

# Econometric Analysis of Foreign Direct Investment and Nigeria's Economic Performance

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## Abstract

The fluctuation in the economic fortune of developing economies coupled with the attendant low level of savings and unemployment has been a cause for concern among experts and policy makers in recent years. Motivated by the above and the controversy in international finance/economic literature with respect to the effectiveness and potency of foreign direct investment on economic performance of Nations; the study, using multiple regression analytical technique, discovered that a statistically significant relationship exist between GDP, FDI and EXR. The result showed that variations in gross domestic product had been significantly influenced by FDI, Financial depth and exchange rate within the period under study. The study also confirmed the existence of long run relationship between GDP and FDI, with GDP granger causing FDI and not the other way round. It is therefore recommended among others that government should put up policies that will nip insurgency and other vices in the bud, so as to create a conducive atmosphere for the attraction of foreign direct investment into the country. The issue of money and capital market deregulation should be sustained, so as to deepen the financial market space, as well.

**Keywords:** Foreign Direct Investment, Economic Performance, Financial deepening, Co-integration.

## 1. Introduction

For increased and sustainable economic growth and development to be achieved in developing countries of the world, there is need for increased levels of investment and capital formation. To this end, Foreign Direct Investment (FDI) is considered a critical and essential source of foreign material and human capital for developing countries in general and Nigeria in particular.

In Nigeria, there is a general low level of domestic savings, low level of technical know-how and low level of foreign exchange earnings with the resultant effect of low level of Economic Investment. The adverse multiplier effect of this low level of domestic investment is a fall in the levels of employment, income, consumption and output, and these have impacted negatively on economic activities in the country over the years. Infact Akpan (2000) confirms that the basics of high performance is to recognize risk levels that is consistent within the system. This is so because foreign direct investment comes with its attendant risks (Political, Interest rate, Capital and Inflation). Furthermore, he went on to profess the need for a conducive political and socio-economic environment as a must for attracting foreign investment (capital), for the promotion of domestic investment.

Foreign trade policy in Nigeria falls into three era, these are; Pre-SAP, SAP and Post-SAP. The Pre-SAP era covering the period between 1980-1986 was characterized by general lack of political will. The trade policy of Nigeria during this period was highly restrictive as noted by IMF (1992). Various control policies were put in place including qualitative restrictions in the form of import and export licensing requirements, imposition of tariffs and restrictions on certain categories of imports and exports.

During the Sap period – September 1986 to 1998, trade policy objective was to liberalize trade, with emphasis on promoting export trade. Consequently, there was considerable level of protection. One major change from previous policies was the industrial policy of 1988 which embodied some trade liberalization and Foreign Direct Investments provisions that vary fundamentally from the previous policies. This policy stipulated, among other things, an extensive list of fiscal incentives including the 10% tax holiday for five years, plus additional 5% depreciation beyond the initial capital; depreciation allowance for investment in disadvantage areas, in addition to tax reductions for construction of infrastructure, research and development activities in Nigeria; and in plant training programme. In this regard, Ahmed, (1998) asserted that, “Nigeria, like most other countries in the developing world, seeks to influence the locational decisions of foreign investors by offering direct and indirect incentives”.

The Post-SAP period also promoted the deregulation of trade but with the emphasis on economic integration amongst African nations as reflected in the objectives of New Partnership for Economic Development (NEPAD). This trend and conscious efforts of successive government is further in line with the world's economic globalization principle, which entails a growing interpretation among economies. However, it has been observed that FDI in most developing countries and Nigeria in particular has remained, in relative terms at the margin of the process of expanding; resulting in a very small percentage of the world's inflows. FDI inflows is, to a large extent a function of location specific advantages, such as the size of the domestic market,

the growth of the domestic economy and openness of the international trade. This goes ahead to portray the fact that FDI is a major determinant of economic performance.

To this end, this paper is focused on the assessment of Foreign Direct Investment and her impact on Nigerian economic performance. This work is compressed in five sections: section one is the Introduction, Section two focuses on review of related literature and the theoretical framework of the paper. In section three, the research methodology of this study is dealt with. Section four will present results and discuss findings and five will conclude and make recommendations.

## 2. Literature Review and Theoretical Framework

Foreign Capital flows into the economy mainly in the form of portfolio and direct investments. Investment in long term bond and corporate equity constitute portfolio investment. The investors are more interested in high yields, safety of capital and appreciation of investment value. On the other hand, direct investment occurs when a company holds physical assets and control ownership structure of the firm abroad. The flows of foreign direct investment into the Nigerian Economy has been characterized by large inconsistent fluctuations resulting largely from the prevailing socio-political and economic situation of the country. Nyong (2000), observed that foreign direct investment is increasing in importance in the global economy because of the additional resources they pooled for development in the host country. In recent years, he said foreign direct investment has attracted renewed interest both in underdeveloped and developed countries. He asserted that even at The United Nations Conference on Trade and Development (UNCTAD) and now World Trade Organization (WTO) There has been growing suspicions about foreign direct investment. Chakraborty and Nunnenkamp (2008), asserts that growth effects of FDI vary extensively across sectors, while Ayanwale and Bamire(2001), reported a positive spillover of foreign firms on domestic firm's productivity, in assessing the influence of FDI on firm level productivity. According to Akinlo(2004), foreign capital has a small and not statistically significant relationship with economic growth in Nigeria, while Aluko (1961), Brown(1962) and Obinna (1983) report positive linkages between FDI and economic growth in Nigeria.

In line with the above, foreign direct investment refers to "the ownership and control of decision-making in an enterprise located in one country by investors located in another country". Larger share of FDI is made by enterprises called Multinational Corporations (MNCs) or enterprises (MNEs). Multinationals are attracted to a country with an open economy which translates into trade liberalization and by doing so they provide FDI, often using capital raised in the domestic capital market of their home country. Oseghale and Amonkhenan (1987), found out that a greater inflow of FDI improves economic performance. Ayanwu and Yameogo(2015), In their paper analysed drivers of FDI to West Africa using a panel data set spanning 41 (1970-2010) years, asserts that the relationship between economic development and FDI flows to West Africa is a U-shaped one.

Several literature has emphasized that there are fundamental reasons why foreign direct investment has attracted the attention of most governments in developing economies. First, is the desire to extend the market system because many developing countries have high external debt portfolio. The problem of external debt burden is not solved by borrowing more but by attracting more private capital flows in the form of FDI. The second reason deals with the need to fill the foreign exchange gap. In the face of serious resource gap, the country has to find one way or the other of filling the gap. One way of doing so is to attract foreign direct investment into the country through a rational liberalization or openness of the economy.

Akinyosoye , Akande, Akokogje and Mbanefoh (1998) were of the view that during SAP period, trade policy objective was to liberalize trade, with emphasis on promoting export trade. To this end, there was a considerable reduction in protection for the so-called "infant" industries that have refused to grow. Rahman, (2000) noted that with the increasing trend of globalization, liberalization and integration, the prominence of foreign direct investment in developing countries' external capital flow has been gaining momentum. He argued that it is not only the attempt of trade liberalization but also the credibility of liberalization policies that among other things matters to attract FDI inflow; as a considerable amount of sunk cost is associated with foreign direct investment. Lack of credibility of liberalization may be viewed as a risk factor and thus can restrain foreign investment. Infact foreign investors may be sensitive to this credibility issue than domestic investors; because, on the one hand they know relatively less about the politico-economic complexities of a host country tradition and nature of its government and institutions that abound.

It is also argued that one key responsibility of government is to ensure credibility of trade liberalization and to attract foreign direct investment into the country. What this applies is that foreign investors are not only concerned about a country's trade liberalization but also the credibility of liberalization as a considerable amount of sunk cost is associated with foreign direct investment. In his view, Nwachukwu, (1998) posit that foreign policy of any country is a reflection of its domestic policies. To this end, he asserted that in the area of foreign investment in Nigeria, there is a correlation between foreign assessment of the policies which we adopt in the domestic front and the amount of foreign investment of the country can attract. He argued that in view of our low

capital base, foreign direct investment in the economy must represent a valid option as a supplementary effort to local sourcing of finance. In line with this, the investment climate of any developing country must offer, foreign investors adequate incentives and guarantee economic returns on investment.

He concluded that to ensure credibility, government must cope with such trade malpractices as over-invoicing, fraud, fake business names, failure to meet contractual obligations in remittance of funds for good supplied. Ahmed (1998) focused on strategies for foreign investment promotion in Nigeria, where he postulated that Nigeria; like most other countries in the developing world, seeks to influence the locational decision of foreign investors by offering direct and indirect incentives. He maintained that some incentives are intended to guarantee commodity protection by altering prices of goods and services bought or sold by a firm; while some others are designed to guarantee factor protection by altering the prices of the inputs of production employed by a firm.

He viewed the policy instruments for the first group of incentives to comprise mainly tariffs and quotas on imported competing products and exemptions from import duty on inputs. The instruments for the second group consist of tax holiday and investment allowances. Apart from the financial incentive measures analyzed above, government pursues, as a matter of priority, the maintenance and expansion of existing infrastructural facilities. That is, road, railways, sea and airports, water and telecommunication networks.

Arubayi, (1998), affirmed that there are three major economies which foreign investments may operate successfully. The first is made up of the non-socialists (or capitalist) industrial countries, the second consist of the socialist countries, and the third is comprised of developing countries. He contended that in each of these three worlds there are different general economic political frameworks, diverse levels of economic development, and a variety of economic conditions. According to him, "if the foreign firm is to be successful, it must carefully analyze the interaction of its policies with the economic environment in order to maximize efficiency.

It is a widely known principle that no industrial enterprise can exist separately from its environment, as foreign firms influence and are significantly influenced by the nature of the total environment. However environmental constraints (barriers) and tariffs, limit the inflow of foreign capital into developing economies. These constraints, further limits the relative efficiency of the foreign firm and thus adversely affect the growth of developing economies in general. Bello and Adeniyi(2010), using Autoregressive Distributed Lag(ARDL) approach to investigate the causal relationship among FDI, economic growth and environment, found no long run relationship between FDI and growth, but confirms the existence of a long run causal link between environmental quality and FDI.

This paper has employed three theories to explain the subject matter. This first is the McKinnon (1964) two-gap theory which is widely considered as a theory that more vigorously and practically lays a solid foundation for the openness of an economy for foreign direct investment. It simply postulates that given the importance of financial capital in economic development, developing countries of the world may be constrained by the unavailability of adequate resources to prosecute their development in programmes. According to Nyong (2004), "the two-gap theory identifies two gaps that may exist in a developing economy: saving gap and the foreign exchange gap. This is because of the low income that leads to low savings" and once this occurs, saving rate will lag behind its target rate. Moreover, given the high debt burden, developing economies and their dependence on primary exports characterized by price instability or both. A foreign exchange gap may result because the country does not have enough foreign exchange earnings to pay for its imports. In this regard, foreign capital inflow appears to be the more viable or potent option to finance the gap through a rational openness of the economy or trade liberalization.

The second theory is the Vernon (1996) product Cycle Theory which states that a firm becomes a multinational corporation only a certain stage of its growth process. At the initial stage, economic growth is promoted by expansion into overseas market, making use of differences in technological capability among countries and industries. The new markets are developed and expanded by the international demonstration effects of rich countries. The firm establishes contacts with both its product market and its suppliers. It maintained that once the firm has standardized its production process, it looks overseas for lower cost location and new markets. The firm may allocate component production and assembly to different plants. On the demand side, the firm creates new markets by price reduction or product differentiation in the case of an oligopoly as the multinational corporation (MNCs) matures. Lastly we have the endogenous growth theory which is considered to provide a more convincing and rigorous conceptual frame work for the analysis of the relationship between FDI and economic growth via trade liberalization route. The model shows that it is possible to establish a long run relationship between trade liberalization and economic growth in a number of ways. Firstly, import liberalization is expected to promote technology transfer through the import of advanced capital goods. The import technologically superior capital goods is also enhanced by growing export receipts and higher inflows of foreign capital, which takes into account the country's ability to repay out of export earnings. Secondly, an export-oriented development strategy generally leads to higher growth. Thirdly, foreign direct investment (FDI) brings export technology from industrial countries to developing countries. Fourthly, outward orientation makes

it possible to use external capital for development without encountering serious problems in servicing the corresponding debt. Fifthly, the opening up of an economy is likely to speed up the rate economic growth by leading to larger economies of scale in production due to the positive effects emanating from technological developments in industrial countries. Dutta and Ahmed (2006)

Using the “human capital model of endogenous growth, Ahmed (1999) was able to validate endogenous growth model developed by Lucas (1998), to show the positive effect of trade liberalization and investment in human capital on economic growth.

### 3. Methodology

This study used annual data from various issues of the Central Bank of Nigeria Statistical Bulletin covering the period 1980 to 2014. The major variables for the study are foreign direct investment (inflow), financial depth of the system (ratio of money supply to GDP- M<sub>2</sub>/GDP) and exchange rate.

Specifically we have; GDP f (FDI, M<sub>2</sub>/GDP, EXR, PS)

Where,

GDP= Gross Domestic Product

FDI= Foreign Direct Investment

M<sub>2</sub>/GDP = Financial Deepening

EXR = Exchange Rate

PS = Policy Shift

The methodology of this paper will evolve thus:

- Test unit root of two time series;
- Johansen co-integration test;
- Vector Error Correction Estimates;
- Error Correction Model

The Augmented Dickey Fuller (ADF) and Phillips Perron (PP), unit root test are used to investigate the order of integration of the variables in the model. The regression takes the form;

$$\Delta Y_t = a_0 + a_1 Y_{t-1} + a_2 t + \sum_{i=2}^n \beta_i \Delta Y_t + e_t$$

Where  $Y = -1 [ - \sum_{i=2}^n a_2 ]$ ,  $\beta_i = \sum_{i=2}^n a_2$ ; n indicates the lag length and t represent the trend. When the estimated coefficient of Y is equal to zero, the equation is in first differences and contains a unit root. If the calculated ADF statistic is higher than Mckinnon’s critical value then the null hypothesis cannot be rejected and it may be concluded that the variable of interest is non-stationary and therefore the procedure needs to be repeated after transforming the series into first differences. The long and short run dynamics between GDP, FDI, FINANCIAL DEEPENING EXCHANGE RATE and POLICY SHIFT is tested using VECM model of Sawhney, Anuruo and Feridun (2006).

$$\Delta GDP_t = \alpha + \sum_{t=1}^a \varphi_i \Delta y_{t-1} + \sum_{t=1}^b \varphi_i \Delta GDP_{t-1} + \sum_{t=1}^c \varphi_i \Delta FDI_{t-1} + \sum_{t=1}^d \varphi_i \Delta M_2/GDP_{t-1} + \sum_{t=1}^e \varphi_i \Delta EXR_{t-1} + \sum_{t=1}^f \varphi_i \Delta PS_{t-1} + \varphi_i \mu_{t-1}$$

Where  $\Delta$ , stands for the difference operator, and others as stated above. The lag lengths are automatically determined by the modified AIC and are represented by a, b, c, d, e and f.  $\mu_{t-1}$  is the error term lagged one period. The error correction term assess the deviation of the variables from the long run equilibrium association. The null hypothesis of non-causality will be rejected if sum of the regression co-efficient of the dependent variable is significantly different from zero.

### 4. Results and Discussion of Findings

#### 4.1 Table1: Summary of OLS Result: Dependent Variable LGDP

Variable	Coefficien	Std. Error	t-Statistic	Prob.
LNFDI	0.862988	0.161301	5.350178	0.0000
M2GDP	-6011.152	1404.654	-4.279453	0.0002
EXR	0.028612	0.005970	4.792571	0.0000
PS	-0.787326	0.640884	-1.228499	0.2295
C	-3.740690	3.297030	-1.134563	0.2662

R<sup>2</sup>=95%, Adj. R<sup>2</sup>=94%, D.W =1.62, F.Stat=143.95, Prob F (0.000000)

The result showed a high level of relationship between the dependent and independent variables. The F-statistic showed that the entire model is good. FDI, EXR and Financial deepening (M<sub>2</sub>/GDP) significantly affected economic performance, while policy shift did not significantly affect performance, within the period

under review.

#### 4.2 Stationarity Test

The result of the Unit Root tests performed on all the variables in the model, using both the ADF & PP, revealed stationarity at first difference. A time series that has one unit root and another that has double unit root can still be integrated, where the resulting linear combination is  $I(1)$ . Razak (2007). Therefore, if the above is true, the OLS estimator of the regression in the levels is consistent. From our result, the null hypothesis of the presence of unit root in the series is rejected.

Table2: Stationarity test result      ADF @ 5% (2.9558)      PP @ 5% (2.9591)

	LEVELS	1 <sup>ST</sup> DIFF	REMARK	LEVELS	1 <sup>ST</sup> DIFF	REMARK
LGDP		-3.748	1(1)		-4.608	1(1)
LFDI		-4.407	1(1)		-11.02	1(1)
M <sub>2</sub> /GDP		-4.179	1(1)		-5.755	1(1)
EXR		-3.66	1(1)		-5.44	1(1)
PS		-4.000	1(1)		-5.744	1(1)

#### 4.3 Pairwise Granger Causality Test

Table3: Pairwise Granger Causality Test Result

Null Hypothesis:	Obs	F-Statistic	Probability
LNFDI does not Granger Cause LNGDP	31	0.63036	0.54034
LNGDP does not Granger Cause LNFDI		3.12609	0.06073
M2GDP does not Granger Cause LNGDP	33	3.10583	0.06050
LNGDP does not Granger Cause M2GDP		0.47481	0.62692
EXR does not Granger Cause LNGDP	33	0.00310	0.99691
LNGDP does not Granger Cause EXR		8.38399	0.00140
PS does not Granger Cause LNGDP	33	0.49798	0.61304
LNGDP does not Granger Cause PS		4.38406	0.02206
M2GDP does not Granger Cause LNFDI	31	0.16453	0.84917
LNFDI does not Granger Cause M2GDP		0.17191	0.84301
EXR does not Granger Cause LNFDI	31	2.32045	0.11823
LNFDI does not Granger Cause EXR		0.45383	0.64013
PS does not Granger Cause LNFDI	31	2.24229	0.12636
LNFDI does not Granger Cause PS		0.15134	0.86031
EXR does not Granger Cause M2GDP	33	0.16821	0.84602
M2GDP does not Granger Cause EXR		3.72205	0.03686
PS does not Granger Cause M2GDP	33	0.26174	0.77158
M2GDP does not Granger Cause PS		2.20048	0.12954
PS does not Granger Cause EXR	33	0.16676	0.84724
EXR does not Granger Cause PS		68.4252	1.7E-11

The result from table 4.3 showed the direction of causality among stationary variables of the model. Using a lag length of 2 and a 5% significance level, it shows a unidirectional causality between GDP and FDI, and GDP and EXR., indicating that GDP Granger causes FDI and EXR, within the period under review. The result also showed that financial deepening causes a significant effect on exchange rate in Nigeria

#### 4.4 Co-integration Analysis

Table4: Johansen Co-integration Test

Eigenvalue	Likelihood Ratio	5 Percent Critical Value	1 Percent Critical Value	Hypothesized No. of CE(s)
0.681957	86.73962	68.52	76.07	None **
0.569571	51.22695	47.21	54.46	At most 1 *
0.399227	25.09480	29.68	35.65	At most 2
0.253195	9.299107	15.41	20.04	At most 3
0.007987	0.248603	3.76	6.65	At most

The result from Johansen test showed two co-integrating relationship with a lag length of one, indicating a long run relationship exist among the variables entered.

Table4b: Long- run Estimate

Repressors <sup>7</sup>	Long run estimates	Standard error	t-values
LGDP	1.000000		
LFDI	11.47984	25.5943	0.44853
M2/GDP	-85946.72	192082.	-0.44745
EXR	-0.334129	0.61293	-0.54513
PS	12.01424	22.2889	0.53902
C	-213.3854		

Table4c: Short-run estimates

Error Correction	D(LGDP)	D(LFDI)	D(M <sub>2</sub> /GDP)	D(EXR)	D(PS)
CointEq1	-0.001564 0.00708 -0.22075	-0.037150 0.01702 -2.18218	3.44E-07 2.2E-06 0.15405	1.656681 0.46302 3.57801	0.005483 0.00296 1.85447
D(LGDP(-1))	0.632257 0.45884 1.37796	3.065800 1.10258 2.78058	-3.97E-05 0.00014 -0.27432	-76.62014 29.9876 -2.55506	0.127610 0.19150 0.66638
D(LFDI(-))	0.055047 0.08286 0.66433	-0.632462 0.19911 -3.17641	-2.03E-05 2.6E-05 -0.77762	-7.820739 5.41541 -1.44416	-0.016190 0.03458 -0.46814
D(M <sub>2</sub> /GDP(-1))	1520.697 1192.97 1.27471	5329.068 2866.70 1.85895	-0.079519 0.37613 -0.21141	-33748.59 77967.9 -0.43285	755.7730 497.897 1.51793
D(EXR(-1))	-0.000242 0.00278 -0.08690	-0.003025 0.00668 -0.45295	5.87E-07 8.8E-07 0.66939	-0.011911 0.18164 -0.06557	0.012657 0.00116 10.9117
D(PS(-1))	-0.585901 0.49164 -1.19172	0.190424 1.18141 0.16118	0.000321 0.00016 2.07087	-34.75730 32.1318 -1.08171	-0.278095 0.20519 -1.35530
C	0.057628 0.14675 0.39268	-0.603138 0.35265 -1.71030	1.07E-05 4.6E-05 0.23188	29.93895 9.59128 3.12147	0.073440 0.06125 1.19904

R<sup>2</sup>= 34%, Adj. R<sup>2</sup>= 7%, F-Statistic =.8367, Akaike AIC = -0.234712, Schwarz SC =0.325766

The results of the VECM presented in tables 4a and b, shows a poor fit, with R<sup>2</sup> of 34%. The result of the short run test indicates that FDI has a value of 0.055047 and a long run value of 11.47984. This suggest that a 10% improvement in GDP, will be caused by a 6% increase in FDI, in the short run. Whereas, in the long run, a 10% increase in FDI, will lead to a 110% increase in GDP. The result of short run value of exchange rate is -0.000242 and a long run value of -0.334129. This suggest that exchange rate showed very little influence on GDP in the short run, while in the long run a 10 % improvement in GDP will cause 33% fall in exchange rate. However, the error correction coefficient, which is the speed with which the system will adjust to shocks and restore equilibrium between the short and long run periods as measured by the ECM is -0.001564. The model came with the expected sign, showing that the speed of adjustment will be very sluggish. This is expected considering the political situation of incessant kidnapping, Boko Haram insurgency and the recent change of power in the polity. A lot of caution will be taken from foreign investors and this will involve time.

## 5. Conclusion and Recommendations

Foreign Direct Investment has been said to play a catalytic role in developing an economy. The paper utilized the Granger causality and the Vector Error Correction Model (VECM), to investigate the causal direction and relationship between economic performance (GDP) and foreign direct investment. With ADF and PP stationarity tests showed that the underlying series were all stationary at first difference. The Johansen co-integration test confirmed the existence of a strong and stable long run relationship among the variables entered in the model.

The study established that there exist a unidirectional causality between economic performance and FDI, with GDP granger causing FDI and EXR, at 10% significant level. The ECM applied to avoid spurious regression result, confirmed the existence of a statistically significant short and long run relationship between GDP and FDI.

### 5.1 Recommendations

Foreign Direct Investment, can only thrive where there is peace and harmony in the system. Therefore,

government should put up policies that will nip insurgency and other vices in the bud, as shown by the study, Nigeria's economic performance drives FDI inflow. The issue money and capital market deregulation should be sustained, so as to deepen the financial market space.

The foreign exchange market deregulation should be guided, so that foreign investors would engage in real and not speculative investments.

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