CHAPTER 2

REVIEW OF LITERATURE

This chapter is focused on theoretical rationale and empirical research of foreign direct investment in developing countries. It is important to delineate in the beginning that coverage of chapter has purposely been selective, the major criterion being the relevance of the material to the purpose and scope of the present study. The present chapter is structured as follows: Section 2.1 presented theoretical reviews and section 2.2 provides empirical evidence which is further divided into three subsections. Sub-sections 2.2.1 to 2.2.3 are devoted to studies related to nature and magnitude of FDI, determinant of FDI and impact of FDI on economic growth.

2.1 Theoretical Review:

Since FDI theory is derived from economic growth theory, there are those scholars who explained FDI determinants based on neo-classical theory and those who used more modern new growth theories that “built” on neo-classical theory in their search of an alternative model. Neo-classic theory under the assumption of a perfect market asserts that multinational corporations invest abroad as a result of differences in returns on investments among countries. According to this theory, factors of production are usually moved from countries with low returns on investments to countries with high returns on investments (Fan, 2002).
The neo-classic theory looks at FDI from the free-trade perspective, but it is unrealistic because the market is not perfect, and the theory fails to explain how a region may have a relatively high return at a given period and still not be attractive to foreign investors during the same period. The new endogenous theory assumes imperfect market conditions. With imperfect markets, the monopolist or oligopolist tends to profit through product differentiation due to asymmetric information or economy of scale.

Lucas (1993) derived demand theory that was a monopolist model with multiple plant production that incorporated differentiation across plants with the purpose of maximizing profits. The new endogenous theory assumed imperfect market conditions. With imperfect markets, the monopolist or oligopolist tend to profit through product differentiation due to asymmetric information or economies of scale. In the oligopolistic industries, firms had economies of scale and other characteristics that gave them market power advantages. These market advantages were usually taken to be disadvantages since multinational companies (MNCs) often had to operate in host countries given their competition against local firms in countries those have FDI activities (Brewer, 1993).

The treatment of capital from the firm's perspective without much consideration in comparison to the impact government policies had on FDI determinants remained the main weakness of this theory. A strand from the modern theory just mentioned above and perhaps one of the most
popular one that focused on the internalization of transactions and cost minimization within MNCs. This theory used the transactions cost differentials across borders to explain the generalized motive for international investment.

Dunning's eclectic theory (1998), which integrates internalization theory, remains the most widely mentioned theory to date on FDI determinants because it attempts to provide a more generally plausible theory of FDI determinants. Dunning's theory of FDI determinants or OLI (Ownership, Location, and Internalization) relies heavily on the configuration of three sets of forces for FDI to occur in a location. First, a firm must be able to compete with domestic firms, which have obvious advantages due to the possession of information on the local economy. The foreign firm is able to overcome asymmetric information disadvantages with its market power advantages of technology, human training and skills, including access to large capital, etc. Second, there must be location advantages (possessing natural resources), which attract FDI more than the natural resources in other locations.

Third, there must be internalization, meaning transaction costs differentials (such as trade and licensing) created by an imperfect market across-borders making FDI a more attractive alternative. Yeaple, (2002) in his study revealed that avoiding costs associated with international trade was considered a major motive for a multinational enterprise to set up firms in multiple countries. Production process can be decomposed into
various stages and might produce in multiple countries to determine where their productive factors could be put into use at minimum cost.

Dunning's theory provides a framework for the study on FDI determinants by introducing, as he puts it, "a methodology and a set of generic variables possessing the ingredients necessary to explain certain forms of international transactions" (Dunning, 2001). The eclectic paradigm provides the tools for analyzing the determinants of international production, which is why this theory has been selected in this study to provide the framework for explaining the MNC's cross-border investment decisions.

Barro and Martin (1997) agree with the neo-classical model when a pattern of conditional convergence emerges in their own diffusion of technology model (when two economies' technologies tend to narrow due to blending). They argue that there was relatively low cost of imitation at the initial stage and follower nations tend to grow faster to catch up with leader nations, but, the costs of imitation tend to rise and the followers' growth rate tends to fall" indicating diminishing returns of capital.

Solow's (2001) neoclassical growth theory explained economic growth with the accumulation of factors of production to be subjected to diminishing returns to scale. The neo-classical model was the earlier model and literally forms the basis for the new growth theory. These major theories on which those debates were built are reviewed, followed by the discussion of some of the main studies on foreign direct investment
incentives. Solow's neo-classical theory argued that there was a faster rate of growth that occurred in the economies starting further below their steady-state positions (condition of the economy in which productivity of labour and capital intensity do not change over time); so, holding the determinants of the steady-states positions fixed, the neo-classical model predicted faster per capita growth rate in poorer economies.

2.2 Empirical Reviews:

The Empirical review of literature is divided under three sub-sections as follows:

2.2.1 Studies Related to Nature and Magnitude of FDI

2.2.2 Studies Related to Determinants of FDI

2.2.3 Studies Related to Impact of FDI on Economic Growth

2.2.1 Studies Related to Nature and Magnitude of FDI

As early as in 1957, Mundell studied the production factors those were considered to be similar in all the countries and the regions. The international trade and mobility of the production factors carried a feature of substitution rather than being complementary for the countries where the trade barriers existed. Accordingly, while the increase in the trade barriers warned the factor movements, the barriers on the factor movements promoted the trade.

Stevens (1969) demonstrated a statistically significant relationship between the flows of FDI from the US into manufacturing sector of
Argentina, Brazil, and Venezuela in this sector. He found that the flow of FDI into less developed countries is correlated with their GDP.

United Nations Report (1998) revealed that global market was a very competitive place for the host countries looking for investment capital as well as for multinational corporations. Multinational corporations planned to expand overseas must take more innovative steps in their operations to be competitive. These steps included seeking bigger market shares, pursuing creative assets such as technology through research and development, and increased innovative capacity with the corollary of a skilled workforce. These people-made created assets take competition to a higher level.

Salinger (2001) in his study revealed that one way to increase profit was to reduce input cost, such as on transportation, communication, utility, and other operating costs through efficiency driven FDI. Unfortunately input costs such as cost of transportation, communication, and tariffs were quite high in Sub-Saharan Africa (SSA). Africa had the highest transport cost in any region. Freight cost for import was sometimes 70 per cent higher in East and West Africa than in developing Asia (Ngowi, 2001). These high costs were due in part to the geographical locations of many African countries those were landlocked with no access to the outside World via commercial waters like big rivers, lakes, seas, and oceans.
Ghosh (2005) analyzed that if India learnt to remove its inhibitions about FDI and followed the footsteps of China, then India would be in a position to realize its full potential. China’s FDI saga had been a textbook replay of what institutional economics would call “adaptive efficiency” on the part of its political regime. The country made courageous but careful choices in difficult circumstances, signaling radical departure from the belief system which had been accustomed to for decades.

Guruswamy, et al., (2005) found that retail in India was severely constrained by limited availability of bank finance and dislocation of labor. The study suggested suitable measures like need for setting up of national commission to study the problems of the retail sector and to evolved policies that would enable it to cope with various inputs of FDI. The study concluded that the entry of FDI in India's retailing sector was inevitable. However, with the instruments of public policy in its hands, the government could slow down the process. The small retailers were given the opportunity to provide more personalized service, so that their higher costs were taken advantage of by large supermarkets and hypermarkets.

Mickiewicz, Rasosevic and Varblane (2005), examined the role of FDI in job creation and job preservation as well as their role in changing the structure of employment. Their analysis pertained to Czech Republic, Hungary, Slovakia and Estonia. They presented descriptive stage model of FDI progression into Transition economy. They analyzed the employment
aspects of the model. The study concluded that the role of FDI in employment creation/preservation had been most successful in Hungary than in Estonia. They found that the increasing differences in sectoral distribution of FDI employment across countries were closely related to FDI inflows per capita. The bigger diversity of types of FDI was more favorable for the host economy. There was higher probability that it would lead to more diverse types of spillovers and skill transfers. If policy was unable to maximize the scale of FDI inflows then policy makers should focus much more on attracting diverse types of FDI.

Denisia, (2010), identified the main trends in FDI theory and highlighted how these theories were developed, the motivations that led to the need for new approaches to enrich economic theory of FDI, revealed that for FDI there is not a unified theoretical explanation, and it seems at this point very unlikely that such a unified theory will emerge. Neoclassical trade theory failed to explain the existence of Multi National Corporations. Explanations in terms of differences in rates of return between countries could explain portfolio investments, but not foreign direct investments (FDI). Till 1960, it was not clear with the available explanation. After all, these different attempts to explain why FDI takes place, the pioneering work by Hymer (1976), the conceptual framework and one of the important theory proposed by Dunning (1977), the OLI paradigm came in to existence.
Bhavan et al., (2011) investigated the determinants and growth effect of FDI in case of four South Asian countries over the period of 1995-2008. It comprised two major analytical parts. Firstly, incorporation of gravity model equation in order to investigate potential determinants of foreign direct investment in these countries. Secondly, study used a growth model equation to investigate growth effect of foreign direct investment in the countries. In both analyses, researchers used panel data and employed Arellano-Bond dynamic panel system method of moment estimator. The results derived from this study suggested that the pulling, pushing and cyclical factors are crucially important in determining FDI in South Asian countries and foreign direct investment in South Asian countries is significant and positively associated with growth rate, but seems to be having average supportive to the growth rate in these countries.

Castiglione et al., (2012) investigated the factors attracting FDI into highly diversified Russian regions during the phase of transition, and verified the impact of transition experience on the current FDI inflow. Using cross-sectional and panel data, the results demonstrated that the highly inhomogeneous investment pattern is explained, in addition to classical demand factors, by specific economic and socio-institutional regional characteristics. Russia appeared as an idiosyncratic country where foreign investors sought a stable social and institutional context. Using recent FDI data the study showed that transition experiences
influence current FDI inflow, particularly when the strength of the institutional environment and availability of infrastructures were taken into account.

2.3.2 Studies Related to Determinants of FDI

Hymer's (1960) influential work refined and publicized by Kindleberger (1969), in which an alternative classification of the host country determinant of FDI distinguished between business facilitation measures, the policy framework for FDI and economic determinants. Business facilitation measures included investment incentives, measures directed at reducing the hassle cost related to corruption and administrative inefficiency, and social amenities. Policy determinant of FDI comprised policy and political stability, rules relating to FDI, international agreements on FDI and privatization, trade and tax policies. The economic determinants included market size, market structure, availability of raw materials, labor physical infrastructure, cost of resources, labor productivity.

Root and Ahmed (1979) have analyzed the determinants of FDI inflow for 70s countries over the period 1966-1970. Using the discriminant analysis, they tested whether sixteen economic variables, five social variables, and seven political variables have a significant influence on FDI inflows. They found that four of the economic variables namely per capita GDP, GDP growth rate, economic integration and
infrastructure (commerce, transport, and communication), one social variable namely degree of urbanization, one political variable namely number of changes in government leadership were all found to be significant at 5% level.

Levis (1979) tested the hypotheses that economic considerations were primary and political considerations were secondary determinants of FDI. He tried to study a regression for 25 developing countries from Africa, Asia, and Latin America for the period 1965 to 1967 and found balance of payment position, per capita GNP and government capabilities to be important determinants of FDI. He concluded that economic variables were more important determinants of FDI.

Dunning (1981) used eclectic theory of FDI to test how FDI inflows reacted to the degree of industrialization in host countries. He studied 67 countries for the period 1967-1978. The study used multiple discriminant analysis to determine which of the three variables, organizational human capital (measured as percentage of professional, technical, administrative and managerial workers to total workforce), expenditure on R&D as a percentage of GNP; internationalization (royalties and other fees received by home companies) and locational variables natural resources endowments (measured by exports of primary products), infrastructure index (the average of the percentage of urban to total population and the percentage of secondary school children registered to the total in the appropriate age group) and risk index best explained FDI inflows. He
found that while economic variables were significant determinants of FDI, political variables were not.

Petrochilos (1989) used time series data for the period 1955-1978 to identify the determinants of FDI in Greece. The variable he chose were GDP (a proxy for market size), absolute change in GDP, percentage change in GDP, tariff rates, interest rate, US long term bond yield (a proxy for cost and capital) and a dummy variables to capture political effects. Using a log-linear multiple regression model, he found that main determinants of FDI in Greece were size of market, tariff production for manufactures, the Greece interest rate and political stability.

Lucas (1993) examined the determinants of FDI inflows into Indonesia, South Korea, Malaysia and Philippines, Singapore, Taiwan and Thailand for the period 1960-1987. He found that FDI flows were responsive to costs and prices in the host country. Greater wages and industrial disputes were found to have a negative impact on FDI. In most countries he found a positive association between foreign and domestic investment. He found that FDI was more elastic with respect to aggregate demand in export market than domestic demand. Using episodic dummies, he argued that where factors were insufficient to explain departure from the pattern of FDI inflows, we must look at political instability or changes in regimes for explanations.

Wei (1995) showed that geographical proximity was a strong factor in a choice of location, but the case of China was unique. In case of India
intra-regional trade and investment was still small although a great deal of potential existed. Western developed countries had been India's largest trading and investment partners. Although Japan, Korea, and Mauritius had emerged as important investors in India. It was hypothesized that western investors were going to dominate the FDI scene in India for quite some time. In the Indian context therefore a positive relationship was observed between FDI and distance.

Jun and Singh (1996) have postulated that desired stock was based on political instability and tested the model for 31 countries for the period 1970-1993. The researchers used control variables like market size, wage cost, exchange rates and private sector structuring programs and exports and used cross section and time series model. They concluded political instability to be a significant determinant of FDI.

Nishat and Aqeel (1998) discussed the variety of variables to study the determinants of FDI in Pakistan. GDP general index of share prices, coal production (proxy for mineral resources) value added in wholesale and retail trade, value added in transport and communications, employment in manufacturing and mining, number of industrial disputes, ratio of export to GDP, number of telephone lines, length of road in kilometers, primary education enrollment and a structural dummy had all been used as variables. They found GDP, value added in wholesale and retail trade, employment in mining, manufacturing and telephone connections to be significant variables.
Nugent and Pashamova (1998) used pooled cross section and time series data for 49 developing countries over 1970-1995 to examine the effects of corporate tax rates, tariff rates, degree of openness, exchange rate distortions, contract enforcement, nationalization risk, bureaucratic delay and corruption FDI inflows. A multivariate analysis of the effects on FDI of each type of policy, with and without control for other determinants was concluded. Some important finding were that exchange rate distortion did not have significant effect on FDI inflows, institutional factors such as bureaucratic delay and contract enforcement had dextorous effect on FDI and high corporate marginal taxes exerted a significant negative impact on FDI.

Dees (1998) examined panel data to study the determinants of FDI in China. The variable used were GDP (proxy for market size) the relative wage rates between Chinese economy and east countries in the vicinity that were potential revival destinations for FDI in the region, the real exchange rate, the stock of parents registered by home countries in the US (proxy for the cost of licensing agreements, which in turn was taken to be related to the degree of innovation by the investing firms) and the exports of the home countries to China. Twelve countries which accounted for about 90 per cent of the total FDI flows to China had been included in the study. The period covered was 1983-1995. The results showed that the level of GDP had a large positive effect on the stock of inward investment.
and negative relationship between FDI and real wage rate and real exchange rate.

Talerngsri (2001) in his study identified and investigated the 'industry-level Determinants' of FDI in the context of Asian industrialized countries by using the data on Japanese FDI in Thailand. The study examined the influences of location-specific characteristics of host industries such as factor endowments, trade costs, and policy factors. More distinctively, it examined the effect of vertical (input-output) linkages among Japanese firms. The study found out that Japanese FDI in Thailand was not evenly distributed across manufacturing activities. Some capital technological intensive industries like rail equipments and air crafts did not receive any FDI during a specified period. On the other hand, other relatively labour intensive industries like TV Radio, and communications equipment industry and motor vehicle industry received disproportionately large values of FDI.

Ngowi (2001) studied consumer buying power and preferences and selection criteria of firm that concerned market size, structure, and growth, access to regional and global markets about market-seeking type of FDI. There were multinational corporations those were more concerned with the resources of a country or region. The search targeted countries with the needed raw materials, cheap labor, and physical infrastructure. Multinationals selected the regions like Sub Saharan Africa (SSA),
because of abundant natural resources of the region. As a result the SSA was rich with resource seeking FDI more than any other form of FDI.

Garibaldi et al., (2002) analyzed the FDI and portfolio investment that flowed to 26 transition economies in Eastern Europe including the former Soviet Union from 1990 to 1999. The regression estimation indicated that the FDI flows were well explained by standard economic fundamentals such as market size, fiscal deficit, inflation and exchange rate regime, risk analysis, economic reforms, trade openness, availability of natural resources, barriers to investments and bureaucracy. However, the portfolio flows were poorly explained by the fundamentals.

Afees (2004) analysed the determinants and impact of Foreign Direct Investment on economic growth in developing countries. The study observed that inflation, debt burden, and exchange rate significantly influenced FDI flows into Nigeria. The study suggested the government to pursue prudent fiscal and monetary policies that would be geared towards attracting more FDI and enhanced overall domestic productivity, ensure improvements in infrastructural facilities and to put a stop to the incessant social unrest in the country. The study concluded that the contribution of FDI to economic growth in Nigeria was very low even though it was perceived to be a significant factor influencing the level of economic growth in Nigeria.

and long-term determinants of both FDI were estimated. This study concluded that, in the short and the long run, Japanese FDI was found to be driven by trade factors and the yen appreciation. While the American FDI was driven by market factor, specifically the income level of Thai people. Japanese FDI was trade oriented, whereas the American FDI was market seeking oriented.

Dunning (2004) in one of his studies stressed upon the significance of institutional infrastructural development as a determinant of FDI inflows into the European transition economies. The study examined the critical role of the institutional environment (comprising both institutions and the strategies and policies of organizations relating to these institutions) in reducing the transaction costs of both domestic and cross border business activity. By setting up an analytical framework the study identified the determinants of FDI, and how these had changed over recent years.

Iyare, Bhaumik and Banik (2004), found that FDI flows were generally believed to be influenced by economic indicators like market size, export intensity, institutions, etc, irrespective of the source and destination countries. This paper looked at FDI inflows in an alternative approach based on the concepts of neighborhood and extended neighborhood. The study showed that the neighborhood concepts were widely applicable in different contexts particularly for China and India, and partly in the case of the Caribbean. There were significant common
factors in explaining FDI inflows in selected regions. While a substantial fraction of FDI inflows explained by selected economic variables, country specific factors and the idiosyncratic component account for more of the investment inflows in Europe, China, and India.

Andersen and Hainaut (2004) found that high labour costs encouraged outflows and discouraged inflows and that such effect can be reinforced by exchange rate movements. The distribution of FDI towards services also suggested that a large proportion of foreign investment was undertaken with the purpose of expanding sales and improving the distribution of exports produced in the source countries. According to this study the principle determinants of FDI flows were prior trade patterns, IT related investments and the scopes for cross border mergers and acquisitions. Finally, the authors found clear evidence that outflows complemented rather than substitute for exports and thus helped to protect rather than destroy jobs.

Minquan, Luodan and Liu (2004) presented findings from a Survey of Foreign Invested Enterprises (FIEs) in Guangdong China, on the relationship between Foreign Direct Investment and wage related labour standards (regular wages, and compliance with official overtime and minimum wage) which showed that wage related standards were statistically high in FIEs whose home countries' standards were higher, after controlling for other influences. However, a cost reduction FIE was more likely to be associated with inferior standards.
Jongsoo (2004) examined that industrial clusters were playing an important role in economic activity. The key to promoting FDI inflows into India had laid in industries and products those were technology intensive and had economics of scale and significant domestic content.

Thai (2005) examined the impact of FDI on Vietnamese economy by using Partial Adjustment Model for time series data from 1976 to 2004. FDI was shown to have not only short run but also long run effect on GDP of Vietnam. The study also examined the impact of trade openness on GDP and it was found that trade was stronger than that of FDI.

Jordaan (2005) evaluated the impact of a number of economic and socio political influences of neighbouring countries on the host country’s FDI attractiveness. Three groups, consisting of developed, emerging and African countries were evaluated, with the main emphasis on African countries. Results of the study indicated that an improvement in civil liberties and political rights, improved infrastructure, higher growth rate and a higher degree of openness of the host country, higher levels of human capital attracted FDI to the developed countries but discouraged FDI in emerging and African countries indicating cheap labour as a determinant of FDI inflows to these countries. Further, oil owned countries in Africa attracted more FDI than non oil endowed countries emphasising the importance of natural resources in Africa.

Ming, Hua and Ching (2005) examined the impact of exchange rate movements on Foreign Direct Investment. Their empirical findings
indicated that the exchange rate level and its volatility in addition to the relative wage rate had a significant impact on Taiwanese firms' outward FDI into China. They concluded that the relationship between exchange rates and FDI was crucially dependent on the motives of the investing firms.

Meyer, et al., (2005) showed considerable variations of the characteristics of FDI across the four countries, all had restrictive policy regimes, and had gone through liberalization in the early 1990. Yet the effects of these liberalization policies on characteristics of inward investment varied across countries. This analysis found appropriate ways to control the determinants of mode choice, when analyzing its consequences. The study concluded that the policy makers needed to understand how institutional arrangements might generate favourable outcomes for both the home company and the host economy. Hence, we needed to better understand how the mode choice and the subsequent dynamics affected corporate performance and how it influenced externalities generated in favour of the local economy.

Galan (2006) analysed the importance of liberalization and FDI in Mexico's economy. The major findings of the study demonstrated that the main determinants of GDP were capital accumulation, labour productivity and FDI. Further, findings confirmed that exports, differences in relative wages and currency depreciation were explicative of FDI. Exports were highly dependent on the World economy and exchange rate fluctuations.
Labour productivity and FDI improved human capital. Similarly GDP and human capital induced productivity gains and capital accumulations improved due to technology transfers, infrastructure, personal income. The study showed that an expansionary monetary policy had the capacity to decelerate the interest rate and thereby to enhance FDI and its spillovers.

Ramirez (2006) examined the impact of foreign direct investment on labour productivity function for the 1960-2001 period. It included the impact of changes in the stock of private and foreign capital per worker. The error correction model estimates suggested that increase in both private and foreign investment per worker had a positive and economically significant effect on the rate of labour productivity growth. However, after taking into account the growing remittances of profits and dividends, there was a marked decrease in the economic effect of foreign capital per worker on the rate of labour productivity growth. The study assessed the short term interactions of the relevant variables via impulse response functions and variance decompositions based on a decomposition process that did not depend on the ordering of the variables.

Lipsey and Chrystal (2006) offered a definition for hyperinflation. They stated it as “Inflation so rapid that money ceases to be useful as a medium of exchange and a store of value.” But it was also conceded that countries with inflation rate higher than 50 per cent, to some 200 per cent plus, had proven to be manageable as the population adjusts in “real
term”. These literatures had highlighted that inflation destroyed the value of currency. The impact on growth was negative, and in turn, a negative impact on FDI.

Crespo and Fontoura (2007) in their work “Determinant Factors of FDI Spillovers – What Do We Really Know?” analyzed the factors determining the existence, dimensions and sign of FDI spillovers. They identified that FDI spillovers based on many factors like absorptive capacities of domestic firms and regions, the technological gap, or the export capacity.

Rusike (2007) analysed trends and determinants of inward foreign direct investment to South Africa for the period 1975-2005. The analysis indicated that openess, exchange rate and financial development were important in long run determinants of FDI. Increased openess and financial development attracted FDI, while an increase (depreciation) in the exchange rate prevented FDI to South Africa. Market size emerged as a short run determinant of FDI although it was declining in importance. The analysis also showed that FDI itself, imports and exchange rate explained a significant amount of the forecast error variance. The influence of market size variable was small and declining over time.

Matei (2007) in her study, “Foreign Direct Investment location determinants in Central and Eastern European Countries” focused on central and Eastern European former state planned economies and investigated why multinationals chose to locate their investments in those
countries. The main findings of the study were that market potential, privatization and agglomeration factors had significant effects upon FDI location choice, helping to explain the attractiveness for FDI of these host countries.

Kostevc, Tjasa and Andrej (2007) analyzed the relation between FDI and the quality of the institutional environment in transition economies. The analysis confirmed a significant impact of various institutional aspects on the inflow of foreign capital. To isolate the importance of the institutional environment from the impact of other factors, a panel data analysis was performed using the data of 24 transition economies in the period 1995-2002. The findings showed that in the observed period the quality of the institutional environment significantly influenced the level of FDI in transition economies. Other variables that proved to have a statistically significant influence were budget deficit, insider privatization and labour cost per hour.

Beijnen (2007) investigated the existence of a significant FDI – Export linkage in China, using panel data at the provincial level over the 1995 to 2003. The theory of FDI proposed the possibility of an export creating effect. However, the results showed that if the model was correctly specified, there was no evidence for the existence of a significant FDI-export linkage. The study concluded that the claims of the reference studies concerning the presence of a FDI export linkage were not valid.
A study undertaken by Luo et al., (2008) was based on panel data covering 98 inland cities from 1999 to 2005. It was found that well-established factors such as natural resources and low labor costs were not important factors in determining FDI locations within China's inland. Instead, policy incentives and industrial agglomeration were the most important factors.

Mottaleb and Kalirajan (2010) studied the gap between domestic savings and investment and bringing the latest technology and management know-how from developed countries, foreign direct investment (FDI) can play an important role in achieving rapid economic growth in developing countries. Among the developing countries a few, such as China, India, Nigeria and Sudan, are the major recipients of FDI, with the rest vying for the scraps. Using panel data from 68 low-income and lower-middle income developing countries, identified the factors those determine FDI inflow to developing countries. Based on a comparative discussion focusing on why some countries are successful in attracting FDI, the study demonstrated that countries with larger GDPs, higher GDP growth rates, higher proportion of international trade and a more business-friendly environment are more successful in attracting FDI.

Vijayakumar et al., (2010) examined the factors determining FDI inflows of BRICS countries using annual dataset from the period 1975 to 2007 (for Russia required data set is available from 1990 onwards). The study employed Panel data analysis and finds that the selected variables
Market size, Labour cost, Infrastructure, Currency value and Gross Capital formation as the potential determinants of FDI inflows of BRICS countries. The Economic Stability and Growth prospects (measured by inflation rate and Industrial production respectively), Trade openness (measured by the ratio of total trade to GDP) are found to be the insignificant determinant of FDI inflows of the BRICS countries. The empirical results are robust in general for alternative variables determining FDI flows.

Blonigen and Piger (2011) studied of bilateral foreign direct investment (FDI) activity show substantial differences in specifications with little agreement on the set of covariates that are (or should be) included. Researchers used Bayesian statistical techniques that allow one to select from a large set of candidates those variables most likely to be determinants of FDI activity. The variables with consistently high inclusion probabilities were traditional gravity variables, cultural distance factors, parent-country per capita GDP, relative labor endowments, and regional trade agreements. Variables with little support for inclusion were multilateral trade openness, host country business costs, host-country infrastructure (including credit markets), and host-country institutions. Results suggested that many covariates found significant by previous studies are not robust.
2.3.3 Studies Related to Impact of FDI on Economic Growth:

Chen, et al., (1995) used time series data for the period of 1979–93, estimated the regression between GNP, domestic saving in one period lag, and FDI was one period lag (all in logarithmic value). The results of the study showed that there was a positive relationship between FDI and GNP and it was significant at 5 per cent level for the Chinese economy did not support the unidirectional causality from FDI to Index of Industrial Production (IIP), where IIP is taken as the proxy for GDP. In fact, this study used the monthly data of IIP for GDP, which included seasonal component in its variation and hence, it was required to de-seasonalise the data.

Schneider and Frey (1985) analysed four models; namely; the economic, the political, the amalgamated and politico-economic model-to test the relationship between FDI and selected economic and political variables. GNP per capita, rate of growth of GNP, rate of inflation, balance of payment deficit; wage cost and availability of skilled labor force were economic variables. The political variables used were political instability, government ideology, percentage of aid received from the communist block, percentage of aid received from western countries and amount of multilateral aid received. These four models were tested using cross section data for 54 developing countries over three years 1976, 1979, 1980. It was found that most important economic determinants were a country’s level of development (as measured by per capita GNP) and
balance of payment position. Among the political determinants, the amount of bilateral aid coming from the western countries was found to have the strongest effect on FDI, followed by multilateral aid received. Political instability was found to have reduced FDI substantially.

Weinhold and Nair (2000) analyzed the new test of causality to emphasize that the effect of FDI on growth was quite heterogeneous across countries, while this link from FDI to growth is well understood. Relatively less emphasis was there on the literature to understand the two way link between FDI and growth. FDI promoted growth and growth in turn attracted more FDI. In the context of India, uncovering this two way linkage between FDI and growth was crucial for explaining the massive surge of foreign capital in an emerging market environment.

Boon (2001) in his study, “Foreign Direct Investment and Economic Growth” investigated the causal relationship between FDI and economic growth. The findings of the study thesis were that bi-directional causality existed, between FDI and economic growth in Malaysia. FDI had played a key role in the diversification of the Malaysian economy, as a result of which the economy was no longer precariously dependent on a few primarily commodities. Manufacturing sector became the main engine of growth due to flow of FDI in the country.

Chakraborty and Basu (2002) by using a vector error correction model (VECM) tried to find the short run dynamics of FDI and growth. The study revealed that GDP in India was not Granger caused by FDI; the
causality ran more from GDP to FDI and trade liberalization policy of the Indian government had some positive short run impact on the FDI flow.

Meyer (2003) analysed the impact of FDI on host economies and on policy and managerial implications arising from this potential impact. The study found out that as the emerging economies integrated into the global economies international trade and investment would continue to accelerate. MNEs would continue to act as pivotal interface between domestic and international markets and their relative importance may even increase further. The extensive and variety interaction of MNEs with their host societies tempted policy makers to micro manage inwards foreign investment and to target their instruments at attracting very specific types of projects. The study concluded that the first priority should be on enhancing the general institutional framework such as to enhance the efficiency of markets, the effectiveness of the public sector administration and the availability of infrastructure.

Sud and Khan (2003) in their work "The effects of FDI inflows and information and communication technology (ICT) infrastructure on exporting in Association of Southeast Asian Nations /ASEAN Free Trade Area (ASEAN/AFTA): A comparison with other regional blocs in emerging markets", explored the impact of both the increase in FDI inflows and the increase in information and communication technology infrastructure investments on exporting in Association of Southeast Asian Nations (ASEAN) compared with two other major trade blocs: Central
European Free Trade Agreement (CEFTA) and Latin American Integration Association (LAIA). The analysis was based on data from cross-section of countries (26 emerging markets from three trade blocs) over time (from 1995 to 2000). The results showed that the increase of investment in ICT infrastructure yielded positive and significant returns in the national exporting level only for the ASEAN/AFTA and CEFTA sample. The impact of the increase of FDI inflows on export was significant only in the CEFTA and LAIA samples.

Andreas (2004) discussed the potential of FDI inflows to affect host country economic growth. He argued that FDI had a positive effect on economic growth as a result of technology spillovers and physical capital inflows. Performing both cross section and panel data analysis on a data set covered 90 countries during the period 1980 to 2002, the empirical part of the paper found indications that FDI inflows enhanced economic growth in developing economies but not in developed economies. He has investigated that the direction of causality went from inflow of FDI to host country economic growth. However, economic growth could itself caused an increase in FDI inflows. Economic growth increased the size of the host country market and strengthens the incentives for market seeking FDI. This could have resulted in a situation where FDI and economic growth were mutually supported. However, for the ease of most of the developing economies growth was unlikely to result in market seeking FDI due to the low income levels. Therefore, causality was primarily
expected to run from FDI inflows to economic growth for these economies.

Bilgic (2006) examined the possible causal relationship between FDI and Economic Growth in Turkey. The study found that there was neither a long run nor a short run effect of FDI on economic growth of Turkey. Thus the study could not find any patterns for each hypothesis of “FDI led Growth” and “Growth driven FDI” in Turkey. The main reason of this result was that the country had unstable growth performances and very low FDI inflows for the period under analysis. The study suggested that in order to have a sustained economic development the government should improve the investment environment with the ensured political and economic stability in the country.

Vittorio and Ugo (2007) analysed the underpinning factors of foreign Direct Investments towards the Middle East and North Africa (MENA) countries. The main interpretative hypothesis of the study was based on the significant role of the quality of institutions to attract FDI. MENA experienced that the growth of FDI flows proved to be notably inferior to that recorded in the European Union (EU) or in Asian economies, such as China and India. The study suggested that the institutional and legal reform were fundamental steps to improve the attractiveness of MENA in terms of FDI. It was concluded from the above studies that market size, fiscal incentives, lower tariff rates, export intensity, availability of infrastructure, institutional environment, IT
related investments and cross-border mergers and acquisitions were the main determinants of FDI flows at temporal level. FDI helped in creation/preservation of employment. It also facilitated exports. Diverse types of FDI led to diverse types of spillovers, skill transfers and physical capital flows.

It enhanced the chances of developing internationally competitive business clusters (e.g. Association of Southeast Asian Nations (ASEAN), South Asian Preferential Trading Arrangement (SAPTA), North American Free Trade Area (NAFTA) etc.). The increasing numbers of Bilateral Investment Treaties (BITs) among nations, which emphasized non-discriminatory treatment of FDI between nations were found to have a significant impact on FDI flow. Extended neighborhood was widely applicable in different contexts for different countries. It was concluded that FDI played a positive role in enhancing the economic growth of the host country.

Youg (2007) examined the effect of economic integration on FDI flows and the effects of FDI flows on economic growth in 5 countries of Association of Southeast Asian Nations (ASEAN). The study found that market size, economic integration, human capital, infrastructure and existing FDI stock were the important determinants of FDI for ASEAN countries. The study also found that FDI, economic integration and human capital were robustly significant to economic growth, manufacturing sector growth and high technology sector growth for ASEAN countries.
The FDI flow into ASEAN countries was found to be inversely proportional to the per capita income of the five countries. Study concluded that the effect of FDI on economic growth of ASEAN countries was found to be higher for countries with higher per capita income.

Kurlantzick (2008) calculated that more FDI outflow by Indian corporate could encourage greater levels of foreign investments into India too, as there was greater awareness and appreciation of India’s potential and inherent strengths. In addition, as Indian firms overseas repatriated part of their profits or dividends back to the home country, India’s gross national product (which is more relevant to national income) had risen, even if its GDP had not. At an even broader level, the Chinese were found to have used their outward investments in developing economies to enhance their foreign policy objectives.

Zhang (2008) in his study discussed four empirical studies related to FDI, Governance, economic growth and the environment. The results of the study were, first, an intra-country pollution haven effect did exist in China. Second, FDI was attracted to regions that had made more effort on fighting against corruption and that had more efficient government. Third, government variables did not have a significant impact on environmental regulation. Fourth, economic growth had a negative effect on environmental quality at current income level in China. Lastly, foreign
investment had positive effects on water pollutants and a neutral effect on air pollutants.

Adams (2009) provided a review of Foreign Direct Investment and economic growth literature in the context of developing countries and particularly Sub Saharan Africa. The main findings of the study were as follows, first, FDI contributed to economic development of the host country in two main ways, augmentation of domestic capital and enhancement of efficiency through the transfer of new technology, marketing and managerial skills, innovation and best practices. Secondly, FDI was found to have both benefits and costs and its impact was determined by the country specific conditions in general and the policy environment in particular in terms of the ability to diversify, the level of absorption capacity, targeting of FDI and opportunities for linkages between FDI and domestic investment.

Kumar, Mohapatra and Chandrasekhar (2009) examined that an Indian company that invested overseas helped to generate positive linkages to the rest of the economy by using Indian factors of production (management, construction, IT, etc.) and also brought back to India new technologies, brand names, export markets etc. All of this had positive spillovers on India’s GDP.

Jacques (2010) examined the relationship between foreign direct investment and economic growth in the case of ten Sub-Saharan African countries. To this end, study used two new econometric approaches,

Georgantopoulos and Tsamis (2011) investigated the causal relationship between economic development as measured by GDP per capita and foreign direct investment for an European Union (EU) member country, Greece, by applying cointegration tests and Granger causality analysis, during the period 1970 - 2009. Robust empirical findings drawn from the Johansen cointegration analysis suggested the existence of a long-run equilibrium relationship. Furthermore, Granger causality test indicated that no bi-directional causal links on the FDI-GDP relationship were found. However, there was a one-way causality running from GDP to FDI, as results for the one and two year lags implied, strongly indicating that foreign capital penetration Granger-caused economic growth in Greece. Hence, adequate tax incentives, infrastructure quality and
promotion of the human capital base, could guarantee inflow of foreign funds in the future, as evidence imply for the case of Greece.

2.3 Conclusions

The perusal of existing literature suggests that FDI patterns contributing to the growth of the emerging markets have undergone significant changes over time. The FDI trend in last decade indicates a shift of flows from the developed World to the developing World and emerging markets. FDI is impacting development in these emerging economies in significant way.

The foregoing discussion about theoretical as well as empirical literature review revealed that countries with greater openness i.e., those which pursued export/import led growth strategies reaped huge benefits from foreign direct investment. In this chapter we have observed the effects of FDI on the host countries’ economic growth and revealed that FDI enhanced economic growth in developing economies. We found that in developing economies FDI and economic growth were mutually supporting. In other words economic growth increased the size of the host country market and strengthened the incentives for market seeking FDI.

It was also observed that causality exist between FDI and economic growth i.e. growth in GDP attracted FDI and in some cases FDI also contributed to an increase in output. It was noticed that bigger diversity of types of FDI led to more diverse types of spillovers and skill transfers
which proved more favorable for the host economy. Studies on role of FDI in emerging economies showed that general institutional framework, effectiveness of public sector administration and the availability of infrastructural facilities enhance FDI inflows to these nations.

FDI also enhanced the chances of developing internationally competitive business clusters. It was observed that apart from market size and openness other variables like industry production, infrastructure facilities and capital formation have also gained importance. In many studies determinants of FDI in developing countries were inflation and exchange rate. It was also observed that FDI have both short as well long run effect on the economy.

Therefore, regulatory policies must be formulated in order to attract FDI and at the same time to protect interests of developing economies. In this section we have offered theoretical and empirical support for our choice of dependent and independent variables. There were several reasons why such wide ranging and to some extent, conflicting results are generated by empirical analysis of FDI. Some possible reasons were the differences in the applied methodologies, choice of variables and differences in time periods and country coverage.