

## **The Impact of Economic Growth and Foreign Direct Investment on Financial Development: Empirical Evidence from Palestine**

### **ABSTRACT**

**Purpose:** This study aims to analyze the impact and the existing relationship between economic growth and foreign direct investment on financial development in Palestine experimentally, in addition to the role of financial development in shaping this relationship.

**Design/Methodology/Approach:** This research used the process of deductive reasoning associated with quantitative research, supported by experience and positivism as philosophical positions. Data on economic growth indicators, foreign direct investment, financial development and other control variables covering the period (1999-2019) were also used. Johansen's co-integration analysis method will be applied to find out whether there is an effect and a relationship between economic growth, foreign direct investment and financial development in Palestine.

**Results:** Johansen's co-integration discovered that there is a positive effect and a Long-Term relationship between economic growth, foreign direct investment and financial development. In addition, the interaction between stock market financial development indicators and foreign direct investment was statistically clear.

**Practical Implications:** This study contributes to the literature by examining whether FDI stimulates growth through financial development networks and other factors that can drive growth along with FDI. Research shows professionals that a well-developed financial market will improve the impact of indirect FDI on economic growth. A well-developed stock market will accelerate capital accumulation activities and output growth by providing adequate liquidity services that improve links between local and foreign investors.

**Originality/Value:** The novelty of this study is to determine the impact and relationship between economic growth and foreign direct investment in Palestine on financial development, which must be taken into account in the Long-Term Development of all developing countries. At the same time, this study is a step forward towards analyzing the relationship between economic growth and foreign direct investment in Palestine and their main role in financial development.

**Keywords:** *Economic Growth, Foreign Direct Investment (FDI), Financial Development, Palestine.*

**JEL Classifications:** *C58, E44, E47, F40, F43, G00.*

## 1. INTRODUCTION

At present, one of the main components of the growth and development of the economy of countries is a foreign direct investment (Adams, [2009](#); Borensztein et al., [1998](#); Jašková, [2019](#)). A significant impact on capacity productivity in the host country arises via capital, technology, marketing experience, management systems and other external factors, which are external resources for foreign direct investment (Caves, [1996a](#)).

Due to the persistent geopolitical conditions, the economy of the Mashreq countries has always been affected by the political turmoil in the Middle East, and the constant economic and demographic pressures are causing economic and financial instability in the region (Kliestikova et al., [2018](#)). However, a progressive economic liberalization policy has been developed in Palestine, which attracts and encourages the inflow of capital into the country (Oudat et al., [2019](#)).

Several studies have revealed that FDI can positively affect development and economic growth such as (Borensztein et al., [1998](#)), (Ehimare, [2011](#)), (Grančay et al., [2015](#)), (Meyer and Meyer, [2020](#)), (Ślusarczyk, [2018](#)), not only enhance productivity and technological development but can also lower unemployment and the difference between gross domestic savings and desired gross domestic investment.

However, the effect of FDI on economic growth remains uncertain (Görg and Greenaway, [2003](#)), (Mura and Slezia, [2015](#)), and the potential effects on economic growth and the FDI relationship have failed to be exemplary.

The relationship between economic growth and foreign direct investment depends on other dominant factors such as the local conditions of the financial markets.

Moreover, the degree of financial market development has a clear impact on the effect of FDI on economic growth (Alfaro et al., [2003](#); Badulescu et al., [2018](#); Ślusarczyk and Kot, [2012](#)). On the other hand, economic growth depends on other indicators such as the quality of the business environment. (Khan et al., [2019](#)) or tourism and services, especially in states with many natural beauties (Kelić et al., [2020](#)).

By the current role of directing financial markets in the contribution of foreign direct investment to development economics, the main objective of this article is to empirically examine the relationship between economic growth and foreign direct investment in Palestine and to investigate how financial development shapes this relationship.

Several studies have explored the factors that may determine FDI flows to Palestine, (Abu Ghanniyeh et al., [2013](#); Al Rawashdeh et al., [2011](#); Kardoush, [2004](#)). Those studies subjected the relationship of foreign direct investment and economic growth that exists in Palestine to different methodologies to explore the factors that may deliberately affect this relationship.

As an example, (Kardoush's, [2004](#)) research confirmed that location is a determinant of FDI. During their study, time series data for the main location factors were analyzed as to whether they affected the degree of FDI flows to Palestine during the period ([2001-2011](#)).

Studies revealed a linear relationship between the infrastructure of the host country, openness to foreign trade and foreign direct investment by the economy, and the size of the domestic market.

Indicators such as real economic growth, foreign direct investment, and financial development were used as the main data set in this study.

The availability of Palestinian data observations across the period from ([1998 to 2019](#)) was a primary basis for selecting this period, and the sample consists of time series data

consisting of 26 observations. Other factors were used as control variables (engines of growth and determinants of foreign direct investment), including population growth, government consumption/GDP, inflation and trade openness. The World Bank's Statistical Bulletin of World Development Indicators was used to obtain data.

This study uses the econometric method to analyze the co-integration, where the Johansen test was used to analyze the co-integration to find out whether there is a Long-Term relationship between economic growth, foreign direct investment and financial development.

The remainder of the article is arranged in the following manner: theoretical principles and empirical facts are explained in section 2, data and methods used in the analysis are specified in section 3, and the results are discussed in section 4 and section 5 provides a conclusion.

## **2. OBJECTIVES OF THE STUDY**

The main objective of this study is:

- To empirically analyze the impact and relationship between economic growth and foreign direct investment on financial development in Palestine.
- To examine the role of financial development in shaping this relationship between the periods (1998-2019).

## **3. LITERATURE REVIEWS**

The literature is flooded with research that reflects how beneficial FDI is to the domestic economy, that is, new products and processes can be introduced into the domestic market by foreign firms, resulting in improved productivity. The reasons for the company's presence in international markets can vary and have a reactive or proactive motive, target markets can change from geographically and culturally closer to distant ones, and different entry modes are implemented. It is necessary to study information about the foreign investment laws in force in the territory of the requested country (Freixanet, 2014).

Foreign companies can also stimulate the transfer of new technology and the dissemination of technical knowledge and management skills (Zamir, 2019) points out that knowledge sharing affects many aspects of the company, human capital in terms of employee learning and adaptability, efficiency and innovation, which affects the benefit of products, and new products emerge based on new knowledge.

In recognition of these advantages, the positive impact of FDI on economic growth will depend on the absorptive capacities indicated by the derived literature on FDI (World Bank, 2001), and the development of functional national financial markets is one of the main components of those absorbing markets. Capacities (Alfaro et al., 2004; 2009; Hermes and Lensink, 2003; Oláh et al., 2019; Iusarczyk and Kot, 2012).

Expansion of capital accumulation, economic growth and technological innovation has been discussed and discussed extensively in the setting of well-functioning financial markets (Boyd and Prescott, 1985; King and Levine, 1993a; 1993b; Schmitt, 1974).

There is no doubt that economies - especially developing ones - need to attract more FDI although the impact of taxation and the institutional environment are key factors (Islam et al., 2020; Vaz da Fonseca and Juca, 2020; Jindrichovska et al., 2020).

### 3.1 History and Overview of “FDI” Foreign Direct Investment

“FDI” Foreign direct investment can be defined as the net inflow of investments to a company operating in a country different from that of the investor who invested, to acquire a protracted interest in management” (World Bank, 2001).

Financial transactions were mostly lent by Great Britain to the host countries in the form of cash, which resulted in the growth and development of the host country's economy globally. However, after a while, especially after World War II, foreign direct investment began to decline. After World War II, FDI remittances to host countries began to increase due to the birth of new technologies that were sold and spread globally (McINTYRE, Neuse, 1982).

(UNCTAD, 2018) The United States has recorded the largest amount of inflows and outflows over the years, which has led it to become a leading provider of FDI outflows. This is due to the expanded operations of awareness-raising and branches of American companies and companies above all outside their national borders, moreover, the global participation of the United States in expanding resources and assistance to different countries by providing labour, technical expertise, money and technology.

Other developed countries such as China, Great Britain, Germany, France, Singapore and Japan are having a huge impact on the global level by making amazing inflows to emerging and developing economies. According to the (UNCTAD, 2019) World Investment Report, current trends of FDI inflows showed that the share of developing countries in FDI inflows is 52% of the world total. Flows in Latin America tend to increase in (2018 and 2019) while flows in developing Asia remained somewhat flat during the same time scale. FDI inflows to economies in transition jumped 59% to \$54 billion and FDI inflows from developing countries decreased by 2% to \$684 billion (UNCTAD, 2018).

FDI is a driving force to boost the performance of the economy amid an insufficient investment base in transition and emerging economies (Todorović et al., 2019).

From the point of view of UNCTAD, (UNCTAD, 2003) considered FDI to be a strategic policy response to host economic development, and this idea articulates the call for the integration and coordination of FDI about the competitive advantage of recipient countries and the corporate strategies of their firms. Accordingly, for FDI to be discussed efficiently as a global response to the development of the economy, FDI should be tailored to the conditions of the host country (Rodrik, 2006).

(UNCTAD, 2003) however, a different school of thinking suggests that a liberalized, informal economy may be less beneficial and more detrimental to growth. For example, to stimulate foreign investment, the host economies should provide some incentives to attract foreign direct investment, such as the implementation of tax incentives, support systems and all forms of incentives that may be unsustainable in the Long-Run.

(Kumar, 2009) believes that national policies in the host country should be carefully formulated to align interests concerning FDI (Jayachandran and Seilan, 2010).

Much of the research on FDI aims to provide explanations about the conditions that affect FDI positively to make it behave as disguised, detrimental or detrimental to growth. The manner or nature of FDI inflows into and out of the economy is dominant, moreover, one of the positive effects of FDI on economic growth is external factors, such as large capital mobilization to increase domestic investment and technology transfer (Chakraborty and Noninkamp, 2008; OECD, 2002; UNCTAD, 2003).

A Post-Reform study in India where sectoral FDI and causal effects were controlled for in the structure of the co-integration model (Chakraborty and Nunnenkamp, 2008; Katekhaye et al., 2019).

This study argues that different sectors are affected differently by FDI, even the relationship that exists between growth and FDI has shifted to different sectors. For example, an internal relationship was found between productivity and FDI stock in the manufacturing sector, however, there was no evidence of a causal relationship in the primary sector. There is the second evidence of spillovers between industries, one of which is the flows between the service sector and the industry sector (Prokop and Karbowski, 2018).

Concerning the development of financial markets, the paper linking economic growth, financial markets and foreign direct investment mainly proved that countries with developed financial markets show more gains that are positive from foreign direct investment. (Alvaro et al., 2009), also demonstrated that analysis of the effects of FDI in isolation produces equivocal results (Fazaalloh, Lyeonov et al., 2019).

### **3.2 A Summary of the Case Study: “FDI” Foreign Direct Investment in Palestine**

One way to assess the investment attractiveness of a country is to analyze the different types of ratings compiled and published by international organizations (Witkowski et al., 2017). In the late (1990s), foreign capital inflows began to appear in Palestine (Laureti and Postiglione, 2005). In terms of attracting FDI inflows, Palestine can be considered as one of the top three countries in the Middle East and North Africa (MENA) (Mohammed and Sideropoulos, 2010), which has an increasing and steady trend (Kharrawish and Siam, 2010).

One of the main components of Palestinian FDI is Arab FDI, which makes average FDI growth among the highest in the region (Al-Muhtasib, 2009). However, political instability and turmoil in the region has led to differences in these flows (Al-Abdul-Razzaq and Al-Batayneh, 2007).

Some of the explanations for the expansion of foreign direct investment in Palestine have been absorbed, including investor confidence in the Halal and Shouting Economic System (2010), Attractive Investment Climate (Al-Muhtasib, 2009), and the Palestinian Muhtasib Investment Promotion Law (2009), (Al-Namaat, 2009), (Khrushche and Siam, 2010), Financial Strategies and Economic Policies in Palestine by (Abdul Razzaq and Al Batayneh, 2007), and Iraqi Capital by Air in (2003 and 2004) (Mishaal and Abu Al-Leila, 2007).

(Hodrob Rami, 2017) confirmed that the performance of incoming foreign direct investment flows in Palestine is lower than that of other countries in the Arab Mashreq region, compared to their capabilities. The investment environment in Palestine still needs a lot of improvement. Table 1 represent FDI inflows in millions of dollars to Palestine and other developing countries in the Middle East and North Africa (stacked columns used for comparison).

**Table 1 - Net Inflows of FDI to Palestine & MENA Region (In US\$ Million)**

<b>Year</b>	<b>Palestine</b>	<b>Jordan</b>	<b>Iraq</b>	<b>Egypt</b>	<b>Lebanon</b>
2005	622.6	1984.5	515.3	5375.6	3321.5

2006	422.2	3544.0	383.0	10042.8	3131.7
2007	962.6	2622.1	971.8	11578.1	3376.0
2008	336.9	2826.3	1855.7	9494.6	4002.0
2009	513.1	2413.1	1598.3	6711.6	4378.9
2010	1226.2	1688.6	1396.2	6385.6	3708.4
2011	1462.7	1485.9	1882.3	-483.0	3137.1
2012	1311.2	1548.3	3400.4	6031.0	3111.3
2013	1663.2	1946.8	-2335.3	4256.0	2661.9
2014	1876.3	2178.4	-10176.4	4612.0	2862.6
2015	1552.9	1600.3	-7574.2	6925.2	2159.3
2016	1234.7	1553.0	-6255.9	8106.8	2568.5
2017	1962.1	2029.7	-5032.4	7408.7	2522.4
2018	789.7	949.9	-4885.1	6797.6	2879.8
2019	1048.3	1326.5	-3998.4	7459.8	2438.7

Source: UNCTAD Statistics.

### 3.3 Trend Analysis of “FDI” Foreign Direct Investment Inflow to Palestine (1998-2019)

Table 2 presents the statistics of the flow of foreign direct investment in Palestine during the period (1998-2019). Between (2001 and 2002), FDI inflows jumped from US\$15.51 million to US\$360.93 million. Subsequently, inflows jumped to more than US\$3544.01 million in (2005) and reached the maximum in (2009) of US\$2216.10 billion. The foreign direct investment represents a small percentage of Palestine's GDP; however, it made up 1.26% in (2006).

**Table 2 - FDI Inflows to Palestine (1998-2019) (In US\$ Million).**

Year	FDI	FDI/GDP	Year	FDI	FDI/GDP
1998	-33.55	-0.933	2009	2216.10	0.300
1999	2.85	-0.366	2010	1688.60	0.106
2000	13.31	-0.400	2011	1485.92	0.105
2001	15.51	-0.616	2012	1548.31	0.017
2002	360.93	0.134	2013	1633.22	0.062
2003	310.01	0.026	2014	1366.11	0.046
2004	156.40	0.055	2015	1243.56	0.037
2005	3544.01	-0.904	2016	1463.22	0.065
2006	2622.14	1.267	2017	1865.36	0.098
2007	2826.26	0.058	2018	1556.12	0.076
2008	2978.32	0.163	2019	969.76	-0.022

Source: UNCTAD Statistics.

## 4. METHODOLOGY OF THE STUDY

This study used the deductive reasoning method associated with quantitative research, supported by experience and positivism as philosophical positions. (Bryman, 2008)

recommends that quantitative research generally depict social life, through a fascination with the use of estimation procedures.

Therefore, quantitative parameters vary from measuring central tendency (mode, median, and mean) to measuring sample dispersal (variance and standard deviation), in addition to other statistical techniques such as correlation analysis and regression. The search strategy for quantitative research is objective and reductive.

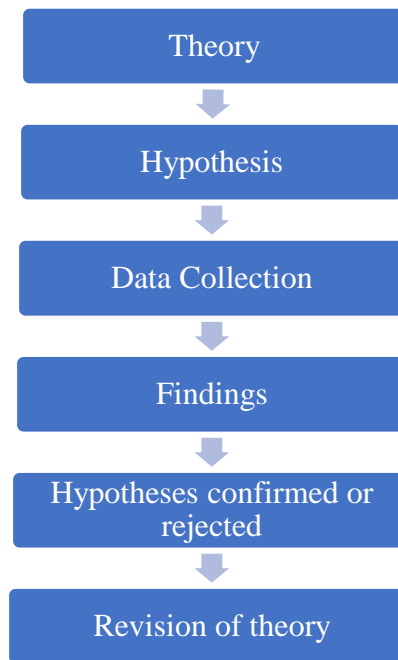
To accomplish the hypothesis, capital accumulation may be enhanced by financial development, which may lead to building links between economic growth and foreign direct investment, this paper on economic growth and foreign direct investment will study quantitative secondary data.

Thus, the deductive approach in Figure 1 proves or disproves a particular theory by analyzing the data collected and unlike the inductive approach where data analysis will be followed by the formulation of a theory (Saunders et al., 2007).

Measures and sources of real economic growth, indicators of foreign direct investment, and indicators of financial stock development are the main data set used in the research. A sample of time series data consisting of 26 observations across the period from (1998 to 2019).

The World Bank's World Development Indicators (WDI) statistics were used to obtain indicators of financial development data and some of the dominant variables such as inflation and population growth. FDI information has been collected using the UNCTAD online database, which contains net flows of FDI, both outward and inward.

**Figure 1 - Deduction process**



Source: (Bryman, 2008: 10).

#### 4.1 Description of Measurement Variables

**Growth indicators:** a follow-up to (Borensztein et al., 1998), real GDP per capita was used as dependent variables for the study, which can be obtained by finding the real GDP ratio of the population. Studies such as (Ayanwale, 2007; and Dinda, 2008) used GDP per capita. Since the use of absolute GDP in the relationship between growth and FDI has failed to reflect the purchasing power or income of citizens, the correlation of studies has been challenged in the literature and thus has become a poor indicator of foreign investor products with market potential (Chakraparte, 2001; Nițescu and Murgu, 2019).

**FDI Inflows:** Net FDI inflows are measured for Long-Term participation in the management of a corporate entity located in an economy different from the investing country through FDI. Foreign direct investment, shown in the balance of payments “is the sum of reinvestment of profits, equity capital, and other short and Long-Term capital” (Mohammed Al-Sagheer and Ubaidah, 2013). This study adopted a model that focuses on net flows to the Palestinian economy.

**Financial development variables:** At the global level, several important studies have demonstrated that economic growth can be positively correlated with financial development and capital accumulation (Beck and Levine, 2002; Cole, 1974; King and Levine, 1993a; 1993b; Levine and Zervos, 1998).

According to the literature, indicators of financial development are classified into two groups: (a) market-based indicators, (b) bank-based indicators. Market-based indices, which were adopted during this study, are mostly concerned with the stock market. (Brasoveanu et al., 2008) broke down stock market indices to variable fluidity and volume variable. The ratio of market capitalization to GDP is the main variant of the volume variable while volume / GDP and market turnover are the main variants of the liquidity variables (Levine and Zervos, 1998).

**Control Variables:** Various variables will be included in this study as control variables, such as (a) Trade openness, A measure of the ratio between trade (exports and imports) and

GDP, the less restricted and more open the economy is, the greater the FDI inflow, the more open the economy can be to attract and thus more growth (Harrison, 1996; Yanıkkaya, 2003). (b) Government consumption, which is an indicator of the size of the government and its total expenditures. Some models of economic development developed by (Barrow, 2013; and Ram, 1986) have shown that a larger size of government will contribute positively to economic growth. (c) Population growth rate, which is a measure of the speed with which a population is growing. Economic growth can be driven by a high rate of population growth (Essien, 2016).

However, the evidence is mixed because some studies have revealed a negative relationship between economic growth and population growth rate (Khordaghi and Saleh, 2013). (d) The inflation rate, which is a measure of macroeconomic stability. Recent studies show that high inflation is harmful and counterproductive to economic growth (Barro, 2013; Fischer and Modigliani, 1978; Paul et al., 1997; Smyth, 1994).

## 4.2 Description of Econometric Analysis

Financial and economic time series often show trends arguing that trends may be either deterministic (i.e. time-dependent) or stochastic (a stochastic but persistent Long-Term relationship) (Fabozzi et al., 2014).

Modelling changes in stochastic trends over time is essential to revealing relationships between economic variables. Co-integration can also be used to identify common stochastic trends. When a long-term relationship exists, it means that the economic variables are interrelated. A framework for interpretation, estimation, and inference can be provided through co-integration analysis.

This paper aims to test the trajectory of financial development where FDI may be beneficial to growth, thus, it is important to study the joint movement of economic growth, FDI and indicators of financial development first (Johansen, 1988; 2003).

Therefore, Johansen's co-integration analysis method will be applied to find out whether there is a relationship between economic growth, foreign direct investment and financial development. This paper has adopted Johansen's co-integration approach because it recognizes more than one complementarity relationship.

However, the participants in the Johansen test are subject to some asymptotic characteristics, that is, the use of large samples. (Besaran et al., 2001) said that the results might not be reliable when the sample size is less than 30.

However, the sample size used during this study is ( $T = 25$ ) which is smaller than 30, due to lack of data, Julius' approach is still in use. It is essential to be able to describe a data set and find the links between different variables before performing a full econometric analysis.

Therefore, descriptive statistics are performed to find the numerical characteristics of variables and to be able to compare them (Saunders et al., 2007). Descriptive statistics results will summarize the sample into a structure of variables that form the basis of econometric analysis. The descriptive analysis is divided into two parts; the first part includes a preliminary test of the data set that performed unit root analysis and univariate analysis. The second part analyzes the multiple linear relationships and the correlation between the measurement variables found in this study.

## 5. RESULTS AND DISCUSSION

## 5.1 Descriptive Analysis

It is essential to be able to describe a data set and find the links between different variables before performing a full econometric analysis. Therefore, descriptive statistics are performed to find the numerical characteristics of variables and to be able to compare them (Saunders et al., [2007](#)).

Descriptive statistics results will summarize the sample into a structure of variables that form the basis of econometric analysis. The descriptive analysis is divided into two parts; the first part includes a preliminary test of the data set that performed unit root analysis and univariate analysis. The second part analyzes the multiple linear relationships and the correlation between the measurement variables found in this study.

### 5.1.1 Characteristics of Measurement Variables

The section summarizes the results of the univariate analysis statistics performed on the variables of this study. Table 3 presents the characteristics of the variables, especially the maximum and minimum values, the mean and standard deviation.

**Table 3 - Characteristics of Variables**

Variable	Mean	Standard Deviation	Minimum	Maximum
Real GDP Per Capita	2702.633	1110.759	1353.257	4241.789
FDI	1234.815	1018.275	-33.550	3544.006
FDI/GDP	0.005	0.422	-0.933	1.278
Market Turnover	5.73E+09	7.74E+09	3.50E+08	2.72E+10
Trading Volume	33.130	47.412	4.986	186.566
Trade Openness	116.812	15.862	90.054	144.881
Inflation	3.338	2.941	-0.877	13.971
Population Growth	3.529	1.367	1.761	5.476
Government Expenditure	20.030	3.346	15.271	25.195

Source: Author own composition.

### 5.1.2 Unit Root Test for Stationary

Measurement Before performing a full regression analysis, the stability of time-series data must be determined (Shawa, [2014](#)), because the variance and mean of the time-series constant data must remain constant over time, thus questionable regression results can be avoided. However, if a non-stationary time-series data set is used in the regression, spurious and misleading results can emerge.

Dickey and Fuller ([1979](#)) and ([1981](#)) to test whether or not variables have unit roots developed a method. It has been assumed that the variable in the null hypothesis will have a unit root while in the alternative hypothesis variable it does not have a unit root. A representation of the hypothesis is found below, where H0 represents the null hypothesis and H1 represents the alternative hypothesis:

H0:  $\delta = 0$ : Variable does have a unit root (Non Stationary) = I(1)

H1:  $\delta \neq 0$ : Variable doesn't have a unit root (Stationary) = I(0)

The null hypothesis will not be rejected when the total value of the ADF test is less than the critical value. The results of the ADF test for the variables used in this study are represented in Table 4. Looking at Table 4, the results show that six measurement variables are non-stationary, while three are stationary (order of integration I(0)).

The results showed that the value of real GDP per capita (-0.807) is greater than the values of all other critical values (-3.750, -3.000 and -2.630), therefore, the unit root is present, and the null hypothesis of real GDP per capita cannot be rejected and assuming that the variable is immutable, implying a single integral order I(1).

**Table 4 - Unit Root Test**

Variable	ADF Test Statistic Z(t)	Critical Value (1%)	Critical Value (5%)	Critical Value (10%)	MacKinnon ~ p-value for Z(t)	No of Lags	Conc.
Real FDI Inflows	-1.732	-3.75	-3	-2.63	0.4149	1	I(1)
FDI/GDP	-5.878	-3.75	-3	-2.63	0.0000	1	I(0)
Real GDP Per Capita	-0.807	-3.75	-3	-2.63	0.8171	3	I(1)
Market Turnover	-2.453	-3.75	-3	-2.63	0.1274	4	I(1)
Trading Volume	-1.872	-3.75	-3	-2.63	0.3454	1	I(1)
Trade Openness	-1.120	-3.75	-3	-2.63	0.7070	1	I(1)
Government Expenditure	-0.189	-3.75	-3	-2.63	0.9398	1	I(1)
Population Growth	-4.069	-3.75	-3	-2.63	0.0011	4	I(0)
Inflation	-4.662	-3.75	-3	-2.63	0.0001	1	I(0)

Source: Author own composition.

### 5.1.3 Multicollinearity Test

When a linear regression model is implemented and the degree of correlation between the variables is high, it is said to be multilinear. A poly-linear relationship can be perfect or imperfect. If the regressions are perfectly correlated, then the poly-linear relationship is called perfect, and the regression coefficients with undefined independent variables and infinite standard errors are in full poly-linearity (Gujarati, 2003).

When the regression factors are imperfectly correlated, the multiple linear relationships is less than perfect and the regression coefficients have large, but still specific, standard errors. This indicates an inaccurate estimation of transactions.

Montgomery and Beck (1982) note that the following factors may cause a multiple linear relationship: (I) deficiencies in the method of data collection, (II) the limitation of the

specific model or population sampled. Finding the regression when there are multiple linear relationships can be tricky because the percentage of standard errors that occur will be higher. Estimation of the variance inflation factor (VIF) is one of the effective methods for discovering multi-collinearity.

Higher values of VIF indicate higher collinearity of the independent variable. Kleinbaum and others. (1988) said that the value of VIF is greater than 10, which will occur when R<sup>2</sup> is above 0.9, meaning that the variable is highly collinear. The values of VIF and R<sup>2</sup> are shown in Table 5.

Looking at Table 5, five independent non-overlapping variables are found, because they have a VIF value smaller than 10, which is below the threshold. However, three variables have a VIF value greater than 10, which means that if these variables are included in the regression calculations, multi-collinearity may become a problem.

To sum it up, the mean value of VIF is 15.22 for all variables, which are on the very edge of the threshold. The common general rule is that one has to worry about poly-linearity when the condition number is 15, and it becomes a very serious problem if it is greater than 30 (Belsley et al., 1980).

**Table 5 - Initial Test of Multicollinearity**

Variable	VIF	1/VIF	R <sup>2</sup>
Market Turnover	45.03	0.0222	0.9778
Trading Volume	38.37	0.0261	0.9739
Trade Openness	12.84	0.0779	0.9221
FDI	7.85	1.27E-01	8.73E-01
Government Expenditure	7.35	0.1360	0.8640
Population Growth	5.05	0.1981	0.8019
Inflation	3.48	0.2875	0.7125
FDI/GDP	1.82	0.5492	0.4508
Mean VIF	15.22		

Source: Author own composition.

It is necessary to drop the high values of VIF, so two of the financial development variables (market turnover and turnover) were omitted. This resulted in a significant decrease in the average value of VIF (2.79), as can be seen in Table 6.

**Table 6 - Final Test of Multicollinearity**

Variable	VIF	1/VIF	R <sup>2</sup>
Government Expenditure	4.49	0.2227	0.7773
Trade Openness	4.01	0.2496	7.50E-01
FDI	2.61	0.3830	0.6170
Population growth	2.51	0.3990	0.6014
Inflation	1.73	0.5792	0.4208
FDI/GDP	1.38	0.7225	0.2775
Mean VIF	2.79		

Source: Author own composition.

#### 5.1.4 Correlation

The numerical way to estimate the strength of a relationship that exists between two variables is to find the correlation (Koop, 2009). The value of correlation ( $r$ ) present for two variables ( $X$  and  $Y$ ) can have any value between 1 and -1, if the value of  $r$  is positive, this indicates that  $X$  and  $Y$  have a positive relationship.

There is a negative correlation when  $R$ -values are negative if  $r$  is zero, and then  $X$  and  $Y$  have no relationship (Gujarati, 2003). Correlation values for all measurement variables found in this research can be found in Table 7. Low correlation between variables can be observed, with some exceptions. A strong positive relationship appears between real GDP per capita and real foreign direct investment ( $r = 0.67$ ), which explains the presence of high economic growth during the study period in Palestine, which reflects the growth of foreign direct investment significantly. This is in line with several studies that have identified the Long-Term positive relationship between economic growth and FDI (Egbo and Onwumere, 2011; HarunaDanja, 2012).

However, the correlation does not express a causal relationship; other underlying factors may lead to or influence the relationship of real FDI and per capita GDP (e.g. human capital, carrying capacity of domestic institutions, institutional quality physical infrastructure, and financial development).

However, for this study, real GDP per capita has negative relationships with both trade openness ( $r = -0.36$ ), government consumption of GDP ( $r = -0.94$ ) and turnover ratio ( $r = -0.01$ ). However, a positive correlation was found between market turnover and real GDP per capita ( $r = 0.2$ ).

Interestingly, there are positive correlations between real foreign direct investment and all the variables of financial development. The relationship with market turnover was found to be strong ( $r = 0.77$ ), which indicates that higher levels of financial development can be linked to higher values of foreign direct investment, i.e., stock market development. This indicates that economies with developing financial markets can attract FDI, and this may promote financial development if FDI levels rise.

However, this study did not include FDI and causation in the development of financial markets.

## 5.2 Empirical Analysis

After exploring the descriptive characteristics of the data, the Long-Run relationship between economic growth and foreign direct investment can be found. In this section, a co-integration analysis is created. Cointegration links between economic growth and foreign direct investment can be found by implementing the Johansen method, this method gives the number of co-integration equations. (Fabuse et al., 2014), argue that for testing the co-integration of multiple variables, the Johansen test is most appropriate.

The recommendations of (Tsay, Paulsen, 1984), and (Nielsen, 2006) were followed in STATA. It should be noted that only the non-stationary variables are included, as co-integration can take only the non-stationary variables, real GDP per capita, real foreign direct investment, market turnover, trade openness, turnover, and government spending.

Looking at the results in Table 8, a null hypothesis without co-integration was discovered in a model with two lags, which indicates at least one Long-Term relationship between one of the measurement variables and the real GDP of the individual.

Since there is at least one co-integration relationship between the variables, which means there is a co-movement between financial development, foreign direct investment and economic growth. Hence, Johansen's co-integration analysis found that there is a Long-Term relationship between FDI, financial development and economic growth (Johansen, 1988; 2003; Meyer et al., 2017).

The interaction between the financial development indicators of the stock market and foreign direct investment was statistically clear. This indicates that development indicators in the stock market tend to shape economic growth and the relationship of foreign direct investment in Palestine.

This means that the growth benefits of foreign direct investment flow to Palestine are enhanced by the amount of financial development that exists in the country. The results also show that market turnover and population growth are the main positive drivers of growth in Palestine.

**Table 7 - Correlation Matrix.**

	Real GDP Per Capita	FDI	FDI/GDP	Market Turnover	Trading Volume	Population Growth	Trade Openness	Government Expenditure	Inflation Rate
Real GDP Per Capita	1								
FDI	0.6615	1							
FDI/GDP	0.2160	0.2045	1						
Market Turnover	0.1977	70.56E-01	2.94E-01	1					
Trading Volume	-0.0139	-0.6125	0.3167	0.9448	1				
Population Growth	0.3703	0.4015	-0.1896	0.3077	0.1857	1			
Trade Openness	-0.3597	-0.2645	-0.0197	0.6607	0.7370	0.3892	1		
Government Expenditure	0.9406	-0.5739	-0.1987	-0.1172	0.0146	-0.3946	0.3617	1	
Inflation Rate	0.0787	0.3373	-0.1692	0.5475	0.4408	0.3146	0.5772	0.0510	1

Source: Author own composition.

**Table 8 - Johansen's Co-Integration Test**

Constant Trend			Observation Number =24		
Duration: 1998 - 2019			Lags =2		
Maximum Rank	Parms	LL	Eigenvalue	Trace Statistic	Critical Value 5%
0	42		-1059.2273	124.7178	94.15
1	53	-1034.5925	0.87164	75.4483	68.52
2	62	-1015.6712	0.79336	37.6058*	47.21
3	69	-1004.0692	0.61972	14.4018	29.68
4	74	-997.62075	0.41572	1.5048	15.41

5	77	-996.86833	0.06078	0	3.76
6	78		-996.86833		0

Source: Author own composition.

## 6. CONCLUSIONS

This paper examined the relationship between foreign direct investment and economic growth in Palestine and how the impact of financial development shaped this relationship.

Moreover, the impact of other determinants of the growth of the Palestinian economy was considered. Over the years, developing countries have embraced foreign direct investment as an important strategy for economic growth. For the host country, capital growth, technological transfers, knowledge and productivity gains are major positive effects of FDI (Caves, 1996b; Chakraborty and Nunnenkamp, 2008; OECD, 2002; UNCTAD, 2003).

However, several studies have found that the host country needs to build absorptive capacity to allocate the benefits of FDI World Bank (2001), which includes expanded financial markets (Abdel-Bahri et al., 2017; Alvaro et al., 2004; 2009; Hermes and Lisink, 2003; Imran and Bulbul, 2003; Shah, 2016).

This study, in particular, has highlighted that having a well-developed financial market can improve the impact of indirect foreign direct investment on economic growth. A well-developed stock market will accelerate capital accumulation activities and production growth by providing adequate liquidity services and improving links between domestic and foreign investors (Beck and Levine, 2002; Levine and Zervos, 1998).

The Palestinian government needs to implement and establish appropriate and investment-friendly macroeconomic policies to attract and sustain foreign investment.

This study makes a significant contribution to the literature by examining whether FDI stimulates growth through financial development networks and other factors that can drive growth along with FDI.

Despite the contribution and importance of this study, it still has some limitations. First, the data set used had relatively few observations ( $n = 26$ ) which were limited in terms of the methodological approach. When the number of observations is higher (e.g.:  $n \geq 200$ ), it may become possible to use other techniques.

However, to overcome those challenges, initial tests of unit root and multi-collinearity were used. Second, not including some influencing variables for growth models is the second limitation in this study, and these variables are gross fixed capital formation, measures of institutional quality, rule of law, bureaucratic quality, corruption, and political stability (due to missing or incomplete data). Therefore, deleting such variables may increase the risk of biased results in the model.

The focus will be on three areas in future researches. First, other absorptive capacities will be considered whether they enhance the growth benefits of FDI, such as infrastructure development and human capital. Second, it would be great to see which segments stimulate more development benefits than others do, given that FDI flows to Palestine could be driven by other sectors.

Therefore, the impact of this link on the Long-Term Development of the Palestinian economy must be taken into account. However, the availability of data at detailed sectoral rates may limit this.

Finally, it may be important to study the indirect environmental and social impacts associated with FDI. Globally, environmental activities and extractive industries are interrelated.

## **7. POLICY RECOMMENDATIONS OF THE STUDY**

Based on the results of the current study, the following recommendations were made:

- The Palestinian government should provide an enabling business/investment climate, foreign direct investment that encourages ease of doing business in the country encourages foreign investors, and established businesses to thrive, raise economic growth rates and expand foreign direct investment in the country to escape from it. To reach the required financial stability rate and financial development.
- The Palestinian government must ensure that foreign loans are legally and properly invested in the specific projects/programs for which they were borrowed in the first place, as the negative effects on Palestinian financial stability are not constant or constant, but on average and long-term duration. These programs will have positive effects on the Palestinian economy and financial stability and financial development will increase the ease of doing business and investing in the country.
- The Palestinian government should also curb illegal and illicit trade and investment practices, as these infrastructure projects and programs will reduce the country's production costs.
- The Palestinian government should create an appropriate investment environment for foreign investments to increase economic growth rates and encourage businesspersons and capital owners to invest these funds inside the country to maintain stability in the country.
- The Palestinian government must use all foreign aid funds in the appropriate place to raise the rate of economic growth, inject these huge funds coming from abroad into successful projects, and create job opportunities for the unemployed, thus achieving positive rates in Palestinian financial stability and financial development.

## **8. LIMITATIONS OF THE STUDY AND SUGGESTIONS FOR FUTURE STUDIES**

The study explores the impact of economic growth and foreign direct investment and its relationship to financial development in Palestine by estimating the growth model. This effect is considered a positive impact on Palestinian financial stability and financial development.

To achieve this goal, the period (1998-2019) was chosen based on the availability of data on the variables used in the study. It should be noted the previous studies that dealt with the title of the current study, and what are the most important results, conclusions and recommendations of those studies.

Therefore, the current study represents some important determinants, such as its reliance on previous studies and an appropriate scientific approach to the problem of the study and the process of data analysis, and data from reliable official government sources were used and analyzed, and the study. It reached positive, good and satisfactory results.

However, the conclusions and recommendations are fit for purpose based on the data analyzed by the author, and another important limitation is that this study used the quantitative approach to the data more extensively and the qualitative method less.

The statistical method has been used to reach those results available for future studies, and future studies will benefit from this study, where the results, conclusions and recommendations are summarized and written in the most prominent ones.

Besides, the type of scientific method used and the methodology used to solve and examine the study problem are appropriate and useful for future studies and research.

In addition, One of the important determinants of this study is that it revealed the real impact of the relationship of economic growth and foreign direct investment on financial development in Palestine, and the impact of the flight of local and foreign investors on economic growth and financial stability, and the volume of incoming remittances also affects the process of economic growth and financial development in the country.

As for the short and long term, it showed the impact of each of the variables used in the study on the process of financial development in Palestine, and the study proved that with empirical evidence from the current Palestinian economic situation.

Therefore, future studies and research will benefit from the current study for its findings, conclusions and recommendations, and will help the authors and other researchers in this field to conduct broader studies related to the topic and problem of the current study.

Besides, the study result is limited in terms of data quality. This limitation arises from the inconsistency and inaccuracy of the data reported by various government institutions, private sector enterprises, and even by different departments in the country.

In addition, there is a lack of data used in our study due to the lack of available sources, and due to the length of the study period, these data could not be used as they should.

## **NOVELTY OF THE STUDY**

The novelty of this study lies in the new findings, conclusions and recommendations that provide a real benefit to decision-makers in the state and the decision-making process in another way.

The analysis of the data and the analysis of the quantitative content of these data in the study showed that there is a noticeable positive impact of the relationship of economic growth and foreign direct investment on financial development in Palestine.

It should be noted that the process of economic growth and foreign direct investment has caused an increase in the rate of Palestinian financial development and progress in economic development as a whole.

This novelty can be deduced from the results of the study in addition to the conclusions and recommendations made by the study, and this novelty is a useful model for future studies in this regard.

## **DECLARATIONS**

The views, conclusions, and recommendations derived here are the narratives concluded by the author, based on the data (Facts/Tables) that derived in this paper, which do not reflect the official views and perspectives of the Organizations where the authors are associated now. This study was conducted in early (2021), in the second year of the onset of (Covid-19).

## DATA AVAILABILITY STATEMENT

The data and materials that support the findings of this study are available from the corresponding author upon request. Datasets are derived from public resources and made available to the author. Data analyzed in this study were a reanalysis of existing data, which are openly available at locations cited in the references section.

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