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FINANCIAL DEVELOPMENT, FOREIGN DIRECT INVESTMENT AND ECONOMIC GROWTH: EVIDENCE FROM SUB-SAHARAN AFRICA

Jacinta Mwelu Masila
PhD Candidate, Department of Finance and Accounting,
Faculty of Business and Management Science, University of Nairobi, Kenya
jmasila2013@gmail.com

Winnie Nyamute
Professor, Department of Finance and Accounting,
Faculty of Business and Management Science, University of Nairobi, Kenya
nyamute@uonbi.ac.ke

Johnbosco Kisimbii
Senior Lecturer, Department of Finance and Accounting,
Faculty of Business and Management Science, University of Nairobi, Kenya
jkisimbii@uonbi.ac.ke

Abstract

This study investigates the effects of financial development and foreign direct investment (FDI) on economic growth in Sub-Saharan Africa (SSA) countries, addressing persistent economic disparities and the need for sustainable growth strategies. Utilizing a longitudinal design across 45 SSA countries from 2002 to 2021, the research analyzes secondary data from World Bank databases with advanced statistical methods, including stepwise regression and panel data analysis. Financial development, measured by indicators such as broad money, domestic credit to the private sector, and interest rate spread, exhibits a significant yet mixed impact on economic growth: broad money negatively affects growth, while domestic credit to the private sector shows a positive influence, and interest rate spread highlights inefficiencies in financial *intermediation. FDI partially mediates the relationship between financial development and economic growth, with its influence varying across these financial indicators. The findings underscore a strong joint effect of financial development and FDI on economic growth, suggesting that integrated policies enhancing financial system efficiency and maximizing FDI inflows are critical for sustained economic progress in SSA. Anchored in Endogenous Growth Theory, the study recommends improving financial intermediation and creating conducive environments for FDI to drive long-term growth.*

Keywords: Financial development, economic growth, broad money, domestic credit, interest rate spread, and foreign direct investment

INTRODUCTION

The United Nations' Sustainable Development Goals (SDGs), particularly Goal 8, aim to promote decent work and economic growth by 2030, a target highly relevant to Sub-Saharan Africa (SSA) where economic disparities persist (UN, 2015). Financial development is pivotal in this context, as robust and inclusive financial systems provide capital for businesses and stimulate private sector investment, driving economic growth. Empirical studies, such as Ibrahim and Alagidede (2017) and Abbas et al. (2022), affirm that well-functioning financial systems enhance productivity and foster growth. In SSA, financial development has progressed since 2000, evidenced by banking sector expansion and mobile financial innovations like M-Pesa, though challenges like credit inadequacy hinder inclusive growth (Tyson, 2021). Scholars like Shaw (1973) and McKinnon (1973) from the financial repression school, and Keynes (1936, 1937) and Hicks (1969) from the liberal school, underscore that efficient financial systems are critical for capital accumulation and investment, directly linking financial development to economic growth.

Foreign direct investment (FDI) further complements this dynamic by promoting innovation and injecting capital into financial systems, amplifying economic growth in SSA. Between 2000 and 2019, SSA's average annual economic growth rate was 4.6%, with FDI inflows rising significantly from USD 29 billion in 2020 to USD 73 billion in 2021 (UNCTAD, 2022). This increase, though still a modest 3.9% of global FDI, reflects SSA's growing attractiveness to foreign investors, contributing to economic expansion. However, the optimal level of financial development to sustain FDI's growth-enhancing effects remains unclear, with studies like Nguyen (2022) noting conflicting findings. Theoretical support from the neoclassical growth theory (Solow, 1956) highlights exogenous factors like technology—often introduced via

FDI—while endogenous growth theory (Romer, 1986) emphasizes internal innovations, both of which tie FDI to economic growth through financial system enhancements.

The interplay of financial development and FDI has driven SSA's economic growth, with GDP per capita rising from an average of -0.32% in 1991–2000 to 2.18% in 2001–2010 (African Development Indicators, 2023). The classical theory of financial intermediation (Allen and Santomero, 1996) supports this by arguing that financial intermediaries reduce transaction costs and manage risks, facilitating FDI and growth, while the financial market theory of development (World Bank Group, 2000) advocates for market liberalization to attract foreign capital. Despite these advances, SSA's economic growth faces challenges, including reliance on external factors and inefficiencies in financial systems. This study builds on these foundations to explore how financial development and FDI jointly influence economic growth, offering insights into sustainable strategies for SSA's development amidst its unique economic landscape.

Research Problem

Numerous studies affirm that effective financial systems enhance productivity and drive economic growth, a relationship well-documented in Sub-Saharan Africa (Ibrahim and Alagidede, 2017; Abbas et al., 2022). Foreign direct investment also plays a vital role, with evidence suggesting it boosts economic growth, particularly in African contexts (Yeboua, 2019). However, excessively high levels of financial development may dampen FDI's growth-enhancing effects, as noted by An and Yeh (2021), creating uncertainty about the optimal financial threshold for maximizing FDI's impact. Over the past two decades, SSA achieved an average GDP per capita growth rate of 4.6%, partly due to improved financial access, yet the COVID-19 pandemic reduced this to 3.6%, with projections of a further decline to 3.1% in 2023 amid dwindling aid inflows (World Bank, 2023; African Development Indicators, 2023). This economic slowdown necessitates a deeper understanding of how financial development and FDI interact to sustain growth.

SSA's financial development presents a mixed picture: the median ratio of private sector credit to GDP has doubled since 2000, and innovations like M-Pesa have lowered transaction costs, positioning the region as a leader in mobile financial services (IMF, 2016). The growth of Pan-African banks has further bridged service gaps, enhancing economic integration. However, financial market depth and inclusion remain low compared to other regions, potentially limiting the capacity to leverage FDI effectively. FDI inflows surged to USD 73 billion in 2021 from USD 29 billion in 2020 (UNCTAD, 2022), yet their uneven distribution and the region's structural challenges—like post-pandemic recovery—raise questions about their sustained contribution to economic growth alongside financial development.

Despite SSA's potential to harness financial development and FDI for economic growth, empirical evidence on their combined effects remains scarce. Recent studies in Africa have been limited, with three focusing on specific countries (Gashirayi, 2017; Puatwoe and Paibuo, 2017; Pinshi, 2020) and one broader SSA study by Asante et al. (2023) examining financial development and growth through an institutional lens, neglecting FDI's role. This research gap highlights the need for a comprehensive, region-wide analysis to inform policy. Consequently, this study addresses the critical question: How do financial development and FDI interrelate to influence economic growth in SSA? By examining these variables on a larger scale, the research aims to provide actionable insights for enhancing regional economic strategies.

LITERATURE REVIEW

Theoretical Foundation

The theoretical foundation of this study integrates frameworks that elucidate the roles of financial development and foreign direct investment in driving economic growth in Sub-Saharan Africa, as emphasized by Stewart and Sambrook (2011). The Neoclassical Growth Theory (Solow, 1956) posits that economic growth stems from capital, labor, and exogenous technological progress, often introduced through FDI. In SSA, technological advancements in financial systems, such as mobile banking, align with this theory, suggesting that external innovations enhance financial development and, consequently, economic growth. However, its limitation lies in treating technology as exogenous, underrepresenting endogenous financial innovations that also fuel growth. This theory anchors the study by linking FDI-driven technological inputs to financial development and sustained economic progress.

The Endogenous Growth Theory (Romer, 1986) shifts focus to internal factors, asserting that financial development—through innovations, knowledge, and human capital—endogenously drives economic growth. In SSA, local financial advancements like M-Pesa exemplify this, enhancing productivity and resource allocation. The theory highlights financial systems' roles in facilitating investment and risk management, critical for leveraging FDI effectively. Critics, such as Onyimandu (2015), note its oversimplification of developing economies' challenges, like institutional weaknesses, yet its relevance lies in framing financial development as an internal growth engine that amplifies FDI's impact. This perspective supports the study's exploration of how SSA's financial innovations and FDI jointly contribute to economic expansion.

The Classical Theory of Financial Intermediation (Allen and Santomero, 1996) and the Financial Market Theory of Development (World Bank Group, 1999) further connect financial development and FDI to economic growth. The former posits that financial intermediaries reduce market imperfections, channeling FDI into productive sectors and fostering growth, a process evident in SSA's expanding banking sector. Critics like Scholtens and Wensveen (2000) argue that globalization diminishes information asymmetry, yet intermediation persists, enhancing FDI's growth effects. The latter theory advocates market liberalization to attract FDI, boosting local entrepreneurship and economic growth, as seen in SSA's increasing FDI inflows (UNCTAD, 2022). Despite critiques from Singh (1997) questioning stock markets' necessity, these theories collectively underscore how financial development facilitates FDI's role in driving SSA's economic growth, forming a robust theoretical basis for this study.

Empirical Review

Sirag et al. (2018) investigated the relationship between foreign direct investment (FDI), financial development, and economic growth in Sudan. In this study, they utilized annual data on GDP per capita measured in constant US dollars as the dependent variable. To assess the level of financial development, proxies such as the share of domestic credit to the private sector in relation to GDP and money supply were employed. The researchers employed a combination of fully modified ordinary least squares and dynamic ordinary least squares techniques to estimate the long-run relationship. The findings of the study indicated that both financial development and FDI positively and significantly influenced economic growth in Sudan. However, the study revealed that financial development had a more substantial impact on economic growth compared to FDI.

In Bahri et al. (2019) research, the researchers employed a non-linear method to investigate the correlation between financial development, foreign direct investment (FDI), and economic growth. Utilizing a dynamic panel data model, the study incorporated variables such as real gross domestic product per capita, FDI inflows as a percentage of GDP, financial development, and a range of control variables including the consumer price index, gross fixed capital formation, and human capital. The authors determined that the impact of FDI on economic growth relied on the level of financial development. Furthermore, they concluded that the connection between FDI and economic growth was not linear, signifying that the effect of FDI on economic growth fluctuated based on the level of financial development.

Yeboua (2019) conducted a study on 26 African countries from 1990 to 2013, utilizing a panel smooth transition regression model (PSTR) to investigate the interconnectedness of FDI, financial development, and economic growth in Africa. The growth rate of GDP per capita served as a proxy for economic growth, while FDI was measured as the stock of FDI inflows as a percentage of GDP. The outcomes indicated the existence of a minimum threshold level of financial development. Above this threshold, the positive impact of FDI on growth was evident for African countries, implying that only countries surpassing this specific level of financial development could benefit from the growth-enhancing effects of FDI. These findings emphasize the need for African financial policymakers to enhance local financial market conditions to maximize the economic advantages derived from FDI.

Musa and Abbas (2023) explored the joint effect of financial development and FDI on economic growth in 15 emerging economies, with a focus on Africa. Using data spanning 2002 to 2021, the study utilized a panel cointegration and causality analysis to establish the long-run and short-run relationships among the variables. The study found a bidirectional causality between financial development and FDI and demonstrated that the combined effect of these variables significantly enhances economic growth. The findings emphasized the need for African countries to adopt integrated policies that simultaneously promote financial development and attract FDI to achieve sustainable growth.

RESEARCH METHODOLOGY

This study employed a longitudinal research design to examine the relationships between financial development, foreign direct investment (FDI), and economic growth across 45 Sub-Saharan African (SSA) countries over a 20-year period from 2002 to 2021. Secondary unbalanced panel data were collected from credible sources, including the International Monetary Fund's International Financial Statistics (IFS) for financial development indicators (broad money, domestic credit to the private sector, and interest rate spread), and the World Bank's World Development Indicators (WDI) and UNCTAD databases for FDI (net inflows as a percentage of GDP) and economic growth (real GDP per capita). The 20-year timeframe, beginning with the African Union's launch in 2002, provided sufficient observations (900 for most variables, 700 for interest rate spread) to analyze trends and variability, despite some missing data points, ensuring a robust dataset for capturing the dynamics of these variables in SSA.

Data analysis utilized advanced statistical techniques, including stepwise regression and panel data analysis, to assess the individual, mediating, and joint effects of financial development and FDI on economic growth. Descriptive statistics offered insights into data distribution and variability, while panel data methods, such as cointegration and causality tests, evaluated long-run relationships and directional influences among the variables. The methodology, anchored in Endogenous Growth Theory, enabled the study to test hypotheses about financial development's direct impact, FDI's mediating role, and their combined contribution to economic growth, providing empirical evidence to inform policy in SSA.

FINDINGS AND DISCUSSION

The objective of this study was to determine the effect of foreign direct investment on the relationship between financial development and economic growth among Africa countries. This was accompanied by a hypotheses which was stated as follows:

H_{01}: Foreign direct investment has no significant mediating effect on the relationship between financial development and economic growth among Sub-Saharan Africa countries.

H_{01a}: Foreign direct investment net inflows have no significant mediating effect on the relationship between broad money and economic growth among Sub-Saharan Africa countries.

H_{01b}: Foreign direct investment net inflows have no significant mediating effect on the relationship between domestic credit to private sector and economic growth among Sub-Saharan Africa countries.

H_{01c}: Foreign direct investment net inflows have no significant mediating effect on the relationship between interest rate spread and economic growth among Sub-Saharan Africa countries.

The Baron and Kenny (1986) four-step method was used to determine whether the relationship between financial development and economic growth was mediated by a third variable and in this case foreign direct investment. The results of **H_{01a}** are as provided in Table 1

Table 1: Broad Money, Foreign Direct Investment and Economic Growth

Dependent Variable: GDP
Method: Panel Least Squares
Date: 11/01/24 Time: 10:33
Sample: 2002 2021
Periods included: 20
Cross-sections included: 45
Total panel (balanced) observations: 900

Variable	Coefficient	Std. Error	t-Statistic	Prob.
FOREIGN_DIRECT_INFLOWS__	0.033764	0.020091	1.680538	0.0932
BROAD_MONEY___OF_GDP	-0.031425	0.007810	-4.023902	0.0001
C	2.963074	0.301781	9.818616	0.0000

R-squared	0.220380	Mean dependent var	2.156740
Adjusted R-squared	0.218196	S.D. dependent var	4.972755
S.E. of regression	4.927307	Akaike info criterion	6.030790
Sum squared resid	21777.68	Schwarz criterion	6.046798
Log likelihood	-2710.855	Hannan-Quinn criter.	6.036905
F-statistic	9.330489	Durbin-Watson stat	1.385998
Prob(F-statistic)	0.000098		

The results indicate that **H01a:** Foreign direct investment net inflows have no significant mediating effect on the relationship between broad money and economic growth among Sub-Saharan Africa countries cannot be rejected. Although FDI influences both GDP and broad money, it does not fully mediate their relationship, as broad money remains significant in the presence of FDI. These findings highlight the complexity of the interactions between financial development, FDI, and economic growth in the region.

Table 2 shows the results of **H01b.** The results indicate that **H01b:** Foreign direct investment net inflows have no significant mediating effect on the relationship between domestic credit to private sector and economic growth among Sub-Saharan Africa countries cannot be rejected. Although FDI has significant individual effects on both GDP and private sector credit, it does not fully mediate the relationship between these variables. This highlights the importance of domestic credit as a direct driver of economic growth while recognizing the supportive role of FDI in the broader financial ecosystem.

Table 2: Credit to the Private Sector, Foreign Direct Investment and Economic Growth

Dependent Variable: GDP
Method: Panel Least Squares
Date: 11/01/24 Time: 10:55
Sample: 2002 2021
Periods included: 20
Cross-sections included: 45
Total panel (balanced) observations: 900

Variable	Coefficient	Std. Error	t-Statistic	Prob.
FOREIGN_DIRECT_INFLOWS__	0.029125	0.020211	1.441053	0.1499
DOMESTIC_CREDIT_TO_PRIVA	0.019778	0.007622	2.594795	0.0096
C	2.416646	0.244732	9.874674	0.0000

R-squared	0.010127	Mean dependent var	2.156740
Adjusted R-squared	0.007920	S.D. dependent var	4.972755
S.E. of regression	4.953025	Akaike info criterion	6.041202
Sum squared resid	22005.61	Schwarz criterion	6.057210
Log likelihood	-2715.541	Hannan-Quinn criter.	6.047317
F-statistic	4.588285	Durbin-Watson stat	1.376935
Prob(F-statistic)	0.010410		

The results of **H01c** are presented in this section. The results indicate that **H01c:** Foreign direct investment net inflows have no significant mediating effect on the relationship between interest rate spread and economic growth among Sub-Saharan Africa countries cannot be fully rejected. While FDI influences both GDP and interest rate spread individually, it does not serve as a significant mediator in the relationship between these variables. This underscores the complex dynamics between financial inefficiencies, investment inflows, and economic growth in the region.

Table 3: Interest Rate Spread, Foreign Direct Investment and Economic Growth

Dependent Variable: GDP
Method: Panel Least Squares
Date: 11/01/24 Time: 11:08
Sample: 2002 2021
Periods included: 20
Cross-sections included: 35
Total panel (balanced) observations: 700

Variable	Coefficient	Std. Error	t-Statistic	Prob.
INTEREST_RATE_SPREAD	0.015314	0.019376	0.790375	0.4296
FOREIGN_DIRECT_INFLOWS__	0.020187	0.016977	1.189079	0.1839
C	1.944256	0.198465	9.796463	0.0000
R-squared	0.052560	Mean dependent var		1.823738
Adjusted R-squared	0.039727	S.D. dependent var		4.380867
S.E. of regression	4.359508	Akaike info criterion		5.786872
Sum squared resid	13246.70	Schwarz criterion		5.806377
Log likelihood	-2022.405	Hannan-Quinn criter.		5.794412
F-statistic	4.432947	Durbin-Watson stat		1.551080
Prob(F-statistic)	0.012216			

CONCLUSIONS AND RECOMMENDATIONS

This study concludes that financial development exerts a significant yet differentiated influence on economic growth in SSA. Specifically, domestic credit to the private sector positively drives growth, highlighting the critical role of accessible and well-targeted credit in stimulating productive activities. In contrast, broad money exhibits a negative effect, suggesting inefficiencies in liquidity utilization and resource allocation across the financial system. The interest rate spread, also negatively associated with growth, reflects the persistent challenge of high borrowing costs, which deter private investment and constrain economic expansion. Furthermore, foreign direct investment plays a partial mediating role, strengthening the positive impact of domestic credit but showing limited ability to offset the adverse effects of broad money and interest rate spreads. This finding underscores the insufficiency of FDI alone in addressing systemic financial inefficiencies and reinforces the need for robust, context-specific financial sector reforms.

The study further establishes the complementary nature of financial development and FDI in promoting economic growth in SSA. When financial systems function efficiently, FDI can enhance capital accumulation, technology transfer, and enterprise development. However, the growth-enhancing effects of FDI are substantially diminished in environments characterized by poor financial intermediation and structural weaknesses. Therefore, a disjointed approach—where FDI is pursued without corresponding improvements in financial systems—yields suboptimal outcomes. This calls for an integrated policy framework that simultaneously strengthens financial development and strategically channels FDI into sectors with high growth potential.

In light of these findings, the study recommends several actionable measures. First, enhancing financial intermediation efficiency is paramount. Policymakers should prioritize channeling credit toward productive sectors—particularly agriculture, manufacturing, and SMEs—through risk-based lending frameworks, improved credit information systems, and inclusive financial products. Secondly, governments should address high-interest rate spreads by fostering greater competition within the banking sector, improving regulatory oversight, and supporting capital market development to offer alternative financing options.

To attract and maximize the benefits of FDI, SSA countries should implement targeted incentive structures, such as tax reliefs, investment protection guarantees, and political risk insurance, particularly for investments in technology, renewable energy, and infrastructure. Equally important is fostering knowledge and technology transfer mechanisms, such as local content requirements and partnerships between foreign firms and domestic enterprises.

Finally, the study advocates for a comprehensive regional policy approach. This includes leveraging digital financial innovations—such as mobile banking and fintech solutions—to expand access to finance and improve operational efficiency across financial institutions. Furthermore, regional cooperation through harmonized financial regulations, cross-border banking frameworks, and capital market integration can amplify the collective benefits of financial development and FDI. Governments must also strengthen institutional capacities to ensure transparent, efficient, and accountable use of financial and investment resources. Through coordinated and evidence-based strategies, Sub-Saharan African countries can harness the dual engines of financial development and FDI to accelerate inclusive and sustainable economic growth across the region.

AREAS FOR FURTHER RESEARCH

This study suggests several directions for future research to enhance understanding of financial development, foreign direct investment, and economic growth in Sub-Saharan Africa. It recommends exploring institutional quality—such as governance, corruption, and political stability—as mediators in the financial development-economic growth nexus, extending beyond quantitative indicators like broad money and domestic credit. Sector-specific analyses could uncover how financial development and FDI differentially impact industries like agriculture or technology, offering precise policy insights. Additionally, investigating the role of fintech, given SSA's rising mobile banking adoption, could reveal how these innovations interact with traditional financial systems to drive growth. Finally, employing advanced methodologies like dynamic panel models or qualitative approaches, such as expert interviews, could capture short- and long-term dynamics, enriching theoretical and practical contributions to SSA's economic development.

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