TRADE BALANCE AND FOREIGN DIRECT INVESTMENT INFLOWS: A NEW PERSPECTIVE ON GROWTH IN AFRICA

ARODOYE NOSAKHARE LIBERTY
University of Benin, Nigeria
nosakhare.arodoye@uniben.edu

IZEVBIGIE NORENSE JOHN
University of Benin, Nigeria
norense.izevbigie@uniben.edu

IGBINOBA DAVID ETINOSA
University of Benin, Nigeria
rasaq190four@icloud.com

Abstract

This study analyses the relationship between Foreign Direct Investment (FDI), trade balance and economic growth in Africa employing Panel least square methods (Fully Modified Least Squares (FMOLS) and Dynamic Least Squares (DOLS)) for forty-two (42) Africa countries for the period of 1995 to 2017. The analysis revealed that Foreign Direct Investment (FDI) positively and significantly affect economic growth in Africa while trade balance exhibited a negative and significant effect on economic growth in Africa. These results were separately and individually affirmed by Panel least square methods estimation techniques employed. From the findings, recommendations such as ensuring that trade deficits emanates through productive investment, implementation of policies that attract more FDI inflows to Africa and strengthening of cross border relations using the instrumentality of Africa Union (AU) were proffered.

Keywords: Trade, Foreign direct investment, economic growth, dynamic panel estimator

JEL Classification: F11, F21, F43, C33

1. INTRODUCTION

Most African countries depend heavily on trade and capital inflows for economic growth. International trade and inflows of capital to an economy help boost domestic investment (Fosu and Magnus, 2006). This means that besides the available domestic resources, trade and capital inflows provide additional resources for economic growth.

Trade enlarges consumer choice, provides access to new technology, and has the potential of enhancing productivity, employment creation and growth (Thirlwall and Nureldin, 1982). Harmonization of trade policies; advancement in information and telecommunication technology and global paradigm shift from trade protectionism amongst others account for the increasing dependence of African countries on trade (United Nations Conference on Trade and Development(UNCTAD), 2016). However, a major factor in the determination of the external balance of an economy is its trade balance. This is because trade balance measures net export. It is the value of exports less imports. When exports are greater than imports it means there is surplus in trade but when export value is less than import value, there is deficit in trade. More so, a country experiencing trade deficit will definitely seek for avenues such as borrowing to finance the deficit while a country with trade surplus either save or plough back such found into the economy by way of investment.

Capital inflows such as Foreign Direct Investment (FDI) to Africa have been on the increase over the years showing that the continent has been part of the worldwide increasing trend. In the last decades, the upward trend in FDI inflows to Africa made it to rank amongst the largest sources of external capital inflows to the continent (United Nations Department of Economic and Social Affairs(UNDESA), 2017; United Nations Development Programme (UNDP), 2009; Organisation for Economic Cooperation and Development (OECD) 2014; World Bank, 2017). FDI is regarded as a major component of foreign investment with a more significant impact on growth as a result of its illiquid form which makes it difficult to flow out of recipient country at the first sign of trouble compared to other capital inflows (Edo, 2007 and 2011). Thus, most developing countries in general and Africa countries in particular have been making efforts to attract and sustain FDI inflows via offered incentives and regulations.

The studies that abode in the literature are mainly on the examination of the effect trade/trade openness has on economic growth. This in actual fact does not capture the effect trade balances have on economic growth. Also, there exist mixed results in the extant literature on the effects FDI has on economic growth. This may not be unconnected to the analytical method employed which do not correct for country specific and endogeneity in cross country studies. This forms the motivations for this study covering forty-two Africa countries for the period 1995-2017.

2. BACKGROUND ISSUES

A.   TRADE BALANCE IN AFRICA
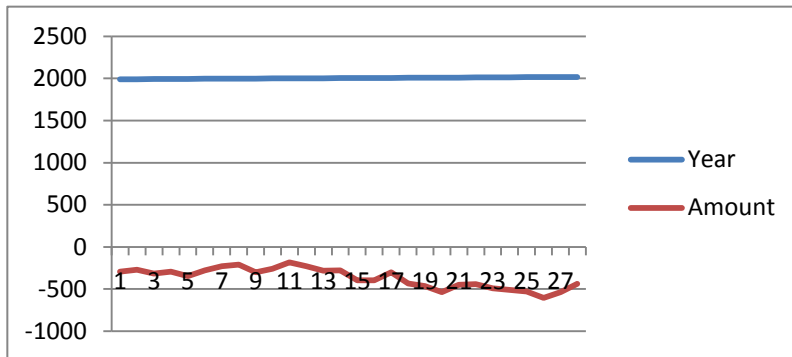
Figure 1. *Trend in Trade Balance in Africa between 1990 and 2017 (Billions of US Dollars)*
Source: Authors Computation using World Development Indicator, 2018

Figure 1 shows the trend in trade balance in Africa from 1990 to 2017. From the Figure, it can be observed that Africa experienced negative (deficit) trade balance in virtually all the years, that is from 1990 to 2017. Though some countries recorded surplus in trade balance, the deficit values recorded in most of the countries cancels out these surpluses resulting in deficit trade balance for the continent. This could be attributed to the fact that most Africa countries are still marginal players in international affairs especially with respect to exportable product. They often indulge in export (narrow base) of primary produce whose price fluctuates in the international market and the demand for their produce at the mercy of trading partners. This no doubt often manifest in deficit trade balance and by extension weak revenue generation from trading activities.

B.   FDI FLOWS ACROSS AFRICA

Generally, there has been an increase in FDI inflows to Africa in the last decades. Though some countries in the continent recorded fall in FDI inflows, this were however neutralise by huge increases recorded in other countries in the continent. Increase in the demand and prices of some goods and the continuous non-resource-seeking investments in some Africa countries plays key roles in the increase in FDI flows to Africa (UNCTAD, 2018).
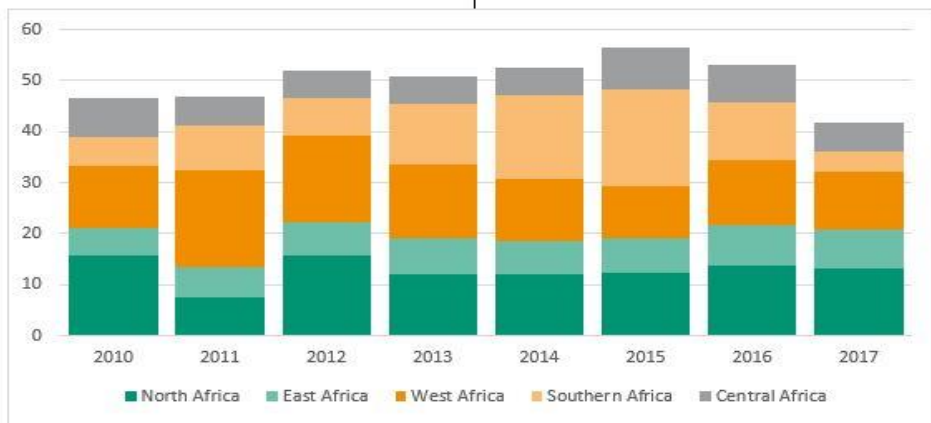
Figure 2. *Foreign Direct Investment inflows Across Africa 2010 to 2017*
(Billions of dollars)
Source: *Adopted from UNCTAD, World Investment Report 2018.*

From Figure 2, of the five (5) sub-regions, FDI flows to North Africa recorded some relative stability between 2010 and 2017 with the exception of year 2011 wherein a decline was recorded. This relative stability can mainly be attributed to elevated investments in oil and gas industry, stable economic performance and a diversified economy in most countries that make up North Africa. Egypt and Morocco are the two North Africa countries that accounts for a large proportion of the increase in FDI flows to North Africa (UNCTAD, 2018). There was also an increase in the volume of FDI inflows to East Africa region. This may not be unconnected to the fact that most of the countries in the sub-region lessen the rigidity in their hitherto restricted economy in other to allow for more openness. This has led to massive investment in manufacturing, hospitality, chemicals and oil and gas. East Africa is the fastest-growing region with respect to FDI flows and Ethiopia and Kenya ranks top in the sub-region (UNCTAD, 2018). FDI flows to West Africa recorded some increase between 2010 and 2011 (UNCTAD, 2018). There was a relative stability between 2011 and 2013 before it thereafter recorded a decline. Most FDI flows to West Africa are mainly concentrated in gas and minerals sectors and Nigeria due to the size of her economy is usually accounts for huge volume of FDI inflows in the sub-region. Thus, the general decline in FDI flow to West Africa could be as a result of the drop in the volume of FDI inflow to Nigeria owing to a number of factors such as hostage taking, militancy and incessant disputes between the Nigeria Government and some Multinationals.

C. AFRICA ECONOMIC GROWTH PATTERN
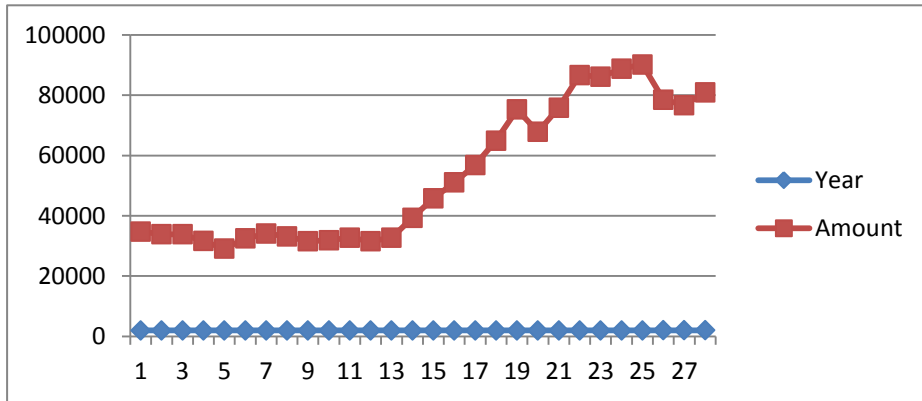
*Figure 3. Trend in Africa Growth between 1990 and 2017 (Billions of US Dollar)
Source: World Bank, World Development Indicator (2018)*

Figure 3 shows the yearly trend in Africa growth from 1990 to 2017. A look at the figure shows an upward trend in growth except for some few years such as 1993, 1994, 1997, 1998 and 2001 wherein there was marginal decline. Major decline in Africa growth were recorded in year 2009 and 2015. This major decline could be as a result of the aftermath of global economic meltdown in 2006 and 2008, the persistence insecurity, civil disturbances and unstable political environment in some countries in the continent. Thus, it can then be concluded that the economic growth in Africa increase fairly from year 1999 to 2017.

3. REVIEW OF LITERATURE

Much analysis has been carried out with respect trade and growth on one hand and FDI and growth on the other hand. Some of such studies are reviewed. Nicole (2016) investigated the role of trade in current account imbalances in using the components of BOP in SSA. It was found that openness to trade in SSA resulted in current account deficits in most of the countries of the sub region. Suphian (2018) investigated trade balance determinants in East Africa. The model was estimated using cointegration regression under the full modified least square (FMOLS) and the vector error correction model (VECM). The study found that FDI was the major determinant of trade balance. It was recommended that EAC countries should concentrate on export-oriented development policies because of the huge amounts of FDI flow into the sector. Similarly, Osoro (2013) investigated the determinants of trade balance in Kenya for the period spanning 1963 to 2012. Johansen's co-integration and Error Correction Modelling (ECM) were employed and it was found that trade balance were positively and significantly related to budget deficits, FDI and real exchange rates.

Gould and Ruffin (1996) examined the causes and consequences of trade balances in relation to economic growth using correlation analysis with a

Benchmark models. It was found that a negative relationship exist between trade imbalance and economic growth. This was however weak and exhibited low impact on economic growth rates taking into consideration the major determinants of growth. Mohammad and Sherif (2015) investigated the correlation between trade balance and remittances inflow using eleven (11) MENA countries. Difference GMM and fixed effects panel modelling for the period 1992-2012 was employed and it was found that remittances inflows are accompanied by trade deficit which result in imports led consumption expenditures in MENA countries.

Shah (2015) investigated the determinants of balance of trade in Pakistan between 1975 and 2010 using multiple regression models. It was found that only the Pakistan Rupee exchange rate had a significant impact on balance of trade (BOT) while money supply, FDI, GDP and total domestic consumption were insignificant. Hong and Siok (2011) carried out a comparative study on the determinants of current account surpluses and deficits in Australia, Cyprus, Italy, Portugal, United States and Germany, Japan, Singapore, Norway, Switzerland using a GMM estimator technique. The study revealed that reserve accumulation impact on current account movements in countries with current account deficits. Duasa (2007) examined the determinants of trade balance in Malaysian using autoregressive distributed lag (ARDL) framework. The study specifically determines short and long run relationship between trade balance, exchange rate, income and money supply. Income and money variables were used to test monetary and absorption approaches while exchange rate was used to test conventional approach of elasticity. It was found that there is long-run relationship between trade balance, income and money supply variables. Also, there was no relationship establish in trade balance and real exchange rate. The Marshall-Lerner condition did not also hold for long run, thus it was recommended that Malaysian trade balance should be viewed from absorption and monetary approaches.

Shoukat, Anam and Rana (2015) investigated the impact of macroeconomic variables, FDI and trade balance has on the growth in Pakistan for the period 1990 to 2014 using VECM technique. It was found that trade balance exhibited a significant negative impact on growth while FDI exhibited a significant positive impact on growth. Vikneswaran and Wai (2019) examined the dynamic relationships that exist among trade balance, domestic income, exchange rates, inflation rates and money supply in Malaysia for the period 2000 to 2015. The results from ARDL model and Granger Causality indicated that domestic income, inflation rates and exchange rates exhibited significant effect on trade balance. However, the effect of money supply on trade balance was found to be insignificant. Driffiield and Jones (2013) investigated the impact of FDI, foreign aid and migrant remittances have on growth in emerging countries. A systems methodology that account for the endogeneities concerns was adopted. The result revealed that foreign aid, FDI and migrant remittances had significant and positive impact on growth only when institutions are taken into consideration.

Alege and Ogundipe (2013) investigated the relationship between FDI and economic growth in ECOWAS using the System GMM panel estimation technique covering the period 1970-2011. The results revealed that FDI was insignificant and impacts negatively on growth in ECOWAS sub-region despite controlling for the role of human capital and quality of institutions in the model. Also, Orji, Uche, and Ilori (2014) examined the implications of four different types of foreign capital inflows, namely; FDI, foreign aid, FPI and remittances on output growth of the WAMZ economies over the period 1981-2010. Using SURE technique, their results showed that there are differences in the growth impact of the various forms of foreign capital inflows in the WAMZ countries and that more than one form of capital inflow contributed positively to output growth in Nigeria. They also found that foreign aid positively contributes to output growth in Sierra Leone and Ghana, whereas, FDI foster more output growth in Nigeria and Gambia. Furthermore, their result showed that remittances have the highest contribution in Liberia and that none of the inflows has positive impact on Guinea's economic growth. Mercan and Yergin (2013) examined the effects of FDI on economic growth in Turkey using the bounds testing approach (ARDL) in a quarterly data spanning the period 1991-2013. It was found that the effect of FDI and exports on economic growth were positive and statistically significant. The effect of FDI was considerably low while the coefficient of error correction term was negative and statistically significant indicating that deviations among variables converge to equilibrium.

4. THEORETICAL FRAMEWORK, MODEL SPECIFICATION AND METHODOLOGY

A. THEORETICAL FRAMEWORK

This study is hinge on gravity model. The model has also garnered a lot of interest in analysing trade relations because it is readily applied to a world of multinational corporations in a multiproduct world (Enders, Sachsida and Sandler, 2006). Tinbergen (1962) held that coefficients of economic flow and distance became 'the expected signs' in all subsequent analyses. Also, coefficient of economic attractors was positive while distance was negative and statistically significant. This however creates room for further modifications Anderson (2011). Thus, Frankel (2011) opined that GNP, per capita GDP, population, infrastructural development are used as proxies for Economic flow. These measures are usually introduced in nominal terms because deflating them may result in zero impact if time fixed effects is introduce (De Benedictis and Taglioni, 2011).

B. MODEL SPECIFICATION

In Tinbergen (1962), Newton's physical law of gravity of economic interaction over space is stated as:

$$Y_{ij} = G\,(X_i E_j)/D_{ij}2 \qquad (1)$$

Where:

Y_{ij} = Economic flow from origin i to destination j; G = Gravitational constant; X_i = economic activity at origin i; E_j = economic activity at destination j; D_{ij} = Distance between i and j.

To further relate flows to economic activities, a relevant constant is substituted for the gravitational constant *(G)*. This does not often fit prediction and thus implies that the exponential distance value of *'2'* be replace by a more appropriate value for the mass variables based on physical principles (Tinbergen, 1962). This therefore results in the equation below:

$$y_{ij} = \beta_0 \, X_i\beta_1 \, E_j\beta_2 \, D_{ij}\beta_3 \, \text{£}_{ij} \qquad (2)$$

Where:
y = the fitted value of Y; β_1; β_2; β_3 = Parameters; £ =Error term

The linearisation of equation (2) result in equation (3) below:

$$y_{ij} = \beta_0 + \beta_1 X_i + \beta_2 E_j + \beta_3 D_{ij} + \text{£}_{ij} \qquad (3)$$

With reference to Blonigen and Wang (2004), Anderson (2011) and Enders, Sachsida and Sandler (2006), we augment this model to bring in variables of interest. Thus, form equation (3), the model for this study is stated as:

$$PCI(t) = f[TBAL(t)), FDI(t), EDT(t), AIDI(t), PRT(t)] \qquad (4)$$

Where:
PCI = GDP per capita; $TBAL$ = trade balance; FDI = foreign direct investment; EDT = external debt; AID = net aid flow; PRT = remittances; t = time trend; f = functionality

The explicit form of the model in time trend is functionally represented as:

$$PCI_{it} = \beta_o + \beta_1 TBAL_{it} + \beta_2 FDI_{it} + \beta_3 EDT_{it} + \beta_4 AID_{it} + \beta_5 PRT_{it} + \text{£}_{it} \qquad (5)$$

Where:
β_o = *constant term*; β_1, β_2, β_3, β_4, = *coefficients*; i = countries; £= *error term*

The *'a priori'* signs for each of the variables employed as represent by their coefficients is stated as; β_1, $<> 0$, β_2, β_3, β_4, $\beta_5 > 0$

From equation (5), the model to be estimated is presented in compact form as:

$$PCI_{it} = c_i + A_i \, e_{it} + \text{£}_{it} \qquad (6)$$

Where:
c = constant term; A_i = *slope coefficients*; e_{it} =Vector of explanatory variables

C.   METHODOLOGY

This study employed least squares estimation techniques such as; dynamic ordinary least square (DOLS) and fully modified ordinary least square (FMOLS).

DOLS is a robust single equation approach which corrects for regressor endogeneity by the inclusion of leads and lags of first differences of the regressors and for serially correlated errors by a Generalized Least Square (GLS) procedure. It also has same asymptotic optimality properties as the Johansen distribution. The FMOLS estimate cointegrating relations directly by taking into account endogeneity and serial correlation. In cases where there are major differences with OLS the sources of differences are easily located and this in turn helps provide the researcher with additional information about important features of the data.

Annual secondary data comprising forty-two Africa countries sourced from Word Bank WDI (2018) and UNCTAD (2016) were employed for this study.

5. EMPIRICAL ANALYSIS

A. DESCRIPTIVE STATISTICS

This shows basic characteristic within the series. It is reported and explain below:

Table 1. Descriptive Statistics for Pooled Sample

Metrics	pci	Edt	Fdi	Aid	prt	Tbal
Mean	1359.81	8.94	6.49	10.18	8.69	-9.11
Median	656.83	3.52	1.32	8.03	1.02	-8.15
Maximum	10716.2	1.76	1.16	94.95	2.37	36.68
Minimum	111.36	0	-7.40	-0.26	11470.97	-161.43
Std. Dev.	1755.85	1.61	1.50	10.83	2.91	17.94
Skewness	2.55	5.33	2.87	2.95	5.57	-2.55
Kurtosis	10.07	42.32	18.99	17.38	35.58	19.84
Jarque-Bera	3090.42	67417.2	11727.68	9814.58	48158.65	12569.59
Probability	0.00	0.00	0.00	0.00	0.00	0.00
Sum	1325815	8.72	6.32	9926.25	8.47	-8885.21
Sum Sq. Dev.	3.00	2.51	2.21	114202.1	8.27	313533.6
Observations	975	975	975	975	975	975

Source: Authors' Computations

From the table above, average of PCI is about 1360 for the period. This is however unstable due to the high standard deviation value of over 1755. The skewness is relatively low compared to the mean and standard deviation indicating that PCI figures lie to the left (are less than) of the mean value. The J-B has a high value of over 3000 and it is significant at 1 percent. This indicates that the density function of the series is non-normally distributed.

Again, the mean value of TBAL is about -9.11 for the period. This is unstable due to the relative high standard deviation value of 17.94. The skewness value of -2.55 is however low showing that TBAL growth rate lie to the left (are

less than) of the mean value. The high J-B statistics of over 12569 is significant at 1 percent. This once more shows that the density function of the series is non-normally distributed.

With respect to FDI, the mean value is about 6.50 for the period. This is relatively stable due to the relatively low standard deviation value of 27.02 compared to GDPPC. The skewness value of 1.50 is low indicating that FDI growth rate lie to the left (are less than) of the mean value. The J-B of over 11727 is significant at 1 percent. This also shows that the density function of the series is non-normally distributed. Similar position can also be held for the other variables except AID which have a relatively high standard deviation showing some level of instability.

B. TEST OF STATIONARITY

This was determined by means of homogenous and heterogeneous process.

Table 2. *Panel Unit Root Test*

Variables	Homogeneous Unit Root				Heterogeneous Unit Root			
	Level		1st Diff		Level		1st Diff	
	LLC	Breitung	LLC	Breitung	IPS	ADF-Fisher	IPS	ADF-Fisher
PCI	-1.78	4.36	-11.41	-4.06	-0.16	76.48	-11.27	288.23
EDT	7.20	6.73	-4.34	-3.73	7.75	30.55	-7.02	189.74
FDI	0.73	-1.12	-7.45	-9.86	-2.40	130.79	-14.61	357.55
AID	-8.18	-3.42	-11.11	-11.26	-6.13	201.28	-16.22	392.18
PRT	0.69	2.37	-9.16	-3.12	1.11	62.99	-9.51	300.71
TBAL	-0.58	-1.43	-21.19	-9.34	-1.76	108.01	-16.55	403.13

Source: Authors Computation

From Table 2, the result shows that the variables were all non-stationary at level rather, they all attained stationarity at their first differences at 5 percent significant level. This is as revealed by homogenous and heterogeneous tests.

C. COINTEGRATION TEST

Table 3. *Panel Cointegration Results*

	Within Dimension		Between dimension	
	Statistic	Weighted Statistic		Statistic
Panel v	-4.58	-2.78	Group rho	7.08
Panel rho	6.35	4.36	Group PP	-2.98
Panel PP	3.71	-2.29	Group ADF	0.96
Panel ADF	3.97	1.09		

Within and between co-integration test in Table 3 indicates that the null hypothesis of no cointegration of the series should be rejected. This is because the results passed the significant test at 5 percent level and thus implies that a long run convergence exist among the variables in the model.

D. DYNAMIC ANALYSIS

Table 4. *Panel FMOLS and DOLS Estimates*

variables	panel fmol			panel dols		
	coefficient	t-stat	prob	coefficient	t-stat	Prob
Edt	1.72*	4.37	0.00	2.87*	6.53	0.00
Fdi	2.36*	9.59	0.00	1.29*	2.99	0.00
Aid	-16.68*	-7.73	0.00	-11.93**	-2.43	0.02
Prt	4.74*	4.83	0.00	8.78*	4.07	0.00
Tbal	-6.30**	-1.96	0.04	-7.25**	-2.41	0.02
R-square	0.82			0.96		
adj R-square	0.81			0.90		
S.E.E	757.99			402.73		

Source: Authors' computations with EVIEWS. * /** = 1% and 5% significance level respectively

Table 4 shows the result of Panel FMOLS and DOLS Estimations. From the Table, trade balance is negatively and statistically significant in relation to economic growth in both estimates. This captures the situation where there is more spending on goods and services in an economy compared to what is produced for the period. A 1 percent increase in trade balance results in over 6 percent and 7 percent decrease in economic growth both estimates. Also, Table 4 shows that FDI is positively and statistically significant in relation to economic growth in both estimates. Other variables such as external debt and remittances were positively and statistically significant in relation to economic growth in both estimates. However, net aid flow was negatively and statistically significant in relation to economic growth in both estimates. R-square and the adjusted R-square values of 82 percent and 81 percent for FMOLS; and 96 percent and 90 percent for DOLS shows that the regressors has high explanatory power with respect to variations in the dependent variable.

The implication of the above findings is that trade in Africa has been in a deficits trend. This raises concerns that Africa's future debt burden could worsen and by extension makes the continent vulnerable to financial crises. This is because the current account deficits in Africa are as a result of high imports of consumer goods that could be produced domestically. Also, FDI inflows affect Africa economic growth positively and thus these inflows should be sustained.

6. RECOMMENDATIONS AND CONCLUSION

A. RECOMMENDATIONS

The following recommendations are proffered:

1. Since trade is indispensable to any economy, Africa countries should strive to maximize gains of trade through the implementation of relevant policies.
2. Deficits arising from trade should be channel to productive investment in other to be able to generate revenue for trade expansion and growth.
3. Policies that aid the attraction and sustenance of FDI inflow to Africa should be implemented. This is as a result of its positive effects on economic growth.

B. CONCLUSION

The relationship and effects trade balance and FDI has on economic growth in Africa (comprising Africa forty-two countries) was carried out for the period 1995 to 2017 (22 years). FMOLS and DOLS technique employed shows that trade balance was negatively and statistically significantly related to economic growth while foreign direct investment was positively and statistically significantly related to economic growth. This means that the variables of interest (trade balance and FDI) exhibited similar pattern of relationship and effects on economic growth in the two techniques employed. This was thereafter followed by recommendations.

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