficient of 0.036349 and is statistically significant at a 5% significance level. As a result, holding other variables constant, a percent increase in TOP increases FDI by 0.36% on average. This is consistent with economic theory, as open economies tend to attract more foreign investment. Trade liberalization upsurges demand for commodities produced within the country and consequently attracts foreign investors. This aligns with previous research (Lee et al., 2024; Korsah et al., 2025), which found trade openness to be a key driver of FDI inflows.

Finally, the post-estimation test indicates that the model is normally distributed.

5. Conclusion

5.1. Summary of Research Findings

The FMOLS regression analysis revealed several key findings. Firstly, while Total Stock Market Capitalization (TSC) showed a negative coefficient, it was statistically

insignificant. This indicates that, within this model, there is insufficient evidence to conclude that TSC significantly affects FDI inflows in Nigeria. Control of Corruption (COC) was found to have a positive and significant effect. Similarly, Political Stability and Absence of Violence/Terrorism (PSAVT) showed a positive and significant influence. Trade openness (TOP) also positively and significantly affected FDI. Conversely, the Real Effective Exchange Rate (REXCH) had a significant negative impact, underscoring the adverse effects of exchange rate volatility on FDI inflows.

Regarding the interaction term (INT) between TSC and Institutional Quality (INQ), specifically Regulatory Quality (RQ), the regression showed a positive coefficient, but this result was statistically insignificant. Therefore, within this model, there is insufficient evidence to confirm that institutional quality significantly moderates the relationship between financial development and FDI inflows in Nigeria. This contrasts with some prior expectations and studies that found a significant moderating effect, reflecting underlying complexities in the Nigerian economic environment, such as challenges in the effective enforcement of regulations, which could weaken any potential moderating effect.

These results have provided answers to the pre-established research questions in Section 1 of this study as follows:

1. There is no significant relationship between financial development, as proxied by Total Stock Market Capitalization (TSC), and FDI inflows in Nigeria.
2. Institutional quality does not significantly moderate the relationship between TSC and FDI inflows.

5.2. Limitations to the Study and Areas of Further Research

The insignificant interaction between institutional quality and results highlights the need for a deeper exploration of how financial development, specifically the stock market and institutional quality, are measured and implemented in Nigeria and whether they effectively translate into a stable and attractive environment for foreign investment. To further advance the complex relationship between financial development, institutional quality, and FDI, future research could explore the specific dimensions of institutional quality driving the negative moderating effect and investigate potential non-linear relationships between these variables.

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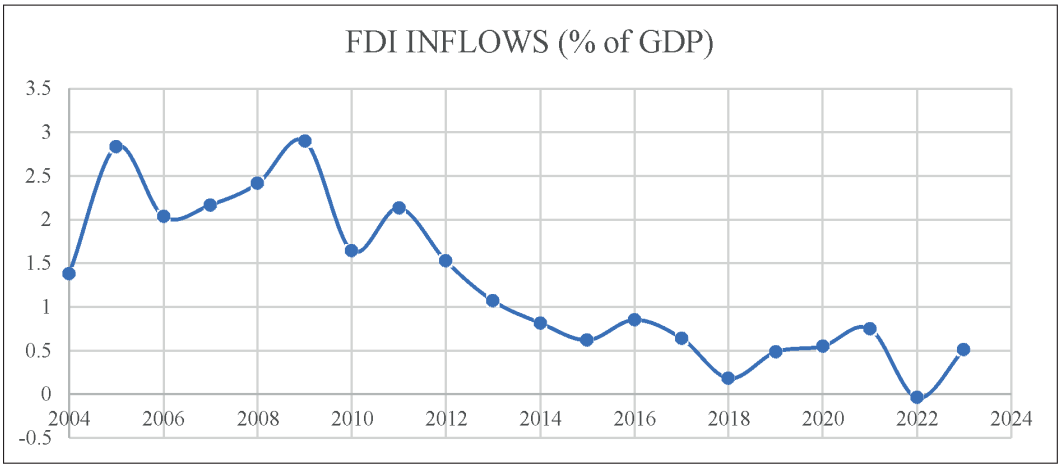
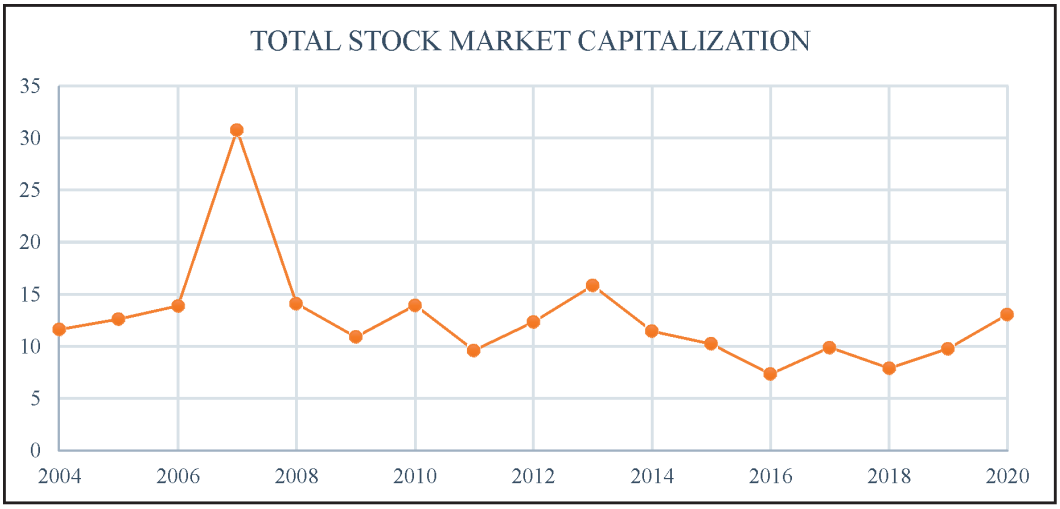
APPENDIX

Figure 1.1: Nigeria's Foreign Direct Investment Inflows



Source: Author's construct using data from World Development Indicators (WDI, 2025)

Figure 1.2: Financial Development in Nigeria



Source: Author's construct using data from World Development Indicators (WDI, 2025)