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The effect of Foreign Direct Investment on Economic Growth of Cape Verde: An ARDL Approach

Ladson Pires Andrade
Institution: *Hunan University, Changsha, Hunan Province, P. R. China Post code:410079*
**Corresponding Author: Ladson Pires Andrade*

ABSTRACT:- This article examines the effect of foreign direct investment (FDI) in Cape Verde's economic growth (EG) from the year 1985 to 2018. FDI is one of the vital indicators of growth which may influence the economy positively or negatively. Inward investment helps the local economy by bringing the managerial skill, decrease the jobless rate, bring innovation, and increase productivity in the recipient nation. For the last three decades, Cape Verde has been able to attract a higher proportion of external investment, which has been one of the key drivers of the national economy. Thus, a detailed analysis is presented on the effect of FDI on the GDP of Cape Verde. The study uses time-series data and since this data requires us to check the integration order of the variable, the auto-regressive distributed lag (ARDL) model is more appropriate in this case. Therefore, we have applied the ARDL approach to this research. The empirical result shows that there is a long-run association running from FDI, labor force, and inflation to GDP growth in Cape Verde. Further, FDI does not granger cause EG. While the factors openness and domestic investment does not have a long-term association with GDP in the national economy. We conclude the study by giving some suggestions.

Keywords: FDI inflow, economic growth (EG), Cape Verde, ARDL model.

I. INTRODUCTION

FDI is often viewed as the main driver of the receiving country. external investment helps the receiving nation by bringing new technology and innovation, it helps improve the unskilled labor force, increases the employment rate and trade. It creates backward and forwards linkages in different sectors with the new production process. Furthermore, external investment helps the receiving economy with the managerial skills to the local management that will lead to higher productivity in the local firms. FDI plays a very crucial role in accelerating the economic growth (EG) of a nation, Gestrin (2016). It has been found over the years that FDI's effect on the receptor countries is quite significant and this helps in contributing towards promoting national competitiveness, Resende- Santos (2016). In the developing countries, the inflow of FDI providing the much-needed capital that supports reaching the targeted level of nationwide income.

FDI has been quite a blessing for Cape Verde, as this has boosted the country's economy for years. The reason for Cape Verde to get a high inflow of FDI, which is because it has economic as well as political stability and along with which there are robust institutions, Boly et al. (2015). Most of the opportunities that have been enjoyed by Cape Verde are from segments such as tourism, fishing, and public works, Gossel (2017). In this paper, a detailed discussion is carried out to see whether FDI has a positive or negative effect on the economy of Cape Verde. Do FDI and EG have a long-run relationship? So, to answer these questions we need to conduct an empirical study, which will allow us to better understand the effect of FDI on EG in Cape Verde.

II. LITERATURE REVIEW

As Resende- Santos (2016) has emphasized on the development policy of Cape Verde that in a globalized economy; nations like Cape Verde have very limited options of growth and can sustain socio-economic development. The country's competitiveness and growth have been affected by the fall in net inflows of foreign investment. Adam (2013) calculated the inflow of FDI in the Economic Community of Western African States (ECOWAS) and found that political constraint, trade openness, and current account are significant in explaining the inflow of FDI in ECOWAS states. Rjoub, et al. (2017) has conducted research and showed that FDI affects positively the national growth in the region of Sub Saharan Africa. The impact is considered positive and significant. The research also suggests that there is an important relationship between domestic investment and growth so it suggests that there is no crowding-out effect of FDI on domestic investment.

Nwaogu and Ryan (2015) got a positive outcome from his study on the impact of FDI, remittances, and external aid on GDP of the Caribbean and the African nations and he concluded that FDI has desirable results for Africa nations instead of Caribbean nations when controlling remittances and foreign aid.

As mentioned by Jadhav (2012), the task of economic, institutional, and political factors in catching the attention of external investments to BRICS economies is extremely important. He used panel data over the year 2000 to 2009 and noted that the market size, openness, and rule of law plays a major task in attracting external investments to BRICS, whereas natural resource does not have a positive impact, implying that FDI in BRICS is largely market-oriented. The effect of external investment, official development assistance (ODA), and remittances on the EG of the emerging economies were analyzed by Mamoun Benmamoun & Kevin Lehnert (2013), using the GMM approach. The authors noted that external investment, ODA, and remittances exert a significant and positive effect on the EG of these nations. The authors also found that the participation of the worker transfer of funds to the EG is greater than FDI, and ODA.

Schoors et al. (2002) suggested that FDI might have an insignificant impact on the internal market, repatriation of profit "market stealing effects" are good examples. Carkovic & Levine (2002) confirmed that FDI does not have a positive effect on the growth of the receiving nations by using cross-country data from 1960 to 1995 and applying a GMM technique. Their conclusions were not consistently using the theory, that FDI has an optimistic effect on the receiving nation-state.

a. Economic History of FDI in Cape Verde

The immediate independence of Cape Verde did not witness much FDI inflow but the flow was steady after the mid-1990s (UNCTAD, 2015a). In the period 1992-2000, the country was able to attract foreign investment of the amount of 190 million dollars. The implementation of the sound economic policies led to the integration of the global value chain and good governance and that helped in making the global economic situation favorable (AfDB, OECD and UNDP, 2015). This led to the rise in the phase for FDI driven growth that was featured by important Greenfield investment. This was the time that Cape Verde was able to witness a rise in the inflow of FDI, particularly in the tourism sector. The peak FDI inflows were witnessed during 2008, 2011, and 2014 (UNCTAD, 2015b).

The external financial inflows, as well as the FDI, helped the country to achieve economic growth, improve the quality of infrastructure, boosted some important sectors such as manufacturing and financial services (UNDP, 2014). Several socio-economic indicators such as education, poverty reduction, gender equality, and literacy were seen to improve successfully. Spectacular growth was witnessed by Cape Verde between 2000 and 2007; the growth rate of GDP increased to 7.2% and this was the time that Cape Verde earned the title of Least Developed Country (European Commission and World Tourism Organization, 2013).

b. Impact of the financial crisis on FDI inflow

The main export market of Cape Verde is the European Union, as the former relies on the latter as the source of foreign investment, and the citizens of the EU also are the consumers of the tourism services of Cape Verde, Nondo, Kahsaiand Hailu (2016). During 2008-2016, the share of the EU on the merchandise exports tends to fluctuate between 73% and 89%, Agbloyor, et al. (2016). The export revenue that is earned by Cape Verde is sourced from the travel services and most of the tourists are seen to come from Europe (UNCTAD, 2016a). The crisis that emerged in 2009-2014 caused a serious impact on the growth of Cape Verde's economy. The real GDP growth rate fell drastically from 15% in 2007 to -1.2% in 2009. However, the economy by 2016 has shown positive signs of recovery with the GDP growth of 3.9% (UNCTAD, 2016a).

Figure 1, shows the relationship between GDP growth and FDI inflows from the year 1985 to 2018.

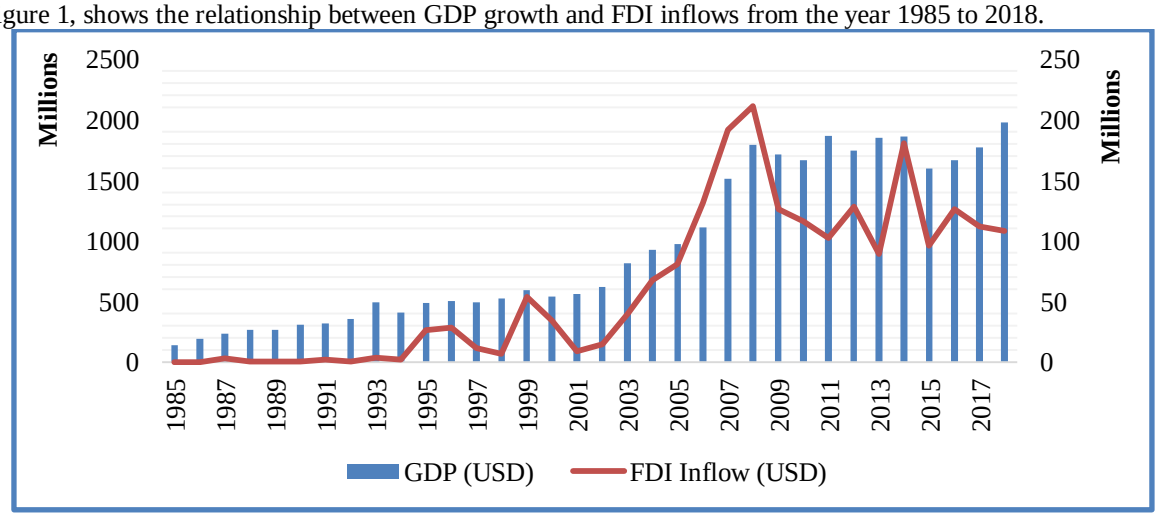

Figure 1: GDP and FDI inflow in Cape Verde for a period of 1985-2018

The graph above shows the relation between FDI and GDP in Cape Verde from 1985-2018. From the1985 until 1994 Cape Verde didn't receive much inflow of FDI since during 1980 the nation was a closed economy. However, after its opening up to the world, the country starts to have the inflow of external investment; but, it started to see the acceleration of the FDI inflows in the earlier 2000s and its uppermost FDI inflows in 2008 that is over $200 million. But from 2008-2013, there was a decline in FDI to its lowest level since 2008, with a little increase in 2011/2012 and down again in 2013. The main reason for this is the financial crisis in some European Union nations that began from 2008 to 2014 since the island depends heavily on the European FDI. An attractive fact concerning the period of a decreasing FDI inflow, there was a slight decrease in the GDP from 2008-2010; but in 2011 there was a rise in GDP and the FDI was a downward sloping, one the reason is an increase of its Diaspora remittance which boost the consumption. In the year 2014, there was an upward trend for both variables. Since then there's fluctuation for both FDI and GDP, and again the GDP shows to have a slight increase from 2015-2016.

III. METHODOLOGY AND DATA

3.1 Definition of variables and model specification

The author uses secondary data in this research and data are taken from world development indicators of world bank (WDI-WB), the Penn world table (pwt 9.1), and the international monetary fund (IMF); the dependent variable is ***economic growth*** measured in current USD and the source is WDI. The explanatory variables are ***foreign direct investment*** measured in current USD and the source is WDI. ***Openness*** measures the sum of exports and imports over GDP measured as a share of GDP, and WDI is the source. ***Labor force***, which is used as a proxy of population percentage of 15-64-year-old and it comes from WDI. ***Domestic investment*** is used as a proxy of the share of gross capital formation at current PPPs. ***Inflation***, measured by the consumer price index reflects the yearly percentage change in the cost to the average consumer of acquiring a basket of goods and services, and it was obtained from IMF.

The model employed in this research is derived from the traditional production function. Many researchers have been using the same model, such as Maliwa & Nyambe (2015), Chaudhry et al., (2013), Akinlo (2004) and Saqib et al., (2013); all of them have been used a similar production function to observe the effect of FDI on EG over the year.

Our model can be specified as follows

$$LGDP_t = \beta_0 + \beta_1 LFDI_t + \beta_3 LOPEN_t + \beta_4 LF_t + \beta_5 DI_t + \beta_6 INF_t + \varepsilon_t \quad (1)$$

Where *LGDP* means log of the gross domestic product; *LFDI* represents the log of foreign direct investment; *LOPEN* represents the log of the sum of export and import over GDP; *LF* represents the labor force*; DI* denotes domestic investment, and *INF* represents inflation; ε_t is the error term.

Being a time series data, the research adopts the Auto-regressive Distributed Lag (ARDL)/bounds test to testing the co-integration procedure to estimate the long-run relationships and dynamic interaction among the variables of interest. Pesaran et al. (2001) proposed an ARDL approach to investigate the existence of co-integration relationships among variables. The ARDL approach is the best option to be used when variables are integrated in a different order, that is I(0) and I(1), but not in I(2). The second reason is that the ARDL approach can be relatively more efficient when the sample size is small. Also, Belloumi (2014) pointed out that the ability to get the unbiased estimate of the long-run model could be another advantage of the ARDL approach.

3.2 Econometric Methodology

3.2.1 Unit Root Test or Augmented Dickey-Fuller Test

To check the order of the variable integration, the author employs the stationarity test. The ADF test supports linear regression. Also, it's used in the replacement of correlation since ADF can handle the most complex and bigger models. The ADF statistic usually is a negative number, and its form is described as follows:

$$\Delta Y_t = \alpha + \beta_t + \rho Y_{t-1} + \varsigma_i \sum_{i=1}^{p} \Delta Y_{t-1} + \mu_t \quad (2)$$

A lagged difference is the main factor of this test to oppose the auto-correlation. Therefore, we apply it as an approach to analyze the co-integration among FDI and growth in this research.

3.2.2 ARDL method

By bearing in mind the ARDL method advantages stated before, and to assess the long-term and short-term association of the FDI on the GDP, our model would be as follow:

$$\Delta LGDP_t = \beta_0 \sum_{t=1}^{p} \beta_{1t}\, \Delta LGDP_{t-1} + \sum_{t=1}^{q} \beta_{2t}\, \Delta LFDI_{t-1} + \sum_{t=1}^{q} \beta_{3t}\, \Delta LOPEN_{t-1} + \sum_{t=1}^{q} \beta_{4t}\, \Delta LF_{t-1} + \sum_{t=1}^{q} \beta_{5t}\, \Delta DI_{t-1} + \sum_{t=1}^{q} \beta_{6t}\, \Delta INF_{t-1} + \beta_7 LGDP_{t-1} + \beta_8 LFDI_{t-1} + \beta_9 LOPEN_{t-1} \beta_{10} LF_{t-1} + \beta_{11} DI_{t-1} + \beta_{12} INF_{t-1} \quad (3)$$

Where, Δ refers to the first difference; p and q is the optimal lag length of the dependent variable and the regressors respectively; β1, β_2, β_3, β_4, β_5, and β_6 refers to the short-run dynamics and β_7, β_8, β_9, β_{10}, β_{11}, and β_{12} are the long-run elasticity

3.2.3 Error Correction Model (ECM)

The ECM was introduced in 1987 by Engle and Granger (1987) is applied to find the information on the causal factors influencing the variables included in the model. The error correction term of the ECM must be negative to shows the long-tern association between the variables. In case of a positive sign of this term, it indicates a divergence in the model. The following equation, equation (4) represents the ECM equation.

$$\Delta LGDP_t = \beta_0 \sum_{t=1}^{p-1} \beta_{1t}\, \Delta LGDP_{t-1} + \sum_{t=1}^{q-1} \beta_{2t}\, \Delta LFDI_{t-1} + \sum_{t=1}^{q-1} \beta_{3t}\, \Delta LOPEN_{t-1} + \sum_{t=1}^{q-1} \beta_{4t}\, \Delta LF_{t-1} + \sum_{t=1}^{q-1} \beta_{5t}\, \Delta DI_{t-1} + \sum_{t=1}^{q-1} \beta_{6t}\, \Delta INF_{t-1} + \lambda EC_{t-1} + \varepsilon_t \quad (4)$$

Where p-1 and q-1 are the optimal lag length of the dependent variable and the regressors respectively; λ refers to the speed of adjustment parameter; EC refers to the error correction term.

3.2.4 Heteroskedasticity, auto-correlation, and stability test

Doing an empirical study in economics requires us to test for some other tests such as to check if the model is homoscedastic or heteroscedastic; check if we are in the presence of the serial correlation or not no matter which model we are using. Thus, this study applied the Breusch pagan Godfrey test for heteroskedasticity and the auto-correlation issue. For the stability of the model, the Ramsey Reset test has been employed.

IV. RESULTS AND DISCUSSION

Before we go further with the econometrics model, it is required to check the order of integration of selected variables, and we applied the well-known ADF unit root test to check in which order the variables are integrated. The following table, table (1) provides the results of the stationarity of the variables.

Table 1: ADF unit root test

Variables	Status	ADF test statistics	
		Constant	Constant and Trend
LGDP	At level	-0.057540 (0.0376)	-1.053814** (0.0006)
LFDI	At level	-0.118974 (0.1750)	-0.449486 (0.0096)
LOPEN	At level	-0.189324 (0.1126)	-0.454904** (0.0016)
LF	At level	-0.005934 (0.4934)	-0.072897*** (0.0005)
DI	At level	-0.146337 (0.1741)	-1.264816*** (0.0003)
INF	At level	-0.511015** (0.0028)	-0.848204** (0.0032)
ΔLGDP	First Difference	-0.982009*** (0.0000)	-1.045360*** (0.0000)
ΔLFDI	First Difference	-1.523755*** (0.0000)	-4.232338** (0.0008)
ΔLOPEN	First Difference	-1.206673*** (0.0000)	-1.245494*** (0.0000)
ΔLF	First Difference	-0.103531** (0.0274)	-0.156158 (0.1285)
ΔDI	First Difference	-1.327782*** (0.0000)	-1.330527*** (0.0000)
ΔINF	First Difference	-1.448641*** (0.0000)	-1.447521*** (0.0000)

Note: ***and **, denotes significant at 1% and 5% P-values in the parenthesis Δ, represents the first difference.

Source: author's computation using Eviews 10.

Table 2, provides the results of all the necessary diagnostic tests to be applied after run the ARDL model or the short-term estimation such as the heteroskedasticity test, the auto-correlation of the residual, and the stability of the model. From the P-value of the heteroskedasticity test which is 0.806 proves that our model is homoscedastic; the Breusch-Godfrey auto-correlation test also showed that our model is free from the serial correlation since the P-values is above 0.05. Another test is applied to check the functional form of our model. The Ramsey reset test exposed that the functional form of the used model is good.

Table 2: Results of residual and stability diagnostic

Tests	F-statistics	P-values
Heteroskedasticity test: Breusch-Pegan-Godfrey	0.586027	0.806
Breusch-Godfrey serial correlation LM test	1.494382	0.251
Ramsey Reset test	2.189142	0.155

Source: Author's computation using Eviews 10.

The next table, table (3) shows the short-term estimation results of the ARDL method. Further, we provide, some other results such as the Akaike info criterion (AIC), Durbin-Watson stat, and also the F-statistics value has been reported. From the short-run results, we can prove that foreign investment does have a positive and significant of Cape Verde economy at a 1% confidential level. Thus, FDI and GDP growth of the nations is associated, meaning that an increase of one percent of the foreign direct investment leads to a 3.9% rise in the economic growth, on average ceteris paribus. Hence FDI and GDP exhibits an elastic relation. The predictor open presents a negative sign but statistically significant in the short-run. Meaning that a one percent decrease in openness leads to a reduction of 69% of the national growth. In another word, it means that if the country administration introduces some measures that may affect the multinational corporations it may lead to a stagnation of economic growth. The regressor labor force displays a positive coefficient and statistically significant at a 5% level of significance. In another word, this means that the labor force is always important for the national economy. The domestic investment demonstrates that its significant at a 5% confidential level. This means that a one percent rise in the domestic investment leas a national economy up by 64.5%. last, the predictor inflation presents a positive sign and its significance at a 1% level of significance. Meaning that a 1% rise in the inflation rates increases the GDP growth by 1.6%.

Table 3: ARDL short-run Estimation

Variables	Coefficients	T-statistics	P-value
Constant	6.926**	2.621	0.016
LGDP(-1)	0.589***	5.207	0.000
LFDI	0.039***	2.920	0.009
LOPEN	-0.690***	-4.062	0.000
LOPEN(-1)	0.503**	2.608	0.017
LF	0.213**	2.274	0.034
LF(-1)	-0.183**	-2.184	0.041
DI	0.645**	2.492	0.022
DI(-1)	-0.433	-1.664	0.112
DI(-2)	0.519**	-2.084	0.050
INF	0.016***	3.353	0.003
R^2 = 0.995			
Adj. R^2 = 0.993			
AIC = -2.085			
F-statistic = 448.277			
Prob (F-statistics) = 0.000			
Durbin-Watson stat = 1.982			

Note: ***and **, denotes significant at 1% and 5% P-values in the parenthesis Δ, represents the first difference.

Source: author's computation using Eviews 10.

The following table, table (4) displays the long-term estimation outcomes.

Table 4: Long-run estimation

Variables	Coefficient	t-statistics	P-value
LFDI	0.094***	2.886	0.009
LOPEN	-0.457	-0.815	0.424
LF	0.074***	5.794	0.000
DI	-0.746	-1.200	0.244
INF	0.038***	0.011	0.003

Source: Author's computation using Eviews 10.

In the long run, FDI, labor force, and inflation exerts a positive influence on Cape Verde's EG. The coefficient of FDI shows that a 1% increase in FDI causes a 9.4% rise in GDP at 1% at the level of significance, on average ceteris paribus. Hence foreign investment and GDP growth are linked and they exhibit an elastic association. In the same way, the coefficient of labor force expresses that a 1% change in this regressor causes a 7.4% change in the country's economy. Our finding is similar to the Rjoub et al., (2017), Nwaogu and Ryan (2015), and Mamoun Benmamoun & Kevin Lehnert (2013). All these studies found a positive effect of running from FDI EG. Equally, the inflation rate indicates that a 1% change adds up 3.8% on economic growth at a 1% level of significance. Openness and domestic investment do not have any significance in the national economy.
Further, table 5 shows the ARDL bound F-test co-integration results. If the values of F- test if higher than the I(1) bound test, we do reject the null hypothesis of no co-integration, but if the value of the F-test is bellowing the I(0) bound we cannot reject the null of no co-integration. Furthermore, if the value of the F-test lies between the I(0) and I(1) the results are inconclusive. Thus in our case, the F-test values are completely higher than the I(1), so our model thus has co-integration.

Table 5: Results of ARDL Bounds F-tests Co-integration

Variables	Lag length	F-statistic	Critical Value 1%		Critical Value 5%	
			I(0)	I(1)	I(0)	I(1)
LGDP| LFDI, LOPEN, LF, DI, INF	(1, 0, 1, 1, 2, 0)	5.859574	3.41	4.68	2.62	3.79

Source: Author's computation using Eviews 10.

The final table, table (6) displays the ECM outcome. As we have said earlier the ECM(-1) or the speed of adjustment must be negative and significant, which shows the long-run association among the variables. Therefore, we got the expected sign and significant P-value of the ECM, which proves that our model has a long-run association among the variables.

Error Correction Model (ECM)

Variables	Coefficients	t-statistics	P-value
Constant	6.926***	6.713	0.000
ΔLOPEN	-0.690***	-6.796	0.000
ΔLF	0.214***	5.828	0.000
ΔDI	0.645***	3.185	0.000
ΔDI(-1)	0.519**	2.784	0.011
ECM(-1)	-0.411***	-6.629	0.000
R^2 = 0.844			
Adj. R^2 = 0.813			
Durbin-Watson stat = 1.982			
AIC = -2.917			
SC = -2.639			

Note: ***and **, denotes significant at 1% and 5% P-values in the parenthesis Δ, represents the first difference.

Source: author's computation

The GDP growth of Cape Verde is just like any other nation is affected by many macroeconomic factors such as FDI, openness, inflation rate, labor force, and domestic investment, and so on. Of all the macro indicators, FDI has been found to have a very important role when comes to the national economy. In another word, we find that FDI has a strong influence on the Cape Verde economy in the long-run. The evaluation of the

data on GDP growth and FDI for the period of 1985 to 2018 has shown that there has been a gradual uprising trend of both the curves. Although there has been a slight decrease in the FDI in 2008-2009 due to the great financial crisis, later the inflow of FDI on the nation has gradually risen and is projected to rise in the future, Raheem and Adeniyi (2015). The financial crisis of the Eurozone has also played a serious impact on the inflow of FDI in the nation. It received the lowest FDI since the crisis begun in Eurozone nations. The GDP and FDI amount over the years for the period of 1985-2018 shows that the amount of FDI inflow has not been in par with GDP. However, the GDP growth has been noticed along with FDI inflows for the period taken under consideration.

V. CONCLUSION AND RECOMMENDATIONS

The effect of FDI on economic growth in Cape Verde from 1985 to 2018 has been studied through this research, and the overall conclusion of the empirical findings suggested that external investment exerts a greater influence on the Cape Verde economy. Hence, foreign investment does have a strong association with the GDP growth in both the short and long-run in the country. This empirical finding suggests that inward investment is vital for the nation's sustainable economic enlargement. Thus, our results go with the same line of the studies from Rjoub et al., (2017), Nwangu and Ryan (2015), where the authors argued that external investment helps the receiving nation. In this study, we employed the Augmented Dickey-Fuller (ADF) unit root test to check the order of integration of the variables. Since the variables are integrated in a different order such as I (0) and I (1) the best econometric method to be used is an ARDL approach. The co-integration test showed that there is a long-term relationship between the variables used in our study. Lastly, the ECM results show that openness, labor force, and domestic investment are the main driver of the national economy of Cape Verde.

From the empirical outcomes, we suggested that the government and policymakers must take policy reform related to different types of FDI; particularly, in the greenfield investment, which will reduce jobless. Reform and incentive policies should be made in the export sector such as in the manufacturing area. Last, but not least more incentive policy in the domestic investment is needed as it can be an alternative to the inward investment for the national economy.

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Corresponding Author: Ladson Pires Andrade
Institution: Hunan University, Changsha, Hunan Province, P. R. China Post code:410079