

Private Sector Investment and Economic Growth in Palestine (1990-2015)

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Abstract

This study examines the impact of private sector investment on economic growth in Palestine using quarterly time series data from 1990-2015. Multiple regression and co-integration methods are employed to analyse the data. The objectives of this study are to analyse the trends of private investment and economic growth in Palestine from 1990-2015 and to examine the impact of private sector investment on economic. Being a time series data, to avoid spurious regression results, the first step is to test for the stationarity of the data by using Augmented Dickey-Fuller unit root test. Then ordinary least square (OLS) regression technique is used to estimate of each independent variable effect on the dependent variable. Test the stationary of the error term is done to test the long run co-integration among variables. The result of stationarity and normality test will reveal that the model is fairly well specified and could be used for policy analysis or not. The co-integration test result will indicate that private sector investment and economic growth have a long run significant effect on one another. The unit root tests, which conducted, confirm that variables are stationary in first difference and the co-integration tests also confirm the existence of long term relationship between the variables. The findings of the study concluded that there exist a short-run and long run relationship between private sector investment and economic growth in Palestine. This study recommends the Palestinian government to promote and encourage both domestic and foreign direct investment. The investment policy should be more transparent, attractive and competitive

Keywords: Domestic private sector investment, Economic growth, Palestine.

1.0 INTRODUCTION

The growth of economic and development of countries is heavily depending essentially on a country's ability to invest and make efficient allocation of its resources. Hence, Bayraktar (2003) noted that investment is the result and cause of economic growth. The role of the private sector is important in both contributions to quantity of gross domestic investment and its ability to allocate and employ resources efficiently. Private sector investment has been the engine of employment and income creation, provision of infrastructure as well as social services, Nwakoby and Bernard (2016). Hence, it plays an essential role in the expansion of the economy's production capacity and long-term economic growth, Chhibber et al. (1992). Respect of domestic investment at the level of the national economy, capital spending on new projects in the sectors of public utilities and infrastructure such as incision main and branch roads projects and extensions of water and sewerage connections and create urban plans and construction projects, housing and extensions of electricity and power generation, as well as social development in the areas of education, health and communication projects, projects as well to projects that relate to economic activity for the production of goods and services in the production and service sectors such as industry, agriculture, housing, health, education and tourism, Bakari (2016). This means that the presence of the private sector can at least spur economic growth and poverty reduction.

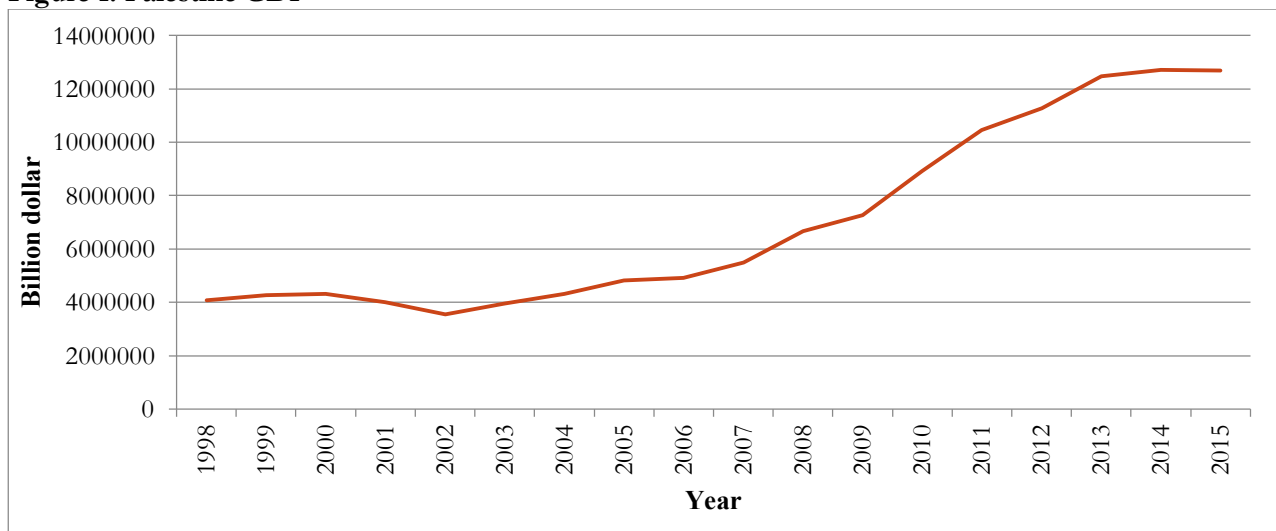
The Palestinian private sector investment is one of the main players in the Palestinian economic development. It contributes to the Gross Domestic Product (GDP) and employs a major amount of the Palestinian labour force. There is a consensus on the importance of the Palestinian private sector. The private sector investment is believed to have the primary role in facilitating Palestinian economic growth, employment, fighting poverty, reducing the trade deficit and reducing the budget deficit. A number of studies have illustrated that there exists a positive impact of private investment in Palestine GDP. The magnitude of the effect of private sector investment on economic growth depends on the level of private investment in a developing country like Palestine. When the level of Palestinian private investment in many sectors is high, the development of the entire economy is greater and that leads to a greater effect on economic growth. However, this study comes to confirm this finding and to fill the gap of limited studies that covered Palestinian private investment in recent years. The aims of the current study are to analyse the trends of private investment and economic growth in Palestine from 1990-2015 and to examine the impact of private sector investment on economic growth in Palestine. This study contributes to the literature on economic growth by examining the impact of private sector investment on economic growth in Palestine using quarterly time series data from 1990-2015.

The rest of this paper is organized as follows: section two provides a discussion of overview of the Palestinian economy in general and private sector investment in Palestine, section three presents a review of the relevant literature, and section four discusses the methodology, theoretical framework and model specification, the results of the empirical analysis and their implications are presented in the section five, section six concludes and suggests some policy recommendations.

2.0 OVERVIEW OF THE PALESTINIAN ECONOMY

The Palestinian economy faces many challenges that limit and harbour its ability to grow and improve to achieve sustainable economic development. Most distinguished of these challenges and risks are the persistence of the Israeli occupation and the force dependence of the Palestinian economy on its Israeli counterpart, the dependence on foreign aid and the escalating political and economic uncertainty as well. Every year the Palestinian economy faces a new shock in relation to the mentioned challenges, whether at political and security levels, as in a new Israeli aggression, or at the level of public finances, as in the block of clearance revenues and the ensuing grave implications on the Palestinian economy. The situation is further aggravated by repeated tightening of the siege on the Gaza Strip, the periodically intensified restrictions in the West Bank and the limitations on the freedom of movement and access for people and goods all around the whole of the Palestinian territories. Shocks also include the decline and fluctuation in foreign aid over the recent years and the linking of aid to the political positions of the Palestinian National Authority. Over the past years, the above-mentioned factors have led to economic slowdown. At times, even negative growth rates were realized. This has been the case in 2014 the first such occurrences since 2006; not to mention the reflection of poor economic performance on unemployment rates, which remained high, especially in the Gaza Strip, where growth rates realized were insufficient to ingest the increasing labour supply. As the figure 1 below show the trend of Palestinian GDP over the years, on x axis year and on y axis billion dollar.

Figure 1: Palestine GDP



Source: World Bank 2016

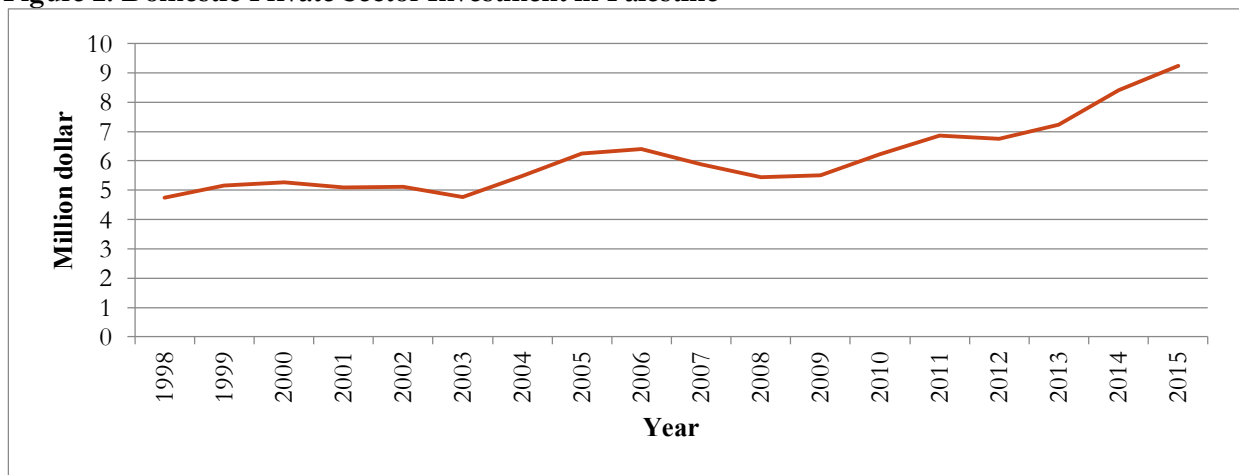
The Palestinian economy has a diversified structure in which different sectors contribute to the Gross Domestic Product (GDP). In 2009, the sectoral contributions to GDP were: Agriculture and Fishing 8.1%. Mining, manufacturing, water and electricity 14.6%. Construction 7.4%. Transport, storage and communications 8.7%. Brokerage 5.5% and financial services 17.5%. GDP increased by 6.5% in 2009, while real per capita incomes increased by 3%. This growth is largely the result of augmented development activities, which significantly expanded at the end of 2007 and the

beginning of 2008. The most prominent feature of the development activity is that it included all sectors in the West Bank. Development in the Gaza Strip is still disabled due to the Israeli blockade that has been in place for years. The macroeconomic framework for the reform and development plan expects a 15% increase in GDP in the year 2010, Palestine Investment Guide (2010).

2.1 INVESTMENT IN PALESTINE

Between 1990-2015 private sector investment in Palestine has experienced an upward trend. As the figure 2 below shows, on x axis year and on y axis million dollar. This is a reflection of the role played by the market forces. Continued efforts aimed at reforming and privatizing the public sector, removing price distortions, liberalizing foreign trade and payments, opening the market up to foreign direct and portfolio investments, and strengthening the capacity of the financial system to mobilize domestic savings and allocate financial resources have all contributed to the share of private investment in developing countries, Bayraktar (2003). Nevertheless, Palestine as one of the developing countries still has the opportunity to improve its private investment performance. This would be better done when the effect of private sector investment on economic growth of the country is understood. Many sectors in Palestine are open for private sector investment such as construction sector, agricultural sector, manufacturing sector, tourism sector as well as information and communication technology sector.

Figure 2: Domestic Private Sector Investment in Palestine



Source: World Bank 2016

Several institutions and entrusted international development agencies have established by the Palestinian National Authority (PNA) to achieve the primary role in facilitating economic growth, employment, fighting poverty, reducing the trade deficit and reducing the budget deficit. Incentives have focused on encouraging small and medium enterprises, which comprise more than 95% of the Palestinian private sector. These initiatives include: Agreement with MIGA on insurance of investment against political risks, which has been signed by PNA in 2008 with the World Bank that guaranteed local and foreign investments in the West Bank and Gaza as well as The European Palestinian Credit Guarantee Fund (EPCGF), which was established in 2005 with an initial capital of EUR 29 million, supported by the European Commission, Germany and the European Investment

Bank to help SMEs in Palestine to overcome credit difficulties. Loan Guarantee Facility (LGF) from the Palestine Investment Fund and OPIC for SMEs. In 2007 Palestine Investment Fund (PIF) launched a partnership with the Overseas Private Investment Corporation (OPIC) and the Middle East Investment Initiative (MEII) called the Loan Guarantee Facility Project (LGF) for SME loans. Moreover, Political Risk Insurance in Partnership with OPIC helps to form mechanisms and tools for promoting the development of the Palestinian economy.

3.0 LITERATURE REVIEW

Many studies have covered private investment from different perspectives, and examined focused variables and their relationship differently. Most relevant and useful studies for this study are included. Suhendra and Anwar (2014), studied the effect of private investment and public investment in Indonesia GDP from 1990-2011. Using Ordinary least square OLS they found out that government investment, economic growth, credit available for private investment, and the exchange rate have a positive and significant impact on private investment. Interest rates and inflation have a negative and significant impact on private investment. The higher the interest rate and inflation, the lower private investment. While, Hussein and Benhin (2015) used Co-integration and error correction models to identify public and private investment and Economic Development in Iraq based on a neoclassical growth framework covered the period from 1970 to 2010. They found that in the long run, private investment, public investment, growth in the labour force and growth in oil revenues affect real gross domestic product (GDP) positively and statistically significant.

Alcatel (2005) examined the impact of Saudi government budget deficits on private investment, especially investment in Saudi Arabia by employing recent developments in econometrics. Results show that government budget deficits have a crowding out effects on private sector investment. Thus, it is possible that financing government budget deficits by borrowing from domestic markets reduces financial resources available to the private sector and discourages private sector investment. Moustain and Fatima (2004) explore the causality issue between financial development and economic growth in the Moroccan context over the period 1970-2000 based on Granger causality tests. They suggest a spasmodic short-term, rather than long-term causality relationship between finance and growth. These findings may be attributed to the newness of financial sector reforms in Morocco, along with the absence of an appropriate investment climate required to foster significant private investment and promote growth in the long run.

According to Imoisi, Abuo and Sogules (2015), they investigated the impact of domestic investment on economic growth for Nigeria from 1970 to 2013. Using co-integration and error correction mechanism techniques, their result indicate that private investment has positive but insignificant impact on economic growth. The study shows that private domestic investment and government productive expenditure influenced economic growth positively, but was not significant for the period of study. Meanwhile, Zinabe (2014) analysed the impact of investment on economic growth in Ethiopia. The methodology adopted is the new neo-classical growth model of Cobb Douglas Production Function utilizing the error correction model (ECM). The model is implemented empirically using macroeconomic data for Ethiopia from 1981 to 2011 period. The co-

integration tests confirmed the existence of long term relationship between the variables. The findings of the study concluded that there exist a short-run and long-run relationship between investment and economic growth in Ethiopia. This implies that investment impacts positively economic growth in the short and long run process.

Again, Tan and Tang (2011) (Personal, Archive, Roncalli, & Weisang, 2013) examined the dynamic relationship between private domestic investment, the user cost of capital, and economic growth in Malaysia over the period of 1970 to 2009. Co-integration, Granger causality, variance decomposition, and impulse response frameworks are techniques used to achieve the objectives of the study. The Johansen co-integration test in association with the small sample correction procedure indicates that private domestic investment is co-integrated with the user cost of capital, and economic growth. In the long run, economic growth has a positive effect on private domestic investment while the user cost of capital is negatively affecting private domestic investment in the long run. Ghazali (2010) identifies the causal relationship between foreign direct investment (FDI), domestic investment and economic growth (GDP) in Pakistan over the period 1981 to 2008. The correlation result shows that there is a high degree of positive relationship between domestic investment and economic growth; great economic growth spurs large domestic investment, and vice versa. The co-integration result states that there is a positive long run relationship between FDI inflow, GDP and the net domestic real investment. The analysis results clearly state the FDI inflow into Pakistan supplements domestic investment.

Osman (2014) applied the auto-regressive distributed lag (ARDL) model as an approach to co-integration, on annual time series data from 1974-2012 to investigate the relationship between private sector credit and economic growth in Saudi Arabia. The study found that there is a long-run relationship between private sector credit (BF) and economic growth. Moreover, private sector credit (BF) has positive long and short run relationship and the elasticity of GDP to the private sector credit (BF) was (0.054) and (0.068) for long-run and short-run respectively. Sumei Tang, E. A. Selvanathan and S. Selvanathan (2008), investigates the causal link between foreign direct investment (FDI), domestic investment and economic growth in China for the period 1988 - 2003 using a multivariate VAR system with error correction model (ECM) and the innovation accounting (variance decomposition and impulse response function analysis) techniques. The results indicate that while there is a bi-directional causality between domestic investment and economic growth, there is only a single directional causality from FDI to domestic investment and economic growth. Rather than crowding out domestic investment, FDI is found to be complementary with domestic investment.

4.0 METHODOLOGY

This section described how to carry out the investigation. Therefore, the section exposes the research design, variables, data collection and sources, method of data analysis and the estimated model.

4.1 Research Design

An empirical study of the presumed reasoning becomes necessary to create a more specific relationship between private and public investment, as well as economic growth in the economy. This study will employ the ordinary least Square (OLS) method in analysing the relationship between the variables in the model.

4.2 Variables used and Sources of Data

The data used for this study were mainly secondary time series data. Quarterly data samples covered from 1990 to 2015 were collected to run the model namely:

GDP- Gross Domestic Product: GDP is the sum of gross value added by all resident producers in the economy plus any product taxes and minus any subsidies not included in the value of the products. It is calculated without making deductions for depreciation of fabricated assets or for depletion and degradation of natural resources. The GDP is the proxy for economic growth. It is the dependent variable.

DPSI- Domestic Private Sector Investment: Domestic credit to the private sector by banks refers to financial resources provided to the private sector by other depository corporations, such as through loans, purchases of non-equity securities, and trade credits and other accounts receivable, that establishes a claim for repayment. It is an independent variable and proxied by Total Credit to Private Sector.

FDI- Foreign Direct Investment: It represents investments by the foreign investors into the Palestinian real sector. It is an independent variable.

REXR- Real Exchange Rate: The exchange rate captures the reaction of foreign investors to currency risk of investing in Palestine in the face of exchange rate uncertainty. It is an independent variable.

CPI- Consumer Price Index: is a measure that examines the weighted average of prices of a basket of consumer goods and services. It is an independent variable.

POP- population: the total population of Palestinian in Gaza and West Bank. It is an independent variable.

The data used for this study, were sourced from the World Bank group and Statistical Bulletin and Annual Reports and Statement of accounts from the Palestine Monetary Authority (PMA).

4.3 Method of Data Analysis

To estimate the Econometric analysis, we checked stationarity of the series, because non-stationary variables result in spurious regression. To verify that time serious data are stationery or not we used unit root tests. There are several ways of testing for the presence of a unit root. The most common one in econometric work is the Augmented Dickey-Fuller (ADF) test. Hence the emphasis here will be on using the Augmented Dickey-Fuller (ADF) approach to testing the null hypothesis that a series contains a unit root against the alternative that it is stationary.

Testing for the co-integration and estimating the relationship among co-integrated variables using the (Engle Granger 1987) methodology, in this methodology the residuals from the long-run relationship are tested for stationary to determine whether the variables are co-integrated in the long run or not. To determine the residuals order of integration, the Augmented Dickey-Fuller (ADF) test could be performed. Augmented Dickey-Fuller (ADF) test verifying unit roots of the error term and then error terms with I (0) properties the series in question are said to be co-integrated. So if the variables are co-integrated a long-run relationship between these variables exists. The existence of a long-run relationship also has its implications for the short-run behaviour of the I (1) variables, because there has to be some mechanism that drives the variables to their long-run equilibrium relationship. Then ordinary least square (OLS) regression technique is used to estimate of each the independent variable effect on dependent variable.

4.4 Model Specification

The choice of the above variables for the model was drawn from the literature. The model follows the neoclassical growth framework of Solow (1956). The model was used by Baghebo and Edoumiekumo (2012), Haque (2013), Suhendra and Anwar (2014) and Kalu and Mgbemena (2015) in similar studied. The framework of the growth model takes as its starting point an aggregate production function of Cobb-Douglas function which related output to factor inputs and variable referred to as total factor productivity.

$$Y = A f(K, L)$$

A: Is the technological shift parameter which is generally assumed to be exogenous.

Y: Is the level of output.

K: Is the stock of physical capital.

L: Is the labor force.

f: Is the functional notation of the potential aggregate output.

The aggregate potential production function hinges on the theoretical assumption that the inputs (in the form of investment) yield output (economic growth). Thus the functional representation of the relationship between private sector investment and economic growth is thus:

$$GDP = f(DPSI, FDI, REXR, CPI, POP)$$

Specifying the production function in the log linear form with an error term μ_t , the following equation can be written:

$$\ln GDP_t = \beta_0 + \beta_1 DPSI_t + \beta_2 \ln FDI_t + \beta_3 REXR_t + \beta_4 CPI_t + \beta_5 \ln POP_t + \mu_t$$

Where, β_0 = the constant term is assumed to capture the growth of productivity as well as other left-out exogenous variables. $\beta_1, \beta_2, \beta_3, \beta_4, \beta_5$ = Coefficients of the explanatory/Independent variables. μ = Stochastic or error term t = denote time period and \ln = the natural log that smoothen the scholastic effect of time series variables. The relationship expressed above shows that Gross Domestic Product, which captures the aggregate demand conditions in the economy is expected to exert a positive effect on private sector investment. This goes to say that the coefficient

of GDP is expected to be positive, as the aggregate demand condition in the Palestinian economy is increasing, private sector investment should increase as well.

5.0 EMPIRICAL FINDINGS AND DISCUSSION

To begin with a standard approach, it is important to examine the stationarity of a time series in the form of unit root tests. Augmented Dickey- Fuller (ADF) test is the most common tests available to check the stationarity of variables to find the order of integration of each series used in the model.

From the table 1, the results show that there is no variable is stationary at level. Other variables, including LGDP, DPSI, LFDI, REXR, CPI and LPOP are non-stationary at a level and stationary in their first differences. Since all of the variables are stationary at first difference, co-integration analysis is conducted at the 1 (1) order of integration (that is, at lag 1).

Now turn to apply the approach proposed by (Engle and Granger 1987) methodology to examine whether the empirical evidence is consistent with co-integration relationship implied by the theory. As defined by (Engle and Granger 1987), the stationary of a variable determines the degree of integration of the variable. (Engle and Granger 1987) have demonstrated that the linear combination is integrated at any order less than d , and then these variables are integrated.

Table 1: Unit Root Test Summary Statistics (Augmented Dickey Fuller)

Variable	ADF Test t-Statistics		Probability Values		Order of Integration
	Level	1st Difference	Level	1st Difference	
LGDP	-2.646029	-1.771518	0.2621	0.0727*	I (1)
DPSI	-1.989420	-1.726841	0.5963	0.0798*	I(1)
LFDI	-0.277412	-3.757005	0.5824	0.0003***	I(1)
REXR	-0.463599	-7.540520	0.5103	0.0000***	I(1)
CPI	-2.111410	-7.881838	0.5294	0.0000***	I(1)
LPOP	-2.836535	-3.734693	0.1902	0.0271**	I(1)

*Significant at 10%, **significant at 5%, *** significance at the 1% level

Table 2: Residual based Single Equation Tests for Co-integration

Null Hypothesis: RESIDUAL has a unit root		
Exogenous: Constant		
Lag Length: 1 (Automatic - based on SIC, maxlag=10)		
	t-Statistic	Prob.*
Augmented Dickey-Fuller test statistic	-3.903357	0.0034
Test critical values	1% level	-3.531592
	5% level	-2.905519
	10% level	-2.590262

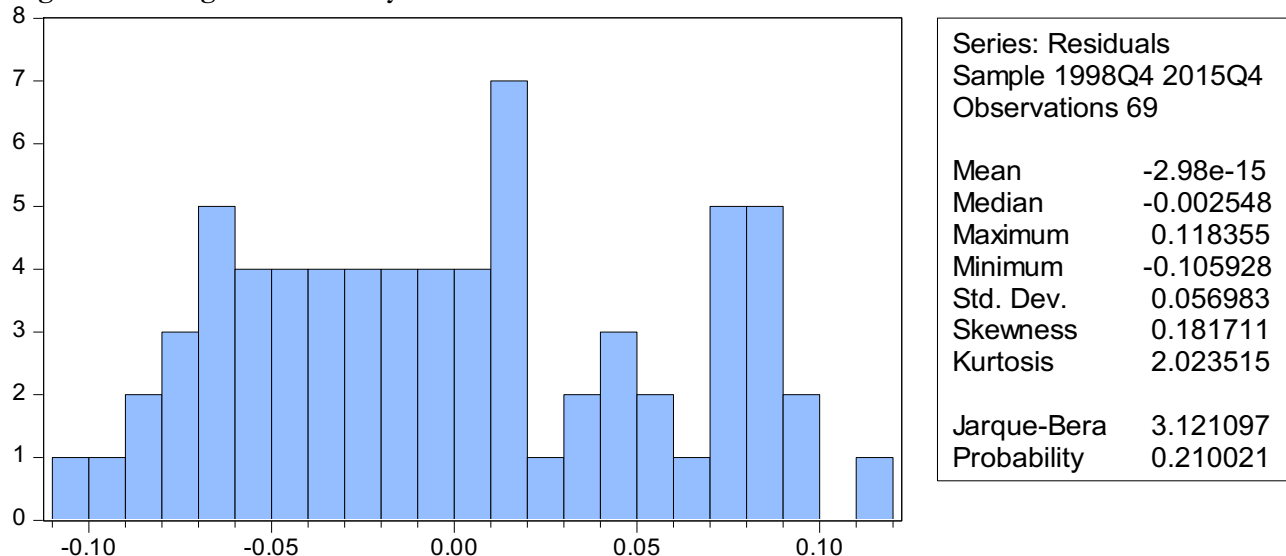
The results of the co-integration tests are reported in the table above. We reject the null hypothesis of no co-integration in Augmented Dickey-Fuller (ADF) test which is strong evidence of having co-integration among the variables. Since the error term of the variables with different

combinations is stationary, we can make inferences that the variables will move together and never diverge in the long run although they might show some divergence from time to time.

The residuals from the ordinary least squares (OLS) regression are usually taken as a proxy for the linear combination in the empirical analysis. For example, the variables in the regression equation which has the same integration degree $I(1)$, will be co-integrated and have a steady state relationship, if and only if the residual of the OLS regression has the integration degree $I(0)$. When it is satisfied, the short-run equation can be constructed by using the error correction model (ECM) in order to realize long-run equilibrium (Zinabe, 2014).

Using Augmented Dickey-Fuller (ADF) unit root test results, the variables are integrated of order one $I(1)$, then ordinary least square estimation (OLS) results indicate a long run relationship among the variables. The long-run static model is estimated and its results indicate and confirm that co-integration exists between the series. The residual is integrated of order zero, $I(0)$ therefore can be used in the dynamic equation as an error correction mechanism.

Figure 3: Histogram Normality Test



The serial correlation LM test, Jarque-Bera normality test used to test the diagnostic of the model which failed to reject the null hypothesis of all the variables and confirm that all variables are normally distributed.

Table 3: The Estimated Long-Run Static Model

Dependent Variable: LGDP				
Included observations: 69				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	53.21763	18.81732	2.828120	0.0063
DPSI	0.066488	0.024654	2.696810	0.0090
LFDI	0.068556	0.016202	4.231399	0.0001
EXR	-0.123978	0.030341	-4.086141	0.0001
CPI	0.043578	0.011119	3.919416	0.0002
LPOP	-2.354015	1.300894	-1.809537	0.0751

R-squared	0.983896
Adjusted R-squared	0.982618

Table 3 presents the estimation results of the static model, which represent the rejection of the hypothesis that there exists no relationship between private sector investment and GDP growth in the long run. This implies that the growth of investment has long run positive impact on economic growth in Palestine. The regression result shows that when the domestic private sector investment in Palestine increases by 1 percent the Palestinian GDP will increase by 6.6 percent which supports the theoretical and empirical findings. It is also observed from the results that the rest of the variables included in the regression such as foreign direct investment and the consumer price index have a positive and significant impact on economic growth. The coefficient for foreign direct investment is very close to private sector investment that is 6.8 percent, which implies that the foreign direct investment and domestic private sector investment affect the Palestinian GDP at almost the same level. While, the exchange rate and population have a negative and significant impact on Palestine economic growth. The goodness of fit of the model is good, because, the R-squared and R-squared adjusted are 98.38 and 98.26 percent, respectively.

Figure 4: Palestinian GDP and Domestic private sector investment trends

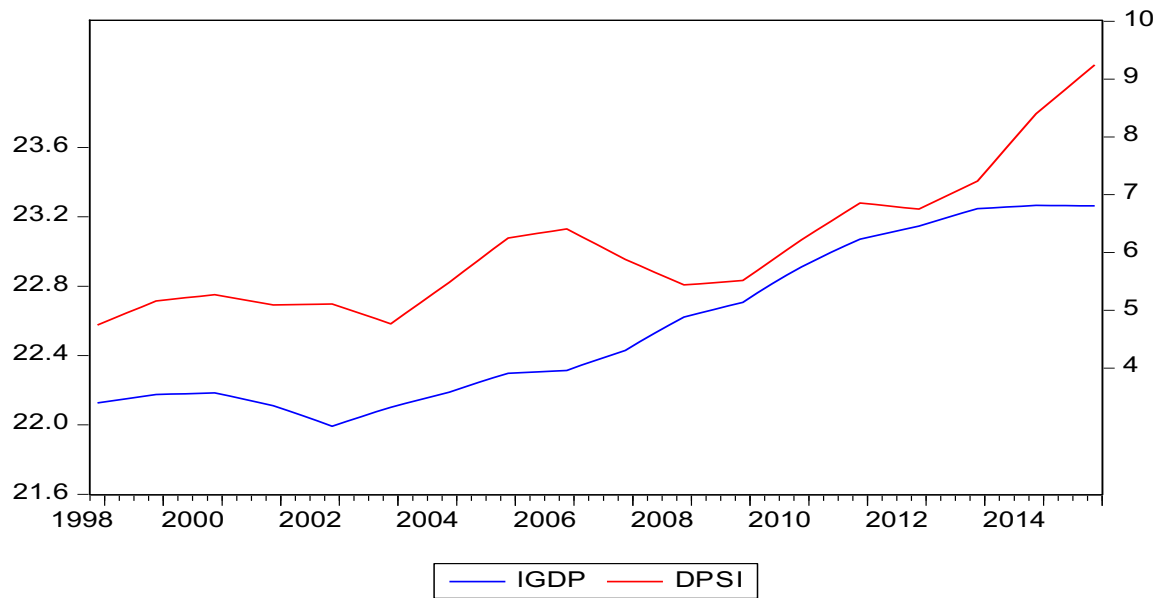
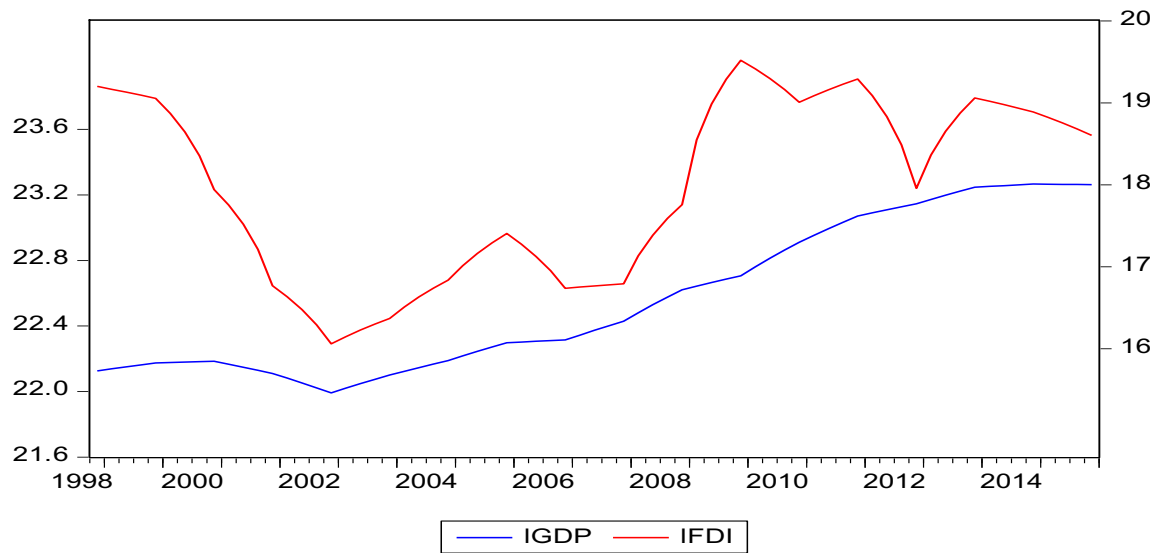


Figure 5: Palestinian GDP and Domestic Foreign Direct Investment trends



From the figure 3 and 4 we can observe that the domestic private sector investment and foreign direct investment trends are moving together along with Palestinian GDP through the time period 1998 to 2015. The x axis show the time period in years, and the y axis represent the logged values for GDP and FDI. It is clear enough to confirm the finding of a strong positive relationship between Palestinian domestic private sector investment and Palestinian economic growth as well as foreign direct investment and economic growth.

6.0 CONCLUSION AND RECOMMENDATIONS

The aim of this study is to analyse the trends of private investment and economic growth in Palestine from 1990-2015 and to examine the impact of private sector investment on Palestinian economic growth. The paper come to fill the gap of limited literature that covered the effect of Palestinian privet sector investment on Palestinian economic growth. The paper examines the impact of domestic private sector investment on economic growth in Palestine using quarterly time series data from 1990-2015. The study employed the ADF-test to avoid unit root problems that are usually related with time series data. The methodology adopted is the new neo-classical growth model of Cobb Douglas Production Function utilizing the error correction model (ECM). The unit root tests conducted confirm that variables are stationary in first difference and the co-integration tests also confirm the existence of long term relationship between the variables. The findings of the study concluded that there exists a short-run and long-run relationship between private sector investment and economic growth in Palestine. This implies that domestic privet sector investment impacts positively economic growth in the short and long run process. The impact of investment on economic growth is a long standing issue in macroeconomics and development economics. The empirical results of the study have useful implication for Palestine. Thus an important implication for policy is that private sector investment is one of the major determinants of economic growth in Palestine. Since the objective of accelerating economic growth; The Palestinian government is required to promote and encourage both domestic and foreign direct investment. The investment policy should be more transparent, attractive and competitive. This leads to a positive impact on investment in terms of volume and diversification. Therefore; the Palestinian authority must place

emphasis on the growth of investment in efforts to enhance and stimulate economic growth in Palestine.

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