

Influence of Foreign Direct Investment on Economic Growth with Moderating Role of Institutional Quality: Evidence from Asian Countries

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Abstract

Purpose: The aim of this study is to assess FDI's effect on economic growth while taking into account the moderating role of institutional strength.

Research Design: The World Bank's World Investment Reports serve as the data sources for the panel data used in the analysis of the study's variables. The GMM method in order to investigate the relationship that exists between Explained and Explanatory Variables. This examination takes place over the time period of 2001–2021 of 20 Asian countries. Research has been done to investigate the interaction effect in order to determine how foreign direct investment (FDI)

affects economic growth, when institutional quality playing moderating role.

Finding: The study concluded that foreign direct investment (FDI) positively correlated with economic growth in Asian countries. Secondly, this research study also find, institutional quality significant positive moderating variable for studies concerning FDI and Economic growth in Asian countries. Thirdly, this study also finds that institutional quality significantly moderates the affiliation between FDI and economic growth in Asian countries.

Practical implications: The findings of this research having practical suggestion for policy makers in Asian Nations. This study recommends that economic growth can only be focused, if FDI

and multinational investments used, assessed and monitored efficiently, and if efforts by the host countries are made to strengthen their financial markets by using these investments, and also focused on trade liberalization and human capital index.

Keywords: FDI, Economic Growth, Institutional Quality GMM

Introduction:

In the last few decades, the world's economies have become more connected has led to more economic convergence, particularly in trade, which have had a big impact on many economic factors. Therefore, economists and policymakers have focused a lot of attention on FDI inflows (Oduola et al. 2021). Since the beginning of economics as a discipline, the issue of economic growth has been central. Every nation aspires to prosper economically, but rapid expansion is not a natural or inevitable occurrence. As there are substantial differences in the economic performance of different countries, there has been a proliferation of research into the causes of these discrepancies (Opoku& Yan, 2018). Alterations to the economy's underlying structure play a role in the rate of growth. The terms "structural change" and "structural transformation" are widely used in economics, especially in development literature. Structural change, as a subset of development, has been widely recognized as having lasting relevance within the field of development economics (Erumban et al., 2019).

Developing countries want more money to come into their economies because their own savings aren't enough to meet their investment goals. FDI is usually done through businesses in other countries, and science and technology can be traded in the form of mechanical devices. It is not easy for ideas and processes in technology to move from one country to another. When a multinational corporation (MNC) invests money in a host country, new technologies and ideas from the source country can be sent right away and then spread throughout the host country through MNCs. This transfer could also help the host country get better at making things (Degong et al., 2019). Also, technology from other countries can help a host country improve its own technology and lead to research that leads to new ideas and technological advances in the home country (UNCTAD, 1999).

The implications for industrialization have been the focus of one such response. Due to its proven ability to attract technical and managerial expertise, facilitate regional supply chain adherence, FDI is often regarded as a key driver in transitioning to an industrial economy because of its ability to stimulate capital flow, improve firm performance, and increase productivity (Adebayo and Kirikkaleli 2021; Awosusi et al. 2021). FDI has been shown to have an important part in the globalization of industry, as evidenced by recent events in Asia (Gui-Diby and Renard 2015). But another perspective brings up the possibility that FDI's impact on industrialization is muted at best

due to increasing competition driving away domestic producers (Oduola et al. 2021 & Akinsola et al. 2021). While there has been much discussion about the positive and negative effects that foreign direct investment can have on industrialization, little attention has been paid to understanding how these effects are formed in the literature.

Economic expansion is greatly aided by FDI from overseas. This is especially true for developing countries, where domestic firms face greater financial constraints that lower their productivity. Increasing a country's GDP is possible thanks to the rapid spread of cutting-edge technology by multinational corporations (MNEs). Knowledge spillovers (externalities) occur because these MNEs are more innovative, have access to cutting-edge technology, and employ cutting-edge management practises, all of which increase largely efficiency of the household economy (Dasch and Kampik, 2010). Through channels like forward and backward linkages and demonstration effects, FDI spillovers significantly affect GDP expansion. While FDI can have positive effects on economies, there is some discussion about whether or not those effects are contingent on the host country's ability to absorb the capital.

Few empirical research have linked FDI to GDP growth in Asia (e.g. Iqbal and Ahmad, 2014; Khan and Khan, 2011). Iqbal and Ahmad found that FDI has a minor effect on Asia's countries economic growth (2014). Khan and Khan (2011) used panel data to analyse FDI's effect on economic

growth by sector and found a causal relationship. Khan and Khan's (2011) study limited the investigation of economic growth, human capital, and FDI. Investing in people drives economic growth. Human capital investment and FDI have historically been the primary sources of economic growth (see, for example, Borensztein et al., 1998; Li and Liu. 2005). Unfortunately, studies conducted in Asia (Iqbal and Ahmad, 2014 & Khan and Khan, 2011) have not found any evidence to support this hypothesis. Finding that human capital (as measured by literacy rate) significantly affects FDI and economic growth helps to fill a gap in the literature. This quantitative study, using UNCTAD data for a time series analysis, spans from 1970 to 2012. (UNCTAD). Empirical analysis makes use of tools like the vector error correction technique (VECM) and the method of least squares (MLS).

Theoretical Arguments on the Linkage between FDI and Economic Growth

It is widely accepted that foreign investment can help developing nations' economies flourish (Xiaoying & Xiaming, 2005). Liming (2014) argues that in light of the volatility and scarcity of alternative sources of capital and technology, multinational corporations may emerge as a crucial provenance. Several theories of endogenous growth support FDI for its ability to disseminate innovations in technology and transfer useful expertise (Mohammad, Mahmoud, & Liu, 2014). Recipient governments are persuaded to ease up their trade regime and provide encouragement to

foreign investors so that their citizens can reap the benefits of FDI. The lifting of export restrictions on foreign corporations is one example of the type of decision that can lead to local and reciprocal contract over legal challenges and advantageous difference. Policymakers in developing countries have responded to these reactions by shifting their focus from a focus on import substitution to one that is more market friendly.

In past researchers used both theoretical analysis and practical investigation to learn more about the factors contributing to growth. Most of the empirical studies are founded on either the neoclassical or endogenous growth theories, both of which are well-known theoretical frameworks (Chirwa and Odhiambo, 2016). Solow's (1956) theory of economic growth states that while increases in physical capital are crucial to GDP in the short run, technological progress is required for sustained growth in the long run. Later on, the stock of human capital is included alongside physical capital as a crucial driver of economic expansion. In the view of the proponents of endogenous growth theory, technical progress and other measures of productivity are the major engines of economic growth (Grossman and Helpman, 1991). According to Fischer (1992), the success of a country's savings and investment is directly tied to a number of factors. This category includes things like social infrastructure, political and economic leadership, and macroeconomic stability.

Despite doubts about the link between FDI and GDP growth, the spillover effect is widely believed to have a major impact on the recipient country (Zuzana, 2014). Increases in total factor productivity and effective resource utilization within the host country may boost GDP as a result of FDI. The following mechanisms may help us reach our goal: relationships between FDI and other forms of international trade, the effects of FDI on domestic economies as a result of its own externalities and spillovers, and so on. Taking these factors into account, countries like China, India, Malaysia, Singapore, and Brazil have experienced rapid economic growth thanks to foreign direct investment (Carlos & Eddie, 2015). Foreign direct investment (FDI) has the potential to boost productivity in the recipient country through the introduction of innovative technologies, management techniques, and human resource development (Paula, 2014). As a result of the catalyst effect of MNCs, domestic businesses can skip ahead in the development process. It is possible that this method will hasten structural changes, allowing developing nations to quickly overtake the industrialized ones (Carlos & Eddie, 2015). However, the existence of minimal externalities is attributed to FDI having a significant impact on the growth level of least developed nations. In order to reap the full benefits of foreign direct investment (FDI), these nations must first advance to a certain level of development in areas such as infrastructure,

education, healthcare, governance, and the financial industry.

Exogenous growth theory

Exogenous growth hypothesis states technical advancement drives development. Blomström&Sjöholm (1999) say international organizations advocate FDI to boost growth. FDI improves economic growth, according to empirical evidence. FDI transfers knowledge to domestic enterprises, according to Blomström and Sjöholm (1999). FDI improves the host country's communication and transport infrastructure and human resources (Noorbakhsh et al., 2001), which boosts economic growth (Mehtar, 2017).

Exogenous growth theory suggests Chinese FDI contributed to Asia's economic growth by funding human capital and technological advancements for CPEC. Asia's economy is booming thanks to CPEC (Haq& Farooq, 2016). From Kashgar to Gwadar, Construction of oil pipelines, roads, trains, power plants, industrial zones, and optical cables will all be a part of the China-Pakistan Economic Corridor (CPEC) (Kousar et al., 2018 &Shoukat et al., 2016). Increases in commerce (Kousar et al., 2018), income per capita (Mehtar, 2017), social welfare (Haq& Farooq, 2016), and employment prospects (Haq& Farooq, 2016) are all attributable to these massive infrastructure networks (McCartney, 2020), and transportation costs, which helps Asia's economies economic growth

(Kousar et al., 2018). CPEC is the government's only hope for economic growth, according to Mehtar (2017).

Endogenous growth theory

Romer developed endogenous growth theory in 1986. According to this idea, FDI in human capital, technology, and knowledge in the host country boosts economic growth. Endogenous Growth Theory implies that FDI contributes to long-term growth by producing positive returns in output (Ford et al., 2008). This idea argues that the local country's economic progress depends on FDI, which hires skilled and knowledgeable workers, resulting to better output and wealth. The investment country invests FDI for cheap labour costs, strong organisational systems, enhanced marketing, and great productivity (Borensztein, De Gregorio, & Lee, 1998). An open trade policy, stable financial markets, and sufficient human resources are all necessary for a host country to reap the economic benefits of foreign direct investment (Malik, 2015).

Hypothesis development

Heckscher's general equilibrium suggests that a country's endowments are the source of its competitive advantages (Heckscher & Ohlin, 1991). The term "endowment" is commonly used to describe a nation's wealth of resources, such as its machinery, land, people, and initiative (Lenka& Sharma, 2014). Apropos this theory, a country must export its abundant items and import its scarce ones. Some countries have more technology and

machinery than others. First will generate technology-intensive products, then labor-intensive ones. In this case, all countries will be obligated to export both labor-intensive and technology-intensive commodities. This idea guides the research of Chinese FDI and Asia's economic growth. As for CPEC's success, Asia has vast markets with expanding demand, inexpensive labour, more construction land, and good climate (Mehar, 2017; Sahoo, 2006; Sehrawat & Giri, 2016; M. Tahir & Alam, 2020).

Research objectives

1. To explore the relationship among foreign direct investment and economic growth
2. To examine the relationship among the institutional quality and economic growth
3. To investigate the moderating effect of institutional quality on the association between foreign direct investment and economic development.

Review of literature

Numerous studies have found that foreign direct investment (FDI) can boost a country's economic growth. These benefits are documented. Foreign direct investment (FDI) boosts a country's balance of payments, capital stock, and economic growth. In low-income countries, FDI is favored over portfolio capital flows because it is more stable. Foreign investment may also boost exports and integrate the country into global economic channels. Economic impact of FDI Using econometric techniques. Nicholas (2021) used ARDL-bound testing to study

FDI and Kenyan GDP growth. Strong economic growth and careful macroeconomic policies have helped Kenya attract FDI in recent years, according to the study. Foreign direct investment and GDP growth in Botswana were studied by Oscar and Edson (2016) using annual time series data from 1980 to 2012. 1980-2012 data was analysed. By using Panel Study methods, the researchers found a long-term relationship between FDI and Botswana's GDP growth. Gaurav (2015) examined the correlation between rising FDI and economic growth in the five BRICS countries from 1989 to 2012. Long-term FDI and GDP growth are linked by panel co-integration and causality analysis. The benefits of foreign direct investment (FDI) can be maximized if authorities remove obstacles to FDI and increase the economy's ability to absorb it. Masipa (2014) studied FDI's impact on South Africa's economy and employment over 24 years.

South Africa's current climate, foreign investment could promote long-term economic growth, according to a study. Olawumi and Olufemi (2016) studied FDI's impact on African economic growth from 1980 to 2013. They employed the generalised method of moments, modified growth modelling, and OLS. FDI into Central African Republic did not boost the economy. According to panel study, foreign direct investment has a small to non-existent effect on African GDP development. The authors, Sajid and Lan (2010), looked into the connection between FDI and GDP growth in 61 Vietnamese provinces between 1996

and 2005. According to the simultaneous equations model, the growth of Vietnam's GDP is linked to both the inflow of FDI and the improvement of the country's investment climate. This finding, however, was not replicated in every area. Abdillahi and Mohd (2021) used 36 years of time series data to examine the impact of FDI on economic growth in Ethiopia. The results of the vector auto regression (VAR) model indicate that FDI contributes positively and significantly to GDP growth. The authors recommended that Ethiopia's government liberalize its financial system and reorganize its agriculture industry to facilitate a more robust economic expansion.

Hypothesis development

H1: Foreign direct investment has a significant effect on the economic Growth

H2: Institutional quality has positive significant effect on the economic growth

H3: Institutional quality moderates the relationship between foreign direct investment and economic growth.

Research method & Estimation Technique:

The method which be focused in this study will be one among Pooled OLS, Random effect and fixed effect, selected as per the behavior of the data checked through Descriptive Statistics.

$$y_{it} = y_{it-1} + \beta_1 fdi + X_{it} + \epsilon_{it}$$

(1)

$$y_{it} = y_{it-1} + \beta_1 fdi + \beta_2 IQ + \beta_3 (\beta_1 fdi * \beta_2 IQ) + \beta X_{it} + \mu + \epsilon_{it}$$

(2)

In the above model, "i" denotes 'i' country, "t" denotes time, "yt-1" denotes period, "FDI" denotes foreign direct investment, "IQ" denotes institutional quality, and "X" denotes the control variables of the research study.

When trying to estimate models of economic growth, researchers faced with the formidable challenge of endogeneity (Opoku & Yan, 2018). (2017). As a result of these issues, conventional estimators like When this happens, traditional statistical methods like ordinary least squares (OLS), fixed effects (FE), and random effects (RE) can't be relied on. Opoku and Yan remark that the instrumental variable method is frequently employed to deal with the endogeneity problem (2018). According to their research, this method of estimation can be useful in identifying the factors that contribute to growth so long as the cited instruments do not have any direct impact on growth but instead affect growth only via the endogenous variable. However, they did point out some of the method's restrictions. This is because the underlying endogenous variables are often difficult to explain using the variables employed as instruments (Bound et al., 1995). Inconsistencies in regression estimates can result from using these instruments. In order to address the endogeneity and unobserved heterogeneity problem, researchers in the last few decades developed a technique called GMM that employs own lags of the endogenous variables as instruments (Roodman, 2009). Since the GMM estimator had already been used in other

studies (such as Teixeira & Queirós, 2016; Vu, 2017; Opoku & Yan, 2018), it was selected for this investigation.

The two most common types of GMM estimators are referred to as "Difference GMM" and "System GMM," respectively. Using first differences, the difference GMM solves the original equation and removes the effects of country. After that, the endogenous variables' lagging values are instrumented into the 'differences.' A system of three equations, difference GMM consists of two equations and system GMM adds a third. While

both equations make use of differences and lagged levels as tools, only the latter is explicitly used. However, Bond et al. (2001) pointed out that difference GMM estimates may be especially susceptible to the weak instruments problem when dealing with short time series. To conduct empirical analysis, this research favoured system GMM over difference GMM. It can be used for both one-step and multi-stage estimation. The former was selected for study because the latter's standard errors are so skewed to the negative (Blundell & Bond, 1998).

Results and Discussion

Table- Summary Statistic

Variables	Observation	Mean	Std.Dev	Min	Max
GDP	252	0.067	0.019	0.045	0.089
FDI	231	0.017	0.101	0.212	0.119
QI	231	0.000	1.000	-0.021	0.123
INF	231	0.013	0.081	0.123	0.342
FD	231	0.023	0.034	-0.012	0.231
GOVEXP	231	0.034	0.098	0.012	0.056
DO INVT	231	0.009	0.232	0.231	0.567

Correlation Matrix

Variables	GDP	FDI	IQI	INF	FD	GE	DI
GDP	1						
FDI	0.045	1					
IQI	0.078	0.056	1				
INF	-0.013	-0.038	0.039	1			
FD	0.078	0.027	0.027	0.034	1		
GE	-0.087	-0.061	0.039	-0.045	-0.034	1	

DI	0.490	0.043	0.021	0.034	0.034	0.029	1
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Note: INF is the inflation rate, FD is the financial development, GE is the government expense, and DI is the domestic investment.

GMM Estimation:

Variables	Coefficients of Std.Error T-statistic		
Lagged of GDP	0.681*** (0.457)		
GDP	0.789** (0.065)		
FDI	0.071** (0.150)		
IQI	0.389*** (0.056)		
INF	-0.012*** (0.039)		
FD	0.017** (0.059)		
GOVEXP	-0.078** (0.056)		
DOM INVT	0.089*** (0.689)		
FDI*IQ	0.038*** (0.067)		
Direct Diagnostic test		Moderating Diagnostic test	
No, Group	20	No, Group	20
No, Instrument	17	No, Instrument	18
AR2	0.291	ARE	0.321
H-Test	0.171	H-Test	0.219

Note: ***, **, * represent that the P value is 0.01, 0.05 and 0.10%. IQ is the institutional quality Index, INF inflation of the countries, GOVTEXP is the expense of govt DOMINVT is the domestic investment.

Results and Discussion:

This section of the study presents the empirical findings, which are consistent with other countries. The FDI index has a favorable effect on GDP growth, and FDI has a positive link with economic expansion in Asia. Both findings support the research that the FDI index boosts economic growth. Both findings are consistent with the research, which found that FDI index increases

economic expansion. Both findings are consistent with the research that found FDI index positively affects economic growth. Both findings match research. This research confirms earlier global research. According to the study, FDI's share of GDP boosts economic growth. This section of the research study presents the empirical findings, which are consistent with other countries.

Empirical studies found a positive and significant correlation between Asian economic growth and FDI. This correlates positively with Asian economic growth. This study, like others, found that FDI positively affects economic growth. The study found that this positive influence was significant. The investigation's conclusion and subsequent discovery were made possible by the FDI index. These findings are consistent with global research (Athukorala, 2013; Hlavacek&Bal-Domaska, Ciftci and Durusu-Ciftci 2022). The research found that the institutional quality index positively affects economic growth, which is consistent with other international studies (Ashraf et al., 2022; Zakari & Khan, 2021). The findings of the study indicate that institutional quality has been a significant factor in positively accelerating the association between FDI and economic growth.

This conclusion can be drawn from the fact that the relationship between these two variables has been positively accelerated. This is the logical conclusion that can be reached when taking into account the fact that the relationship between these two factors has recently undergone favorable acceleration. The findings of the study allow for the following inference to be made regarding their significance: This finding is supported by the fact that it has been found that the quality of the institution plays a significant role in the relationship. This finding is supported by the fact that it has been found. The fact that this finding has been found lends credence to the validity of this

finding. (Athukorala, 2013; Hlavacek & Bal-Domańska, Ciftci and Durusu Ciftci, 2022).

Additionally, the research found that the institutional quality index has a positive influence on economic growth, which is consistent with the findings of other international studies that have been conducted on the subject (Ashraf et al., 2022; Zakari & Khan, 2021). (Ashraf et al., 2022; Zakari & Khan, 2021). The findings of the study also indicate that institutional quality has been a significant factor in positively accelerating the relationship between FDI and economic growth. This conclusion can be drawn from the fact that the relationship between these two variables has been positively accelerated. The conclusion that can be drawn from the findings of the study is as follows. This finding is supported by the fact that it has been found that the quality of the institution plays a significant role in the relationship. This finding is supported by the fact that it has been found.

Conclusion:

This article examines the relationship between Foreign Direct Investment (FDI) and Asian Countries economic growth. Secondly, this study also analyzed institutional quality's moderating effect. The analysis concluded that FDI boosts Asian Countries economy. This study found that institutional quality has increased the link between FDI and growth in Asian Countries. The research also found that institutional quality has positively and significantly moderated the links among FDI and economic growth in Asian countries.

According to this study, Asian Countries should boost its economic growth, by using these multinational investments properly. To increase the country's literacy rate, robust economic measures are needed. Higher human capital can also be achieved by the Asian Countries, if they get more foreign direct investment, for this purpose strengthen political and economic atmosphere security and stability is compulsory. This empirical paper's limitations is

that it measures human capital using adult literacy rather than secondary school enrollment (percent). Similarly, the lack of R&D data for Asian Countries limited the information, further we can incorporate in our research about domestic investment absorptive capacity and FDI. We focused on domestic investment's absorptive capacity in comparison to FDI.

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