

**A GRANGER-CAUSAL EXAMINATION OF THE
RELATIONSHIP BETWEEN FOREIGN DIRECT
INVESTMENT AND ECONOMIC GROWTH IN NIGERIA
(1981 – 2007)**

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ABSTRACT

The paper conducts an empirical examination of the relationship between foreign direct investment (FDI) and economic growth taking real domestic product (RGDP) as a proxy for growth in the Nigerian economy, using Granger causality test and Simple Linear Regression. The data used were mainly sourced from Central Bank of Nigeria Statistical Bulletin of the year 2009. The results have revealed evidence of causality between the two variables running unidirectionally (one-way) from FDI to growth. However the Granger causality test employed in examining the relationship is not without the limitation of providing only the explanation of growth by the two periods lagged values of FDI, that is what necessitates the use of Simple Linear Regression to investigate the nature of the relationship between FDI and Economic Growth in Nigeria. However, to avoid having into spurious regression results, augmented Dickey Fuller unit root test was conducted and the variables were found stationary at level which suggests that the regression results are not spurious. Based on the findings of the paper, it is recommended that government stabilization measures be geared towards attracting FDI by providing an investment friendly environment bereft of political and macroeconomic instability as that would help propel growth.

KEYWORDS: Foreign Direct Investment, Economic Growth Granger Causality

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I. INTRODUCTION

Foreign direct investment in an economy is undertaken by nonresidents, in most cases by multinational corporations, in enterprises located in host countries. Foreign direct investment implies full or partial control of the enterprise and physical presence by foreign firms or individuals. In Nigeria Foreign Direct Investment (FDI), is more often than not encouraged through the introduction of incentive packages based on the perception that domestic resource gap can be partly filled through foreign direct investment.

Before the structural adjustment period of 1986, especially during the oil boom era, the Nigerian government theoretically encouraged FDI but in practice there were series of policies and pronouncements that served as disincentives. The global oil crises of 1981, the ad hoc policies and their haphazard implementation got the economy entrapped into ominous doldrums. With commercial bank lending to developing economies drying up in the 1980s, most countries eased restrictions on foreign direct investment (FDI) and many aggressively offered tax incentives and subsidies to attract foreign capital. The rapid growth of foreign direct investment (FDI) and its overall magnitude had sparked numerous studies dealing with the channels of transmission from FDI to growth. Theoretically, models of "endogenous" growth were recently combined with studies on the diffusion of technology in an attempt to emphasize the major role played by FDI in the economy. In spite of the austerity measures put in place during the period (1986), the Nigerian economy was still in balderdash of recession as the stop gap measures namely; tax exemptions, reduced tariffs etc aimed at attracting foreign direct investment could not yield fruitful results.

The concept of sustainable economic growth presents an immense challenge for policy makers especially in developing countries. The issues underlying the concept of economic growth have become even more distinct in the prevailing era of globalization where business processes and decisions have become a "global" trait as opposed to the historical national traits. With globalization, there has been increased deregulation and liberation of international markets that has led to increased trade and international investment across boundaries of countries (Kiiza, 2007). Up until the late 1980s, most of the developing countries relied on bilateral and multilateral donor assistance (Overseas Development Assistance – ODA) as a source of project development finance.

The decade between 1990 and 2000 witnessed a remarkable and consistent decrease in development assistance to developing countries that forced them to search for alternative and sustainable sources of finance. Subsequently, by 1998, foreign direct investment had emerged as the largest source of capital for developing countries rising from US\$174 billion in 1992 to US\$664 billion in 2006. Up till date, the growth in foreign direct investment shows that sustainable growth for several developing countries is progressively being influenced by multinational enterprises (MNEs) through foreign direct investment flows. Thus, attracting foreign direct investment has become very crucial for most countries because of its perceived positive impact on economic growth and development. Many countries have undertaken structural and regulatory reforms such as privatization of state enterprises, liberalization of their foreign exchange markets and establishment of fiscal incentives like tax holidays in order to attract more foreign direct investments (Kiiza, 2007).

The quest by developing countries for increased foreign direct investment stems from the assumption that foreign direct investment leads to economic benefits within the host country, these assumptions are based on economic theory. In addition, there is existing empirical research that has further highlighted the benefits of foreign direct investment. According to World Bank, developing countries should endeavor to attract more foreign direct investment because; it encourages production improvements, contributes to the advancement in technology, boosts employment opportunities, bolsters business sector competition and creates exports. Fortanier and Maher (2001) indicate that foreign direct investment through multinational enterprises is an influential and effective means to propagating technology from developed to developing countries. They further indicate that foreign direct investment is habitually the only source of innovation and the creation of new technologies. Empirical researches also support the assertion that foreign direct investment positively contributes to the enhancement of the economies of host countries. Mansfield and Romeo (1980) shows that technology that comes with foreign direct investment is newer compared to that sold through licensing.

In his paper, Johnson (2005) argues that foreign direct investment affects the economic growth of host countries mainly through two channels, which include technology spillover and inflow of human capital. Technology spillover to the host country's economy is normally through imitation and forward and backward linkages with domestic enterprises and suppliers. Most studies failed to investigate the causal relationship between FDI and economic growth; such studies however went ahead and assumed that economic growth is solely dependent on FDI.

This paper therefore, investigates using data from 1981 to December 2007 obtained from the Central Bank of Nigeria, the direction of causality between foreign direct investment (FDI) and economic growth in Nigeria, taking the real gross domestic product (RGDP) as a proxy for economic growth, the choice of the time frame has to do with the availability of data. The paper is therefore, organized into four sections. After the Introduction, Section II contains literature review and some theoretical issues. Section III is the methodology and result presentation/discussion the last section contains summary and concluding remarks.

II.LITERATURE REVIEW AND THEORETICAL ISSUES

Nigeria is one of the few countries that have consistently benefited from the FDI inflow to Africa. Nigeria's share of FDI inflow to Africa averaged around 10%, from 24.19% in 1990 to a low level of 5.88% in 2001 this rose to 11.65% in 2002. Evidence showed that Nigeria as the continent's second top FDI recipient after Angola in 2001 and 2002 (Ayanwale, 2007). The literature is replete with studies on investment and growth in Nigeria with varying results and submissions. For example, it was reported that the factors affecting FDI flow into Nigeria in both the pre and post structural adjustment programme (SAP) era and found that the macro policies in place before the SAP were discouraging foreign investors. This policy environment led to the proliferation and growth of parallel markets and sustained capital flight. It was also reported by many researchers that there exists negative contributions of public investment to GDP growth in Nigeria for reasons of distortions. While there exists positive linkages between FDI and economic growth in Nigeria. It was also found by Ayanwale (2007) that FDI is positively associated with GDP.

Most countries strive to attract foreign direct investment (FDI) because of its acknowledged advantages as a tool of economic development. Africa and Nigeria in particular joined the rest of the world in seeking FDI as evidenced by the formation of the New Partnership for Africa's Development (NEPAD), which has the attraction of foreign investment to Africa as a major component (Ayanwale, 2007).

Foreign direct investment (FDI) is an investment made to acquire a lasting management interest (normally 10% of voting stock) in a business enterprise operating in a country other than that of

the investor defined according to residency (World Bank, 1996). Such investments may take the form of either “greenfield” investment (also called “mortar and brick” investment) or merger and acquisition (M&A), which entails the acquisition of existing interest rather than new investment. Sub-Saharan Africa as a region now has to depend very much on FDI for so many reasons. The effort by several African countries to improve their business climate stems from the desire to attract FDI (Ayanwale, 2007). Nigeria as a country, given her natural resource base and large market size, qualifies to be a major recipient of FDI in Africa and indeed is one of the top three leading African countries that consistently received FDI in the past decade. However, the level of FDI attracted by Nigeria is not sufficient compared with the resource base and potential need. The empirical link between FDI and economic growth in Nigeria is yet unclear, despite numerous studies that have examined the influence of FDI on Nigeria’s economic growth with varying outcomes (Oseghale and Amonkhienan, 1987; Odozi, 1995; Oyinlola, 1995; Adelegan, 2000; Akinlo, 2004). Most of the previous influential studies on FDI and growth in sub-Saharan Africa are multi country studies. However, recent evidence affirms that the relationship between FDI and growth may be country and period specific. Asiedu (2001) submits that the determinants of FDI in one region may not be the same for other regions. In the same vein, the determinants of FDI in countries within a region may be different from one another and from one period to another. The results of studies carried out on the link between FDI and economic growth in Nigeria are not unanimous in their submissions. A closer examination of these previous studies reveals that conscious effort was not made to take care of the fact that more than 60% of the FDI inflows into Nigeria is made into the extractive (oil) industry. Hence, these studies actually modeled the influence of natural resources on Nigeria’s economic growth (Ayanwale, 2007). The impact of FDI on economic growth is more contentious in empirical than theoretical studies, hence the need to examine the relationship between FDI and growth in different economic dispensations. There is further the problem of endogeneity, which has not been consciously tackled in previous studies in Nigeria. FDI may have a positive impact on economic growth leading to an enlarged market size, which in turn attracts further FDI (Ayanwale, 2007). The authors in this paper have attempt to investigate, using a simple OLS estimation technique and a Granger Causality approach, the relationship as well as the direction of causality between FDI and economic growth using GDP as a proxy for growth in the Nigerian economy. Annual data obtained from the Central Bank of Nigeria (CBN) which covers the period 1970-2005 was used.

A lot of research interest has been shown on the relationship between FDI and economic growth, although most of such work is not situated in Africa.

The focus of the research work on FDI and economic growth can be broadly classified into two. First, FDI is considered to have direct impact on trade through which the growth process is assured. Second, FDI is assumed to augment domestic capital thereby stimulating the productivity of domestic investments. These two arguments are in conformity with endogenous growth theories (Romer, 1990) and cross country models on industrialization in which both the quantity and quality of factors of production as well as the transformation of the production processes are ingredients in developing a competitive advantage. FDI has empirically been found to stimulate economic growth by a number of researchers. (Borensztein et al., 1998; Glass and Saggi, 1999). For example, Dees (1998) submits that FDI has been important in explaining China's economic growth, while De Mello (1997) presents a positive correlation for some selected Latin American countries. Inflows of foreign capital are assumed to boost investment levels. Blomstrom et al. (1994) report that FDI exerts a positive effect on economic growth, with certain threshold level of income above which FDI has positive effect on economic growth and below which it does not. The explanation was that only those countries that have reached a certain income level can absorb new technologies and benefit from technology diffusion, and thus reap the extra advantages that FDI can offer. Previous works suggest human capital as one of the reasons for the differential response to FDI at different levels of income (Ayanwale, 2007).

The neoclassical economists argue that FDI influences economic growth by increasing the amount of capital per person. However, because of diminishing returns to capital, it does not influence long-run economic growth. They assert that even though FDI is positively correlated with economic growth, host countries require minimum human capital, economic stability and liberalized markets in order to benefit from long-term FDI inflows (Ayanwale, 2007)

On the other hand, to Obwona (2001), FDI also influences long-run variables such as research and development (R&D) and human capital. FDI could be beneficial in the short term but not in the long term. In his study of the determinants of FDI and their impact on growth in Uganda that

macroeconomic and political stability and policy consistency are important parameters determining the flow of FDI into Uganda and that FDI affects growth positively but insignificantly.

It was reported by Ayanwale, (2007) that political regime, real income per capita, rate of inflation, world interest rate, credit rating and debt service explain the variance of FDI in Nigeria, however, Nigeria's credit rating is very important in drawing the needed FDI into the country. Furthermore, spillover effects could be observed in the labor markets through learning and its impact on the productivity of domestic investment through technology transfer to their affiliates and technological spillovers to unaffiliated firms in host economy, transnational corporations (TNCs) can speed up development of new intermediate product varieties, raise the quality of the product, facilitate international collaboration on R&D, and introduce new forms of human capital. FDI also contributes to economic growth via technology transfer. TNCs can transfer technology either directly (internally) to their foreign owned enterprises (FOE) or indirectly (externally) to domestically owned and controlled firms in the host country.

Spillovers of advanced technology from foreign owned enterprises to domestically owned enterprises can take any of four ways: vertical linkages between affiliates and domestic suppliers and consumers; horizontal linkages between the affiliates and firms in the same industry in the host country.

The pace of technological change in the economy as a whole will depend on the innovative and social capabilities of the host country, together with the absorptive capacity of other enterprises in the country. It is however embedded in the literature that FDI increases growth through productivity and efficiency gains by local firms. The empirical evidence is not unanimous, however. Available evidence for developed countries seems to support the idea that the productivity of domestic firms is positively related to the presence of foreign firms. The results for developing countries are not so clear, with some finding positive spillovers. Some of the reasons adduced for these mixed results are that the envisaged forward and backward linkages may not necessarily be there and that arguments of TNCs encouraging increased productivity

due to competition may not be true in. Further, the role of FDI in export promotion remains controversial and depends crucially on the motive for such investment (World Bank, 1998).

The consensus in the literature appears to be that FDI spillovers depend on the host country's capacity to absorb the foreign technology and the type of investment climate. This once again corroborates the fact that the impact of FDI on economic growth is far from being conclusive. Most studies on FDI and growth are cross-country evidences, while the role of FDI in economic growth can be country specific. Further, only a few of the country specific studies actually took conscious note of the endogenous nature of the relationship between FDI and growth in their analyses, thereby raising some questions on the robustness of their findings. Finally, the relationship between FDI and growth is conditional on the macroeconomic dispensation the country in question is passing through (Ayanwale, 2007).

However, one set of factors that influence FDI-economic growth relationship has so far received little systematic empirical attention: the heterogeneous characteristics of FDI itself. In the field of economics, where most studies on FDI and growth can be found, FDI is generally conceptualized as homogeneous flows of capital. In the field of International Business, the differences in types of investors and investments (e.g. the organizational, technological, managerial and strategic characteristics of the firms) are recognized, but these are mostly related to firm performance, rather than "host country performance". This article examines whether taking into account the differences in the characteristics of FDI in empirical research helps our understanding of the impact of FDI: i.e. whether, to what extent and under what conditions the entry of TNCs enhances economic growth in host economies.

Foreign direct investment (FDI) and TNCs affect economic growth (and other dimensions of development) through three key mechanisms: size effects, skill and technology effects and structural effects. Size effects refer to the net contribution of FDI to the host country's savings and investment, thus affecting the growth rate of the production base. Most of the potential costs and benefits of foreign capital, however, result from more indirect effects of FDI either through the transfer of skills and technologies or through structural change in markets (competition and linkages). Whether these effects are positive or negative is a fervently debated research question.

On the one hand, De Mello (1999) found that foreign investors increased growth in host countries. Baldwin et al. (1999) established that domestic technological progress was aided by foreign technological progress, and also presented evidence that FDI had a larger impact on economic growth than investment by domestic firms.

The characteristics of FDI have hitherto received very little empirical attention as determinants of FDI-growth relationship. However, FDI is not a uniform flow of capital across borders and should not therefore be treated as such. Rather, FDI differs by the size and mode of entry; the nature of the (production) techniques chosen; the trade orientation of the parent company; the role of the affiliate in the global production network; the type of activity that takes place; and the aim with which the investment is made (Bornschier (1980) The impact of FDI on growth as mentioned earlier differs depending on host country's characteristics. It also depends on the quality of host country's institutions, in particular the rule of law and the protection of property rights. Moreover, the extent to which FDI contributes to growth also depends on the level of technological sophistication and the stock of human capital available in the host economy. FDI has been found to raise growth only in those countries that have reached a minimum threshold level of technological sophistication or the stock of human capital

III. METHODOLOGY AND PRESENTATION OF RESULTS

Granger causality Test developed by Granger (1969) was employed to investigate the direction of causality between foreign direct investment (FDI) and economic growth in Nigeria. The results of the test presented in Table 1 below have revealed a one-way or in other words a unidirectional causality running from foreign direct investment (FDI) to economic growth as proxied by the gross domestic product (GDP). The basic idea here is anchored on the fact that FDI granger causes growth because its past values were found helpful in the explanation of growth over the sample period. Moreover, the question of whether FDI Granger causes growth is to see how much of the current values of it can be explained by its past values and then to see whether adding lagged values of GDP which is chosen as a proxy for growth can improve the explanation. This can be algebraically represented by this set of equations:

$$GDP_t = a + \sum_{i=1}^p \mu_i RGDP_{t-1} + \sum_{j=1}^q \rho_j FDI_{t-1} + v_t \text{-----(1)}$$

$$FDI_t = b + \sum_{i=1}^m \gamma_i FDI_{t-1} + \sum_{j=1}^n \delta_j RGDP_{t-1} + \varepsilon_t \text{-----(2)}$$

Equations (1) and (2) above express a causal relationship between FDI and economic growth. The first equation shows that GDP is related to both the lagged values of itself and those of FDI. While the second equation expresses a causal link between the current value of FDI, the lagged values FDI and the lagged values of GDP respectively.

Table1: The Granger Causality Test

Null hypothesis	Observations	Number of Lags	F-statistics	Probability
*FDI does not Granger cause RGDP	25	2	1.41	0.37
*RGDP does not Granger cause FDI			0.25	0.75

Source: Authors' Computation Using (E Views 5.0)

Growth is said to be Granger-caused by FDI if FDI helps in the prediction of growth, or equivalently if the coefficients on the lagged values of FDI are statistically significant. It is worth noting however that Granger causality measures precedence and information content but does not by itself indicate causality in the more common use of the term. The reported F-statistics as they appear in the table above are the Wald statistics for the joint hypothesis given as:

$$\beta_1 = \beta_2 = \dots = \beta_k = 0.$$

In each case, the null hypothesis is that RGDP does not Granger cause FDI in the first equation, and FDI does not Granger cause RGDP in the second. The results reported in Table(1) above suggest that we can not reject the hypothesis that RGDP does not Granger cause FDI but rather the hypothesis that FDI does not Granger cause RGDP is rejected. It is worth noting that the acceptance or rejection of the null hypothesis is based on the value of F-statistics associated with

the hypothesis. The rule of thumb is that; a hypothesis associated with lower value of F-statistics is accepted relative to that with higher value of F-statistics. It appears once again then, based on the results obtained from the test that the causality between FDI and growth is unidirectional running one-way from FDI to real Nigeria's GDP (RGDP) and not the other way.

Table2: Augmented Dickey Fuller (Adf) Unit Root Test On FDI and RGDP Series

SERIES	Order of Integration	t-statistic	Critical Values
FDI	I(0)	-4.2112	-3.7378
RGDP	I(0)	-3.9641	-3.7880

Source: Authors' Computation Using (EViews 5.0)

The results of the augmented Dickey Fuller unit root test reported in table 2 above indicate that the null hypothesis of unit root is rejected because the Mackinnon critical values are greater than the ADF t-statistic. This suggests that the FDI series is stationary at level.

The results of the augmented Dickey Fuller unit root test reported in table 2 above indicate that the null hypothesis of unit root is also rejected here, because the Mackinnon critical values at the 1%, 5% and 10% level are greater than the ADF t-statistic. This as mentioned earlier, suggests that the RGDP series is stationary at level. Since all the series are stationary at level we run the regression without any fear of having spurious results. The table below presents the regression results.

Table 3: OLS Regression Result RGDP as Dependent Variable

Variable	Coefficients	Standard Error
Constant	2297.348	844.66
FDI	60.758	26.89
$R^2=0.34$	Adjusted $R^2=0.28$	F = 11.40

Source: Authors' Computation Using (E Views 5.0)

$$\text{RGDP} = 2297.35 + \alpha_1 60.758 + \varepsilon_i \text{-----}(3)$$

(844.7) (26.89)

From the above regression equation (3) it can be deduced that without FDI the value of RGDP will be about N2297.35 Million, while a unit increase in FDI will lead to a corresponding increase in RGDP by N60.758 Million all things being equal. This indicates a positive relationship between FDI and RGDP. A test of Significance was undertaken by comparing half the numerical value of the coefficients with their standard errors which are presented in the parentheses. All the regression coefficients were found significant at 5% and 10% level of significance respectively. The intercept and coefficient of FDI were found to be statistically significant with correct expected signs. The R^2 and the adjusted R^2 were found to be 34% and 28% respectively. This suggests weak explanatory power of the model as only 34% or 28% variations in the dependent variable (RGDP) are explained by the explanatory variable (FDI). The low R^2 might be due the fact that FDI is not the sole determinant of growth; by and large the level of FDI coming into the country was found to be low due partly to poor state of security and partly to unstable political and economic spheres in the country. However, other determinants of RGDP not included in the model are assumed to be captured by the random error term (ϵ_i) included in the model.

IV. SUMMARY CONCLUSION AND RECOMMENDATIONS

The paper examined the causality between foreign direct investment (FDI) and economic Growth proxied by the Real Gross Domestic Product (RGDP) using the conventional Technique of Causality developed by Granger (1969). After ascertaining the direction of the causality, a simple linear regression analysis was employed in the paper to find out the impact of FDI on economic growth. It was discovered that there is causality between the two variables under consideration running unidirectional (one-way) from FDI to growth; specifically FDI is said to granger cause growth and not vice-versa. The simple regression analysis showed that RGDP is partly determined by FDI though the coefficient of determination is very low. Other finding that emanates from the paper is that the lagged value of RGDP is also among the determinants of RGDP, since previous level of RGDP is partly responsible for the growth of the current level of RGDP.

The conclusions that could be drawn therefore is that; the direction of causality between growth and foreign Direct Investment in Nigeria is one way, that is past values of Foreign Direct

Investment are responsible for causing a change in the growth rate. The relationship between the two variables under consideration was found to be positive that is; a positive change in FDI leads to a positive change in RGDP all things being equal.

It is therefore recommended that government should through its fiscal and monetary policy measures try to attract foreign direct investment into the country since according to what is embedded in the literature foreign direct investment is a sine qua non of growth. Measures that will provide conducive atmosphere for the foreign investors such as reduction in interest rate, taxes should be implemented. In addition to this, there is a need also for the provision of politically and macro economically stable environment for investment. And lastly government should expedite action towards improving the state of national security and infrastructure.

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