

## Impact of FDI on Economic Growth: The Emerging Trends in India



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### Abstract

In order to attract the required amount of the Foreign Direct Investment (FDI), Government of India has brought about a number of changes in its economic policies and has put in its practice a liberal and more transparent FDI policy with a view to attract more FDI inflows into its economy. Previous researches have inferred that there is relationship between FDI and economic growth. Foreign direct investment increases the productive capacity of economy on one hand and influences the demand on the other side due to increase in the income level. Keeping in view the above said phenomenon, Government of India has abandoned its long held restrictive foreign investment policy in 1991, and sought to compete with the successful Asian economies to get a greater share of the world's FDI. The present study is undertaken to identify the emerging trends with regard to FDI and the impact of FDI on Economic Growth Parameters in India. The economic growth indicators selected for the study are gross domestic production and net domestic production. The results of the analysis indicate that gross domestic product and gross national product increase to a large extent increase in the volume of FDI while other selected parameters also indicate the positive relationship.

**Keywords:** (FDI) Foreign Direct Investment, (GDP) Gross Domestic Product, (UNCTAD) United Nation Conference on Trade and Development, (OECD) Organisation for Economic Co-operation and Development,

### Introduction

#### Foreign Direct Investment and Economic Growth in India: The Emerging Scenario

FDI trends are a complex, multi-dimensional phenomenon, which needs to be examined from macro-economic as well as from strategic perspectives for a more realistic analysis. Much of the currently held perceptions of foreign investment's role essentially take a macroeconomic view. Ending its long held restrictive foreign investment policy in 1991, India sought to compete with the successful Asian economies to get a greater share of the world's FDI. Over the decade, India not only allowed foreign investment in almost all sectors of the economy, but also allowed foreign portfolio investment. Further, laws were adjusted to provide foreign firms the same standing as the domestic ones.

FDI has innumerable effects on the economic development process of recipient as well as the investing country. It influences the income, production, prices, economic growth and industrial development of recipient country. It is also probably one of the most significant factors leading to the globalization or internationalization process. Thus, the enormous increase in FDI flows across countries is one of the clearest signs of the globalization of the world economy over the past twenty years (UNCTAD, 2006). The present study is an attempt to identify the relationship between foreign direct investment in India and the economic growth parameters such gross domestic product and net domestic product of the country during the post liberalization period i.e. from 1991 to 2009.

### Review of Literature

FDI has been regarded in the last decade as an effective channel to transfer technology and foster growth in developing countries. This point of view vividly contrasts with the common belief that was accepted in some academic and political spheres in the 1950s and 1960s, according to which FDI was harmful for the economic performance of less developed countries. Thus, the views presented correlation between FDI and the growth rate of GDP (Calvo and Robles, 2003). Some of the major studies done recently are discussed here under:

DeMello (1999) has hypothesized that FDI has positive impact on the productivity, growth and output of the industries. He has studied the determinants of FDI for 15 OECD and 17 non OECD countries for a period of twenty years from 1970 to 1990 and concluded that FDI has positive impact on the growth of economy through the accumulation of capital. The transfer of knowledge also positively serves for the benefit of economy. FDI has a positive effect upon growth of OECD countries as a result of the transfer of knowledge. But the end result will be positive only if FDI complements domestic investment and will be negative if FDI substitutes domestic investment. Xu (2000) has inferred from a similar study of FDI in forty countries during the period of 1966 to 1994 that the developing countries can get high productivity growth due to technology transfer from FDI.

According to the study by Aggrwal (2000) the FDI has a complementary relationship between FDI and National investment. When the economies are open FDI can have more favorable impacts on for the growth. The author in study regarding impact of FDI on India, Pakistan, Bangladesh, Sri Lanka and Nepal has mentioned a manifold increase in the investment by national investors due to inflow of funds through FDI. But this relationship was not present in closed economy prior to 1980. In this period the impact of FDI inflows on growth rate of GDP is negative. It has been slightly positive for early eighties and strongly positive over the late eighties and early nineties.

Bailliu (2000) concluded that FDI results in higher economic growth when the banking sector is developed enough to complement such an investment inflow. The author has analyzed the impact of FDI on financial development and economic growth in 40 developing countries during 1975-95 and found that capital inflows result in faster economic growth, above and beyond any effects on the investment rate.

Lipsey (2000) in his study have inferred that if the schooling level is good in the host country; the FDI can have positive impact on the growth rate of economy. On the other hand back ward schooling proves a hindrance in the way of growth even with large inflow of FDI. But allow us to infer that the effect of FDI on growth is positive, but reduced, and depends strongly on the interaction with the levels of schooling in the host country.

A study for East Asia and Latin America by Zhang (2001) discussed the importance of FDI in the economic growth by importing technological advancement in the host country. Wang (2001) in an empirical study depicted that FDI in manufacturing sector has a significant and positive impact on growth in the host economies of 12 Asian countries: Bangladesh, China, Hon Kong, India, Indonesia, Korea, Malaysia, Pakistan, Philippines, Singapore, Thailand and Taiwan during the period 1987-97. Thus FDI can play an important role in any developing economy.

According to world investment report of UNCTAD (2003), India is considered as a hub for investment in services, particularly information and

communication technology. In China, about 2/3<sup>rd</sup> of FDI inflows flow into a diverse range of manufacturing industries. Other Indian neighbors, such as Indonesia, Malaysia, and Thailand are also relying heavily on FDI for pulling ahead in economic growth, income levels and productivity, while also increasing their security and geopolitical influence in the world community

Pardhan Jaya Prakash (2003) strongly expressed in his empirical study that FDI can have higher positive impact on the growth process of economy if the level of human development is better. For developing countries with higher human development, the impact of domestic investment on growth is not only positive but also statistically significant, whereas, it has no significant impact in the case of developing countries with lower human development. The study found that the FDI has positive impact on growth process, if the country has a lower human development than a country with a higher human development.

Similarly Sanchez-Robles (2003) posited that economic growth increases with FDI inflows with adequate human capital. Economic stability and liberalized market supplement these inflows. This study was carried out in Latin America and showed a positive correlation between FDI and economic growth. The pre-requisite of long term benefits from FDI are high quality human capital sufficient infrastructure and liberalized market. Study by Alfaro, Chanda, Kelemli-Ozcan and Sayek. (2004) supports the similar views that FDI can play a clear role in the economic growth of a country. The authors studied the relationship between FDI and growth in the financial developed markets covering the period 1975-95.

Lee and Vivarelli (2006) in their study has concluded that controlled liberalization result in high economic growth and human development otherwise financial liberalization can lead to increased poverty and high income disparity. Fry (1992) make a cross action analysis of 16 developing countries for the period 1966-88. His results indicated that FDI is not having any significant impact on economic growth in comparison to domestic investment rather FDI has a negative impact on domestic investment by crowding it out.

Hausmemn and Fernandez-Arias (2000) depicted that a high share of FDI in total capital inflows may be a sign of host country's weakness rather than its strength. A empirical study of Kok and Erosy (2009) shows that the interaction of FDI has a strong positive effect on economic progress in developing countries in some cases. But the interaction of FDI with GDP and inflation gave a negative impact.

Venkateswarlu and Kameshwar Rao (2004) in their empirical has analysis 64 economies for the period of 5 years from 1989-94. They have considered economies of 67 countries again for the period of 5 years from 1995-99. According to their study, there is a strong positive relationship between FDI and per capita GDP. Growth rate of GDP is also found as the determinant of FDI.

Pradhan (2008), in his empirical study identifies these macro-variables, such as current account in balance of payments, economic growth, foreign exchange rate, terms of trade, inflation rate and trade openness, which determine the FDI inflows in India. While the impact of current account in balance of payments and inflation are negative, the impact of openness, economic growth, terms of trade and real effective exchange rate are positive. All are statistically significant except current account in balance of payment and economic growth. Despite the evidence of positive impacts of FDI on growth presented in recent studies, some indicate that developing countries should be cautious in allowing free flow of FDI in their economies.

### Research Methodology

Above, studies have discussed mainly the positive impacts on growth of economy due to FDI. However, some authors argue that FDI can adversely affect the growth process of economy. Singer (1950) argues that FDI has a detrimental impact on developing countries and leads to uneven global development. This is based on the argument that FDI going to developing countries is mainly in the primary sector. However, Singer (1975) modifies his views by focusing on differences between countries rather than commodities. Griffin (1970) and Weisskopf (1972) also support the view that FDI from developed to developing countries does not have beneficial effects. The study has been taken up to establish the relationship between FDI and economic growth parameters in India specifically during the post liberalization period.

### Specific Objectives of the Study

The specific objectives of the study are listed as:

1. To study the growth pattern in FDI in India during the study period.
2. To establish the relationship between FDI and Gross Domestic product.
3. To establish the relationship between FDI and Net Domestic Product.

Eventually the analysis is geared towards evaluating the impact of FDI on the economic growth of the country as represented by selected indicators i.e. GDP at Factor cost, NDP at factor cost, GDP at market price, NDP at market price.

### Data Collection and Analysis

The present study makes use of secondary source of data collected from the publications of Government of India, Reserve Bank of India, Ministry of Industry and Commerce, World Bank, and IMF, UNCTAD, Journals and Periodicals. The reference period of this study relates from 1991 to 2009. Relevant statistical techniques such as growth rate, compound growth rate, t-test and regression analysis has been applied to establish the relationship between foreign direct investment and selected economic growth parameters. FDI is considered as an independent variable and each of the economic indicators as a dependent variable.

### Growth in FDI Inflows

Foreign direct investment is that investment, which is made to serve the business interests of the investor in a company, which is in a different nation distinct from the investor's country of origin. A parent business enterprise and its foreign affiliate are the two sides of the FDI relationship. Together they comprise an MNC. The parent enterprise through its foreign direct investment effort seeks to exercise substantial control over the foreign affiliate company. The trends in FDI inflows in India are presented in Table 1.

**Table- 1**  
**FDI Inflows in India**

Years	FDI Inflows (Rs in Crore)	Yearly Growth (% age)
1991-92	408	
1992-93	1094	168.14
1993-94	2018	84.46
1994-95	4312	113.68
1995-96	6916	60.39
1996-97	9654	39.59
1997-98	13548	40.34
1998-99	12343	-8.89
1999-00	10311	-16.46
2000-01	12645	22.64
2001-02	19361	53.11
2002-03	14932	-22.88
2003-04	12117	-18.85
2004-05	17138	41.44
2005-06	24613	43.62
2006-07	70630	186.96
2007-08	98664	39.69
2008-09	98860	0.20
<b>CAGR (% age)</b>	<b>25</b>	
<b>t test</b>	<b>27.00*</b>	

**Source: Fact Sheet, Department of Industrial promotion, Ministry of Finance, GOI.**

FDI inflows have also shown very unusual trends. But the position regarding the actual inflows was slightly better when we consider the CAGR which worked out at 25 percent for the period 1991-92 to 2008-09. Until the end of 2009 the annual growth rate has been positive. But there has been the presence of the growth at a decreasing rate. When the absolute figures of amount are taken in consideration it is inferred that there has been a gradual rise in the FDI inflows from Rs.408 crore in 1991-92 to Rs.13548 crore in 1997-98 followed by a decline at Rs.10311 crore in 1999-00. The recovery to Rs.12645 crore to place in 2000-01 which ended up at Rs.19361 crore by the end of financial year 2002-03. Having seen a dip to Rs.12117 crore in 2003-04, the actual FDI inflows started rising and by capturing this trend the amount reached to Rs.98860 by 2008-09. The trends in FDI inflows discussed here resulted into a CAGR of 25 percent which is significant as indicated by the t-test (27.00) as well.

### Gross Domestic Product

Gross Domestic Product measures the total output produced within a country's borders - whether produced by that country's own firms or not. Gross domestic product at factor cost is the value at factor

cost of the product, before deduction of provisions for the consumption of fixed capital, attributable to factor services rendered to resident producers of the given country. It differs from the gross domestic product at market prices by the exclusion of the excess of

indirect taxes over subsidies. GDP can be measured in terms of gross domestic product at factor cost, gross domestic product at market price. The growth in India' gross domestic product and net domestic product during the study period is listed in table 2.

**Table- 2**  
**Trends in Gross Domestic Product in India**

Years	GDP FC (Rs in Crore)	Yearly Growth (% age)	GDP MP (Rs in Crore)	Yearly Growth (% age)	NDP FC (Rs in Crores)	Yearly Growth (%)	NDP MP (Rs in Crore)	Yearly Growth (%)
1991-92	594168		654729		532197	--	592759	--
1992-93	681517	14.70	752591	14.95	609389	14.50	680462	14.80
1993-94	792150	16.23	865805	15.04	711268	16.72	784923	15.35
1994-95	925239	16.80	1015764	17.32	831417	16.89	921942	17.46
1995-96	1083289	17.08	1191813	17.33	972163	16.93	1080686	17.22
1996-97	1260710	16.38	1378617	15.67	1132320	16.47	1250226	15.69
1997-98	1401934	11.20	1527158	10.77	1258185	11.12	1383409	10.65
1998-99	1616082	15.28	1751199	14.67	1453881	15.55	1588997	14.86
1999-00	1786526	10.55	1952036	11.47	1605104	10.40	1770614	11.43
2000-01	1925017	7.75	2102314	7.70	1723199	7.36	1900496	7.34
2001-02	2097726	8.97	2278952	8.40	1869429	8.49	2050655	7.90
2002-03	2261415	7.80	2454561	7.71	2010907	7.57	2204053	7.48
2003-04	2538170	12.24	2754620	12.22	2258122	12.29	2474572	12.27
2004-05	2877701	13.38	3149407	14.33	2548660	12.87	2820366	13.97
2005-06	3282385	14.06	3586743	13.89	2902074	13.87	3206432	13.69
2006-07	3779384	15.14	4129173	15.12	3342346	15.17	3692136	15.15
2007-08	4320892	14.33	4723400	14.39	3811442	14.03	4213949	14.13
2008-09	4933183	14.17	5321753	12.67	4353400	14.22	4653280	10.43
<b>CAGR (% age)</b>		<b>12.60</b>		<b>12.50</b>		<b>12.50</b>		<b>12.30</b>
<b>t test</b>		<b>408.88</b>		<b>421.14*</b>		<b>386.80*</b>		<b>401.86*</b>

Note CAGR- Compound Annual Growth Rate.

**Sources:** Compiled from the statistics released by Secretariat for Industrial Assistance, Department of Industrial Policy & Promotion, Ministry of Commerce & Industry & Monthly Newsletter, Indian Investment Centre and Govt. of India.

#### Growth in GDP at Factor Cost

The highest annual growth rate, GDP at Factor Cost is (17.08percent) during 1995-96 and the lowest growth rate (7.75 percent) in2000-01. The period of seven years from 1993-94 to 1999-00 appears to be the period of speedy rise in GDP at Factor cost as the yearly growth rate during these years were the highest (10.55 percent in 1999-00, the minimum and 17.08 percent in 1995-96, the maximum). The decade ending 2001-02 has witnessed wide fluctuations in annual growth rate in GDP at Factor cost, i.e. 7.75 percent is lowest in 2000-01 and 17.08 percent the highest in 1995-96. The CAGR for the study period work out to be at 0.126 percent.

#### Growth in GDP at Market Price

GDP at market price- Its the money value of all final goods and services produced within the domestic territory a country in an accounting year at prevailing market prices.The highest annual growth rate of Gross Domestic Product at Market price is (17.33 percent) during 1995-96 which is also the period of maximum FDI approvals in India. The lowest growth rate is 7.70 percent in 2000-01. The period of five years from 1993-94 to 1997-98 appears to be the period of boom in GDP at Market as the yearly growth rate during these years were the highest (10.77

percent in 1997-98, the minimum and 17.33 percent in 1995-96, the maximum). The CAGR for that period (1991-92 to 2008-09) of eighteen years worked out at 12.50 percent.

#### Net Domestic Product

The net domestic product (NDP) equals the gross domestic product (GDP) minus depreciation on a country's capital goods.Net domestic product accounts for capital that has been consumed over the year in the form of housing, vehicle, or machinery deterioration. The depreciation accounted for is often referred to as "capital consumption allowance" and represents the amount of capital that would be needed to replace those depreciated assets. Thus, NDP estimates how much the country has to spend to maintain the current GDP. If the country is not able to replace the capital stock lost through depreciation, then GDP will fall. In addition, a growing gap between GDP and NDP indicates increasing obsolescence of capital goods, while a narrowing gap means that the condition of capital stock in the country is improving. NDP can be measured in terms of net domestic product at factor cost, net domestic product at market price.

#### Growth in Net Domestic Product at Factor Cost

The highest annual growth rate of Net Domestic Product at Factor Cost is (16.93 percent)

during 1995-96 and the lowest growth rate (7.36 percent) in 2000-01. The period of five years from 2003-04 to 2007-08 appears to be the period of boom in NDP at Factor cost as the yearly growth rate during these years were the highest (12.29 percent in 2003-04, the minimum and 14.03percent in2007-08, the maximum). The decade ending 2001-02 has witnessed wide fluctuations in annual growth rate in NDP at Factor cost, i.e. 7.36 percent is lowest in 2000-01 and 16.93 percent the highest in 1995-96. The CAGR for that period (1991-92 to 2008-09) of eighteen years worked out at 12.50 percent.

### Growth in Net Domestic Product at Market Price

The decade ending 2001-02 has witnessed wide fluctuations in annual growth rate in Net Domestic Product at market price, i.e. 7.34 percent is lowest in 2000-01 and 17.46 percent the highest in 1994-95. The next decade of 2001-2010 has rather

shown a uniform growth except the year 2008-09, where the growth rate has decline at 10.43 percent. The highest annual growth rate is (17.46 percent) during 1994-95 and the lowest growth rate (7.34 percent) in 2000-01.

### Correlation between FDI and Economic Indicators

This section of the study presents the results of inter-correlation analysis with respect to the relationship between FDI inflows in India and individuals economic indicators and the economic indicators inter-se. For the impact of examine the impact of FDI on economy growth is presented by different economic indicators or a vice versa, it is imperative to see their standard of relationship with each other to the values of correlation coefficient. Table 3 presents the results of multiple correlations (Pearson's)

**Table-3**  
**Inter-correlations between FDI and Economic Indicators**

Variables		FDI	GDPFC	NDPFC	GDPMP	NDPMP
FDI	P Cor	1				
	Sig.					
GDPFC	P Cor	.893**				
	Sig.	0.955				
NDPFC	P Cor	.892**	1.000**			
	Sig.	0	0			
GDPMP	P Cor	.892**	1.000**	1.000**		
	Sig.	0	0	0		
NDPMP	P Cor	.887**	1.000**	1.000**	1.000**	1.00**
	Sig.	0	0	0	0	0

\*\* Correlation is significant at the 0.01 level (2-tailed).

P Cor- Pearson's Correlation and their significance at the 0.01 level.

FDI is significantly correlated for the selected economic indicators. In the case of GDPFC, it is seen that it has significant correlations with the other selected variables. The significant correlations range from .973 (between GDPFC and NDPFC) to 1.00 (between GDPFC and NDPFC, GDPMP & NDPMP). It means that there is a perfect correlation between GDPFC and other variables; that value of r is 1.00. In the case of NDPFC, it is seen that it has significant correlations with other selected variables. The significant correlations range from 0.972 (between NDPFC and NDCF) to 1.00 (between NDPFC and GDPMP, NDPMP). It shows that there is a perfect correlation between NDPFC and other variables that is value of r is 1.00. Almost similar results can be seen with respect to the correlation of GDPMP and NDPMP with other variables. In the case of GDPMP the values of significant correlation range from .973 (between GDPMP and NDCF) to 1.00 (between GDPMP and NDPMP). In the case of NDPMP, there

is a perfect correlation between NDPMP and other variables.

### Impact of FDI on Economic Growth

FDI is considered as an independent variable and each of the economic indicators as a dependent variable. The regression results are presented and discussed separately for each set of relationship. The statistical tables for each set of variables are presented in three parts: part 1- Model Summary; part 2- ANOVA; and part 3- Coefficients. The model summary, among other things is the value of R2 which indicates the extent to which the regression line fits the points. Value of R2 can range from 0.000 to 1.000 and the higher value of R2 will indicate that the variation in the value of particular economic indicator is explained by FDI in a larger measure. The model summary also gives adjusted R2, which we have ignored in the analysis because it is used in multiple regressions while we have performed a simple, two variable linear regression analyses. The results so obtained are given in table 4.

**Table- 4**  
**Regression Results**

Variables	R2	F Values	Constant	B
Gross Domestic Product at Factor Cost	0.798	63.09	1294976	0.893
Gross Domestic Product at Market Price	0.795	62.12	1417086	0.892
Net Domestic Product at Factor Cost	0.796	62.28	1160800	0.892
Net Domestic Product at Market Price	0.786	58.85	1288477	0.887

The study has shown if FDI is increased by one unit the GDP at factor cost will be increased by 32.732 units as indicated by equation given below:

$$\text{GDP at factor cost} = 1294976 + 32.732 \text{ FDI}$$

The value of the constant 1294976 says that if FDI were zero the export would be 1294976 Rs in crore. Thus we can say that FDI has a positive impact in GDP at factor cost. The change in GDP at factor cost is 79.8 percent along with change in FDI which also confirms the above relationship. FDI has impacted the GDP at Market price in the same positive manner just as GDP at factor cost. If FDI increased by one unit the GDP at Market price will be increased by 35.455 units. As indicated by equation given below.

$$\text{GDP at Market Price} = 1417086 + 35.455 \text{ FDI}$$

The value of the constant 28142.155 says that if FDI were zero the GDP at Market price would be Rs. 1417086 crores. the change in FDI account for 79.5 percent of the systematic variations in GDP at Market price along with other factors during the period 1991-2009. These results are also supported by F statistics of ANOVA table. These results are also supported by F statistics (ANOVA table), which confirm statistically significance of R2. It is expected that FDI will impact the NDP at Factor cost in a positive manner.

$$\text{NDP at Factor cost} = 1160800 + 28.727 \text{ FDI}$$

The expectation has been met in a positive manner as an increase of one unit in FDI increased NDP at Factor cost by 28.727 units as indicated by above equation. The value of the constant 1160800 says that if FDI were zero the NDP at Factor cost would be 1160800 RS in crore. The same results have confirmed the value of coefficient of determination, represented by symbol R2 is 0.796, which imply that the change in FDI account for 79.6 percent of the systematic variations in NDP at Factor cost along with other factors during the period 1991-2009. The change in FDI account for 78.6 percent of the systematic variations in NDP at market price along with other factors during the period 1991-2009. These results are also supported by F statistics (ANOVA table), which confirm statistical significance of relationship.

$$\text{NDP at market price} = 1288477 + 31.033 \text{ FDI}$$

The t statistics (7.526) and the significance level of coefficients reveal that FDI and NDP at market price have a significant relationship with each other. The value of test statistics for the slope is 7.671.

#### Results and Discussion

The CAGR for GDP at factor cost and at market price worked out at 12.60 percent and 12.50 percent respectively, at the same level of significance. Almost similar picture is obtained with respect to the net domestic product (NDP) at factor cost and at market price of which the CAGR for this period worked out at 12.50 percent and 12.30 percent, respectively. The GDP, which is considered as a robust measure of the economic soundness of an economy, is found to have very high positive correlation with FDI and the other selected variables

of economic growth. The regression results have revealed that the change in FDI account for 79.8 percent of the systematic variations in GDP at factor cost along with other factors.

The descriptive statistics shows that on an overall basis GDP and NDP at market price are the most important variables with growth rate of GDP at market price 17.52 percent and NDP at market price 17.46 percent increase in 1995-95. Thus the study depicts that both FDI inflows and various indicators of growth have positive and statistical significant relationship. The results prevail that all these variables are inter correlated significantly. Thus we can say that gross domestic products and gross national product increase to a large extent with FDI increase. Other factors have also shown a considerable growth due to FDI increase.

#### Conclusions

The paper concludes that FDI can have many positive impacts on the host economy. These impacts come about largely through the transfer of technology and other tangible assets leading to productivity increase, efficiency in there source allocation. The positive impacts also came through contracts with local companies which increase their productivity and facilitate the long term high growth rate. Based upon these findings it is recommended that the Government of India should improve the local regulatory environment, develop financial market and insure market investment opportunity to enhance the benefits of FDI. Since 1991, the government has slowly implemented a program of economic reform under which it has gradually relaxed many of the constraints.

Nonetheless, a complex group of restrictions remains, along with an undercurrent of hostility towards foreign investment from some quarters. These sectors need to be opened on case by case basis for FDI approvals. Thus the government of India should bring such policy reforms which can attract more FDI in country and remove hindrances in the way of FDI in export oriented manufacturing. These investments can help India in expanding manufacture exports resulting into still higher economic growth. Therefore, it is concluded that FDI is a key ingredient for successful economic growth in developing countries.

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