

Capital Market and Recession Dynamics in Nigeria: Lessons for Sustainable Development

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Abstract

This paper explores the capital market and economic recession dynamics in Nigeria using monthly data for 2015–2017. Three variants of the model are estimated and the analysis involves Johansen co integration test, unrestricted Vector Auto regression (VAR) and Vector Error Correction (VEC). Evidence indicates that while both foreign direct investment (FDI) outflow and inflow as a whole impact economic recession, the effect is mostly due to the impact of FDI inflow. Results also indicate the significant FDI outflow from Nigeria during the recession was not really tied to economic fundamentals but could be the result of “herd mentality” occasioned by the onset of economic recession. The VEC result indicates there is expected negative co-movement between economic recession and financial outflows in Nigeria. The speed of adjustment suggests 36.2 percent of the deviation of economic recession from long-run equilibrium is corrected every year, so that it takes over a year to cut the gap in half which could explain why the recession in Nigeria lasted about a year and half before turning the curve. Variance decomposition (VD) outputs indicate own shock has the strongest and most lasting effect on both economic recession and FDI outflow although as time passes, economic recession explains more and more of the shocks in financial outflows while as time passes, financial inflows explain more and more of the shocks in economic recession. The paper recommends policymakers focus on not just attracting but retaining more foreign direct investment in the many economic sectors of Nigeria and that more attention is needed to explore the huge potentials of the capital market as a significant driver for sustainable development in Nigeria.

Keywords: *Foreign portfolio investments, Foreign direct investment, Capital market, Economic recession, Sustainable development.*

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Background

The world conference on environment and development (1987) defined sustainable development (SD) as development that meets present needs without compromising the ability of future generations to meet their own needs. This concept consists of three main dimensions - economic, social and environmental dimensions. Hence, in literature, sustainable development is usually tested on three main pillars which consists of economic growth, income distribution and environmental quality.

In this respect, it's no longer news that the world is now firmly in the era of sustainable development; for which Agenda 2030 comprising 17 sustainable development goals (SDGs) has been set (United Nations 2014, 2015). SDGs 8 and 9 dealing with economic dimensions of sustainable development are the focus of this paper (see Box1).



Box 1: Relevant SDGs

SDG 8: Promote sustained, inclusive and sustainable economic growth, full and productive employment and decent work for all

SDG 9: Build resilient infrastructure, promote inclusive and sustainable industrialization and foster innovation



On the other hand, foreign direct investment (FDI) as a key component of globalization and of the world's economy is perhaps one of the most significant strategies for the promotion of economic growth and development (Feldstein 2008). FDI is seen as a stimulant for productivity growth, capital formation, technology transfer, employment creation, export promotion and supplementary domestic saving (Quazi 2007). This study is related to the endogenous growth works that stress the significance of financial development for long-run economic growth via the effect of financial sector services on capital accumulation and technological innovation. Such financial sector services include mobilizing savings, acquiring information about investments and allocating resources, monitoring managers and exerting corporate control, and facilitating risk amelioration.

Statement of the Problem

Civilian governments since 1999 have employed quite a few approaches to ensure increased flow of FDI into Nigeria given its perceived benefits as the remedy for economic under development as lauded in the literature (Opaluwa 2013, Chia and Ogbaji 2013). Nevertheless, Nigeria still ranks among the poorest countries in the world, having one of the lowest GDP per head, and ranked behind neighbors such as Ghana in attracting FDI (Ako 2016). Furthermore, in term of important indicators for attracting foreign investment, Nigeria is also far behind its contemporaries like Ghana etc. In this respect, measures such as World Bank ease of doing business ranking, corruption ranking, state of infrastructures, electricity generation per person, legal and basic physical institutional reforms etc. are considered barriers to FDI inflow

in Nigeria. Hence, although Nigeria should ordinarily have a huge market advantage given her sizeable population and with Nigeria hosting 59% of the West African regional stock of FDI (Ako 2016), the role of FDI on growth in Nigeria is still open to debate.

Objectives of the Study

The main purpose of this paper is to shed particular light on the relationship between the two aspects of FDI (inflow & outflow) and economic recession (which is the antithesis of economic growth) in Nigeria and interpret it in terms of sustainable development.

Following from this introduction, Section 2 presents a brief literature review on FDI while Section 3 introduces the methodology employed. Section 4 contains the results of the paper while Section 5 concludes with some policy recommendations.

Review of Literature

Theoretical Review

Theories of investment effectively look at investment in two ways following the works of John Maynard Keynes (1936) on Internal Rate of Return and Friedrich A. von Hayek (1941) on capital.

The Hayekian approach to investment theory conceives investment as an adjustment to equilibrium which implies the optimal volume of investment is effectively a decision on the optimal speed of adjustment. Based on this theory, a firm may decide it needs a factory (the "capital stock" decision), but the "investment" decision (how fast to build it or how much to spend on building) is a separate contemplation and in this respect, the capital decision influences the investment decision. If the speed of adjustment is "instantaneous", then there is really no actual investment decision to speak of since the capital stock changes automatically; otherwise, the investment decision becomes crucial. This perspective considers there are different configurations for approaching the desired adjustment in capital stock and the considerations that determine which adjustment pattern to follow.

The "*Keynesian*" approach on the other hand places less emphasis on the "adjustment" nature of investment but emphasizes instead the "behavioural" nature of investment decisions. This perspective argues that capitalists "do" investment as a matter of course and hence this approach underplays the capital stock decision. Accordingly, it considers the main decision is the investment decision for optimal amount of investment and that the capital stock just "follows" from the investment patterns rather than being an important thing that needs to be "optimally" decided upon beforehand. Thus, for Keynesian theory, optimal investment is not about "optimal adjustment" but about "optimal behaviour".

Thus, modern neoclassical theory of investment stems largely from this tradition and regard FDI/international capital flows as closing the savings gap in developing countries (Chenery and Bruno, 1962). In this respect, capital is expected to flow from capital-rich to capital-poor countries and since capital is relatively scarce in developing countries, this should lead to profitable investment opportunities for capital in developing countries. Based on this consideration alone, one might presume there should be no FDI outflows from Nigeria but is that the reality? This research aims to investigate the situation in the face of the contention in literature that different types of incentives are needed to attract the four different modes of FDI which are given as:

- i. Market-seeking FDI whereby transnational corporations (TNCs) serve markets through investment rather than through exports.
- ii. Efficiency-seeking FDI whereby TNCs ensure low labor costs.
- iii. Natural resources-seeking FDI whereby TNCs seek to exploit resource rich markets for gain.
- iv. Strategic asset seeking FDI whereby TNCs seek technology, skills or to take over brand names (Dunning 1993 and 1998, Caves 1996).

Empirical Review

The relationship between FDI and economic growth has been the subject of numerous studies with many results being inconclusive indicating the debate on the impact of FDI on economic growth is far from being over. Furthermore, the role of FDI seems to be country specific and can be positive, negative or insignificant, depending on the economic, institutional and technological conditions in the recipient countries. In this respect, a host of studies on the impact of FDI on economic growth in Nigeria report contradicting and inconclusive outcomes (Oyinlola, 1995 Ekpo, 1997 Anyanwu, 1998, Ayanwale, 2007, Onu, 2012 Fasaya, 2012 Danja, 2012 Akinmulegun, 2012 and Olusanya, 2013).

As shown in Table 1, previous studies in Nigeria, like elsewhere in the world indicate mixed results. Moreover, such studies are yet to focus on the influence of FDI on growth and development when the growth has become negative as in an economic recession. With the Nigerian economy recessing recently, investigating the dynamics involved to determine important effects in the economy becomes crucial. As such, this study is an improvement on the earlier studies on economic growth dynamics in Nigeria as it considers FDI/financial flows an important variable that could not just set off an economic recession but could reasonably compound an ongoing recession.

Table 1: Selected Empirical Findings

Author(s)	Country(s)	Investigation	Main results
Bosworth and Collins (1999)	58 Countries in 5 continents for 1978-1995	Capital Flows Implications	FDI benefits sufficient to ameliorate free capital allocation risks.
Kinda, T. (2010)	77 Developing countries	Investment Climate and FDI	Hurdles in physical infrastructure, finance & institutions discourage FDI
Quazi (2007)	East Asia	Determinants of FDI	Greater openness propels FDI but policy barriers impale FDI.
Baklouti & Boujelbene (2014)	8 MENA countries	FDI Inhibiting & Promoting Factors	Quality of institutions promote but corruption inhibits FDI
Adeleke et al (2014)	Nigeria 1999-2013	Impact of FDI	FDI is an engine of economic growth
Athukorala & Menon (1995)	Malaysia	Impact of FDI	FDI facilitates technology transfer and improves the labor force skills.
Wafure & Abu (2010)	Nigeria	Determinants of FDI	Market size, political instability & exchange rate determinants.

Author(s)	Country(s)	Investigation	Main results
Kinaro (2006)	Kenya	Determinants of FDI	Macroeconomic stability & openness determinants
Obwona (2001)	Uganda	Determinants of FDI	Macroeconomic/political stability and policy consistency
Chia & Ogbaji (2013)	Nigeria	Impact of FDI	Positive but insignificant impact on growth.
Alfaro <i>et al</i> , (2003, 2006)	China, cross-country	Contribution of FDI to Growth	Contribution of FDI alone ambiguous. Depends on the sector of the economy
Abdul Rahim Ridzuan <i>et al</i> (2017)	Singapore	Contribution of FDI to Sustainable Development	Mixed evidence of a relationship
Coban and Seker (2016)	MINT countries	Contribution of FDI to Growth	Contribution of FDI positive but level is country specific.
Moukaila. (2017)	Niger	Impact of FDI on Growth	Significant impact on growth

Methodological Issues

Variable Definitions and Ordering

Three variants of the model are estimated. The first variant treats all the three variables as endogenous, the second variant treats FDI outflows as exogenous while the third variant treats FDI inflows as exogenous. Foreign portfolio investments (FPI) as captured by the Nigerian Stock Exchange is proxy for foreign direct investment (FDI). The categories of the variables GDP, FPO and FPI are defined and specified in Box 2. The endogenous variables are considered structural variables and the exogenous variables policy instruments.

Box2: Definition of Variables	
Variable	Definition
FPO	Foreign Portfolio Outflow which is proxy for FDI outflow
FPI	Foreign Portfolio Inflow which is proxy for FDI inflow
GDP	This is the Dependent Variable proxy for Recession which has value of 0 if before or after the 2016 recession and 1 otherwise.

The choice of variables is motivated by both the background discussion above and the findings in the literature. For the purpose of focus, GDP as defined is assumed to be most endogenous. The reason for the ordering is to enable structural factorization in addition to the Cholesky vector autoregressive ordering.

The Model and Modeling Procedure

Vector Auto regression (VAR) and Vector Error Correction (VEC) Models are employed in the procedure consisting the following estimation steps:

1. Lag length specification and unit root tests to determine stationarity.
2. The VAR based co integration test methodology developed by Johansen (1991; 1995). This addresses the question of long-run determinants and other system variables.
3. Structural VEC to determine the dynamic adjustment of Error correction system variables toward the long-run equilibrium model (representation) in response to various structural shocks.
4. Variance decomposition (VD) analysis on the basis of step 4. This estimates the relative significance of each random innovation to the system variable if policy does not change and looking ahead.

The attraction of the VEC is that the structural VEC approach gives a clearer picture of the relationship between the selected economic variables and dynamic interactions between them.

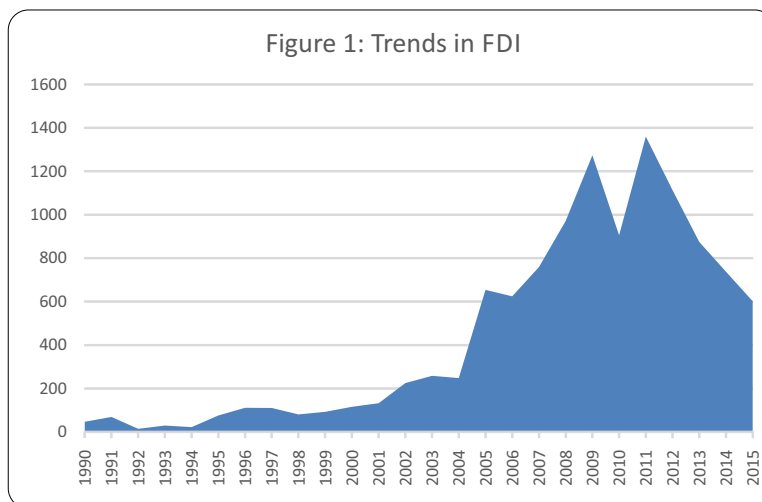
Data

Secondary monthly data from January 2015 – July 2017 on foreign portfolio participation in equity trading obtained from the Nigerian Stock Exchange is employed in the study. The data period ranges from one year (12 months) prior the onset of economic recession and a month after the recession is declared over.

Results and Discussions

Trends in Foreign Direct Investment in Nigeria

Figure 1 displays trends in FDI in Nigeria from 1990-2015; just before onset of economic recession that lasted till Quarter 3 of 2017.



Sources: CBN Statistical Bulletin, World Bank Indicators

FDI inflow in Nigeria increased substantially from 1994 although it fluctuated markedly in some years. For instance, the adverse effect to the global financial crises in 2008 led to decline in the volume of FDI inflow in 2009 even though it was more noticeable in 2010. The sudden increase in FDI inflow in Nigeria from the 1990s period can be attributed to various

government policies designed to promote investment; which included various economic reforms and incentives offered to foreign investors, the involvement of foreigners in the downstream and upstream oil sub-sector as well as the shift from military rule to democratic governance. Nevertheless, the generally low level of FDI in Nigeria in comparative terms has been attributed to a number of factors not limited to macroeconomic instability and fiscal dominance. Poor infrastructural facilities, high debt burden which undermine credit worthiness of the country, incessant social and political instability, corruption, insecurity of life and property are also identified factors which undermined Nigeria's efforts to attract FDI despite the economy's advantages in large market size, strategic location, abundant natural resources and cheap labor force.

VAR Lag Order Selection and Group Unit Root Test

Table 2: VAR Lag Order Selection

Endogenous variables: GDP OUTFLOW

INFLOW

Exogenous variables: C

Lag	LogL	LR	FPE	AIC	SC	HQ
0	-264.3816	NA	20466.84	18.44011	18.58156	18.48441
1	-234.6261	51.30263	4916.603	17.00870	17.57447	17.18589
2	-215.5026	29.01493*	2505.007*	16.31052*	17.30064*	16.62061*

Where * indicate the best (that is, minimized) values of the respective information criteria, FPE = Final prediction error, AIC = Akaike criterion, SC = Schwarz criterion and HQ = Hannan-Quinn criterion.

Table 3: Group unit root test: Summary

Series: GDP, INFLOW, OUTFLOW

Method	Statistic	Prob.**	Cross-sections	Obs
Null: Unit root (assumes common unit root process)				
Levin, Lin & Chu t*	-1.97944	0.0239	3	90
Null: Unit root (assumes individual unit root process)				
Im, Pesaran and Shin W-stat	-2.87022	0.0021	3	90
ADF - Fisher Chi-square	21.2059	0.0017	3	90
PP - Fisher Chi-square	21.1474	0.0017	3	90

** Probabilities for Fisher tests are computed using an asymptotic Chi-square distribution. All other tests assume asymptotic normality.

Table 2 reports a maximum/optimal lag order 2 is selected by all the information criteria while the group unit root test results in Table 3 indicate that the variables are integrated of order one i.e. they are stationary at first difference.

Johansen Cointegration Test Results

The results of both the trace and λ -max tests in Table 4 indicate two co integrating equations or cointegrating vectors at 5 percent and establish the existence of long-run relationship. Hence, the short-run dynamics of the model can be established within an error correction model.

Table 4: Johansen Unrestricted Cointegration Rank Test

Series: GDP OUTFLOW INFLOW

Lags interval (in first differences): 1 to 1

Rank	Eigen value	Trace Test	p-value	λ -max Test	p-value
0	0.89057	55.937***	[0.0000]	30.680***	[0.0017]
1	0.60800	25.257***	[0.0013]	20.384**	[0.0048]
2	0.42781	4.873**	[0.0273]	4.873**	[0.0253]

Where: ***, and **denotes 1% and 5% significance level respectively.

Granger Causality/Block Exogeneity Wald Tests

Table 5: VAR Granger Causality/Block Exogeneity Tests

Dependent variable: GDP			
Excluded	Chi-sq	df	Prob.
FDO	0.093433	2	0.9544
FDI	18.85862	2	0.0001
All	19.82660	4	0.0005
Dependent variable: FDO			
Excluded	Chi-sq	df	Prob.
GDP	2.692327	2	0.2602
FDI	0.402579	2	0.8177
All	3.824985	4	0.4302
Dependent variable: FDI			
Excluded	Chi-sq	df	Prob.
GDP	4.243107	2	0.1198
FDO	37.09551	2	0.0000
All	38.86770	4	0.0000

The results of Block Exogeneity tests presented in Table 5 indicate that for Eq1, FDI inflow with its lag granger causes economic recession at 1% but FDI outflow with its lag does not granger cause economic recession. Taken together however, all explanatory variables with their lags granger cause economic recession at 1%. This shows that while both FDI outflow and inflow as a whole impact economic recession, the effect is mostly due to the impact of FDI inflow. For Eq2 where FDI outflow is the dependent variable, there is no granger causality on all fronts whether the variables are taken singly or together. This could indicate FDI outflow in Nigeria for the period is not really tied to economic fundamentals but could be the result of

“herd mentality” occasioned by the onset of economic recession. This is akin to the random walk hypothesis of the capital market and thus cannot be readily predicted. For Eq3, FDI outflow with its lags granger causes FDI inflow at 1% and taken together, all explanatory variables with their lags granger cause FDI inflow at 1%. The results do not indicate any bi-directional causation between the variables.

Vector Error Correction (VEC) Results

Table 6: VEC - Maximum Likelihood Estimates Results -Unrestricted Constant

Parameter/ Variable	Equation 1 d_GDP	p value	Equation 2 d_FDO	p value	Equation 3 d_FDI	p value
d_GDP_1	-0.088	[0.7519]	12.175	[0.6020]	-14.35	[0.1391]
d_FDO_1	-0.004	[0.1212]	-0.246	[0.2473]	-0.59***	[<0.0001]
d_FDI_1	0.004	[0.3655]	-0.194	[0.6099]	0.2965*	[0.065]
Const	-0.057	[0.3371]	3.397	[0.4922]	-4.399**	[0.0362]
EC1	0.0485*	[0.0584]	-5.171**	[0.0187]	3.446***	[0.0004]
	Equation 1: d_GDP		Equation 2: d_FDO			
d_GDP_1	-0.093	[0.7366]	8.1391	[0.6882]		
d_FDO_1	3.518	[0.9893]	0.0429	[0.8225]		
FDI_1	-0.006*	[0.0521]	0.1466	[0.5347]		
Const	0.2072	[0.2804]	44.595***	[0.0035]		
EC1	-0.0013	[0.9825]	-17.91***	[0.0003]		
	Equation 1: d_GDP		Equation 2: d_FDI			
d_GDP_1	-0.066	[0.7520]	-9.3938	[0.5136]		
d_FDI_1	0.0097***	[0.0097]	-0.0293	[0.9030]		
FDO_1	4.13e-05	[0.9817]	-0.259**	[0.0433]		
Const	0.6821***	[0.0002]	23.719**	[0.0344]		
EC1	-0.362***	[<0.0001]	-7.956	[0.1242]		

Where: ***, **, and * denotes 1%, 5% and 10% significance level respectively; EC1 is the error correction terms; 19 observations, optimal lag length = 2; r=2

Box 3: Time to Close Adjustment Gap

Following Chiang (1984), the time t needed to close λ percent of the gap (or half-life $\lambda = 0.5$) is derived from the relationship:

$$t = -\frac{\ln(1 - \lambda)}{\alpha}; \alpha = 0.362;$$

$\lambda = 0.5 \therefore t = 1.381$ for recession

Where: λ = the adjustment ratio
 α = is the estimated loading parameter or speed of adjustment parameter.

Three variants of a VEC model are estimated using the full information maximum likelihood (FIML) method of the general-to-specific approach which yields more efficient estimates by eliminating redundant or insignificant variables. As a result, the number of parameter estimates reduced to 3 from 6 for the unrestricted initial VAR system and the results are reported in Table 6 above. For brevity, only the results of the VEC estimation are discussed.

From the results of the system variables in the main model in Table 6, past recession performance and financial outflows negatively affect economic recession in Nigeria while past financial inflows have a positive effect on recession but none of the effects is significant. There is expected negative co-movement between economic recession and financial outflows in Nigeria. However, the positive co-movement between economic recession and financial inflows defies economic expectations but could indicate the net effect of financial inflows within the recession period is negative (see Figure 2 below). The result indicates equation one (economic recession) only becomes highly significant ($p < 0.0001$) with coefficient of Error Correction Term (EC1) negative as required and indicating the existence of dynamic stability, in the third variant of the model when the specification uses financial outflows as an exogenous (policy) variable.

In the full model and the second variant of the model which have financial outflows as an endogenous (system) variable, only equation two (financial outflows) is significant at 5% and 1% respectively with coefficient of Error Correction Term (EC1) negative as required to indicate the existence of dynamic stability. The speed of adjustment when the Error Correction Term of the recession equation is significant with correct sign suggests 36.2 percent of the deviation of economic recession from long-run equilibrium is corrected every year, so that it takes over a year to cut the gap in half (see Box 3). This could explain why the recession in Nigeria lasted about a year and half before turning the curve.

Variance Decomposition Results

The results of the Forecast Error Variance Decomposition (FEVD) for the full model indicate that in the period right after a shock, economic recession in Nigeria (GDP) explains 100 percent of its own shocks, financial outflows (FDO) about 96.65 percent of its own and Financial inflow (FDI) about 85 percent of its own. The fact that their movements are largely explained by past values indicates they have a significant lagged effect but the lagged effect on economic recession (negative growth) and financial outflows seems more absolute.

Own shock has the strongest and most lasting effect on both economic recession and financial outflows although after period 2, the contribution of financial outflows to financial inflows is progressively higher than own shock of financial inflows and appears significant and lasting. The results of the second variant FEVD (Table 7) indicate that as time passes, economic recession explains more and more of the shocks in financial outflows whereas as seen from the results of the third variant FEVD (Table 8), as time passes, financial inflows explain more and more of the shocks in economic recession.

Table 7: Variance Decomposition Results-Variant GDP/FDO

Table 7A: Decomposition of variance for GDP

period	std. error	GDP	FDO
1	0.240839	100.0000	0.0000
2	0.324964	99.9993	0.0007
3	0.39251	99.9984	0.0016
4	0.449932	99.9982	0.0018
5	0.500826	99.9980	0.0020
6	0.547004	99.9979	0.0021
7	0.589576	99.9978	0.0022
8	0.629274	99.9977	0.0023
9	0.666612	99.9977	0.0023
10	0.701968	99.9976	0.0024

Table 7B: Decomposition of variance for FDO

period	std. error	GDP	FDO
1	17.6546	0.2237	99.7763
2	17.995	1.7452	98.2548
3	18.3781	5.7643	94.2357
4	18.6669	8.6476	91.3524
5	18.9536	11.3904	88.6096
6	19.2387	13.9966	86.0034
7	19.5191	16.4497	83.5503
8	19.7955	18.7664	81.2336
9	20.0681	20.9582	79.0418
10	20.337	23.0349	76.9651

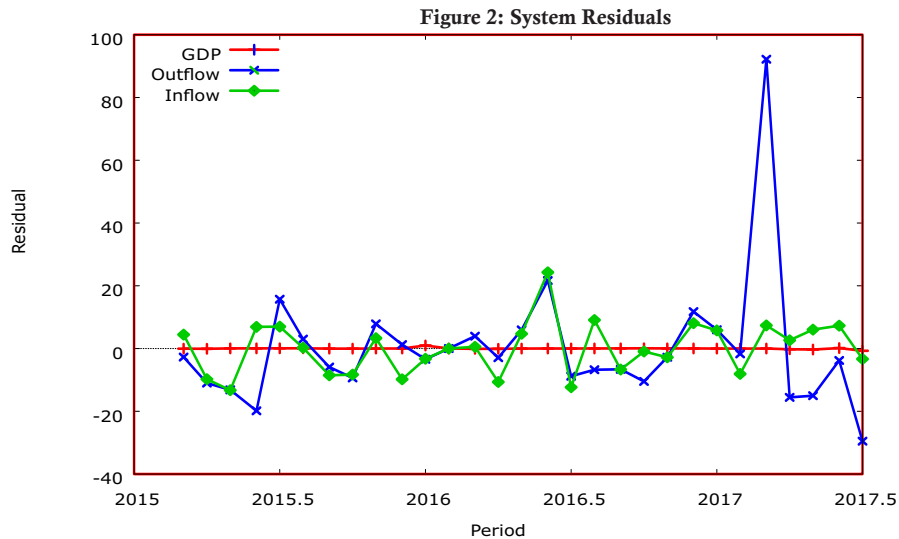


Table 8: Variance Decomposition Results-Variant GDP/FDI**Table 8A:** Decomposition of variance for GDP

period	std. error	GDP	FDI
1	0.183805	100.0000	0.0000
2	0.22045	91.0638	8.9362
3	0.310146	52.7163	47.2837
4	0.398962	36.9663	63.0337
5	0.479037	28.7109	71.2891
6	0.555338	23.4840	76.5160
7	0.625524	20.1836	79.8164
8	0.690023	17.9397	82.0603
9	0.749945	16.3206	83.6794
10	0.805893	15.1119	84.8881

Table 8B: Decomposition of variance for FDI

period	std. error	GDP	FDI
1	12.611	0.1797	99.8203
2	15.2467	3.6075	96.3925
3	16.7561	4.2175	95.7825
4	18.4101	4.3547	95.6453
5	19.8369	4.7273	95.2727
6	21.1065	5.0003	94.9997
7	22.3094	5.2021	94.7979
8	23.4435	5.3821	94.6179
9	24.5189	5.5334	94.4666
10	25.5481	5.6608	94.3392

Conclusions

The paper is an event analysis that explores the causal relationship between the capital market and economic recession using the instrumentality of foreign direct investment (FDI) with foreign portfolio investments (FPI) as proxy. Evidence indicate the series have unit roots and are cointegrated. Evidence also indicate that while both foreign direct investment (FDI) outflow and inflow as a whole impact economic recession, the effect is mostly due to the impact of FDI inflow. Results also indicate the significant FDI outflow from Nigeria during the recession was not really tied to economic fundamentals but could be the result of “herd mentality” occasioned by the onset of economic recession. The speed of adjustment suggests 36.2 percent of the deviation of economic recession from long-run equilibrium is corrected every year, so that it takes over a year to cut the gap in half which could explain why the recession in Nigeria lasted about a year and half before turning the curve. Variance decomposition (VD) outputs indicate own shock has the strongest and most lasting effect on both economic recession and FDI outflow although as time passes, economic recession explains more and more of the shocks in financial outflows while as time passes, financial inflows explain more and more of the shocks in economic recession.

Policy Recommendation

The paper recommends policymakers focus on not just attracting but retaining more foreign direct investment in the many economic sectors of Nigeria and that more attention is needed to explore the huge potentials of the capital market as a significant driver for sustainable development in Nigeria.

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