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Economic Growth, Foreign Direct Investment and International trade, in 10 West African Countries

IGNATIUS ABASIMI[1]
XUAN LI
School of Economics, Northeast Normal University
Changchun, Jilin, China

Abstract

It's factual and empirically evidenced that Foreign direct investment and economic growth has a positive relationship with economic development. However, while some schools of thought are of the view that economic growth attracts foreign investment some are pessimistic that foreign investment promotes economic growth. Economic globalization and liberalization have also paved way for international trade and international capital inflows and outflows. It's against this background that this study was conducted to investigates the relationship between economic growth, foreign direct investment and international trade in 10 West African countries; namely, Ghana, Togo, Nigeria, Burkina Faso, Benin, Cote D'Ivoire, Gambia, Mali, Sierra Leone and Niger. The empirical output from the random effect analysis revealed that economic growth can swell and heighten in these 10 West African economies through foreign direct investment, openness to trade and trade freedom.

It's therefore recommended that these economies should create a conducive and enabling environment to attract investors as well as taking strategic domestic policies to magnify and boost their agricultural and export sectors for potential gains in the global market of trade.

[1] Corresponding author: abasimiignatus@gmail.com

Key words: Foreign direct investment, economic growth, international trade, random effect, West Africa.

1.0 INTRODUCTION

In this 21st century, economic globalization and liberalization is a direct result of international trade and the momentous role of foreign direct investment. Owed to absolute and comparative advantage, and product differentiating, its ideal and typical for countries to engage in international trade, not only for the intensification of their consumption basket, but also to expand and strengthen their economic growth through international capital inflows, transfer of technology, skilled labour and competitive domestic markets (Ignatius A. et al, 2018). Foreign direct investment (FDI) has exhibited an important role in innumerable economies of Africa and other developing countries. There is a rife acceptance amongst investors, trade economics and policymakers that foreign direct investment (FDI) improves the productivity of the receiving countries and encourages development and growth.

Foreign direct investment (FDI) is an investment made by a company or an individual of one country in a firm or business located in another country. FDI sometimes leads to multinational corporations (MNC). It generally happens when the investor acquires foreign business asset through ownership or controlling interest of a foreign company. Foreign direct investment may include transfer of technologies or management as well. We distinguish essentially three types of foreign direct investment: horizontal, vertical and conglomerate. A horizontal direct investment is when the investor is operating in the same activity as in its home country. The vertical one is when the investor is operating in different activity but related to the one in its home country. The conglomerate one is when the investor is operating in a

completely different activity. International trade on its side is the exchange of goods and services between countries. It is difficult for an open economy country to produce all the goods and services needed by its population at a competitive price. The absolute and comparative advantages theories showed us the importance of exchange between countries. Trade facilitates more efficient production of goods and services by shifting production to countries that have comparative advantage in producing them (Makki S. and Somwaru A., 2004).

Notwithstanding the above definition, the World Bank discusses foreign investment as the net inflows of investment to obtain a long-lasting management interest (10 percent or more of voting stock) in an entity, operational in an economy other than that of the investor and can be further developed as the sum of equity capital, reinvestment of earnings, other long term and short-term capitals as publicized in the balance of payments in that economy. Again, International Monetary Fund (IMF) refers to foreign direct investment (FDI) as the investment that encompasses a long-term bond sparkling a lasting awareness of a resident body in one economy (direct investor) in an enterprise resident in an economy other than that of the investor.

In unindustrialized economies Foreign direct investment (FDI) has full-fledged swiftly following financial and political renovations. To increase their share of FDI inflows, many countries have improved limits on foreign direct investment, reinforced macro-economic variables, denationalized state-owned enterprises, established local financial modifications, capital account liberalization and granted tax incentives and subsidies. Most African countries for instance have approved positive tax incentives and stockholder fortification policies to attract foreign investors and also make the environment advantageous for their operations. This ingenuity and policy taken in these countries have increased the number of foreign direct investment and helped in economic growth. The Free

Zones Act 1995 and the Investment Promotion Act 1994 in Ghana has for instance attracted a coherent and quite substantial investors into the country since their implementation (Samuel A, et al, 2013)

Scholars have it that, foreign direct investment and economic growth are positively correlated and significantly inseparable largely because, when foreign investors invest in the domestic economy for a long period of time it generates many growth externalities which are positive and benefits the entire economy which most companies cannot appropriate as part of their peculiar proceeds. These may comprise of transfers of general knowledge and of specific technologies in production and distribution, as well as industrial upgrading, work understanding for the labor strength and the introduction of contemporary management, administration and accounting procedures. The formation of banking interrelation and trading webs, and the advancement of telecommunications facilities may also emerge.

However, domestic conditions, such as the growth of financial markets and the enlightening and literacy standards of a country, affect the impact of foreign direct investment on economic development and growth. It's therefore quintessential that policymakers and financial fiduciaries should be keener and more thoughtful when trying to attract FDI that is corresponding to local production. The superlative acquaintances are between final and intermediate industry sectors, not automatically between local and foreign final goods producers (Laura A. et al, 2006).

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countries that have comparative advantage in producing them (see Makki S. and Somwaru A., 2004; Ignatius A. et al, 2018). International trade allows countries to use their resources efficiently. As explained, international trade and foreign direct investment only happen in open economies. Some authors argue that one leads to the other; some even say that they are complementary or they substitute each other. Generally, foreign direct investment can answer problems of import and export because when foreign brands come to a country with their products, there is no need to import the same products from abroad.

Most empirical studies on foreign direct investment, economic growth and international trade has focused and dealt extensively with the issue, basing their findings on distinct and individual countries to the neglect of group of economies that share the same geographical and some common political interest in terms of trade, investment and economic policies. This study therefore tries to empirically investigates the interrelationships of these economic variables and their impacts on economic growth and development in ten (10) West African countries namely, Ghana, Togo, Nigeria, Burkina Faso, Benin, Cote D'Ivoire, Gambia, Mali, Sierra Leone and Niger.

2.0 LITERATURE REVIEW

The connection between foreign direct investment, international trade, and economic growth is one of the fascinating deliberations in international economics. A couple of research have been carried out on the phenomena using various data and typologies. The results however, vary from one author (s) to another. This section of the paper looked at some of the various empirical studies interlinking these economic indicators.

The working paper of Laura A. et al, (2006) On "How Does Foreign Direct Investment Promote Economic Growth?

Exploring the Effects of Financial Markets on Linkages" extrapolated that holding the scope of foreign existence constant, financially well-developed economies exhibits growth rates that are virtually twice as compared with those economies with meager financial bazaars, they further noted that intensifications and growth in the share of foreign direct investments or the relative productivity of the exotic firm has pathed way to greater growth in financially established economies equated to those noticed in financially under-developed ones, and finally, supplementary domestic circumstances such as market formation and human capital are also significant for the effect of FDI on economic growth.

Olofsdotter (1998) carried out a study on the relationship between FDI and economic growth using cross sectional data and concluded that, an upsurge in the stock of FDI is significantly correlated with growth and stresses that, the consequence is stronger for host countries with a greater level of institutional competence as restrained by the magnitude of property rights safety and administrative efficiency in the host countries.

The recent decade studies of Zhang (2001) and Choe (2003) also revealed a positive and a significant causality between economic and foreign direct investment. Zhang (2001) and Choe (2003) analyses the causativeness between economic growth and FDI. Zhang employed annual time series data for eleven (11) unindustrialized states in East Asia and Latin America. Employing cointegration and Granger causality tests as the econometric technique, Zhang (2001) concluded that in 5 cases economic growth is boosted by FDI but that host country situations such as trade regime and macroeconomic stability are virtually significant. According to the findings of Choe (2003), relationship between economic growth and FDI turns in either direction but with a tendency towards growth causing FDI; there is minute evidence that FDI causes a greater and

robust economic growth in host country but rather rapid economic growth may lead to an increase in FDI inflows.

Li X. and Liu X. (2005) investigated whether foreign direct investment (FDI) affects economic growth based on a panel of data for 84 countries over the period 1970-1999. They used single equation and simultaneous equation system techniques to examine the relationship. They found a significant endogenous relationship between FDI and economic growth from the mid-1980s onwards. FDI not only directly promotes economic growth by itself but also indirectly does so via its interaction terms. The interaction of FDI with human capital exerts a strong positive effect on economic growth in developing countries, while that of FDI with the technology gap has a significant negative impact.

Jamshid Damooei and Akbar Tavakoli. (2006) estimated the output elasticity of foreign direct investment (FDI) and imports in Thailand and in the Philippines from 1970 to 1998. They applied a CES generalization of Cobb-Douglas production function, the output response to FDI is the same in both countries, but imports affect Thailand more than the Philippines. The FDI contribution to every one percentage growth point is about 0.05 of a percentage points in each country where imports contribute about 0.47 of a percentage points in Thailand and 0.31 of a percentage points in the Philippines. As a result, the foreign investment and imports contribute about 52 percent of every one percentage growth point in Thailand compared to a lower 36 percent in the Philippines. The remaining effects on the economic growth are from labor and domestic investment. Both countries are labor intensive, but the impact of labor is more significant in the Philippines. The Philippine economy is also more domestic capital intensive than the Thai economy. Furthermore, the FDI path shows that the effect of foreign investment is more pronounced in the Philippines during the second half of the

1990s, whereas the imports are more effective in Thailand since 1994.

Other authors argue that International trade can impact economic growth but not foreign direct investment. Some authors even argue that there is no positive effect link between the three variables. Nath H. K. (2009) used a fixed effects panel data approach to examine the effects of trade and foreign direct investment (FDI) on growth of per capita real GDP in 13 transition economies of Central and Eastern Europe, and the Baltic region from 1991 to 2005. A significant positive effect of trade on growth is a robust result for transition economies of this region. In addition, domestic investment appears to be an important determinant of growth. In general, FDI does not have any significant impact on growth in these transition economies.

Ignatius A. et al, (2018) noted in their studies international trade, foreign direct investment, and economic growth in togo's economic perspective that, international trade and foreign direct investment have a positive impact on economic growth. Their study employed the Autoregressive distributed lag and Error correction models for the econometric and empirical analysis. The empirical results revealed that in the short run Togo's economic growth can be boosted and revitalized through foreign direct investment, trade freedom, trade openness, and exchange rate appreciation, however, in the long run only trade openness promote economic growth.

Azman-Saini W. N. W., Baharumsha, A. Z. and Law S. H. (2010) investigated the systemic link between economic freedom, foreign direct investment (FDI) and economic growth in a panel of 85 countries. The empirical results, based on the generalized method-of-moment system estimator, reveal that FDI by itself has no direct (positive) effect on output growth. Instead, the effect of FDI is contingent on the level of economic freedom in the host countries. This means the countries

promote greater freedom of economic activities gain significantly from the presence of multinational corporations.

Belloumi M. (2014) examined the relationship between foreign direct investment (FDI), trade openness and economic growth in Tunisia by applying the bounds testing (ARDL) approach to cointegration for the period from 1970 to 2008. The bounds tests suggest that the variables of interest are bound together in the long run when foreign direct investment is the dependent variable. The associated equilibrium correction is also significant, confirming the existence of a long-run relationship. The results also indicate that there is no significant Granger causality from FDI to economic growth, from economic growth to FDI, from trade to economic growth and from economic growth to trade in the short run. The results go against the generally accepted idea considering the positive impact of FDI on economic growth to be automatic.

3.0 METHODOLOGY AND DATA SOURCE

This section of the paper presented the source of the data used for the empirical analysis, the hypothesis of the study and the econometric method employed in the research.

3.1 Data Source

The study used secondary data for the empirical analysis. The research employed annual data from 1995-2013 which is sourced from the website of world Bank development indicators, Index of Economic Freedom -Heritage Foundation and gapminder databases. The variables extracted from these databases includes, foreign direct investment (net inflows), exchange rate, consumer price index (GDP deflator), trade freedom, gross domestic product, exports and imports.

3.2 Hypothesis

Hypothesis 1: $\frac{\partial GDPt}{\partial FDIt} > 0$ Foreign direct investment refers to resources foreign investors are ready to commit or invest in their companies or subsidiaries. It is a kind of an ally linking a parent company and its foreign subsidiary. The study expects foreign direct investment to have a positive relationship with economic growth (proxied as GDP).

Hypothesis 2: $\frac{\partial GDPt}{\partial TOPt} > 0$ Trade openness is as a result of globalization and trade liberalization. Trade openness refers to the outward or inward orientation of a given country economy. Outward orientation refers to countries that take significant advantage of opportunities to trade with other countries whilst inward orientation refers to economies that are unable to take advantage of the opportunities to trade with other countries. Trade openness brings great economic benefits such as transfer of skills and technology, increased in labour and total factor productivity etc. We expect trade openness to have a positive and a significant effect on economic growth.

Hypothesis 3: $\frac{\partial GDPt}{\partial TRFt} > 0$ The extent to which governments allows its economics agents to interact without hinderance as buyers or sellers in the international trade marketplace is quite vital and quintessential for its economic growth. The index of economic freedom emphasizes the need for trade freedom, stipulating that trade restrictions may put advance technological products and service beyond the reach of entrepreneur's and developers hence limiting their overall productivity and development. We expect trade freedom to exhibits a positive relationship with economic growth.

Hypothesis 4: $\frac{\partial GDPt}{\partial INFt} < 0$ Perpetually high inflation is an enemy to economic stability and weakens the value of money. The transmission mechanism of this effect is the retirement of

economic growth. High Inflation rate possesses negative relationship with economic growth.

Hypothesis 5: $\frac{\partial GDPt}{\partial EXHt} <> 0$ When the coefficient of exchange rate is negative it implies depreciation, and appreciation if otherwise. A depreciation of each of the individual country currencies against US dollar or other currencies will weaken its value. Appreciation of these currencies is relatively a good measure of economic stability and perhaps promotes economic growth.

3.3 Econometric Method

Panel data technique was adopted because it has advantage over cross-sectional and time series regressions especially when it comes to heterogeneity bias. The results from panel data technique are less spurious and more generalized than the aforementioned methods. Since the data is a panel data, the study employed the mixed effect method model which comprise of the random and the fixed effect technique. Theoretically, the mixed effect model can be express as follows;

For each observation i:

$$Y_i = \beta_1 X_{i1} + \ldots. + \beta_p X_{ip} + b_1 Z_{i1} + \ldots. + b_q Z_{iq} + \varepsilon_i \qquad (1)$$

where $\beta_1 \ldots. \beta_p$ are the unknow parameters of the fixed effects, **Xi** are the known regressors or the design variables and **Yi 's** are the regressands or observations**.** Moreover, **bi's** are the random coefficients and **Zi** are the random effect design variables, the **εi 's** are the error terms which are expected to be independent and normally distributed with zero mean and variances.

The mixed effects model mixes random effects with the fixed effects of a typical regression model. Winter (2013) describes random effects as something that is commonly nonsystematic and impulsive, hence having random influence

on the data. Fixed effects however, are predictable and systematic.

The standard regression model for the study is given as;

$$\mathbf{Ln\ GDP_{i,t} = \beta_0 + \beta_1 FDI_{i,t} + ln\beta_2 TOP_{i,t} + ln\beta_3 TRF_{i,t} + ln\beta_4 INF_{i,t} + ln\beta_5 EXR_{i,t} + \varepsilon_{i,t}} \quad \mathbf{(2)}$$

Where:

The regressand

GDP_t = Gross domestic product at time t

The regressors are;

FDI_t = Foreign direct investment at time t

TOP_t = Trade openness at time t (total exports + imports/GDP)

TRF_t = Trade freedom at time t

INF_t = Inflation rate at time t

EXH_t = Exchange rate at time t

i is for country

t is for year

Ln represent natural log.

ε is unobserved error term.

And $ß_0 \ldots ß_6$ are unknown parameters and constants to be estimated

3.4 Procedure for data analysis

The study initially performed pooled OLS estimates and on that bases applied the Chow test to ascertained whether the pooled OLS is preferred to the fixed effect or not. The Hausman test was also carried out to investigate whether the fixed effect or the random effect is appropriate for the data. After the preliminary test, the Chow test and the Hausman test refutes pooled OLS and fixed effects techniques. The random effect model therefore was used for the empirical analysis.

4.0 Results and Discussion

Table 1.0 Descriptive statistics

Variables	Obs	Mean	Std. Dev.	Min	Max
LNGDP	190	22.4543	1.503301	20.00385	26.96737
FDI	190	6.24e+08	1.51e+09	-4.07e+07	8.84e+09
LNGTOP	190	-.555311	.3225311	-1.263085	.1663814
LNTRF	190	4.055444	.2493642	2.533697	4.333362
INF	190	9.067962	12.87154	-7.594284	80.75458
LNEXR	190	5.263708	2.292979	-2.120981	8.377739

From table 1.0 above, it's clear that the highest and lowest means are 22.4543 and -.555311 which corresponds to GDP and trade openness respectively. The maximum and minimum values which are 80.75458 and -4.07e+07 again, is traced to inflation and foreign direct investment respectively. We are anticipating that; these three variables (trade openness, inflation and foreign direct investment) may have a great impact on economic growth in the respective countries.

Table 4.2. Correlation matrix

Variables	LNGDP	FDI	LNTOP	LNTRF	INF	LNEXR
LNGDP	1.0000					
FDI	0.7505	1.0000				
LNTOP	0.0389	0.1662	1.0000			
LNTRF	0.3061	0.2819	0.1229	1.0000		
INF	0.1564	0.1245	-0.0244	-0.0257	1.0000	
LNEXR	-0.1781	-0.1756	-0.3023	-0.1020	-0.4166	1.0000

The results of the correlation matrix of the studied variables are displayed in table 4.2, from the table, foreign direct investment, trade openness, trade freedom, and inflation rate have positive correlation with economic growth (proxied as GDP), while exchange rate has negative correlation with economic growth.

Table 4.3 Breusch and Pagan Lagrangian Multiplier Test for Random Effects versus OLS

		Var	SD = Sqrt (var)
LNGDP		2.259915	1.503301
E		0.1632194	0.4040043
U		0.9193646	0.958835
Test: Var(u)	0		
Chibar^2 (01)	747.76		
Prob>chibar^2	0.0000		

Table 4.3 exhibits the Breusch and Pagan Lagrangian multiplier test for random effects vs pooled OLS method. The standard deviation and variance of GDP in the studied countries are 1.503301 and 2.259915 correspondingly. Basing on the p-value (since its smaller than 5%), the study rejects the null hypothesis (pooled OLS is better than random effect) and concludes that the random effect is relatively efficient for the study.

We went further to perform Hausman test of random vs fixed effect to determine and discover which technique is appropriate for the empirical results. The results showed once again that the random effect model is more efficient than the fixed effect model largely because, the P-value of the Chi^2 >5%. We therefore fail to reject the null hypothesis and conclude that the random effect model is more effective than fixed effect model as displayed in table 4.4.

Table 4.4 Hausman Test for Fixed versus Random Effect Models
Dependent Variable LNGDP

Variables	-------Coefficients--------			Sqrt(diag(V_b-V_B))
	(b) Fixed	(B) Random	(b-B) Difference	S.E.
FDI	3.05e-10	3.20e-10	-1.52e-11	8.19e-12
LNTOP	.4618763	.4630872	-.0012109	.0199675
LNTRF	-.6832514	-.6865005	.0032491	.
INF	.0013122	.0015781	-.0002659	.
LNEXR	.0760631	.0380755	.0379875	.036582

b = consistent under Ho and Ha; obtained from xtreg
B = inconsistent under Ha, efficient under Ho; obtained from xtreg
Test: Ho: difference in coefficients not systematic
chi2(4) = (b-B)'[(V_b-V_B)^(-1)](b-B) = 3.52
P>chi2= 0.4744

Table 4.5 Random Effect Model Estimates
Dependent Variable; LNGDP

Variables	Coefficient	Standard Error	z-ratio	P-value
FDI	3.20e-10	3.36e-11	9.54	0.000***
LNTOP	.4630872	.168643	2.75	0.006***
LNTRF	.6865005	.1402453	4.89	0.000***
INF	.0015781	.0029478	0.54	0.592
LNEXR	.0380755	.0694939	0.55	0.584
C	25.08089	.7769894	32.28	0.000***

Note, asterisk ***, means significance at 1% levels
R-sq: (within = 0.5243; between = 0.7104; overall = 0.5194); Wald chi2(4) = 38.58; Prob > chi2 = 0.0000

The Hausman test in table 4.4 rejects the fixed effect model largely because of an insignificant p-value, it's therefore against this statistical background that the random effect technique was employed for the final output of the study. The results from the model revealed that exchange rate and inflation rate have no significant impact on economic growth in the countries considered. However, foreign direct investment, trade openness and freedom from trade were found to be statistical different from zero. It's also imperative to note that these significant variables exhibited a robust impact on economic growth in the selected west African countries.

The positive coefficient of FDI implies that a 1% increase in FDI will raise economic growth by 3.2 units (300%). The study statistics further revealed that openness to trade has a positive and a great impact on economic growth and development in the studied countries, it has 46% effect on economic growth for every percentage increased in the level of openness to trade with the outside world or in the international markets by the respective countries. Lastly, is trade freedom. Trade freedom also possesses a positive and a significant relationship with economic growth. It has a coefficient of 0.69, which implies that a significant percentage increased in trade freedom will increase the volume of economic growth by 0.69% in the respective countries.

It's worth observing that all the empirical and the significant results are in line and confirmation with the study preproposal hypothesis and expectations stipulated in section 3.2 under the methodology section.

The findings of these studies are in line with previous empirical studies. For instance, Ignatius A. et al (2018) found out that in the short run Togo's economic growth can be boosted and revitalized through foreign direct investment, trade freedom, trade openness, and exchange rate appreciation, however, in the long run only trade openness promote economic growth. Ofori D. and Asumadu G. (2017) concluded that trade and FDI inflows could lead to the economic growth in Ghana in their paper "the effects of FDI inflows and trade in the economic development of Ghana". The empirical results of Ali N. and Xialing L. (2017) studies are also in line with this study. Their study confirmed that, there is a positive relationship among international trade, foreign direct investment and economic growth in Pakistan's economic perspective. Other studies that are in line with this study includes Belloumi M. (2014), Azman-Saini W. N. W., Baharumsha, A. Z. and Law S. H. (2010) and Nath H. K. (2009).

5.0 SUMMARY AND CONCLUSION

Foreign direct investment and economic growth are mostly interpreted by developing economist as 'You scratch my back and I'll scratch yours' development term, largely for the reason that FDI leads to multinational corporations (MNC) in the domestic and foreign business environment. It's perceived as an economic restorative and stimulator largely because it involves the transfer of capital, technology, skilled labour, creating jobs and establishing competitive and comparative advantage in developing and developed economics. This research paper empirically investigated the interconnecting relationships between economic growth, foreign direct

investment and international trade, in 10 West African countries; namely, Ghana, Togo, Nigeria, Burkina Faso, Benin, Cote D'Ivoire, Gambia, Mali, Sierra Leone and Niger. The statistical test from the Breusch and Pagan Lagrangian Multiplier Test and the Hausman test confirmed the random effect model to be more efficient for this study. The empirical output from the random effect analysis revealed that economic growth can swell and heighten in these 10 West African economies through foreign direct investment, openness to trade and trade freedom. It's therefore recommended that these economies should create a conducive and enabling environment to attract investors as well as taking strategic domestic policies to magnify and boost their agricultural and export sectors for potential gains in the global market of trade.

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