

Analysis of Foreign Direct investment in West Africa

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Abstract

This study examined the impact of foreign direct investment (FDI) on economic growth in West African countries. The findings highlight that FDI and gross fixed capital formation are key drivers of economic growth in the region. While most West African nations experience a positive relationship between FDI and economic growth, some countries exhibit a negative correlation. The analysis also indicates that high exchange rates and inflation levels hinder economic growth. Moreover, the significance of the constant term in the model underscores the vital role FDI plays in boosting economic performance across the region. Based on these findings, the study recommends that governments implement policies aimed at increasing FDI inflows. These could include measures such as tax holidays, the establishment of free trade zones, and other incentives designed to attract foreign investors. Additionally, efforts should be made to reform exchange rate policies to ensure stability and competitiveness. Controlling inflation should also be a priority, and central banks are encouraged to adopt strategies that reduce inflation to single-digit levels. Let me know if you need this formatted for a conclusion section or turned into bullet points for a presentation!

Keywords: foreign direct investment, economic growth. Exchange rate, inflation and Gross fixed capital formation

Introduction

Foreign direct investment (FDI) plays a crucial role in supporting an open and efficient global economy and serves as a key driver of development. However, the advantages of FDI are not guaranteed and are often distributed unevenly among countries, industries, and communities. The ability to attract FDI and fully harness its developmental benefits largely depends on national policies and the broader international investment framework. The main challenges lie with host countries, which must create a transparent, inclusive, and effective policy framework to encourage investment, while also investing in human capital and institutional capacity. Human and institutional capacities to implement them. With most FDI flows originating from organization of economic cooperation development (OECD) countries, developed countries can contribute to advancing this agenda. They can facilitate developing countries' access to international markets and technology, and ensure policy coherence for development more generally; use overseas development assistance (ODA) to leverage public/private investment projects; encourage non-OECD countries to integrate further into rules-based international frameworks for investment; actively promote the OECD Guidelines for Multinational Enterprises, alongside other components of the OECD Declaration on International Investment, and extend the OECD's peer review-based method for strengthening investment capacity to non-member countries.

Developing nations, emerging markets, and countries undergoing economic transitions have increasingly recognized foreign direct investment (FDI) as a vital engine for economic progress, modernization, income generation, and job creation. In response, many of these

countries have liberalized their FDI frameworks and implemented policies aimed at attracting investment. They have also begun to explore strategies for aligning domestic policies with foreign investment to maximize its developmental impact.

The positive effects of FDI on developing economies are well-supported by research. When supported by suitable domestic policies and a foundational level of development, numerous studies show that FDI fosters technology transfer, enhances human capital, promotes integration into the global trade system, encourages a more competitive business environment, and supports the growth of local enterprises. Together, these outcomes drive stronger economic growth, which is essential for reducing poverty. Beyond economic gains, FDI can also lead to environmental and social improvements by introducing cleaner technologies and encouraging more socially responsible business practices.

In the 1950s and 1960s, many developing countries viewed FDI and multinational enterprises (MNEs) with suspicion, seeing them as threats to national sovereignty and obstacles to genuine economic development. FDI was perceived as an exploitative force, influencing transfer pricing and contributing to enclave economies. At the end of the colonial period, most African countries particularly in West Africa were economically underdeveloped, with inadequate infrastructure, minimal healthcare coverage, and poor education systems.

Since gaining independence, most West African nations have pursued ambitious economic, social, and cultural development goals. They invested heavily in sectors such as public infrastructure, agriculture, industry, and services, often financed through external borrowing. Over recent decades, however, attitudes toward FDI have shifted dramatically. Most African nations have reformed their foreign investment policies to encourage greater participation by multinational corporations. The previously skeptical view of FDI has evolved into one that sees it as a valuable driver of economic growth. This shift can be attributed to factors such as global economic liberalization and increasing pressure on less developed countries to address challenges like unemployment, limited domestic investment, and outdated technologies.

FDI is now widely recognized as a means of transferring production technologies from developed to developing countries, offering greater potential for economic growth than domestic private investment alone. West African countries, in particular, have come to appreciate the economic advantages that foreign investors can bring. These nations are increasingly relying on market mechanisms to correct imbalances in their private sectors and are turning to FDI to help address issues such as excessive debt. From a macroeconomic standpoint, when internal resources are insufficient, foreign capital inflows including FDI can fill the financing gap created by budget and savings shortfalls, trade deficits, and excessive imports.

Like many other developing regions, West Africa has transitioned from resistance to FDI to actively courting multinational corporations. With ongoing regional integration efforts and progress in monetary and financial cooperation, the area has become increasingly attractive to investors. Factors such as geographic proximity and low labor costs add to the region's appeal, making it a promising destination for foreign investment.

2 Conceptual Understanding of Foreign Direct Investment

Trade has consistently played a fundamental role in economic growth, and with the advent of globalization, it has expanded to a global scale. Foreign Direct Investment (FDI) has shown notable resilience during times of financial instability. Its importance in driving economic development is widely acknowledged. FDI contributes significantly to the economic progress of host countries by supplying capital, foreign currency, advanced technology, and by fostering

competition and improving access to international markets. FDI occurs when an investor from one nation acquires assets in another, often involving the transfer of resources such as technology, managerial expertise, and marketing strategies to the host country. Furthermore, the investing firm often gains a degree of control over the operations and decision-making processes of the foreign enterprise, particularly when it holds a significant equity stake. FDI can also take the form of reinvested earnings, where profits generated by the host country's enterprise are retained and reinvested, thereby reinforcing the influence of foreign investors. Let me know if you'd like this to sound more academic, concise, or expanded with examples.

2.1 FDI and Economic Development

Foreign Direct Investment (FDI) plays a significant role in transferring capital and technology between the home and host countries. For developing nations in particular where the need for capital is high FDI can be a critical driver of economic progress. While the benefits of FDI are generally positive, they are not automatic and may vary in magnitude depending on the sector, quality, and volume of the investment. The prevailing belief today is that, under a relatively stable and supportive domestic policy environment, FDI brings essential resources such as capital, advanced technologies, management expertise, marketing practices, and integration into global production networks. Together, these elements help stimulate economic growth and development in the host countries. FDI can influence economic growth through direct, indirect, and reverse impacts, as outlined below:

- i. **Capital Formation:** One of the most direct benefits of FDI is its contribution to capital formation. While domestic investment increases a country's capital stock, FDI complements this by bridging the gap between national savings and investment needs.
- ii. **Job Creation:** FDI has significantly contributed to job creation, particularly through the establishment of new industrial facilities (Greenfield investments) and the expansion of existing businesses via mergers and acquisitions. These developments boost employment, enhance household income, and improve overall purchasing power within the economy.
- iii. **Trade Enhancement:** FDI also fosters increased trade activity, expanding opportunities for both imports and exports. For developing countries, the main trade-related advantage of FDI is its long-term effect in more deeply integrating the host country into the global economy. The combination of domestic and foreign investment raises trade volumes, increases productivity, supports employment, and contributes to higher foreign exchange earnings ultimately leading to an increase in GDP and promoting overall economic development.

2.1.2 Determinants of FDI

The key factors influencing the flow of FDI into a host country can be broadly classified into three categories:

- i. **Policy Framework:** The policy environment plays a vital role in determining the volume and nature of FDI a country receives. This includes aspects like tax policies, political stability, and overall economic governance. Investors closely examine the regulatory framework before committing capital, so countries with investor-friendly policies are more likely to attract FDI.
- ii. **Economic Conditions:** A country's economic fundamentals—such as market size, availability of natural resources, and effective consumer demand—are crucial in determining the profitability and viability of investments. These conditions guide investors in choosing the most suitable sectors and investment strategies in the host country.

iii. Business Infrastructure: Factors like infrastructure, technological readiness, and the availability of skilled labor significantly affect an investor's decision. These elements influence both the cost and ease of doing business, and countries with strong business environments are more likely to attract higher volumes of FDI.

2.1.3 Trends of FDI in West African Countries

From 1990 to 2012, FDI inflows into West African countries generally showed an upward trend (WBI 2015), although some countries experienced periods of stability or stagnation. Among the region, Niger received one of the highest FDI inflows between 2008 and 2012, indicating strong investor interest. Mali followed, with its FDI levels rising notably from US\$1.9 million in 2004 to US\$80 million in 2010.

Countries like Ivory Coast, Burkina Faso, and Senegal were in the third tier. Ivory Coast, in particular, saw a sharp decline in FDI during years of political instability, recording a significant negative value in 1992 (–US\$234.5 million). Benin maintained a stable FDI trend from 1990 to 2005, with a gradual increase thereafter. Togo, among the poorest in the region, attracted the least FDI due to limited natural resources and weaker economic structures.

Private capital inflows including FDI and portfolio investments have steadily increased in the region since 2000. Although this growth slowed around 2005, FDI saw a resurgence by 2012. Overall, the trend suggests growing investor interest in West Africa, particularly in countries demonstrating political stability, improved infrastructure, and resource availability.

Theoretical literature

2.1 Institutional FDI Fitness theory

Institutional FDI Fitness theory Developed by Wilhems and Witter (1998), the term FDI fitness focuses on a country's ability to attract, absorb and retain FDI. It is this country ability to adapt, or to fit to the internal and external expectations of its investors, which gives countries the upper-hand in harnessing FDI inflows. The theory itself attempts to explain the uneven distribution of FDI flows between countries. Wilhem's institutional FDI fitness theory rests on four fundamental pillars –Government, market, educational and socio-cultural fitness. At the base of the pyramid are socio-cultural factors which according to Wilhelms and Witter (1998), are the oldest and most complex of all institutions. Above that is education, which the authors affirm to being necessary in ensuring an attractive environment for FDI as educated human capital enhances R&D creativity and information processing ability. The actual level of education does not seem to matter much for FDI as the requirements are dependent on the various skills needs of projects to be undertaken.

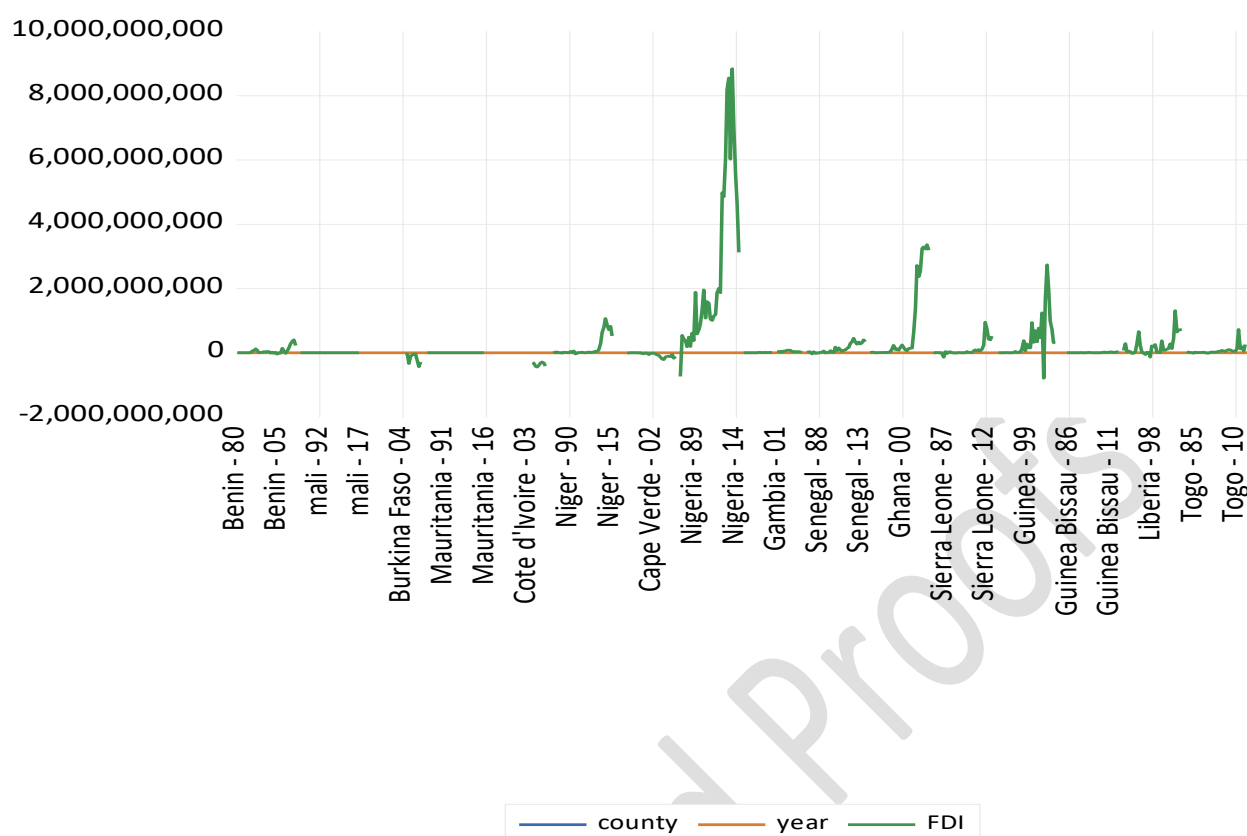


Fig 1: Trend of FDI flow in West Africa

Source: Computed by Author using Eviews 10 From the trend of the flow of FDI in West African countries indicated that Nigeria attracts the highest flow compare to other West African Countries, flowed by Ghana, Guinea Bissau and Togo respectively these may be as a result of policy frame work in those countries, Economic condition or he Business facilities available

In the same vein FDI flow in to countries like Niger, Burkina Faso, Cote d' Ivoire Cape Verde as well as Sierra Leone shows a an unfavourable trend which indicated that FDI has not impacted positively in these Countries. Due to policy and improve in economic as well as Business facilities some countries have shown progress in attracting FDI like Sierra Leone as shown in Figure one above

However, it is clear that foundational education plays a crucial role in enhancing the productivity and efficiency of foreign direct investment (FDI) operations. Basic skills such as speaking, listening, comprehending, interpreting, and executing instructions are essential in attracting and sustaining FDI. The third pillar of institutional FDI fitness, known as markets, refers to the economic and financial infrastructure necessary to support investment activities. This includes physical capital like machinery and financial capital such as credit. Efficient and developed financial markets are particularly attractive to multinational corporations (MNCs) and significantly influence their investment decisions.

The fourth pillar identified by Wilhelms is government. A nation's political stability and governance quality are pivotal in the FDI landscape. A government's "fitness" involves implementing protective regulations to support healthy market operations. According to Popovici and Calin (2014), government effectiveness is further enhanced by economic openness, minimal interference in trade and exchange rates, reduced corruption, and improved transparency. If a country's policies are perceived as hostile or unpredictable, MNCs tend to avoid investing there due to the increased risk.

Wilhelms and Witter (1998) emphasized that although these four institutional pillars education, markets, government, and socio-cultural systems are structured hierarchically, they are in fact deeply interconnected. Government policies can shape market conditions, influence education systems, and regulate socio-cultural dynamics. Similarly, market performance impacts government decisions, educational needs, and cultural trends. Education directly affects human capital development and thereby influences all other pillars. Meanwhile, socio-cultural systems are foundational, influencing governance structures, market behavior, and educational priorities.

Interestingly, the Institutional FDI Fitness theory has been tested, particularly in the African context. For instance, Muthoga (2003), as cited in Popovici and Calin (2014), analyzed Kenya's FDI determinants from 1967 to 1999. The study concluded that economic openness, GDP growth, domestic investment levels, return on investment, and credit availability factors tied to government policy are key in attracting FDI.

In a related study, Musonera Nyamulinda and Karuranga (2010) applied the institutional FDI fitness framework to the East African Community (EAC), analyzing Kenya, Tanzania, and Uganda from 1995 to 2007. They found that FDI inflows into Tanzania and Uganda were influenced by multiple risk-related factors, including population size, economic scale, financial market development, trade openness, infrastructure, and broader political and economic conditions. The findings challenge the notion that Africa's FDI is primarily resource-driven; instead, even resource-scarce countries like Tanzania and Uganda attracted significant FDI by ensuring political and macroeconomic stability, implementing efficient regulations, and curbing corruption.

Methodology

3.1 Method of Data Analysis

The study used panel data estimation techniques to enhance the accuracy of estimations, address multicollinearity, and increase the degrees of freedom. The data spanned the years 1980 to 2017 and was sourced from the World Development Indicators database.

3.1.1 Panel Data Analysis

Panel data analysis is a statistical approach commonly used in disciplines like social sciences, epidemiology, and econometrics to analyze datasets that have both cross-sectional and time-series dimensions. This method involves collecting data over time from the same entities, enabling researchers to run regressions that account for both individual-specific and time-specific variations. With the specific model chosen (fixed or random effects) based on the structure and nature of the dataset.

Panel data analysis is a statistical technique frequently applied in fields such as social sciences, epidemiology, and econometrics to examine two-dimensional datasets—typically combining cross-sectional and time-series data. This method involves collecting data across a specific time period for the same set of entities or individuals, allowing for regression analysis that considers both dimensions simultaneously.

When data spans more than two dimensions such as time, individuals, and an additional variable this is referred to as multidimensional or multilevel analysis.

A Typical Model Used In Panel Data Regression Is Represented As:

$$Y_i = A + B \cdot X_i + E_{it},$$

Where:

- y_i is the dependent variable,
- x_i represents the independent variables,
- a and b are the parameters to be estimated,
- i stands for the individual or unit of observation,
- t represents time,
- ϵ_i denotes the error term.

Pooled ordinary lease square regression:

$$Y_{it} = \beta_0 + \beta_1 X_{1it} + \beta_2 X_{2it} + u_{it} \dots \dots \dots \text{equ(1)}$$

Where Y_{it} are the dependent variables i and X_{it} are the vectors and β_0 is the intercept α is the slope of the parameter in the fixed effect model

Random Effect Models

$$Y_{it} = \beta_{1i} + \beta_2 X_{2it} + \beta_3 X_{3it} + \epsilon_i + u_{it} \dots \dots \dots \text{equ (2)}$$

$$Y_{it} = \beta_{1i} + \beta_2 X_{2it} + \beta_3 X_{3it} + w_{it} \dots \dots \dots \text{equ (3)}$$

$$\epsilon_i = w + u_{it} \dots \dots \dots \text{equ (4)}$$

Where w is the unobserved country specific effect and u_{it} is the error term due to the restrictive nature of the common constant by pooling model, which did take account the as you move across countries differ in policies and endowments. Thus random and fixed effects were employed to take account of these differences.

To test between pooled and random effect model which on is appropriate the Breusch-Pagan Langrange Multiplier (LM) was used, the LM help to decide between the pooled and random effect which is more effective.

The null hypothesis in the LM test is that variance across entities is zero, this is no significant different across units (i.e. no panel effect).

$$H_0: \delta^2 = 0 \dots \dots \dots \text{equ (5)}$$

Fixed Effect Model with Dummy Variables

$$Y_{it} = \alpha_1 + \alpha_2 D_{2i} + \alpha_3 D_{3i} + \alpha_4 D_{4i} + \beta_2 X_{2it} + \beta_3 X_{3it} + u_{it} \dots \dots \dots \text{equ (6)}$$

3.2 Model specification

The model specify Real–Gross Domestic product (RGDP) as proxy for economic development in West African Countries, (FDI) as proxy for Foreign Direct investment flow in Africa, (INF) as proxy for rate of inflation in West African Countries, (EXRT) as proxy for exchange rate in West African Countries and Gross Fixed Capital formation (GFCF) as proxy for domestic investment in West African Countries.

Model I is specified to answer the first objective of the study which is to analyse the impact of foreign direct investment in West African as well as the second specific objective of the study that state that if FDI has positive or negative effect on West African economy.

Model II is specified the second objective of the study is to examine the effect of foreign direct investment on domestic growth in West Africa.

Model I

$$RGDP_{it} = \beta_0 + FDI_{2it}\beta_2 + EXRT_{3it}\beta_3 + INF_{4it}\beta_4 + GFCF_{5it}\beta_5 + u_{it} \dots \dots \dots \text{equ (7)}$$

Were:

RGDP = Real Gross Domestic product

FDI = Foreign Direct Investment

EXRT= Exchange rate

GFCF= Gross fixed capital formation

Model II

$$GFCF_{it} = \beta_0 + FDI_{2it}\beta_2 + EXRT_{3it}\beta_3 + INF_{4it}\beta_4 + RGDP_{5it}\beta_5 + u_{it} \dots \dots \dots \text{equ (8)}$$

Were:

GFCF= Gross fixed capital formation

FDI = Foreign Direct Investment

EXRT= Exchange rate

RGDP = Real Gross Domestic product

Result

Table 1: Pooled, Random effect and Fixed effect model estimations

Variable	Pooled	Random effect	Fixed effect
FDI	6.07261 (0.000)*	-0.09998 (0.989)	1.32865 (0.035)
Exchange Rate	-1.3807 (0.000)*	-1.5707 (0.000)*	-1.62070 (0.000)*
GFCF	.018515 (0.000)*	0.2008 (0.000)*	0.2061 (0.000)*
Inflation Rate	7.5007 (0.101)	-7.1007 (0.122)	-1.0508 (0.025)**
Constant	-5,8509	2.4409	3.9309

	(0.652)	(0.459)	(0.008)*
Number of Observation	410	410	410
B-P LM Test	0.0000		
Hausman Test	0.0111		

Source: Author's Computation Using Stata 14

Note that *, **, & *** indicates significance at 1, 5 & 10 percent respectively

Table 2. Country Specific Effect

Country	Coefficient	Probability
Benin	-1.32	(0.235)
Mali	-5.30	(0.218)
Bukina Faso	-1.59	(0.005)*
Mauritania	1.37	(0.752)
Coted'Ivoire	-6.45	(0.276)
Niger	2.81	(0.484)
Cape Verde	1.17	(0.886)
Nigeria	3.99	(0.000)*
Gambia	9.99	(0.819)
Senegal	-9.13	(0.022)
Ghana	3.12	(0.469)
Sierra Leone	1.24	(0.009)***
Guinea	-1.78	(0.000)*
Guinea Bissau	7.85	(0.067)***
Liberia	1.82	(0.734)
Togo	3.89	(0.371)

Source: Author's Computation Using Stata 14

Note that *, **, & *** indicates significance at 1, 5 & 10 percent respectively

In analysing the data, the Breusch-Pagan Lagrange Multiplier (LM) test was carried out after applying both the pooled and random effects models to determine the presence of individual effects. The test results supported the random effects model, prompting the need to compare it with the fixed effects model using the Hausman test.

The Hausman test was then performed to decide between the random and fixed effects models. The test returned a probability value of 0.0111, which is less than 0.05, leading to the rejection of the null hypothesis that the random effects model is appropriate. Consequently, the alternative hypothesis that the fixed effects model is more suitable was accepted. This implies

that the characteristics of West African countries vary significantly, and the analysis should be interpreted using a fixed effects model with country-specific effects for Foreign Direct Investment (FDI).

The analysis revealed that the coefficient of FDI was positive and statistically significant in several countries, aligning with theoretical expectations. These countries include Mauritania, Niger, Cape Verde, Nigeria, Gambia, Ghana, Sierra Leone, Guinea-Bissau, Liberia, and Togo. Table 3 shows that a unit increase in GDP corresponds to the following changes in FDI: 1.37 in Mauritania, 2.81 in Niger, 1.17 in Cape Verde, 3.99 in Nigeria, 9.38 in Gambia, 3.12 in Ghana, 1.24 in Sierra Leone, 7.85 in Guinea-Bissau, 1.82 in Liberia, and 3.89 in Togo. These findings are consistent with Azman-Saini et al. (2010), who concluded that FDI has a positive effect on economic growth and can significantly contribute to the development of host nations.

Conversely, in countries such as Benin, Mali, Burkina Faso, Côte d'Ivoire, Senegal, and Guinea, FDI showed a negative relationship. The analysis indicates that changes in FDI 1.33 units in Benin, 5.30 in Mali, 1.59 in Burkina Faso, 6.45 in Côte d'Ivoire, 9.13 in Senegal, and 1.78 in Guinea resulted in a one-unit decrease in GDP. These negative outcomes could be attributed to challenges such as political instability, lack of investor-friendly policies, inadequate resources, and limited market access. Regarding the exchange rate, the coefficient was negative yet significant, contrary to initial expectations. A 1.62% reduction in exchange rate was found to result in a one-unit increase in GDP. This suggests that high exchange rates in West African countries can deter FDI inflows, ultimately affecting economic growth.

The results also indicate a positive relationship between FDI and gross fixed capital formation. Specifically, a 0.2161 unit (or 2%) increase in gross fixed capital formation leads to a one-unit increase in GDP, highlighting its contribution to economic growth in the region. Similarly, inflation was found to have a negative and significant relationship with GDP, supporting theoretical expectations. A reduction in inflation by 1.0508% (or 10%) results in a one-unit increase in GDP. The constant term (intercept) was also statistically significant at 3.9309, indicating that even when GDP is held constant, FDI would grow by 39.3%, underscoring its critical role in driving economic growth in West African countries.

Conclusion

This study evaluated the influence of Foreign Direct Investment (FDI) on economic growth in West African countries. It found that FDI and gross fixed capital formation are crucial contributors to growth. The relationship between FDI and economic growth was positive in many countries but negative in a few. Additionally, high exchange rates and inflation were shown to hinder growth, whereas FDI significantly boosts GDP even in the absence of other contributing variables.

Based on these findings, the study recommends that governments adopt policies aimed at increasing FDI inflows. These could include tax incentives, the creation of free trade zones, and other investor-friendly measures. Furthermore, governments should address exchange rate volatility by implementing appropriate monetary policies, and inflation should be a priority for central banks, which should strive to bring it down to single digits.

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Uncorrected Proofs