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EFFECT OF GROSS DOMESTIC PRODUCT (GDP) AND INFLATION (INF) ON FOREIGN DIRECT INVESTMENT (FDI) USING CO-INTEGRATION VAR MODEL FOR THE PERIOD (1998-2017) IN NIGERIA

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ABSTRACT

In the context of the current trends there is highlighted the interest in the emerging economies to attract foreign capital in the form of foreign direct investment (FDI) as a source of external financial and economic recovery factor. FDI is objectively necessary for the developing country like Nigeria given it role in increasing the competitiveness of emerging economies. This study investigates the long run relationship between foreign direct investment, gross domestic product (GDP) and inflation (INF) in Nigeria within the period 1998–2017. The study employed the co-integration approach by using Johansen's co-integration method. The study employed the Granger causality testing procedure suggested to empirically examine the directional relationship between the variables. The study finds that both GDP growth and inflation positively and negatively relates to FDI inflows respectively. Furthermore, bi-directional causal link were found from FDI to GDP. This means that more attention should be paid to ensure optimum inflow of FDI in Nigeria. Therefore, policies should be geared towards addressing the real economic factors that hinder inflow of FDI in Nigeria. To maintain a sustainable economic growth, Nigeria have to be encouraged and supported to attract more foreign direct investment in order to stimulate growth which in tones improve the living standard of its citizenry.

Key words: FDI inflows, GDP growth rate, INF, OLS, Unit root, Co-integration, Granger causality.

1.0 INTRODUCTION

Foreign direct investment (FDI) has become very crucial to both developed industrial and developing economies. FDI introduces foreign capital and skilled labor into an economy. It also brings in technological know-how, raises efficiency and competitiveness, enhances export earnings and improves international marketing activities. Most neoclassical economists believe that foreign investments do not only accelerate the rate of economic growth and development in developing countries, but insufficient foreign investment will lead to a "sudden death" of economy. Consequently, host country governments ensure that enabling environment for foreign investment is created.

To achieve high sustainable economic growth with low inflation as a poverty reduction strategy is the principal objective of policy makers in both developed and developing countries (Khan and Senhadji, 2001). This is because; high growth makes it possible to raise the living standards of the impoverished in the society. In addition, low inflation and high long term growth improves the efficient allocation of resources and increases employment in the economy.

Huybens and Smith (1999) and Boyd (2001) revealed that foreign direct investment (FDI) is an important channel through which the effect of inflation is indirectly transmitted in economic growth for the betterment of society. Low inflation rate is taken to be a sign of internal economic stability in the host country and Low rate of inflation in a country increases the return on foreign direct investment and is an indicator of macroeconomic stability and considered a sign of the willingness of the government to balance its budget and the ability of the central bank to conduct appropriate monetary policy (Schneider and Frey, 1985). Low level of inflation in a country encourages FDI.

When inflation is low, nominal interest rate declines and as a result cost of capital is low. The availability of capital at cheap lending rate enables foreign direct investors not only to locate better partners in the host country with sufficient domestic investment to supplement but also to maximize the return on their investment. Hence, easy availability of capital at lower interest rate and high domestic consumption in the host country as a result of low price levels would attract FDI to spur growth.

Growth in neoclassical theory is brought about by increase in the quantity of factors of production in the efficiency of their allocation. In a simple world of two variables, labour and capital, it is often presumed that low income countries have abundant labour but less capital. This situation of domestic savings in these countries places constraints on capital formation and hence growth. Even where domestic input in addition to labour are readily available and no problem of input supply, increased production may be influenced by scarcity of imported inputs upon which the production processes in low income countries are based.

International Capital Flows (ICF) readily becomes an important source or means of enhancing developing countries to overcome their capital flow in Foreign Private Investment (FPI) other components are:

i. Official flows from bilateral sources (for instance, Developed and OPEC countries) and multilateral sources such as the World Bank and its two affiliates: The International Development Assistance (IDA) and the International Finance Corporation (IFC) on concessional and non-concessional terms.

ii. Commercial loans including exports credit: Economic theory suggests that capital will move from countries where it is abundant to countries where it is scarce. This pattern of movement will be informed by the returns of new investment opportunities which are considered higher in cases where capital is limited.

The result capital relocation will boost investment in the recipient countries and bring about enormous social benefits. With the advent of the third millennium era, globalization has continued to accelerate. In the areas of international trade and finance, many factors including accelerated privatization and economic liberalizations have also pushed globalization in almost every nation in the world. One important economic consequence of globalization for developing countries has been massive and unprecedented inflows of foreign capital during the final decade of the 20th century.

However, Private Capital Inflows (PCI) wrest primarily from public flows, seizing the pre-eminent finance for developing countries. Uche (2012) said, according to Weitz and Lijane (1998) "While official flows total \$56billion in 1990, compared to \$44billion in private flow by 1996, public flows had declined to \$41billion and private flows grew to \$244billion".

United Nation Conference on Trade and Development (UNCTAD) figures showed that in 1997, FDI inflow amounted to US \$400billion and in 1998 rose to an unprecedented level of US \$440billion (Mallampally and Sauvant, 1999). Although GDP have become widely dispersed among recipient countries in recent years, the distribution is still skewed with Asia receiving the lion's share of FDI flows going to developing countries and Africa receiving little.

Among developing countries the distribution of the World FDI inflows is uneven (Mallampally and Sauvant, 1999). In 1997 for example developing Asia received 22%, Latin America and Caribbean 14% and Africa 1%. Another perspective on the skewness of distribution is obtained when it is realized that in 1995, 81% of global FDI flows to developing countries went to 12 countries while 89% of all portfolio flows to almost the same dozen countries. Therefore, the challenge to attract more inflows of foreign investment in developing countries particularly those in Sub-Saharan Africa has increased in recent years due to the accelerating process of globalization.

Opening of a country requires investment for connecting the necessary infrastructure such as roads, telecommunication, power plants and financial system. Given the low income and low savings in many African countries, the investment- savings gap has widened and little hope of closing without the active involvement of private sector, both domestic and foreign.

1.1 Statement of the Problem

Nigeria is believed to be a high risk market for investment because of factor such as unstable macroeconomic policies. Since the coming back of democracy in 1999, the government of Nigeria has taken series of measures necessary to woo foreign investors into the country. These measures include the repeal of laws that are not favorable to foreign investment growth, promulgation of investment laws, oversea trips for image laundry such as "re-branding" campaign, among others. Against this background there is need to study the relationship between the FDI, GDP and INF.

1.2 Aim and Objectives of the study

The study is aimed at determining the link relationship between FDI, GDP and INF with a view to achieve the following objectives to:

- i. Formulate an economic model that link FDI, GDP and INF in Nigeria
- ii. Test for cointegration between the variables
- iv. Test causal relationships between the FDI, GDP and INF.

2.0 LITERATURE REVIEW

FDI is basically divided into two types which include inward FDI and outward FDI or net FDI which is the combination of inflow FDI and outflow FDI. Inward foreign direct investment means inflow of investment in your country and outward foreign direct investment means the flying of local capital towards foreign countries. (Niazi *et al.*, 2011) define Inflation as increasing the quantity of money and bank notes in circulation and the quantity of bank deposits subject to check. But most of the citizens today use the term `inflation' to refers to some certain phenomenon of outcome of inflation, which is the tendency of all prices and wage rates to rise. While GDP is an acronym for "The Gross Domestic Product, is defined as the market value of all final goods and services produced within a geographical entity within a given period of time" (Faiza *et al.*, 2013).

One can extract the specific variables or factors that determine or influence foreign direct investment in the past from previous studies carried out by researchers. Ekpo (1995) examined that the factors like higher profit from investment, low labor and production cost, political stability, enduring investment climate, functional infrastructure facilities and constructive regulatory atmosphere also help to attract and preserve FDI in the host country.

Nanda (2009) suggests that Greenfield foreign investment is more beneficial to host countries as compared to the FDI that comes through the merger and acquisition route. The impact of FDI on growth performance seems to depend on the type of FDI rather than just the volume. Abdullahi *et al.*, (2012) examines the role of FDI on economic growth, making a comparison between selected countries of Africa and Asia, utilizing data for 30 countries, 15 each from Africa and Asia for the period of 1990 to 2009. Using Hausman test, empirical results showed that FDI has positive relationship with GDP growth for both Africa and Asia and it also reported that one way causality for Africa but no such evidence for Asia. The authors suggested for more openness of the economies, more investment in infrastructure and more political commitment in the fight against corruption.

According to Faiza *et al.*, (2013) in Karimi and Yusop (2009) examined the FDI and Economic Growth in Malaysia. They run OLS regression on the data gathered from 45 countries. They found that FDI is a factor that induces economic growth of a country.

Nuzhat (2009) examined the Impact of Foreign Direct Investment on Economic Growth in Pakistan. She concluded her study and figured out that there is statistically negative relationship exist between FDI inflow and GDP. Muhammad *et al.*, (2010) examined A Nexus between Foreign Direct Investment & Pakistan's Economies. They found that there is no significant impact of debt servicing and GDP on FDI inflows in the perspective of Pakistan. Abbas *et al.*, (2011) examined the Impact of Foreign Direct Investment on Gross Domestic product. They used GDP is as dependent variable whereas FDI and inflation are taken as the independent variables. They collected data from South Asian Association for regional Cooperation (SAARC) countries over the period of 2001-2010. They concluded their study by finding out that there is a positive and significant relationship between GDP and FDI while there is insignificant relationship between GDP and inflation.

Alex (2011) examined the effect of exchange rate and inflation on foreign direct investment and its relationship with economic growth. He applied linear regression analysis for finding the relationship between inflation, exchange rate, FDI inflows and economic growth. For his purpose, he collected data for thirty years. He found that Inflation has no effect on FDI. On the other hand exchange rate has effect on FDI. Gaurav and Mohd (2011) examined the impact of FDI on GDP Growth. They collected data from 5 top Asian countries respect of GDP during the period of 1993-2009. By using the regression model they concluded that FDI promotes economic growth and an estimate that if one dollar of FDI is added it will cause 7 dollars GDP increases of each of the five countries.

Faiza *et al.*, (2013) examined the impact of inflation and economic growth on foreign direct investment. They found out that, there is a positive relationship between foreign direct investment (FDI) and inflation and there exist a negative relationship between growth domestic product (GDP) and foreign direct investment (FDI). Mehmet (2011) explored the association between growth, FDI, trade and inflation in turkey using annual time series data over the period from 1970 to 2008. The results of the Johansen co-integration test revealed that inflation and FDI are positively related to growth.

Finally, the foregoing discussion on the literature reveals very interesting dimensions to the linkage between FDI, growth and inflation. From the theoretical literature reviewed, the relationship between FDI and growth can be positive or negative. Also a negative relationship exists between FDI and inflation. In addition, a positive relationship exists between FDI and growth. Furthermore, analysis from available empirical literature indicates that it may not be possible on a prior ground to arrive at any firm conclusion on the directional causality between the variables. The issue is basically empirical and critically depends on the type and nature of the economy being considered.

3.0 MATERIALS AND METHODS

3.1 Sources of Data

Data used for this research work are secondary data spanning from 1998 through 2017, and obtained from the Central Bank of Nigeria, Statistical Bulletins, Seminar papers and journals.

3.2 Methods

FDI inflow and GDP Growth rate have been used as measure for national economic growth and it is tested the existence of a causal correlation between the variables in Nigeria.

To demonstrate the long-term relationship and causal link between the variables under study, the following steps are considered.

Firstly, test for stationarity of the variables using the Augmented Dickey Fuller Test. This test provides evidence on whether the variables under investigation has a unit root, based on the model below;

$$Y_t = \alpha + \rho Y_{t-1} + \delta t + u_t; \quad -1 \le p \le 1$$
 (1)

"Equation (1)" through, ordinary least square (OLS) technique, where is the independently and identically distributed zero-mean error term where (u_t is a white noise error term).

Secondly, test for long-run correlation between the variables using Johnsen's Co-integration test. The Johnson test approaches the analysis of cointegration by taking into consideration the number of the independent linear combinations (k) for m-time series variables which yields a stationary process.

There are possibly $0 \le r \le p$ cointegrating vectors: for this case, a sophisticated sequential procedure for determining the existence of co-integration and for determining the number of co-integrating relationships based on maximum likelihood techniques, known as the Johansen's method is used.

The Johansen's method is similar to the Engle-Granger method but has the advantage of being able to test for any number of co-integrating relations. The method can be described as the application of standard multivariate calculations in the context of a vector autoregression (VAR). Johansen's methodology takes its starting point in the VAR of order p given by;

$$Y_t = \varphi D_t + \pi_I Y_{t-1} + \dots + \pi_p Y_{t-p} + \varepsilon_t$$
(2)

Where Y_t is an (nx1) vector of variables that are integrated of order one, commonly denoted as I(1) and ε_t is an (nx1) vector of innovations.

This VAR can be rewritten as;

$$\Delta Y_{t} = \varphi D_{t} + \pi Y_{t-1} + \Gamma_{I} \Delta Y_{t} - I_{I} + \dots + \Gamma_{p-1} \Delta Y_{t-p} + \varepsilon_{t}$$
(3)
Where, $\pi = \pi_{I} + \dots + \pi_{p} - I_{n}$ and $\Gamma_{k} = -\sum_{j=k+1}^{p} \pi_{j, k=1, 2, \dots, p-1}$

If the coefficient matrix π has reduced rank, $0 < rank(\pi) = r < n$, then there exist $n \ge r$ matrices α and β each with rank r such that $\pi = \propto \beta$ and $\beta' Y_t$ is stationary, r is the number of co-integrating relationships, the elements of \propto are known as the adjustment parameters in the vector error correction model and each column of β is a co-integrating vector.

Thirdly, to test the relationship using Least Square Model.

$$X_{1t} = \boldsymbol{\alpha} + \beta_2 X_{2k} + \beta_3 X_{3k} + \dots + \beta_k X_{kt} + \boldsymbol{\varepsilon_t}$$
(4)

Lastly, to test the direction of the causality by using Granger Causality Test. The test involves estimating the following pair of regressions:

$$y_{1t} = \sum_{i=1}^{n} \alpha_i \, y_{1t-1} + \sum_{j=1}^{n} \beta_j y_{2t-j} + \varepsilon_t \tag{5}$$

$$y_{2t} = \sum_{i=1}^{n} \lambda_i y_{1t-1} + \sum_{j=1}^{n} \delta_j y_{2t-j} + u_t$$
(6)

Where it is assumed that the disturbances ε_t and u_t are uncorrelated.

4.0 **RESULTS AND DISCUSSION**

4.1 Introduction

In this chapter the results obtained using the method described in chapter 3, and the statistical packages E-view are presented and discussed.

The results of the Augmented Dickey -Fuller test, provided in table:1 and highlight for a significance level of 5 percent, both the FDI, GDP and INF are stationary at first difference.

Variable	Level	Prob.	1 st	Prob.
			Difference	
FDI	-2.194906	0.1900	-4.147352	0.0284
GDP	-2.65050	0.9977	-3.028282	0.0001
INF	-2.08845	0.5191	-3.37433	0.0354

Table1: Augmented Dickey -Fuller Test

FDI inflows, GDP growth rate and inflation are all stationary at 1st difference; however, having the same degree of stationarity allows us to investigate the long-run correlation between them. The findings of the Johnson Co-integration test are provided in Table: 2.

Table: 2 Johnson	Co-integration	Test Results
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Unrestricted Co integration Rank Test (Trace)					
Hypothesized			0.05		
No. of CE(s)	Eigenvalue	Trace Statistic	Critical Value	Prob.**	
None *	0.950367	73.48009	42.91525	0.0000	
At most 1*	0.770613	25.87211	19.42423	0.0256	
At most 2*	0.498421	18.20769	12.51798	0.04120	
Trace test indicates 3 Co-integration equations 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		Max-Eigen	0.05		
No. of CE(s)	Eigenvalue	Statistic	Critical Value	Prob.**	
None *	0.950367	54.05586	25.82321	0.0001	
At most 1*	0.770613	21.27716	16.21716	0.03821	
At most 2*	0.698421	14.27069	11.51798	0.04120	
Max-eigenvalue test indicates 3 co-integrating equations at the 0.05 level.					
* denotes rejection of the hypothesis at the 0.05 level.					
**MacKinnon-Haug-Michelis (1999) p-values.					

The values from Table:2 confirm the existence of three co-integrating equations for a 0.05 level, with their associated probabilities less than 0.05. The regression equation is then tested, through Ordinary Least Square Method (Table: 3). The finding emphasizing the fact that FDI inflows is positively influence the GDP growth rate and negatively influence the inflation as far as this research is concerned.

The Model is formulated as follows;

FDI = f(GDP, INF)

 $lnFDI = \beta_0 + \beta_1 lnGDP + \beta_2 lnINF$, where

lnFDI = Foreign Direct Investment

lnGDP = Gross Domestic Product growth rate

lnINF = Inflation rate

 β_0 = intercept, β_1 and β_2 = coefficient of the independent variables

 Table: 3 Least Square Method Results

Variable	Coefficient	Std. Error	t-statistic	Prob. Value	
С	17.71520	1.789537	9.899322	0.0000	
lnGDP	0.495441	0.129564	3.823919	0.0014	
lnINF	-0.193319	0.357882	-3.054970	0.0072	
$R^2 = 0.619187$, Adjusted $R^2 = 0.574386$					
F-statistic = 13 82069 Prob (F -statistic) = 0.000273					

The estimated model is FDI = 17.72 + 0.495 GDP - 0.193 INF

Hence, the predictor variables jointly able to explained 61.9% of variation exist while the remaining 38.1% could be due to the effect of extraneous variables.

Table: 4 Granger Causality Test Results

Null Hypothesis	Observations	F-	Prob.
		statistic	
GDP does not Granger Cause FDI inflow	18	11.5205	0.0346
FDI inflow does not Granger Cause GDP		8.5365	0.0117
INF does not Granger Cause FDI inflow	18	13.9788	0.0282
FDI inflow does not Granger Cause INF		2.1527	0.0859
INF does not Granger Cause GDP	18	1.8052	0.0923
GDP does not Granger Cause INF		9.5598	0.0385

From Table: 4, it shown that there is bilateral causality between FDI inflows and GDP but there is unidirectional causality from inflation to FDI inflow as well as from GDP and inflation.

In Nigeria, the economic analysis has shown that FDI inflows exert a strong and positive impact on the GDP growth rate, confirming the previous findings of the relevant papers in the

area as Edoumiekuma (2009) and Adeleke (2014). So also, the result shown that inflation has a negative effect on FDI inflow as confirm by Ade et al.,(2011) and Djokoto (2012).

The results of Johansen Co-integration test and Least Square method have demonstrated in Nigeria the existence of a long – run relationship between FDI inflows, GDP growth rate and inflation. The findings have supported us into reaching the conclusion that an increased rate of economic growth in Nigeria may likely increase the volume of the FDI inflows in our country. The development of Nigeria is strongly determined by the volume of foreign capital inflows, current policy makers struggle over time various strategies to attract an increased volume of FDI.

Conclusion and Recommendations

The study analyzed the effect of GDP growth rate and inflation on foreign direct investment in Nigeria's over the period of 1998- 2017. The findings revealed that inflow of foreign direct investment is directly related to economic growth and inversely related to inflation and all statistically significant at 5% level. This implies that a good performance of the economy is a positive signal for inflow of foreign direct investment and at the same time will reduce the rate of inflation which in tones improves the living standard of the citizenry. It can be concluded that foreign direct investment is an engine of economic growth. Therefore, there is need to have a stable political and economic environment and improve on the critical infrastructure, level of security at all levels in the country, systems of governance should be is based on accountability, transparency, effective and efficient resource. Furthermore, government needs to liberalize the foreign sector in Nigeria so that all barriers to trade such as arbitrary tariffs; import and export duties and other levies should be reduced so as to encourage investors.



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