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**COLLEGE OF BUSINESS AND ECONOMICS**

**SCHOOL OF COMMERCE**

**DEPARTMENT OF ECONOMICS**

**THE NEXUS BETWEEN FINANCIAL DEVELOPMENT,  
FOREIGN DIRECT INVESTMENT AND ECONOMIC  
GROWTH IN ETHIOPIA**

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# **The Nexus between Financial Development, Foreign Direct Investment and Economic Growth in Ethiopia**

BY

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A research Thesis submitted to Addis Ababa University College of Business and Economics, School of Commerce, department of economics for a partial fulfillment of requirements for MASTER DEGREE IN DEVELOPMENT ECONOMICS.

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## **DECLARATION**

I, the undersigned, declare that this Master’s thesis paper, entitled “The Nexus between Financial Development, Foreign Direct Investment and Economic Growth in Ethiopia” is my original work, prepared under the guidance of Zelalem Gutu (PhD). All sources of materials used for the thesis paper has not been submitted either in part or in full to any other high learning institution for earning degree.

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## CERTIFICATION

This is to Certify that the thesis prepared by *Temesgen Abamo*, entitled: *The Nexus between Financial Development, Foreign Direct Investment and Economic Growth in Ethiopia* submitted in partial fulfillment of the requirements for the Degree of Master in *Development Economics* complies with the regulations of the University and meets the accepted standards with respect to originality and quality.

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## LIST OF ACRONYMS

AFDB: African Development Bank

CBE: Commercial Bank of Ethiopia

DBE: Development Bank of Ethiopia

DCs: Developed countries

EIA: Ethiopian Investment Agency

FDI: Foreign Direct Investment

GDP: Gross Domestic Product

IMF: International Monetary Fund

LDCs: Less Developed countries

OECD: Organization for Economic Co-operation and Development

MNCs: Multi-national Companies

NBE: National Bank of Ethiopia

UNCTAD: United Nations Conference on Trade and Development

WB: World Bank

WDI: World Development Indicator

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## **ABSTRACT**

*Foreign direct investment (FDI) has been recognized as a growth-enhancing factor in various economies more especially in less developed countries. It is among the most vibrant foreign inflows that promote economic growth. Foreign direct investment (FDI) improves economic growth; however, the FDI that contributes to the growth is dependent on the recipient countries circumstances. The aim of this study is to empirically investigate the relationship between financial development, foreign direct investment (FDI) and economic growth, and to examine the effect of the interaction variable on economic growth in Ethiopia. The study used the co-integration and Autoregressive Distributed Lags Approach (ARDL) approach, using time series data which covers from 1981-2019. Also the study employed Granger causality test to see the direction of causality. From the result of the bound test there is a long-run relationship among the variables. The obtained results shows that FDI and private sector credit has a positive and significant impact on economic growth, while, the interaction variable has a significant negative relationship with economic growth in the short run. The result also revealed that in the long run private sector credit and the interaction variable has a positive and significant impact on economic growth. However, the FDI to have a positive effect on economic growth of Ethiopia in the long run if the threshold level of financial development should be attained. Moreover the Granger causality test result shows bidirectional causality from foreign direct investment (FDI) to GDP per Capita, private sector credit to GDP per capita and a unidirectional causality from FDI to private sector credit. The result suggest that there is a need to reform the domestic financial sectors to make it more attractive for any foreign firms to invest in, although, this can be considered as a pre-condition for the positive impact of FDI on growth. Thus, the reform of the domestic financial sector should precede policies that would attract FDI inflow into the Country.*

**Keywords:** *Economic growth, foreign direct investment, financial development, ARDL, Ethiopia*

# CHAPTER ONE

## 1. Introduction

### 1.1. Background of the Study

Foreign direct investment (FDI) has been increasing all over the world and widely recognized as a growth-enhancing factor in various economies more especially in less developed countries. The inflows of foreign investment to the host country plays important role by improving the flow of funds for domestic sector investment (Belloumi, 2014). It is among the most vibrant foreign inflows that promote economic growth. It provides not only the financial resources but rather, it leads to the transfer of foreign technology into the host countries through the absorptive capacity (Abdalla et al., 2018).

Foreign direct investment (FDI) helps to economic growth in a positive way; however, the FDI that contributes to the growth is depend on the recipient countries circumstances. The positive effect that FDI may exert on economic growth may start only if the financial market is developed more than at a threshold level (Azman-Saini et al., 2010; Kou et al., 2019). Shah and Khan (2017) argue that highly developed financial system helps as a channel to attract foreign investors into domestic economy. Hence, foreign investors notice such development in financial sector as a sign of strength, openness to market and striking situation.

In order for the foreign direct investment (FDI) to be beneficial to the economy, the financial sectors of the host countries must be vibrant as the success of the foreign inflow is conditioned on it. The allocations and access of external finance to the domestic country could be achieved through the developed financial sector. Well-functioning financial system support channeling foreign funds more efficiently into the productive investment areas, and hence, create more value for investors and makes the countries more attractive to FDI (Imen, 2018).

It's no doubt that the Ethiopian government has implemented various policy reforms over the years with a view to stimulating aggregate output. The pre-reform (Derg) period all private financial institutions were nationalized. Basically the financial sector during 1974-1990 served the state and the public sector. Nevertheless, in 1991 the transitional government had overtaken and restructured the system to a market economy. In 1994, a new proclamation was issued to

direct the bank towards a free market economic environment, which allowed new reforms to be adopted. These included the restructuring and recapitalization of credit supplied to cooperatives and state farms in the agricultural sector and to public and private enterprises in other sectors (NBE, 2016a). At the core of these reforms was the promotion of financial sector improvement along with policies aimed at stimulating increased capital inflows into the country. At the early stage of this policy reform in 1990's, the government has provided various incentive packages to attract foreign investors. After May 1991, the situation for foreign investment has enhanced due to reforms. Private investment policies are more liberal, commercial performance principles has been applied to enterprises, reform made on tax and tariffs, and the currency has been devalued. In 1996, the revised investment proclamation was ratified and designed additional incentives for foreign investors. In addition, the government opened a number of previously closed sectors of the economy to foreign investment (UNCTAD, 2006).

Since 1990's, Ethiopia has opened many economic sectors for foreign investors. The investment guarantee schemes and incentives by government reform helped to raise the share of inward FDI in total investment from 0.04 percent in 1992 to 27 percent in 1997. Though Ethiopia net FDI inflows fluctuated substantially, it tended to increase through \$131 million in 1995 - 2018 period ending at 3.3bln US dollars and net FDI inflows (as % of GDP) for Ethiopia was 4% in 2018 (World Development Indicator, 2018). According to the latest data from UNCTAD (2018), despite a fall in investments in 2018, Ethiopia maintained its top rank in East Africa, with investments in petroleum refining, mineral extraction, real estate, manufacturing and renewable energy. This study has examined the contribution of FDI to economic growth through the channel of financial development; and the relationships among financial development, foreign direct investment and economic growth in Ethiopia for the period of 1981 to 2019.

## **1.2. Statement of the Problem**

The development of financial system can promote economic growth through various mechanisms. According to Levine, (2005), financial development includes the improvement in allocating resource, monitoring investment, mobilizing saving, supporting trade and commerce, and increasing a more efficient allocation of domestic capital, thereby raises economic development.

Empirical evidence from recent studies has established the presence of a positive relationship between various indicators of financial development and economic growth (Pradhan, Arvin, Bahmani, Hall and Norman, 2017; Tadesse et al., 2019; Birru et al., 2019; Kumar et al., 2019). On the other hand, a number of studies have failed to find evidence of positive relationship between financial development and economic growth (see Caporale et al., 2009; Khobai et al., 2018; Kedibonye, 2018). Hence, the existing results do not provide conclusive evidence on the nature and direction of the relationship.

On the other hand, the link between foreign direct investment (FDI) and economic growth has also gathered much attention in the literature. Foreign direct investment promote economic growth in various economies by providing the financial resources into the host countries. It promotes economic growth and productivity of domestic firms through positive externalities and spillover effects on the local economy (Alfaro et al., 2017).

The positive relationship between FDI inflow and growth could be achieved, providing that the recipient countries have reached a relatively high level of development in their financial system (Adeinyi et al., 2012). The financial sector development of a recipient country serves as prerequisite for the FDI to have a positive impact on economic growth (Sirag et al., 2017). Similarly a study by Shahbaz and Rahman (2012), Li et al. (2017), Alzaidy et al., (2017), Pradhan et al. (2018) and Imen et al., (2018) found that the positive impact of the FDI on economic growth is related to the financial development of the host country. However, the result by Azman-Saini et al., (2010) shown that the development of the financial systems must be at a threshold level for FDI to have a positive effect on economic growth, otherwise the effect not present.

On the contrary, some studies have revealed the opposite. For instance, Durham (2004) empirically investigated the interaction effect between FDI and financial development has no influence on economic growth. Also a study by Hsu and Wu (2009) does not provide evidences that the growth effect of FDI could achieve through financial development. Similarly, Thu-Ha et al., (2020) found that the complementary between FDI and financial sector development shown a negative effect on economic growth.

For many African countries, FDI inflow has risen recently. Ethiopia has been one of the countries that has attracted FDI. However, the role of FDI to economic growth in Ethiopia has led to mixed result. For instance, Mitiku (2013), Meskerem (2014) and Selamawit (2016) found

that foreign direct investment inflow positively affects the real per capita GDP. On the other, Dejene (2015) found that FDI have a positive impact on economic growth of Ethiopia in the long run, but insignificant in the short run indicating that it doesn't have major impact on real per capita GDP in the short run. In contrast, some argues that FDI has a negative effect on economic growth. For instance, Teshome (2012) and Betelhem (2016) found a negative relationship between FDI and economic growth in Ethiopia. The argument is that the increase in FDI does not always contribute to upgrading but sometimes may even act to reduce the host country's long run potential, leading to a crowding-out effect whereby domestic firms are crowded out by foreign-owned enterprises, hence affects economic development negatively. Moreover, the above studies have not addressed the role of financial development in mediating FDI and economic growth in Ethiopia and the level of financial development that channeling FDI to have positive impact on economy.

This study focuses on the complementarities between FDI and local financial system development. Specifically, the study addresses the question: How does FDI affect economic development of host country and what is the role of local financial development in mediating the potential benefits? Hence, this study fills the gap in the literature by investigating the effect the FDI has on economic growth of Ethiopia through the financial development channel, which is not addressed in the previous investigation in Ethiopia.

### **1.3. Objectives**

#### **1.3.1. General Objective**

The general objective of the study is to examine the relationship between foreign direct investment (FDI), financial development and economic growth in Ethiopia during the period 1981-2019.

#### **1.3.2. Specific Objectives**

- To examine the impact of foreign direct investment (FDI) on economic growth of Ethiopia through the channel of financial development;
- To identify the short run and long run relationship between foreign direct investment (FDI), financial development and economic growth; and

- To examine the direction of causality between foreign direct investment (FDI), financial development and economic growth in Ethiopia.

#### **1.4. Research Questions**

In light of the preceding analysis, this work is set to examine the following research questions:

- Does financial development have a role in attracting FDI to the country?
- What is the impact of the interaction effect of FDI and financial development to economic growth in Ethiopia?
- What is the direction of causality between FDI, financial development and economic growth in Ethiopia?

#### **1.5. Research Hypothesis**

In order to achieve the broad objective of the study, the testable hypothesis is:

H1: There is a positive relationship between the interaction of FDI and financial development with economic growth.

H2: There is a positive relationship between FDI inflow and economic growth.

H3: There is a positive relationship between financial development and economic growth.

#### **1.6. Scope of the Study**

The scope of this study was limited in terms of coverage. With regard to coverage, it was limited to the Ethiopian economy as well as the role of financial activities in the FDI and Economic growth relationship. In terms of time, it covers the time period 1981-2019.

#### **1.7. Significance of the Study**

The study is significant in identifying the impact of FDI on economic growth of Ethiopia through the channel of financial development by employing empirical evidence using econometric model. Therefore, the importance of this study is that, it will provide policy makers and the research community with information of the theoretical and empirical relationship between

FDI, financial development and economic growth. It is therefore important for the policy makers to determine how the FDI, financial sector development and overall economy are related to each other, and the implications of such a relationship to other sectors in the economy.

### **1.8. Limitations of the Study**

The study is based on quantitative approach analysis. Due to lack of sufficient data for FDI at various stages, the study may suffer due to inadequacy of time series data. Due to missing value in the data and differences in the value computation in different sectors (i.e. NBE and EIC) for FDI inflow in the country, the researcher used the data from IMF, this may result differences in the outcome.

### **1.9. Organization of the Study**

The paper is organized in such a manner to have five chapters. Chapter one deals with a brief introduction of the study. The next chapter is concerned with review of existing theoretical and empirical literature regarding the subject. Chapter three is about methodology and data analysis of the study. The chapter four and five presents the detailed analysis of the findings, and the conclusion and recommendation based on the study of the result, respectively.

## **CHAPTER TWO**

### **2. Literature Review**

#### **2.1. Theoretical Literature**

The study on the relationship of foreign direct investment (FDI) and economic growth has been given much attention because of the important role of FDI may exert in the development process of the economy. FDI is regarded as a vehicle for economic growth of a country through technical progress and improved production techniques (Borensztein, 1998; Lee, 2010).

Since the middle of 1980s, the FDI becomes more important in the world economy. The growth rate and importance have been over both of the world trade and the international financial transactions. Also this means, that FDI has become increasingly a leading power in the world economy, and dominant element of the world economic integration, by the other name globalization (UNCTAD, 2002). Moreover FDI fuels the economic growth of a country by transferring technological skills and spillovers among the domestic firms (Borensztein et al., 1998). FDI also helps to increase local market competition, introducing modern job opportunities and encourage market access for the developed world which ultimately contribute to economic growth in recipient countries (Hermes and Lensink, 2003).

The positive impact of FDI on the economic growth a country however depends on the absorptive capacity and certain characteristics of that country. For instance, the study by Blomstrom et al., (1992) has shown FDI to have positive impact on economic growth, the country should possess certain level of human capital development.

On the other hand some authors such as Hermes and Lensink (2003), Alfaro et al., (2004), Azman-Saini et al., (2010), have shown that FDI has a positive impact on the economic growth for host country that relatively have a well-functioning domestic financial market. According to those studies a developed banking sector and better financial market plays important role in channeling FDI. Also a study by Alfaro et al., (2004) found the connection between FDI, financial markets and economic growth. They found that FDI alone has an ambiguous contribution to economic growth. This indicates that countries with relatively developed financial markets benefit more from FDI compared to those that are less developed.

However, others have found also the negative relationship between FDI and economic growth of a host country. This is because FDI may force out domestic savings and investment (Ramirez, 2000). Apparently, the less developed countries should have a level of development in human capital, technology, infrastructure and health before being able to benefit from a foreign presence in their markets. Imperfect and underdeveloped financial markets may also prevent a country from gaining the full benefits of FDI. Weak financial intermediation hits domestic enterprises much harder than it does MNEs (OECD, 2002).

### **2.1.1. Theories of Foreign Direct Investment (FDI)**

The growing importance of multinational corporations (MNCs) and foreign investment during the 1950s and 1960s provided incentive for many researchers to examine the issue of MNCs and the existence of international production. As a consequence, many theories were formulated to explain the international movement of capital.

#### **2.1.1.1. Product Life-Cycle Theory**

The production cycle theory, developed by Raymond Vernon in 1966, explains why U.S. manufacturers shift from exporting to FDI. The theory started to take hold after World War II in viewing the international production as a sequential process. Vernon believes that there are “four stages of production cycle: innovation, growth, maturity and decline” (Denisia 2010).

During the early stages of the cycle a product is first produced in the country which has discovered it. The new product is mainly for use in the local market and some limited for exports. At this very early stage, the innovating firm is interested in the domestic market of the product. In this early stage of the cycle, comparative advantage rests with the innovating country because of "technological gap" between the innovating countries vis-a-vis the others place the innovating country in a monopoly position. In the initial phase of the cycle, usually, manufacturing occurs in a developed country, such as the US, where the innovator is motivated by a potential profitable market (Tesfanesh, 2012).

In phase two, when the product becomes standardized in its growth product stage, the U.S. manufacturer has an incentive to invest abroad to exploit lower manufacturing costs and to prevent the loss of the export market to local producers. Growth of demand in the importing

nations may provide sufficient volume to justify local manufacture by the innovating firm and competitors who may copy the innovation (Marandu et al., 2018). Thereby, European firms have started imitating American products that U.S. firms were exporting to these countries. As production begins abroad, the exports of the initiating nation rapidly reduce because other producing countries take a share of the market. The U.S. manufacturer's first investment will be made in another industrial country where export sales are large enough to support economies of scale in local production (Denisia 2010).

In the mature product stage, cost competition among all producers, including imitating foreign firms, intensifies. At this stage, the U.S. manufacturer may also shift production from the country of the initial FDI to a lower-cost country, sustaining the old subsidiary with new products.\

The third stage occurs as the product matures. In the mature product stage, cost competition among all producers, including imitating foreign firms, intensifies. A mature product uses an already established technology and a lower skilled labor content. In this situation, the less developed countries may be able to underprice the more advanced countries by applying their cheap less-skilled labor to the technology already designed to product (Zeqiri et al., 2016). At this stage, the U.S. manufacturer may also shift production from the country of the initial FDI to a lower-cost country, sustaining the old subsidiary with new products. Thus the less developed nations may become attractive production points for multinational firms and begin exporting the product to more advanced countries (Marandu et al., 2018).

The decline stage is characterized by concentration of production in emerging economies. The innovating country becomes a net importer of the product it innovated in the first place. Comparative advantage shifts from one nation to another as a product matures; and so does FDI (Marandu et al., 2018).

#### **2.1.1.2. Monopolistic Advantage Theory**

The monopolistic advantage theory suggests that the MNE possesses monopolistic advantages, enabling it to operate subsidiaries abroad more profitably than local competing firms can (Hymer, 1976). He found that FDI takes place because powerful MNEs choose industries or markets in which they have greater competitive advantages, such as technological knowledge not

available to other firms operating in a given country. These competitive advantages are also referred to as firm-specific or ownership-specific advantages (Lall, 1976).

According to Kindleberger (1969) the advantages enjoyed by MNCs could be useful only in the case of market imperfection. The advantages described by him might be in the form of superior technology, managerial expertise, patents etc. These advantages generally encourage a firm to invest in a foreign country in order to fully exploit them instead of sharing them with potential competitors in the foreign market. The greater the chances of earning monopoly profits, the higher will be the encouragement among firms to invest directly.

Besides superior knowledge, FDI will have the opportunity to achieve economies of scale through either horizontal by reduction in unit cost of services such as financing, marketing, and technological research or through vertical in which each affiliate produces those parts of the final product for which local production costs are lower, the MNE may benefit from local advantages in production costs while achieving maximum economies of scale in the production (Hymer, 1976).

### **2.1.1.3. Internalization Theory**

Internalization theory holds that the available external market fails to provide an efficient environment in which the firm can profit by using its technology or production resources. Therefore, the firm tends to produce an internal market via investment in multiple countries and thus creates the needed market (Buckley and Casson ,1983).

Buckley and Casson analyzed MNCs within a broad-based framework came to be known as internalization theory as they stressed this fact with regard to the creation of MNCs. They articulated their theory based on three postulates:

- a) Firms maximize profits in a market that is imperfect;
- b) When markets in intermediate products are imperfect, there is an incentive to bypass them by creating internal markets.
- c) Internalization of markets across the world leads to MNCs.

The theory explain what happens when the external market which is available to a MNC fails to offer an efficient environment in which the business can profit by using its technology,

production process, and know-how. Under such situation, the firm is likely to create an internal market via investment in multiple countries (Marandu et al., 2018). Due to market imperfections, this theory is superior in explaining firm-specific advantages and demonstrates that companies are conditionally involved in FDI. According to the theory, companies will undertake FDI only if the benefits of exploiting firm-specific advantages are higher than the relative costs of the operations abroad (Zeqiri et al., 2016).

#### **2.1.1.4. The Location Theory**

The main idea of this theory is mobility of some factors of production, such as labor and natural resources. According to this theory, FDI exists because of mobility of some factors of production hence such mobility leads to location-related differences in the cost of factors of production (Zeqiri et al., 2016).

Location theory posits that MNCs choose a location which is close to markets or raw materials. It emphasizes that every host country location is characterized by a set of factors that may attract or repel investment (Marandu et al., 2018). According to Erdal and Tatoglu (2002), these factors are classified into two broad groups. First, there are locational endowments, which mainly consists of proximity to natural resources or proximity to markets. Second, there exists a range of man-made factors such as skilled labor, political, economic and infrastructural factors of host country (Erdal and Tatoglu, 2002).

#### **2.1.1.5. The Eclectic Theory**

The main idea of eclectic theory is integration of internalization theory, industrial organization theory and location theory into one general framework. According to Dunning (2008), “the eclectic paradigm seeks to offer a general framework for determining the extent and patterns of both foreign owned productions undertaken by country’s own companies, and that of domestic production owned and controlled by foreign investors”.

This paradigm includes three variables: ownership-specific (O), location-specific (L), and internalization (I). The paradigm is also called the OLI framework which attempts to explain the international flows and FDI in terms of what is the motive rather than what should be the level and the structure of foreign investment. The OLI paradigm includes both macroeconomic location advantages and microeconomic ownership advantages, as they are incomplete if taken

separately (Straker, 2006). Eclectic theory and its framework is based on three advantages: Ownership (O); Location (L) and Internalization (I).

Ownership-specific variables explains the "why" or motivation, of MNCs activities. Some examples of these advantages are: innovative capacity, access to financial resources, and organizational and marketing systems. Ownership-specific variables includes tangible assets such as natural endowments, manpower, and capital but also intangible assets such as technology and information, managerial, marketing, and entrepreneurial skills, and organizational systems (Dunning, 2008).

Location-specific (or country-specific) variables refer to factor endowments that explains the "where," or location of the companies and which are specific to the country. Examples of such specifics are: labor force (availability and quality), natural resources and societal structure (political structure and legal systems) in which FDI is undertaken

Finally, internalization refers to the firm's inherent flexibility and capacity to produce and market through its own internal subsidiaries. The firm "internalizes" the market transactions by owning or controlling the other firm and the transactions (Dunning, 2008). The more ownership specific advantages a company has compared to competitors the higher is the incentive to internalize their use.

### **2.1.2. The Relation between Financial Development and Economic Growth**

The effects of financial development on economic growth can be classified into three schools of thought, a view holds that finance is not important, another holds that finance is key to economic development while the third discourses a cautionary view. However, the new endogenous models holds that economic growth is achieved through technological spillovers brought about by increased capital (physical and human), the increased capital according to Bhole (2004) can be achieved through increased investment and savings by a developing financial sector.

Theoretically, financial development would serves as an effective precondition in the FDI-growth nexus due to its major functions. For instance the studies by Levine (1997) and Levine and Zervos (1996) found that a well-functioning financial system considered as a vehicle for economic development, accumulation of capital and technological progress. According to Levine

(1997) the function of financial system is to facilitate risk management, to allocate financial resources, to mobilize savings and to ease transaction of goods and services which finally channels the accumulation of capital and/or technological progress to economic growth.

### **2.1.3. The Relationship between Foreign Direct Investment and Economic Growth**

Various literatures ascertain numerous channels through which FDI contributes to economic growth. The first is through the transfer of new technologies and the second by generating positive externalities and spillover effects (Pradhan, 2018). Endogenous growth literature explains how FDI contribute to economic growth through labor training and skill acquisition not merely through capital formation/accumulation and technology transfer. Additionally, through the introduction know-how, domestic firms can learn or imitate from FDI. Hence, FDI is likely to contribute to economic growth by raising total factor productivity due to an observed diffusion of technology and improved efficiency (Blomstrom et al., 1996; Borenztein et al., 1995; De Mello, 1999). The theory has also identified the FDI to have a positive impact on growth the country's conditions must improve such as adequate level of human capital, open trade regimes, and well developed financial markets. Moreover the theory also identified a channels in which FDI can affect economic growth of the host country. First, it increases capital formation to the recipient country by introducing new inputs and technologies. Second, by the accumulation of knowledge and skills, this is inspired by management skill and training. Third, via competition, FDI rise competition in the host country industry by overcoming entry barriers and reducing the market power of existing firms (Gorg, 2004).

Furthermore to the above argument for positive effect of FDI on economic growth, there is also debate on the possible adverse effects of FDI on economic growth. The debate has centered on the economic circumstances of the recipient economy. Human capital and the financial market development in the host country may influence the FDI effects. Borensztein, et al (1998) suggest that the FDI impact on the economic development be contingent on the level of human capital of the host country. On the other hand according to Alfaro et al (2004) local financial market development matters for contribution of FDI to host country's economic growth. There is a consensus that through the introduction of new production techniques,

managerial skills, ideas, and variety of new capital goods, FDI can have a positive impact on economic growth (Alfaro et al., 2004).

Khan (2007) argued that the contribution of foreign investment in the growth process of a poor country has been largely unlucky because of: firstly, LDCs have low level of education, skill, and know-how. Secondly, LDCs are not competent in export sector they only export food and raw materials.

According to Shahbaz and Rahman (2010), FDI can serve to increase competition thereby making markets more proficient. FDI is said to promote economic growth through enhanced production, efficiency, improvement in the quality of production factors, generate an inflow of investment funds to the balance of payment, all of which will lead to increase in exports, increases in savings and investments and ultimately faster growth of output and employment.

#### **2.1.4. The Relationship between Foreign Direct Investment and Domestic Financial Sector**

One of the most direct ways through which FDI can contribute to economic development is by increasing the amount of capital available in the local economy. In developing countries, in which capital is typically scarce relative to labor, policy makers frequently view potential capital injection to be the key benefit of FDI because it directly increases investment and gross domestic product (GDP) in the host economy. FDI thus allows countries to supplement capital provided via local savings with capital coming from abroad. However, the extent to which foreign firm activity indeed generates a net increase in capital depends on local financial conditions (Alfaro, et al. 2014).

It is believed that FDI and local financial system channels capital investment funds for manufacturers. A well-developed financial system can affect economic growth in a positive way through technological innovation and capital accumulation (Alfaro, et al., 2004). He argued that a well-developed financial system is a necessary condition in the adoption of best-practice and new technologies by accessing to financial markets.

Furthermore, well-functioning financial markets can boost the positive effect of FDI on country's economic growth by mobilizing savings, through the allocation of financial resources to investment and by monitoring different investment projects through lowering information costs (Levine, 1991). He argued that a well-developed financial system can help to mobilize savings and monitors investment projects, which in turn, contribute to higher economic growth.

Studies by Hermes and Lensink (2003) and Choong, et al. (2004) found that a well-functioning financial system plays an important role in having a positive relationship between FDI and economic growth of host country. They also argued that a more developed financial system has an important role in the process of technological diffusion and spillover effect of FDI.

#### **2.1.5. The Relationship between Financial Development, FDI and Economic Growth**

Financial development contributes to economic growth by stimulating investment in the country through allocation of financial resources to the most profitable projects. A developed financial sector improves the efficiency and effectiveness and also promotes financial innovations within the sector thereby promotes economic development (Pradhan et al., 2017).

A well-functioning financial sector positively affects economic growth through mobilizing savings; by allocating financial resources to investment and by monitoring investment projects (i.e. lowering information costs); this induces the efficiency of the projects at hand (Levine, 2005). Hence, the more developed the financial sector, the better mobilize savings, and monitors investment projects, thereby results a higher economic growth.

The financial system in general, and financial institutions in particular, may help to reduce risks on investment projects, thereby stimulating domestic entrepreneurs to actually undertake the upgrading of existing technology or to adopt new technologies. Hence, financial sector development positively affects technological improvement, and enhances economic growth (Xu, 2000).

The development of the domestic financial system determines the extent of foreign firms will be able to borrow in order to extend their innovative activities in the host country, which would further increase the scope for technological spillovers to domestic firms (Borensztein, et al., 1998). Hence, the accessibility and quality of domestic financial system influences FDI. This

diffusion process may be more efficient once financial markets in the host country are better developed, since this allows the subsidiary of a MNC to elaborate on the investment once it has entered the host country.

In the growth literature many authors argue that the effect of FDI on economic growth is contingent on certain conditions or absorptive capacity of the host country. It has been emphasized that the spillover effect can only be successful given certain conditions of the environment in the host country. These circumstances determine the absorption capability of technology spillovers of the host country. Therefore, FDI can contribute to economic growth through spillovers when there is a sufficient capability to absorb in the host country (Hermes and Lensink, 2003).

It is widely believed that the positive effect of FDI on economic growth is contingent on some factors such as the development of the financial sector in the host country since a developed financial system enhances the technological diffusion associated with FDI (Pradhan et al., 2017). In the same manner, Ang (2009) argued that both financial development and FDI were positively related to the GDP in the long run. In addition, a higher level of financial development was the main channel through which FDI enhanced output growth.

However studies by Ljungwall & Li (2007) and Choog & Lim (2009) on the tri-variate relationship between financial development, foreign direct investment and economic growth, focused on the role of financial development in improving the positive relationship between FDI and economic growth, but failed to examine the extent of causality between these variables.

Some authors argue that the adoption of new technologies and management skills requires inputs from the labor force. Therefore, the positive effect of FDI on the host economy's GDP should be expected only when a sufficient absorptive capability in the form of certain level of educational to be able to learn to work with new technologies. Therefore, technological spillover is possible only when there is a certain minimum, or 'threshold' level of human capital available in the host country (Borensztein, et al., 1998). This suggests that FDI and human capital are complementary in the process of technological diffusion.

On the other hand, some authors stress that the establishment of property rights – in particular intellectual property rights – is crucial to attract high technology FDI (Smarzynska, 1999). If

intellectual property rights are only weakly protected in a country, foreign firms will undertake low technology investments, which reduces the opportunities for spillover effects and improvements of productivity of domestic firms.

## **2.2. Empirical Literature**

Many authors have investigated the relationship between foreign direct investment (FDI) and economic growth and their results have been mixed, while some concluded a positive effect, others discoursed the contrary. For example, Shahbaz and Rahman (2012) investigated the impact of FDI, imports and financial development on economic growth in Pakistan. The findings revealed that FDI, imports and financial development were positively related to the GDP growth of Pakistan. Also, the causality results have shown a bi-directional causation among the variables. In the same manner Xuemei et al., (2017) examined the relationship between foreign direct investment (FDI), economic growth and financial development in Cabo Verde. They used bound test approach to cointegration (ARDL). They found that domestic credit to private sector is important factors in stimulating the FDI into the country.

Similarly Mohamed (2018) examined the relationships using Generalized Method of Moments (GMM) in a panel data analysis. He found that that financial development appears to be working as a complement to FDI and, that the effect of FDI is more noticeable in the occurrence of the financial development variable. Also Sirag (2018) examined using cointegration tests and found that financial development and FDI are positive and significant relationship with economic growth of Sudan. The findings revealed that FDI leads to better economic performance through financial development.

Pradhan et al., (2018) also found that a well-functioning financial system can amplify further investment and an easier means of raising capital to support the activities of FDI. They conclude that economic growth can ultimately be elevated through both financial development and FDI. Also Khan (2007) used the Bound testing approach to co-integration within the framework of Autoregressive Distributed Lag (ARDL) to investigate the long run equilibrium relationship among variables using Pakistan data from (1972-2005). Variables in the study included growth rate of real GDP, ratio of FDI to real GDP, financial sector development, labor and physical capital. He found that the interaction variable between FDI and financial development is

significant on growth, while FDI taken individually had insignificant effect on growth, this suggests that benefits of FDI will be felt only if financial sector is well developed.

Various literatures have revealed that the absorptive capacity as a key factor to FDI-growth relationships. Financial development considered as a viable channel that would enable the growth effects of FDI to be achieved. Jointly past studies empirically found that higher level of financial system development considered as a pre-requisite to fuel the positive growth effects of FDI. For instance, Hakimah et al., (2016) found the financial development plays an important role in realizing the country's economic growth through the positive effect of FDI in the long run.

Hermes and Lensink (2003) using a cross section of 67 less developed countries for the period of discovered that the development of banks and stock markets are important pre-condition for positive growth effects of FDI to be materialized. Similarly a study by Azman-Saini et al. (2010) found similar results on the important role of financial development in the FDI-growth nexus. Some other studies for examples, Lee and Chang (2009) and Ang (2009) also consistently establish the same finding of the positive link of FDI-growth with the financial development as a pre-condition.

Some other studies also depicts that financial sector development has positive role and significant effect on FDI thereby affect economic growth. For instance, Choong and Lim (2009) using the endogenous growth model have analyzed the role of financial development and FDI in improving Malaysia's economic growth. They examine a dynamic endogenous growth function that includes the impact of FDI and financial sector development with locational determinants by employing co-integration framework. Their finding shows that the interaction between FDI and financial development has positive and significant impact on economic growth of Malaysia.

However, the positive effect of FDI with regard to growth for the recipient country is not always certain. For example, by applying panel data Haddad and Harrsion (1993) reject the growth enhancing-spillover hypothesis for Morocco. Aitken and Harrsion (1999) use annual census data and found no evidence of a positive technology spillover effect from FDI. Similarly, Hsu and Wu (2009) argue that cross-country evidence cannot support the growth effect of FDI through financial development. In addition, Falki (2009) investigated the impact of FDI on economic growth of Pakistan for the period 1980 to 2006. He adopted the new endogenous growth model.

He concluded a negative and statistically insignificant relationship between FDI and economic growth.

Moreover, Thu-Ha et al., (2019) have examined the effect of foreign direct investment (FDI) on economic growth contingent on the development level of the local financial system in 18 emerging and developing Asian countries during the period 1996–2017 by adopting threshold approach. They found that the growth-enhancing effect of FDI is realized only when the FD is on the threshold values, otherwise the positive impact of FDI on economic growth is non-existent.

Therefore, the above discussion indicates that financial development-FDI-growth relationships are not uniform, and there is need for study in view of the country's unique characteristics. Hence, this study, may fill the gap in literature by investigating the effect FDI on economic growth in Ethiopia using financial development as a channel, and in addition the study seeks to ascertain the joint effect of FDI and financial development using an interaction variable on economic growth of Ethiopia.

### **2.3. Financial Development, FDI and Economic Growth in Ethiopia**

#### **2.3.1. Financial Development in Ethiopia**

Ethiopia's financial system during the pre-reform period of 1974-91, since private participation was not allowed, the state-owned commercial banks and the state-owned insurance company covered 100% of the branch network and capital with the CBE takes the lion's share. During the post reform period, the number and share of private banks and insurance companies, in line with gradualism property of the reform process in the market, has been increasing.

In 1994, a new proclamation was issued to direct the bank towards a free market economic environment, which allowed new reforms to be adopted. These included the restructuring and recapitalization of credit supplied to cooperatives and state farms in the agricultural sector and to public and private enterprises in other sectors (NBE, 2016a). Another reform was the adoption of new legislation around monetary and banking policy. Accordingly, this new legislation redefined the status, functions and authority of the NBE under a market-based economic environment so as to provide for a stronger and more autonomous role for the NBE (NBE, 2016a). The legislation stipulated the NBE's relation to Government and other

financial institutions through its supervision of credit, the setting of foreign exchange rates and the framework of interest rate policy (IMF, 1994).

The financial system of a country includes its banking sector, other financial institutions, the stock market and the bond market. The Country's financial system is dominated largely by banks, followed by insurance and microfinance institutions. The number of banks remained 18, of which 16 are private and 2 are state-owned. In 2017/18, banks opened 500 new branches, raising the total number of branches to 4,757 from 4,257. The concentration in the banking sector in Ethiopia is explained by the fact that the public banks accounted for 31 per cent bank branch networks and 60 per cent banking capital (NBE, 2018). The higher degree of concentration in the Ethiopian banking sector explains the lower degree of competition in financial sector.

Generally, three important criteria used to manifest the development level of financial system and the extent and the efficiency of financial intermediation. Those are the size, activity and the efficiency of the financial sector (Beck et al., 2000). In order to measure the size of financial sector, (McKinnon et al, 1973) liquid liabilities ratio calculated by the currency plus demand and interest bearing liabilities financial intermediaries and non -bank financial intermediaries divided by GDP.

Financial development in Ethiopia over the years, as measured by M2/GDP, as an indicator of financial deepening followed an upward trend from 1980 to 2006, with fluctuations between 1992 and 1997 (NBE, 2016). According to NBE (2018), at the end of 2017/18, broad money supply (M2), reached Birr 740.6 billion depicting 29.2 per cent annual expansion. This is mainly due to the flow in domestic credit.

Another indicator measuring the activity of financial sector as well as the common measure of the efficiency of resource allocation in the financial sector is the ratio of credit to the private sector - credit by deposit money banks and other financial institutions to the private sector divided by GDP (credit). Although this indicator also focuses on credits issued to the private sector, it excludes credits issued by the central bank (Levine et al., 2000). Hence, it measures relatively the role of financial intermediaries in channeling funds to the private sector, which affects the investment as well as the efficiency of investment (De Gregorio & Guidotti, 1995).

In terms of disbursement of loan, Commercial Banks and Development Bank of Ethiopia (DBE) disbursed Birr 115.4 billion in fresh loans in 2018. Of the total new loans, about 58.2 percent was provided by private banks and 41.8 percent by the two public banks. About 26.4 percent of the loans went to industry followed by domestic trade (17.3 percent), international trade (16.1 percent), other sectors (11 percent), housing and construction (10.6 percent) and agriculture (9.9 percent) while the remaining balance went to other economic sectors (NBE, 2018).

### **2.3.2. Foreign Direct Investment in Ethiopia**

FDI into Ethiopia started to grow since the liberalization of control of the economy in 1992, just after the institution of democracy. The new regime sought to eliminate the constraints on FDI and to establish an enabling environment for foreign investors. The authorities began to promote Ethiopia more vigorously as a location for FDI in early 1998. In 1999 a new investment guide for potential foreign investors in Ethiopia was published. The liberalization of the economy prompted improved incentives and more efficient marketing in the country. Ethiopia is endowed with a geological environment hosting a wide variety of promising mineral resources. Despite these occurrences, mineral development remained limited. The Government of Ethiopia is taking steps to attract foreign investment in these areas (UNCTD, 2006).

Ethiopia has been making efforts to improve its investment environment over the years by, for instance, reducing taxes, establishing an Ethiopian investment commission (EIC) to better assist foreign investors and by abolishing FDI-related restrictions. Furthermore, increased attention has been paid to policy initiatives at the bilateral, regional, and multilateral levels in order to enhance international cooperation and/or integration in matters relating to FDI. The state has adopted new measures and revised old foreign investment legislation, making it progressively more liberal and development-oriented. As a result, the investment environment for FDI and MNCs in Ethiopia has gradually improved over the decades (EIA, 2013).

According to UNCTAD (2011), FDI inflows into Ethiopia have been generally trending upward, though with some volatility, since the mid-1990s. The uneven distribution is partly a result of several large projects. The ratio of FDI to GDP inflows has shown an increase from 1998 - 2002 i.e. \$214 million to \$409 million (3 - 5% of GDP). However, it has decreased from 2006 to 2012 from 3.5% to 0.5%. After 2012 the flow showed increment with some fluctuation.

It has been reported that as of September 2020 the EIC has processed and licensed a total number of 104,581 FDI projects, of which 12,040 have become operational while other 87,682 projects are under pre-implementation. The rest 4,859 FDI projects are approved foreign investment projects waiting for implementation. Among the FDI projects in the operation the 3,477 are real estate, machinery, equipment rental and consultancy service, whereas 3,396 FDI are the manufacturing sector. It is estimated that these investment projects have created job opportunities for about 1,165,198 of which 503,254 permanent and 661,944 temporary.

According to UNCTD (2019), FDI inflows to Ethiopia contracted by 18 per cent to \$3.3 billion in 2018. Yet the country continued to be the biggest FDI recipient in East Africa, with investments in petroleum refining, mineral extraction, real estate, manufacturing and renewable energy.

According to Greenfield projection in 2018, foreign investment in LDCs continued to be concentrated in a few larger recipients. Accordingly, FDI to Ethiopia will remain concentrated in larger FDI recipients in the LDCs region. Ethiopia's newly built industrial parks are expected to help the country register FDI inflows exceeding \$5 billion as early as 2019 (UNCTD, 2019).

### **2.3.3. Economic Growth of Ethiopia**

Ethiopia's gross domestic product (GDP) growth is estimated to have rebounded to 10.9 percent in FY2017. According to official statistics, Ethiopia's annual rate of economic growth, which averaged 10.3 percent over 2005/06–2015/16, slowed to 8 percent in FY2016 due to drought-related lower agricultural production (see in Fig 2). With agricultural recovery, gross domestic product (GDP) growth rebounded in FY2017. The pursuit of prudent fiscal policy – with a fiscal deficit at 3.4 percent of GDP - should help keep inflation under control, providing monetary conditions remain tight in the aftermath of the devaluation of the Birr in October 2017 (NBE, 2018). Key challenges relate to poor export performance and weak trade balance, which reflect the lack of external competitiveness and the vulnerability to terms-of-trade shocks (World Bank, 2018).

The Ethiopian economy which had showed 9.3 percent average annual growth during 2013/14-2017/18 fiscal years, recorded 7.7 percent growth in 2017/18 fiscal year, slower than

the growth rate registered in the previous year owing to growth deceleration in agriculture and industry sectors.

The growth in real GDP was mainly attributed to 8.8 percent growth in services, 3.5 percent in agriculture and 12.2 percent in industrial sectors. Consequently, the share of industry in GDP rose to 27 percent in 2017/18 from about 26 percent in 2016/17 while that of service increased slightly to 39.2 percent from 38.8 percent in 2016/17. In contrast, the share of agriculture fell to 34.9 percent in 2017/18 from 36.3 percent during the same period. This gradual but steady shift in the structure of the economy reflects the government's policy direction of developing manufacturing sector and promoting export-led growth while continuing to give due attention to modernizing the agriculture sector which has dominated the country's economic base for years.

## **CHAPTER THREE**

### **3. Methodology**

#### **3.1. Data Type and Sources**

The study used quantitative data types and secondary data source. The secondary data are gathered from two different sources from IMF and NBE. Due to inability to get gross fixed capital formation within the required period it is gathered from IMF. In the other hand in order to reduce the missing value and value difference in different sectors for FDI data (i.e. NBE and EIC), the ratio of net FDI inflow to GDP are gathered from international monetary fund (IMF) and it is also consistent with world development indicator data (WDI) and UNCTAD. All other data that is the real GDP per capita birr, ratio of private sector credit to GDP, government expenditure to GDP and trade openness are from National Bank of Ethiopia (NBE).

#### **3.2. Research Design**

A predominantly quantitative research approach was necessary for the study because it was consistent with the nature of the main research questions. Hence, the research in general favors quantitative methods over qualitative approach. Given that the aim of this research is to explain and to understand the relationship foreign direct investment (FDI), financial development and economic growth in Ethiopian economy, thus the research strategy adopted for this research was basically quantitative approach and explanatory research design fit this purpose.

#### **3.3. Method of Analysis**

##### **3.3.1. Justification of Model Selection**

In this study to understand the nature of the series and for future forecasting a time series economic model is used. Recent development in econometrics have however, revealed that often times, most time series are not stationary. Therefore, the estimation of variables with this relationship most times gives misleading inferences or spurious regression. To overcome this problem of non-stationarity and prior restrictions on the lag structure of a model, econometric analysis of time series data has increasingly moved towards the issue of cointegration. The

reason being that, cointegration is a powerful way of detecting the presence of steady state equilibrium between variables (Nkoro, 2016).

Following (Shahbaz and Rahman, 2012; Belloumi, 2014), the Bounds testing approach introduced by Pesaran et al. (2001) is used to test the long run relationship between the variables. Using autoregressive distributed lag (ARDL) bound test several steps were performed. First, to see the order of integration the stationarity of the variables are examined. To do the analysis of stationarity, the conventional Augment Dicked Fuller test (ADF) by Dickey and Fuller (1979) were used. The ARDL bound test is based on the assumption that the order of integration is either  $I(0)$  or  $I(1)$ . Therefore, before applying this test, it is needed to determine the order of integration of all variables using unit root tests. The objective is to ensure that the variables are not  $I(2)$  so as to avoid spurious results. In the case of  $I(2)$ , the results can be spurious which makes the ARDL bound test not suitable (Pesaran & Shin, 1998).

The ARDL bounds testing approach to co-integration has numerous advantages. Firstly, bound testing procedure of co-integration is more appropriate for a small sample size (Pesaran, et al. 2001). Secondly, bound testing approach avoids the pre-testing of unit roots. Thirdly, the long run and short run parameters of the model are estimated simultaneously. Fourth, all the variables are assumed to be endogenous. The ARDL bounds testing approach does not impose the restrictive assumption that all the variables must be integrated of the same order. The approach can be applied to test the existence of a relationship between variables, even if the underlying regressors are integrated of order zero  $I(0)$  or order one  $I(1)$ .

While conventional co-integration methods estimate the long-run relationship within the context of a system of equations, the ARDL method is based on only a single reduced form equation (Pesaran and Shin, 1998). Furthermore, the ARDL approach provides unbiased long-run estimates and valid t-statistics, even when some of the regressors are endogenous (Odhiambo, 2008). The ARDL test also considers a sufficient number of lags to capture the data-generating process in a general-to-specific modelling framework to obtain optimal lag length per variable. Therefore, the ARDL approach is considered to be suitable for the analysis of the underlying relationship. Also, a dynamic unrestricted error correction model (UECM) can be derived from the ARDL bounds testing model through a simple linear re-parameterization.

Thus, the UECM combines the short-run dynamics with the long-run equilibrium without losing any long-run information. For this study Eviews 10 statistical software is used.

### 3.3.2. Model Specifications

The variables of interest for this study include real GDP per capita as a proxy for economic growth, FDI (net inflows as % of GDP), and ratio of private sector credit to GDP as a proxy for financial development. In addition, the control variables used are: ratio of gross fixed capital formation (K) as percentage of GDP, general government expenditure (GE) as percentage of GDP and trade openness as per cent of GDP are included. These indicators are used to determine the impact of FDI and financial development on economic growth in Ethiopia.

The model of the relationship between variables constructed as:

$$Y_t = f(FDI_t, FD_t, K_t, TO_t, GE_t, ) \dots \dots \dots (1)$$

The functional equation (1) is converted in to an econometric model. Equation (1) will be to natural logarithm for efficient estimation as shown below. In starting, the model specified in the following manner:

$$\ln Y_t = \beta_0 + \beta_1 \ln FDI_t + \beta_2 \ln PRVCRD_t + \beta_{3i} \ln X_t + \varepsilon_t \dots \dots \dots (2)$$

where Y refers to the gross domestic product per capita; PRVCRD is private sector credit the indicator for financial development; FDI is foreign direct investment inflows as a percentage of GDP; X is a vector of growth determinants such as: ratio of gross fixed capital formation (K) as percentage of real GDP, general government expenditure (GE) as percentage of GDP and trade openness as percentage of GDP; and  $\varepsilon$  is the error term. While,  $\beta_0$  is the intercept or parameter.

The Equation (3) formed with an introduction of interaction variable of FDI and financial development. As discussed above, a well-functioning financial system enhances the absorptive capacity of a country there by FDI inflows will exert positive effect on economic growth (Pradhan, 2019). Hence, it is necessary to see whether a more developed financial sector would stimulate the process of technological diffusion with respect to foreign capital inflows (FDI).

That is why interaction term between financial development and FDI has included in the basic model to investigate this particular hypothesis.

$$\ln Y_t = \beta_0 + \beta_{1i} \ln FDI_t + \beta_{2i} \ln PRV\_CRD_t + \beta_{3i} (\ln FDI_t * \ln PRVCRD_t) + \beta_{4i} \ln X_t + \varepsilon_t \dots \dots \dots (3)$$

Where (FDI\*PRVCRD) represents the interaction term between FDI and financial development indicator.

The autoregressive distributed lag (ARDL) approach to co-integration is used to investigate long run relationship between the variables. The ARDL co-integration approach involves the investigation of long run relationship and the representation of Equation (3) is formulated as:

$$\Delta \ln Y_t = \beta_0 + \beta_{1i} \Delta Y_{t-1} + \beta_{2i} \Delta \ln FDI_{t-1} + \beta_{3i} \Delta \ln PRVCRD_{t-1} + \beta_{4i} \Delta \ln X_{t-1} + \beta_{5i} (\ln FDI * \ln PRVCRD)_{t-1} + \beta_{6i} \ln FDI_{t-i} + \beta_{7i} \ln PRVCRD_{t-i} + \beta_{8i} \ln X_{t-i} + \beta_{9i} (\ln FDI * \ln PRVCRD)_{t-i} + \varepsilon_t \dots \dots \dots (4)$$

Equation (4) shows the short run and long run relationship among the variables. According to Azman-Saini et al., (2010), to avoid problem of multicollinearity, the interaction term estimated the effect of FD and FDI on economic growth contingent on FDI and FD, respectively.

On Equation (4) the interaction terms between FDI and financial development indicator (lnFDI\*lnPRVCRD) included to check the complementary effect of FDI and financial development in enhancing the process of technological diffusion, and hence, enhances the economic performance (Hermes and Lensink, 2003).

### 3.3.3. Definition of Variables and Measurements

#### Economic growth

Economic growth is the value of all goods and services in a country during a specific time period. In other words, it refers to the economic value of services and goods produced within the borders of the particular country. GDP per capita measured as a total GDP divided by total population has been widely used as a proxy for economic growth. For the purposes of this study, real gross domestic product (GDP) per capita is used to measure economic growth and it is represented by “Y”.

## **Foreign Direct Investment (FDI)**

Foreign direct investment are the net inflows of investment to acquire having control or a significant degree of influence on the management of an enterprise (10 percent or more of the ordinary shares of voting stock) in an enterprise operating in an economy other than that of the investor (WDI, 2019). According to World Development Indicator (WDI) it is the sum of equity capital, reinvestment of earnings, other long-term capital, and short-term capital as shown in the balance of payments. Through introducing new technologies such as new production techniques, managerial skills, ideas, and variety of new capital goods, FDI can enhances capital formation and economic growth (Alfaro et al. 2004; Pradhan et al., 2018). It is expected to have a positive impact on economic growth.

## **Financial Development**

Development in the financial system is often described as the process of causing an improvements or change in the quality, quantity and efficiency of financial intermediary services which broadly includes the capital and money markets. Financial development is also viewed to take place when various financial instruments, markets and intermediaries correlate and operate together with the aim of reducing costs involved in providing information, enforcement and transactions (Levine, 2005).

There are various variables that have been used in measuring financial development. Generally, three important criteria are used to manifest the development level of financial system and the extent and the efficiency of financial intermediation. Those are the size, activity and the efficiency of the financial sector (Beck et al., 2000). The size of the financial sector measured by the ratio of broad money (M2) to total GDP (McKinnon et al, 1973; Beck et al., 2000). The other measure of financial development is the the private sector credit to the total GDP (see Beck et al., 2004; Levine et al., 2000; Levine, 2005; Musamali, 2014). Hence, there is no single indicator which can measure financial development of a country.

In this paper the variable ratio of the private sector credit to GDP (PRVCRD) is used as a proxy for financial development. The proxy PRVCRD is a measure of financial depth; which excludes the public sector and shows how credit is allocated more efficiently since the private sector

utilizes funds more efficiently. According to Calderon and Liu (2003) the private sector credit better measurement of financial indicator since it measures the activity of financial sector as well as the common measure of the efficiency of resource allocation in the financial sector. A high ratio means that funds are available to the private sector to finance their investment activities. It is notable that developed financial sector channels funds to high return projects as well as attracts foreign direct investment, hence impacting economic growth positively.

### **Gross Fixed Capital Formation (% of GDP)**

Gross Fixed Capital Formation is the additions to the fixed assets of the economy plus net changes in the level of inventories (World Bank, 2019). The fixed assets are fences, ditches, drains, and so on; plant, machinery, and equipment purchases; and the construction of roads, railways, and the like (WDI, 2019). It is represented as “K” and expected to have a positive impact on economic growth.

### **Trade Openness**

It is the measures of an economy’s level of integration of bilateral trade relative to other countries. In other words, it measures a country’s level of liberalization related to trade with the rest of the world. Trade openness is computed as the sum of export and imports to GDP ratio and represented as “TO” (WDI, 2019). It is expected to have a positive impact on economic growth.

### **Government consumption expenditure**

It refers to the government expenditure on goods and services to satisfy individual (citizens) and/or collective needs of the population in a country. Government consumption expenditure is measured in nominal terms as a share of GDP in this study and represented as “GE” (WDI, 2019). The effect of government consumption expenditure on economic growth is ambiguous. This implies that if the economy spends more than it produces it impedes growth. Alternatively, if government expenditures are mainly channeled to productive venture, it will improve upon domestic production and growth. The sign of the indicator will either have a positive or negative effect on economic growth (Dao, 2012).

## CHAPTER FOUR

### 4. Result and Discussions

#### 4.1. Introduction

The previous chapter discussed the research design employed to achieve the objectives of the study and to test the research hypothesis. In this chapter, the study analyzes the collected data using statistical tool and present the result and discussions accordingly.

The purpose of this paper is to investigate the impact of FDI will have on economic growth of Ethiopia through the financial sector development channels. In particular, it needs to examine the interaction of FDI with financial development affects economic growth of Ethiopia.

#### 4.2. Summary of Descriptive Statistics

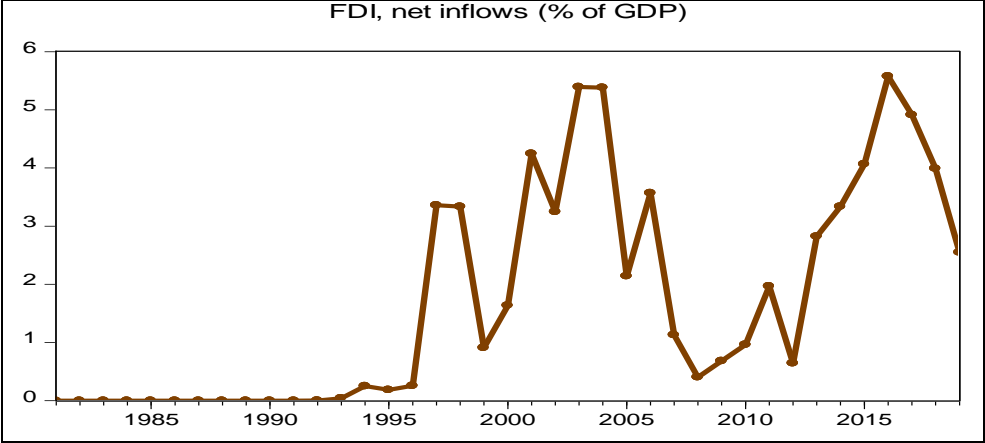
This section presents a preliminary analysis of the data used in this research. From the summary statistics presented in Table 1, it is evident that each of the variables has a positive mean value. Also the summary table depicts that per capita GDP and FDI having the highest and the lowest mean values, respectively.

Table 1: Summary Statistics

	Y	FDI	PRVCRD	GE	K	TO
Mean	5358.964	1.717112	9.716091	10.7002	21.88671	22.37051
Maximum	20360.22	5.576213	20.7444	17.89	39.41704	36.606
Minimum	2408.646	0	1.922842	3.6	10.59422	7.106983
Std. Dev.	4398.435	1.886954	6.099992	3.08841	8.791835	8.383523

According to the summary table, the average FDI inflow as per cent of GDP into Ethiopia during the study period was 1.7%. Though the flow of FDI into the country showed fluctuation from time to time, it has increased from 0.3% in the year 1996 to 5.6% in the year 2016, which is the maximum inflow for the study period (see Figure 1). Compared to where it was in 1996, the FDI inflow into the country has shown impressive growth. However, in recent years the country is witnessing a decline in the FDI inflow. According to UNCTD (2019), FDI inflows to Ethiopia

contracted by 18 per cent to \$3.3 billion in 2018. Yet the country continued to be the biggest FDI recipient in East Africa, with investments in petroleum refining, mineral extraction, real estate, manufacturing and renewable energy. This decline in the inflow partly may have resulted from the political uncertainty in the country and the burning of foreign firms' property during the recent mass protest against the government. If the country is to achieve its development aspiration FDI can help in closing both the financing gap and foreign exchange shortage, therefore the government needs to tackle any issues that might affect the perception of multinational corporations towards investing in the country.



Source: Own Computation

Figure 1: Trend of FDI net inflow per cent of GDP

Similarly, for the study period, the country’s economy as expressed by GDP per capita is on average 5358.964 birr with the maximum and minimum of 20360.22 and 2408.646 respectively. The maximum real GDP growth was recorded in the year 2004, during this year. Notwithstanding the fact that the country’s economy is expanding, the recent trend shows a declining growth momentum. The growth has declined from 10.39 % in the year 2015 to 6.8% in 2018 averaging to 9.03% growth rate between the years 2015 to 2018.

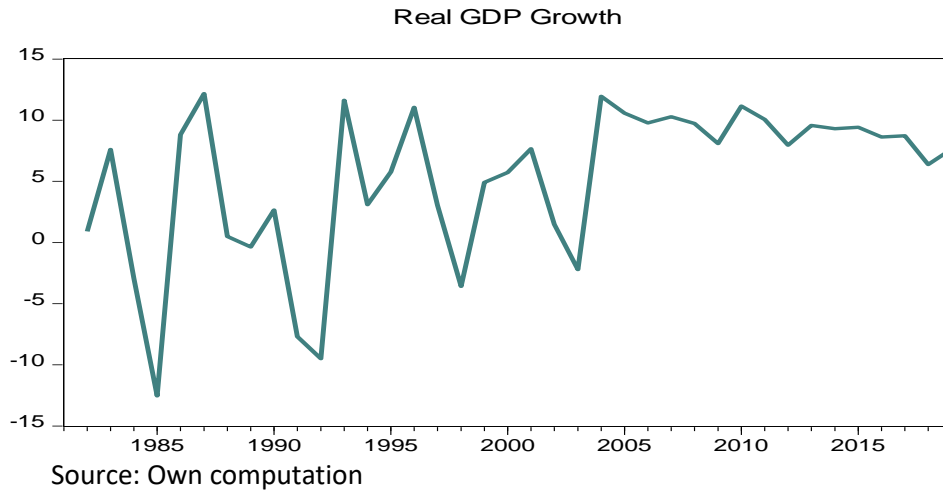


Figure 2: Trend Real GDP Growth

On the other hand, for the study period, the private sector to GDP is on average 9.7% with the maximum and minimum of 20.7444% and 1.922842% respectively. As shown in the figure 3, the bank credit to the private sector grew slowly before the economic reform in the country in 1991. After the economic reform however, the private sector credit by banks has grown relatively due to the increased participation from the private sector. For example the ratio of private sector credit as per cent of GDP in 1999 and 2002 increased up to 19% which is the highest during the period. However it has declined after 2002 until it starts to revive again in 2009.

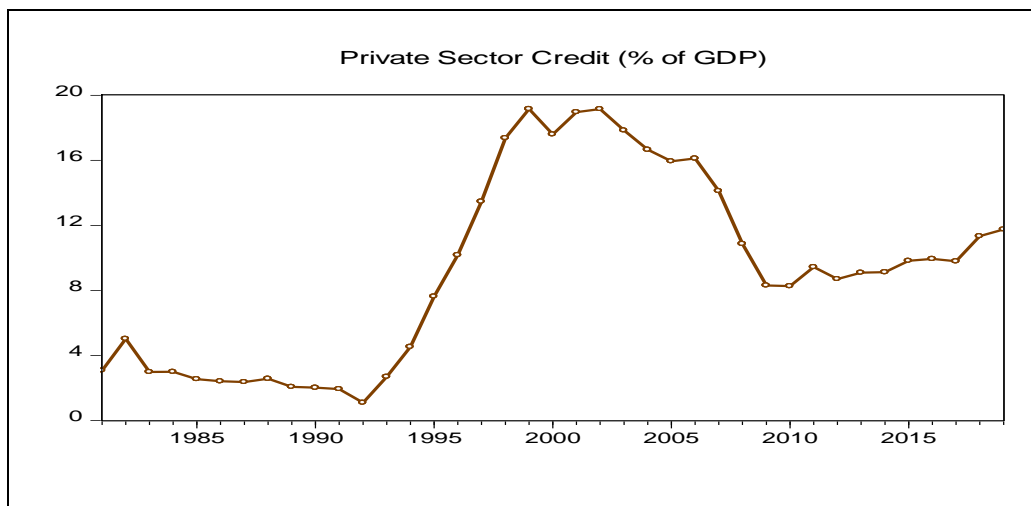


Figure 3: Trend of Private Sector Credit to GDP

### 4.3. Unit Root Tests

Even though, the bounds test approach does not require for pre-testing for stationary, it is important to carry out the tests because the ARDL bounds test to co-integration is not applicable if the order of integration is I (2). Hence, this study used the Augmented Dickey Fuller unit root test approach.

Based on the ADF unit root test (Table 2), the level of lnFDI inflow is statistically significant at the 1 per cent level of significance on intercept and trend which implies that this variables are integrated of order I(0). On the other hand all other variables are statistically significant on intercept and trend at their difference. This implies that the variables are integrated on different orders.

Table 2: Unit root test (ADF)

Variables	Level			1 <sup>st</sup> Difference		
	Intercept	Trend & Intercept	Decision	Intercept	Trend & Intercept	Decision
lnY	2.064941	-0.214753	Non stationary	-5.425958*	-6.728938*	I(1) at 1&5%
lnFDI	-5.433620*	-4.664596*	I(0) at 1%	-7.501720*	-7.399697*	I(1) at 1%
lnPRV_VRD	-1.143028	-1.232829	Non stationary	-5.354468*	-5.261131*	I(1) at 1%
lnFDI*PRVCRD	-2.373586	-2.558242	Non stationary	-5.877550 *	-5.792355*	I(1) at 1%
lnGE	-2.2471	-2.5274	Non stationary	-3.631828**	-3.596264**	I(1) at 5%
lnK	-1.2941	-3.3911	Non stationary	-3.393789**	-3.647234**	I(1) at 5%
lnTO	-1.2982	-1.034326	Non stationary	-6.899603*	-6.847825*	I(1) at 1%

\* \*\* \*\*\* Denotes statistical significance at 1%, 5% and 10% level respectively. Estimation augmented with lag structure obtained from AIC using EViews 10. Source: Authors' computation

### 4.4. Bounds Testing for Cointegration

Having established that the variables are integrated of different orders, it is necessary to proceed the analysis if there exists any cointegration among the variables using the ARDL bounds test approach as developed by Pesaran, Shin and Smith (2001). The bounds test is mainly conducted based on the joint F-statistic. Accordingly, the null hypothesis of no cointegration will be

rejected if the F-statistic is higher than the critical value of both the I(0) and I(1) regressors, and not rejected if otherwise (Belloumi 2014). The use of this test is guided by the critical values given in Narayan (2005).

The ARDL bounds analysis is conducted to investigate the presence of long-run relation among the variables included in the model. The bounds test result is presented below in the table 4.

Table 3: Cointegration Test Result

ARDL Bounds Test

Sample: 1981-2019

Included observations: 36

*Null Hypothesis: No levels relationship*

F-Bounds Test

Test Statistic	Value	Signif.	I(0)	I(1)
F-statistic	7.98	10%	2.12	3.23
k	6	5%	2.45	3.61
		2.5%	2.75	3.99
		1%	3.15	4.43

Applying the ARDL bound testing procedure, the long-run relationship between real GDP per capita and its determinants is examined. As shown from the result in table (3), the null hypothesis of no cointegration is rejected at the 1 percent level of significance, since the value of the F-statistics 7.98 is greater than the upper bound value of 4.43. Hence, this gives evidence that that the long-run relationship between the variables existed.

#### 4.5. Short-Run and Long-Run Analysis

Having established cointegration, the long-run relationships and short run dynamics using autoregressive distributed lag (ARDL) error correction representation approach was conducted. The analysis of the investigation gave main emphasis on the FDI and the interactive term  $\ln\text{FDI}*\ln\text{PRVCRD}$ . The result for the long-run and short-run are depicted in the table 4 and 5, respectively.

Table 4, presents the long-run coefficients for the models estimated. The results of the estimators showed that financial development, as expressed by private sector credit, has a positive and significant impact on economic growth in the long run. The findings indicated that a 1 per cent

increase in financial development will lead to an approximate 3.8 per cent increase in economic growth. The development of the domestic financial system determines to what extent domestic firms may be able to realize their investment plans and also influences the allocative efficiency of financial resources over investment projects. Thus, the financial system may contribute to economic growth through increasing the volume of resources available to finance investment and, through screening and monitoring of investment projects (Levine, 1997).

However, FDI appeared to be having a negative and statistically significant relationship with GDP per capita. In the least developed economies, the FDI effect on growth, has been attributed to the presence of “threshold externalities”. Hence, developing countries need to have reached a certain level of development in education, technology, infrastructure and health before being able to benefit from a foreign presence in their markets (OECD, 2002). Accordingly, the findings do not necessarily imply that foreign direct investment (FDI) is not important. This can be due to the fact that with no financial markets FDI does not have any effect on growth. It is also possible that with no financial markets FDI is not channeled efficiently and has a negative effect on growth (Alfaro et al, 2004). In fact, the results suggest that there is a threshold level of the development of financial markets below which FDI will not have any beneficial effects for growth.

As can be seen from the result, the interactions of FDI and financial development indicator (LNFDI\_LNPRVCRD) have a positive and statistically significant relationship with economic growth at 5 per cent level of significance in the long run. A developed financial system mobilizes savings efficiently which, in turn, expand the amount of resources available to finance investment. Financial development also speeds up adoption of new technologies by minimizing the risk associated with it (Hermes and Lensink, 2003). Moreover, the financial system in general, and financial institutions in particular, may help to stimulating domestic entrepreneurs to actually undertake the upgrading of existing technology or to adopt new technologies introduced by foreign firms. Thus, financial institutions positively affect the speed of technological innovation, thereby enhancing economic growth (Xu, 2000).

Finally, the development of the domestic financial system may also determine to what extent foreign firms will be able to borrow in order to extend their innovative activities in the host country, which would further increase the scope for technological spillovers to domestic firms

(Borensztein et al., 1998). Thus, the availability and quality of domestic financial markets also may influence FDI and its impact on the diffusion of technology in the host country.

Table 4: Long-run Results

<b>Long Run Form</b>				
<b>Selected Model : (1, 2, 1, 2, 1, 2, 2)</b>				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
LNFDI	-1.865749	0.671840	-2.777073	0.0240
LNPRVCRD	3.785083	1.633310	2.317431	0.0491
LNFDI_PRVCRD	0.662165	0.246357	2.687821	0.0276
LNGE	-2.866169	1.134483	-2.526410	0.0355
LNK	3.800526	0.922772	4.118598	0.0034
LNT0	-0.739267	0.286788	-2.577749	0.0327
C	-3.450430	4.875162	-0.707757	0.4992
EC = LNY - (-1.8657*LNFDI + 3.7851*LNPRVCRD + 0.6622*LNFDI_PRVCRD - 2.8662*LNGE + 3.8005*LNK - 0.7393*LNT0 - 3.4504 )				

However, the multiplicative interaction model below in the long-run Equation (5), the estimates of the effect of FD and FDI on economic growth contingent on FDI and FD, respectively. It is worth mentioning that the coefficients  $\beta_1$  and  $\beta_2$  are no longer interpreted as the average effect of FD and FDI, due to the presence of the interactive term (FD  $\times$  FDI), and thus the marginal effect should be calculated (Brambor et al., 2005).

Based on the result, it is possible to find the threshold level of private sector credit (LNPRVCRD) in which the FDI inflow (LNFDI) starts to have positive impact on economic growth of Ethiopia. The threshold value can be calculated by differentiating Equation (5) with respect to LNFDI and put equal to zero (Durham, 2004). The long-run estimated relationship equation is:

$$\begin{aligned}
 LNY &= -1.8657 * LNFDI + 3.7851 * LNPRVCRD + 0.6622 * LNFDI\_PRVCRD - 2.8662 * \\
 &LNGE + 3.8005 * LNK - 0.7393 * LNT0 - 3.4504 \dots \dots \dots (5) \\
 \partial LNY / \partial LNFDI &= -1.8657 + 0.6622 LNPRV\_CRD = 0 \\
 LNPRV\_CRD &= 1.8657/0.6622 \\
 LNPRV\_CRD &= 2.8174
 \end{aligned}$$

Based on the result from equation (5), the long-run threshold level is equal to 2.8174. The result implies that FDI will have a positive impact on economic growth when the private sector credit

relative to real GDP (after transforming the natural logarithm in to exponent form) is above 16.73 per cent in the long-run. This result indicates that the private sector credit should be nearly at its maximum level.

It is understood that financial development acts as a mechanism in channeling the benefits of FDI could have in stimulating the domestic economic growth for the long-run. This can be shown by the coefficient of FDI. The result shows that the interactive variable between financial development and FDI (LNFDI\_LNPRVCRD) is positive and significantly related to the dependent variable GDP per capita (LNY).

Hence, as can be understood that the result fail to rejects the hypothesis that a positive relationship between the interaction of FDI and financial development with economic growth.

The findings suggest that Ethiopia will effectively transform the benefits embodied in FDI inflows, if the evolution of the domestic financial sector has attained a certain development level. Hence, the conclusion from the result also related to the previous finding by Hermes and Lensink (2003); Khan (2007); Azman-Saini et al. (2010); Li et al. (2017); Alzaidy et al., (2017); Pradhan et al., (2018) and Imen et al., (2018).

Other explanatory variables results reveal that in the long run gross capital formation is positively related to the per capita GDP. Capital can be created/accumulated without increased investment by inventions or improved organization that increase productivity, discoveries of new assets (oil, gold, minerals, etc.), the sale of property, etc (Emmanuel et al., 2014). On the basis of this a series of empirical studies have found positive impact of capital formation/accumulation on economic growth. For instance, De Long and Summers (1991) studied the relation between investment or physical capital and the total factor productivity and found out that the countries that confer a greater portion of their product to investments in machinery tend to register a higher level of Total Factor Productivity (TPF).

On the other hand trade openness and government expenditure has a negative relationship with real GDP per capita in the long run. This result is supported by the earlier findings of Kim (2011), who found greater trade openness has negatively influenced on both economic growth and real income in the case of less developed countries. Kim (2011) shows that openness to trade has positive effects on economic growth and real income in developed countries but negative

effects in developing countries. Furthermore, the real effect of trade also depends on the level of financial development and inflation. Openness to trade has negative effect on growth in countries with low financial development, but has insignificant impact in countries with high financial development.

On the other hand Table 5 provides the short run estimation result. The short run result depicts that domestic financial development i.e. private sector credit have a positive impact on economic growth of the country. The findings indicated that a 1 per cent increase in financial development will lead to an approximate 1.3 per cent increase in economic growth.

The results also indicated that the estimated coefficient on FDI suggests that FDI plays a positive role in boosting the economic growth and is statistically significant at 1% level. This is evident by a 1 per cent increase in FDI is associated with an approximate 0.55 per cent increase in economic growth. Hence, FDI improves the host country from the introduction of new processes to the domestic market, learning-by-doing, networks, training of the labor force, and other spillover effects and externalities (Khan, 2007). It is given as certain the fact that FDI contributes to the integration of the host country into the global economy, particularly through the financial flows received from abroad (OECD, 2002). The integration in the international market caused by FDI generates economic growth which is increased as the country is open (Barry, 2000).

However, the interaction between financial development and FDI (LNFDI\_PRVCRD) has a negative effect on economic growth and statistically significant at 1 per cent. Hence, this result suggests that the interaction between FDI and private sector credit does not facilitate economic growth, *ceteris paribus* in the short-run. This is the fact that, FDI in the short run might not depend mainly on financial sector development and it is attracted by other factors. Moreover, imperfect and underdeveloped financial markets may prevent a country from reaping the full benefits of FDI. Weak financial intermediation hits domestic enterprises much harder than it does multinational enterprises (MNEs). In some cases it may lead to a scarcity of financial resources that prevents them from seizing the business opportunities arising from the foreign presence (OECD, 2002). When multinationals mainly financed by the financial markets of host countries the financing needs in the country will have effects in that market, so it is predicted that

the costs of credit increase (Levine, 2002). This competition for funding could withdraw local firms from necessary investments for its development, which may ultimately lead to its disappearance and crowding out of domestic investment (Bhalla and Ramu, 2005).

The other reason for this negative relationship between economic growth and the interaction variable could be that the financial activities are not getting translated to increase economic activities as the funds are not being used for investment purposes. This is true for the pre-reform period (Derg regime), because during the period 1981-1991 the domestic credit to central government grew by 15.7% on average and much of the domestic credit is directed to the central government (MEDaC, 1999).

Regarding the other explanatory variables, trade openness and government expenditure seems to have a negative and significant relationship with economic growth. According to Kim (2012) openness to trade has negative effect on growth in countries with low financial development, but has insignificant impact in countries with high financial development. Trade openness is conducive to economic growth in low-inflation countries but has insignificant impact on growth in high-inflation countries. Kim, Lin, and Suen (2012) provide evidence that trade promotes economic growth in high-income, low-inflation, and non-agricultural countries but has a negative impact in countries with the opposite attributes.

Also Simorangkir (2006) revealed that, trade and financial openness have a negative effect on domestic output and hence on economic growth. He argued that lack of diversification in products created low demand in international market and resulted in low domestic production. Jin (2006) also showed that trade openness has a negative effect on economic growth due to inverse impact of financial markets over macroeconomic performance. Moreover Hye (2011) revealed that human capital and trade openness accelerate economic growth, and suggesting that the performance of human capital must be improved through technical training and education to attain fruits of trade openness on economic growth, and he concluded that negative effects of trade openness on economic growth exist.

On the other hand, the impact of gross fixed capital formation on GDP per capita is positive and statistically significant at 1 per cent level. Lach (2010) have found significant evidence of short run feedback between fixed assets and GDP as well as between fixed assets and employment.

Also Easterly and Rebelo (1993) applied cross country data and found that fixed investment has a positive effect on economic growth.

Table 5: Short-run Results

<b>Short Run Estimates</b>				
<b>Selected Model: (1, 2, 1, 2, 1, 2, 2)</b>				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-1.491188	0.156224	-9.545174	0.0000
D(LNFDI)	-0.370742	0.099333	-3.732296	0.0058
D(LNFDI(-1))	0.546118	0.057385	9.516793	0.0000
D(LNPRVCRD)	1.269214	0.152835	8.304487	0.0000
D(LNFDI_PRVCRD)	0.143473	0.040030	3.584166	0.0071
D(LNFDI_PRVCRD(-1))	-0.224110	0.023686	-9.461715	0.0000
D(LNGE)	-0.897568	0.152271	-5.894527	0.0004
D(LNK)	1.998785	0.179617	11.12804	0.0000
D(LNK(-1))	1.112356	0.120760	9.211280	0.0000
D(LNTO)	-1.020009	0.101265	-10.07272	0.0000
D(LNTO(-1))	-1.012560	0.108107	-9.366311	0.0000
ECT(-1)*	-0.432175	0.043705	-9.888384	0.0000
<b>R-squared</b>	<b>0.936117</b>			
<b>Adjusted R-squared</b>	<b>0.885923</b>			

The error correction term above in the table (5) which denotes the adjustment is found to be negative and statistically significant (-0.432). This term shows the speed of adjustment process to restore equilibrium following a shock in the long run equilibrium relationship. A negative and significant error correction term implies how quickly variables return to equilibrium. A relatively high adjustment coefficient (in absolute term) indicates a faster adjustment process. For instance, this result implies that almost 43 per cent of the disequilibrium are corrected back to the long run equilibrium.

#### 4.6. Granger Causality Results

To study the causal relation between FDI, financial development and economic growth, the Granger Causality (Wald test) used to determine the direction of the linkage and to confirm Granger feedback between the variables under study. After applying the cointegration analysis and seeing that the variables are cointegrated give raise to determine ECM-granger causality to see the direction of the causality between the variables. As mentioned in the previous section, if cointegration exists, it has to be either bidirectional unidirectional or neutral causality between the variables.

From the test, it is evident the null hypothesis of LNFDI does not granger cause LNY and LNY does not granger cause LNFDI is rejected and significant at 1% and 10% level, respectively. This implies that the countries level of economy has a causal influence in attracting FDI and it can also conclude FDI has a significance influence on the country's economy. This result is similar with Li Xuemei (2017) who found bidirectional causality between FDI and economic growth. On the other hand there is also bidirectional causality among financial development and economic growth. The result implies that the efficient provisioning of credit has a positive and significant effect on output and employment opportunities. On the other hand economic growth has a significant influence on financial development by creating more demand for financial intermediation (Prasad, 2018).

The result also indicates that the interaction variable has a significant influence in predicting economic growth of the country. This implies that through channeling financial development FDI has a positive significance influence on economic growth. On the other hand there is also a unidirectional causality from FDI to private sector credit. However, the null hypothesis that PRVCRD does not granger FDI cannot be rejected. This implies that, to have a significant influence on FDI, the private sector credit to GDP should be at a maximum point. This can be conclude that the domestic credit to private sector should be above the threshold level to have a significant influence on FDI.

The results obtained from the table also show bidirectional causality between LNY and LNTO, and LNY and LNK. While having a unidirectional causality from government expenditure (GE) to economic growth (Y) (see table 6).

Table 6: Granger Causality Tests

<b>Null hypothesis</b>	<b>Causality</b>	<b>Probability</b>
LNFDI does not Granger Cause LNY	LNFDI ↔ LNY	0.0068
LNY does not Granger Cause LNFDI		0.0991
LNPRVCRD does not Granger Cause LNY	LNPRVCRD ↔ LNY	0.0063
LNY does not Granger Cause LNPRVCRD		0.0336
LNFDI_PRVCRD does not Granger Cause LNY	LNFDI_PRVCRD → LNY	0.0023
LNY does not Granger Cause LNFDI_PRVCRD		0.2284
LNGE does not Granger Cause LNY	LNGE → LNY	0.0076
LNY does not Granger Cause LNGE		0.4124
LNK does not Granger Cause LNY	LNK ↔ LNY	0.0020

LNK does not Granger Cause LNY		0.0047
LNTD does not Granger Cause LNY	LNTD ↔ LNY	0.0003
LNY does not Granger Cause LNTD		0.0103
LNPRVCRD does not Granger Cause LNFDI		0.2798
LNFDI does not Granger Cause LNPRVCRD	LNFDI → LNPRVCRD	0.0084
LNFDI_PRVCRD does not Granger Cause LNFDI	LNFDI_PRVCRD ↔ LNFDI	0.0000
LNFDI does not Granger Cause LNFDI_PRVCRD		0.0000

#### 4.7. Diagnostic Tests Results

The last issue addressed is related to the goodness of fit of the models. For this purpose, series of diagnostic and stability tests were carried out. The diagnostic tests examine serial correlation, heteroscedasticity, Ramsey's RESET4 test and normality. The Breusch-Godfrey Serial Correlation LM Test used to see the autocorrelation. According to the test if the P-value below the 5% critical value, there is no serial correlation. As indicated in the table 7 there is no serial correlation. On the other hand, the presence of heteroskedasticity has been checked using the Breusch-Pagan-Godfrey test. Based on the result reported in Table (7) it is also evident that the assumption of heteroskedasticity is rejected.

Table 7: Diagnostic Test

<b>Breusch-Godfrey Serial Correlation LM Test</b>	
<b>F-statistic</b>	0.2703
<b>Heteroskedasticity Test: Breusch-Pagan-Godfrey</b>	
F-statistic	0.8662
Obs*R-squared	0.6773

##### 4.7.1. Test of Model Stability

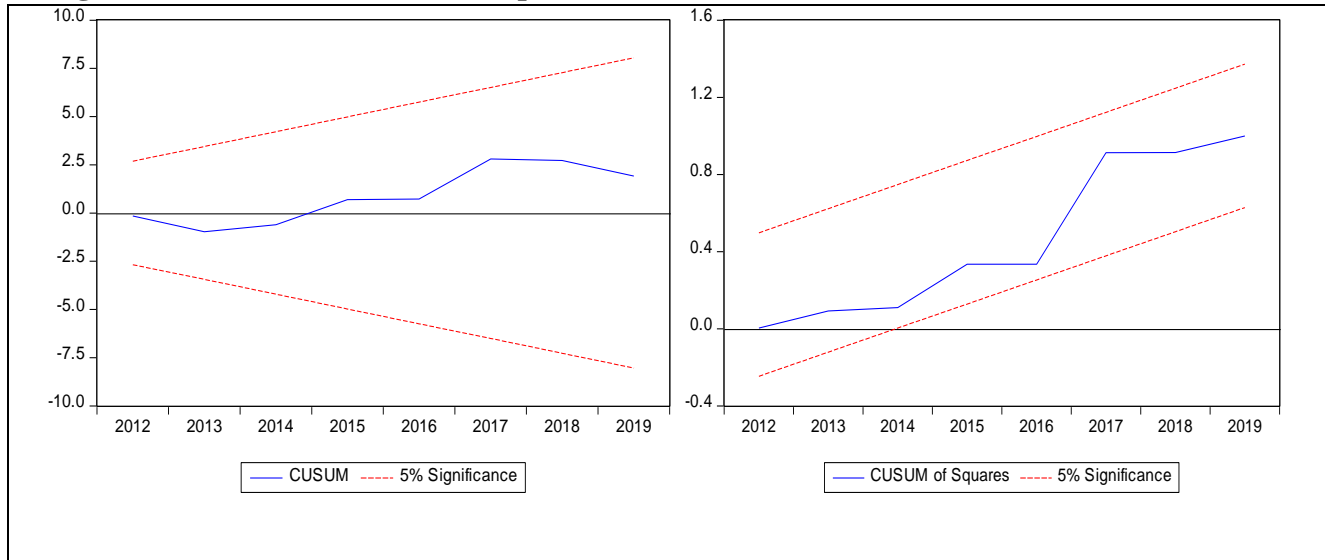
To check the verifiability of the estimated long run model, some diagnostic test is undertaken. The stability of long run estimates has been tested by applying Ramsey's RESET test and the cumulative sum of recursive residuals (CUSUM) and the cumulative sum of squares of recursive residuals (CUSUMSQ) test. Hence, based on the Ramsey's RESET test tests there are no

challenges of misspecification in the model. Also, both (CUSUM) and (CUSUMSQ) test indicate the model is significant at 5% level boundaries (see Figure 4).

Table 8: Ramsey RESET Test

	Value	df	Probability
F-statistic	1.473817	(2, 6)	0.3015

Figure 4: CUSUM and CUSUM Square test



## CHAPTER FIVE

### 5. Conclusion and Recommendation

#### 5.1. Conclusion

Foreign direct investment (FDI) is considered as an important foundation for accelerating development in manufacturing sector for developing countries. Due the positive contribution FDI may have in the domestic economy most developing countries have changed their attention in attracting more FDI to their home countries.

The paper investigated the relationship between financial development, foreign direct investment and economic growth and also if the impact of FDI on economic growth depends on the domestic financial sector development in case of Ethiopia using yearly data for the period of 1981-2019. In doing so, the long run relationships between the variables are investigated using ARDL bounds testing approach to cointegration. Also for the unit root tests ADF technique were used to test the stationarity properties of the series.

In this paper, the focus is on the role of domestic financial system development and the link between FDI and growth nexus. A well-functioning domestic financial system is an important factor in complementing the impact of FDI on economic growth; that is, a country with a well-functioning financial sector experiences a better growth rates.

The most significant finding of this study is that the private sector credit as well as the interaction term between FDI and private sector credit are highly significant and positively affects the economic growth. This is evident that a well-functioning financial system channels the inflows of FDI, and hence fuel economic growth. This indicates that the development of the financial sector is one of the prerequisites for the country to benefit from FDI inflows.

From the above it is understood that the financial sector development and foreign direct investment can influence economic growth of a country in a combined manner, however it depends on the level of financial sector development. Therefore to achieve economic growth, effort should be devoted to encouraging saving mobilization while the macroeconomic

environment should be made to be investment-friendly to enhance the increased inflow of foreign direct investment into the Ethiopia economy.

Finally, future studies might look at the effect of other factors on the FDI – growth. In particular, the level of human capital and institutional quality is one of the significant factor that may affect how FDI influence the economic growth.

## **5.2. Recommendation**

The results suggest that there is a need for concerned stakeholders to reform the domestic financial sectors to make it more attractive for any foreign firms to invest in the domestic economy, although, this can be considered as a pre-condition for the positive impact of FDI on growth. Hence, the reform of the financial sector should lead policies that would attract FDI inflow into the country.

For Ethiopia to benefit most from FDI inflows, an approach that targets promoting FDI in more productive sectors and further cooperation with multinational enterprises is needed. Therefore, the government is advised to maintain its efforts in diplomacy to provide suitable environment for investment.

To promote economic growth, a well-developed market for FDI is needed for Ethiopia. This requires the development of a strategy by which FDI can adjust to the macroeconomic changes in order to enhance long-run economic growth. Policy makers ought to ensure that the FDI environment is healthy and supports knowledge spillover in the host economy to nurture entrepreneurship and next-generation enterprises that can contribute to economic growth. Also a sound institutional setup needed to improve the human capital that able to sustain viable FDI.

Summing up, to stimulate long-term economic growth in Ethiopia, policy makers should give priority to financial sector reforms, particularly with reference to banking sector development. Additionally, sustainable economic growth ought to be a goal in the country, since it would generate additional opportunities for banking sector development, as well as FDI, at least in the short run.

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