2.1 Introduction

It was after the Second World War when the forces of globalization emerged into the world and the expansion of FDI really took off. The growing importance of multinational enterprises and foreign investment during the 1950s and 60s particularly FDI flows from US to European countries gave an impetus to many researchers to examine the issue of MNCs and the existence of international production. As a consequence of growing interest in FDI, a large body of studies has analyzed the factors and effects of such investment. It is in this context that the present chapter of the study surveys the existing theoretical and empirical literature on FDI flows. This is attempted to identify the research issues and knowledge gap for the present study. The current chapter is divided into two distinct parts. In the first part, different theories have been examined and in the second part review of existing empirical literatures have been undertaken.

2.2 Theorems of International Flow of Capital

In the beginning, the theory of capital-market and theory of portfolio investments were used to describe the initiation of FDI. Initially, direct investment used to be considered by economist as an international capital movement only.\(^1\) In fact prior to 1960, FDI was considered to be as subset of portfolio investment. However, with the increasing role of MNCs, academicians have attempted to integrate the activities of MNCs with theories of FDI.\(^2\) As per these theories, the most important reason for

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\(^2\) See Rayome and Baker (1995)
capital flows was the differences in the interest rate. This approach states that when there are no uncertainties or risks, capital tend to flow to the regions where capital gets highest return. However, this context fails to incorporate the fundamental difference between portfolio and direct investment.

It was in the 1950s that a proper explanation for FDI was attempted. Over a period of time, these theories have highlighted different factors for the international movement of capital. Some theories considered market imperfections as the cause for the FDI flows, while some theories contemplated oligopolistic and monopolistic advantages for the movement of capital from one country to another country. There are also FDI theories which relate FDI with international trade. In the foregoing section, an attempt has been made to examine these theories.

The objective of this attempt is three fold. First, understand the basic motivation of the firms to go abroad. Second, highlight the weakness of these theories. And third, pinpoint theories of FDI which can be all encompassing.

Here, it has to be noted that the inflow affects the host country’s economy while the outflow affects the investing country’s economy in different ways. Accordingly, there are bodies of theories which explain the impact of FDI in an economy. These impacts can be on economic growth, employment and overall trade of the host country. Thus, there is a different genre of FDI theories also.³

### 2.2.1 Theories of FDI based on Perfect Competition

The early works of FDI theory can be traced in the works of MacDougall (1960) who established his model based on the assumptions of perfectly competitive markets. In his model, he tried to assess the issues and consequences which lead to the international flow of investment. His theory was further elaborated by Kemp (1964). In their model MacDougall and Kemp considered a two country model where prices of the capital are equal to its marginal productivity. Prices being equal in both the countries movement of the capital between the two countries were also assumed to be

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³ Attempts have been made by other researchers to review these theories. See Agarwal (1980), Mainardi (1987), Lizondo (1991), and Rayome and Baker (1995), Nayak (2004), Denisia (2010)
free. The authors found that after investment, the output of the investing country falls but it does not lead to any decrease in the national income of the country. This is because the investing country in the long run gets higher income from its investment abroad. However, due to the assumption of perfectly competitive market situations the model fails to explain the origin and expansions of FDI. The theories explaining the international investment in the similar way can also be found in the works of Simpson (1962), Frankel (1965), Pearce and D.C. Rowan (1966) Caves (1971) Knickerbocker (1973).

The assumption of FDI theory based on perfect competition does not hold well in today’s investment and economic scenario. This is because the assumption of equal prices in two different countries can never be true. Moreover, the movement of capital can also never be totally free between any two nations, until there is an agreement between them. In addition, even when the prices of capital in two countries are same, still FDI can take place because FDI is not a movement of capital only, but also includes other factors. In the context of this, other authors therefore tried to explain capital flows in imperfect market setup.

2.2.2 Theories of Imperfect Market

*Industrial Organization Approach*


Hymer argued that the imperfection in the market leads to the existence of MNCs. His theory focused on the two types of imperfections in the market. First, the

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4 Most of the FDI flows through MNCs; consequently theories explaining FDI are also invariably explaining MNCs.
imperfections in transaction-cost and second, the imperfections in the size of the organization. According to Hymer the bigger sized firm will bring the ownership advantages to the host countries in order to compete with domestic firms. The industrial organization approach explains that an MNC faces a number of disadvantages in investing in the foreign nation. These disadvantages are in the form of legal complications, cultural and language differences etc. However, in spite of these differences an MNC enjoys some firm-specific advantages over the domestic firm. These advantages include superior technology, brand name, managerial skills and economies of scale. Sodersten (1970) also argued that willingness to increase profits by taking the advantage of some technological superiority or superior organizational form are the main causes of direct investment. The rate of return motivates the movement of capital and capital moves from countries with low marginal productivity to the countries with high marginal productivity and thus their activity equalize the marginal productivities to throughout the world (Viner 1951). These explanation transformed FDI from neoclassical trade theories into industrial organization theory. But this approach fails to explain the reasons for MNC's decision to go international. This has been attempted by the eclectic approach by Dunning (1977, 1979, & 1988) and internalization theory by Buckley and Casson (1976).

**Product Life Cycle Theory of FDI**

Raymond Vernon (1966) used the US multinational data to explain the cycle of their expansion. This theory is popularly referred to as Product Life Cycle Theory. This theory assumes that most products follow a life cycle in which they first appear as innovations and ultimately become completely standardized. The theory attempts to integrate three stages of production to explain the life cycle of a product. In the first stage of the introduction of the product the stage is called as "innovation". At this stage the producers are mainly concerned with the degree of freedom of their product and they invest highly on the research and development (R &D) of the product. At this stage the product is designed, developed and produced domestically and in limited number. After the establishment of the product in the home market, the foreign demand is generally met by export in the initial phase.
In the second stage the product gets ‘mature’. In this stage the price elasticity of demand for the product is comparatively low. The demand for the product rises in the foreign market and competitors emerge. The producer establishes its production unit in the foreign country to cater to the increased foreign demand and to compete with the rivals. Thus, in the second stage the firm goes international. The final stage is characterized by product standardization. The production technique become well known and reaches its zenith. As a result, investment gets moved further to lower cost and lower wage countries. Thereafter, the product is exported to the original country of innovation where the product is phased out in order to favour innovation of new product. Thus the exporter becomes importer in this stage of production.

The investment recognizing PLC theory in modern economy is very hard to find. Of course, when a product is developed and matured in domestic market then it is exported or international production unit is opened in countries with low labour cost. But, the proposition that the low waged countries will export the same product to the original country of innovation is hard to find. The original country of innovation which is developed country generally focuses on the new innovation rather than using the old technique and product by importing it from LDCs.

**Monopolistic Power to attract FDI**

Kindelberger (1969) in his remarkable work ‘American Business Abroad’ put forward his theory of FDI on the basics of monopolistic power by extending the works of Hymer (1960). Kindelberger argued that advantages enjoyed by a Multinational firm can be useful only in the case of market imperfection. The advantages described by him may be in the form of superior technology, managerial expertise, patents etc. These advantages generally encourage a firm to invest in a foreign country. A firm will like to fully exploit these advantages instead of sharing them with potential competitors in the foreign market. Higher the chances of earning monopoly profits, higher will be the encouragement among the firms to invest directly. Thus, the monopolistic advantages and economics of scale enjoyed by foreign firms over the host country firms are the major determinants of international investment by MNCs. The zeal among the international retail firms like Wal-Mart to invest in India reflects the proposition of the monopolistic power theory of Kindleberger.
Kindleberger described various forms of advantages generally enjoyed by a firm over the host country firm. But he failed to describe which advantage a firm should focus. Apart from monopolistic advantages, some other important determinants also play a significant role in attracting FDI in a country.

**Internalization Theory of FDI**

Buckley and Casson (1976) came out with argument that foreign direct investment is the result of the firm’s intermediate products, notably knowledge which helps them to internalize their product. This is a complementary work to Coase (1937) where he argued that firm’s internal practice with transaction costs are better suited than the market to organize transactions. Following Hymer (1960) the authors also maintained the assumption of market imperfection and firm specific advantages for a firm to become international. This theory differs from Hymer on the assumption that firms do not need monopolistic or oligopolistic power at the beginning. However, it acknowledges later that monopolistic or oligopolistic advantages could also be internalized.

Buckley and Casson identified five different types of market imperfections that results into internalization. First, at the time when the co-ordination of resources for a long period is required, second, when the efficient exploitation of market power requires discriminatory pricing, third, when bilateral monopoly produces unstable bargaining situations, fourth, when the buyer cannot correctly estimate the price of the goods on sale, finally, when government interventions in international markets create incentives for transfer pricing. Teece (1981) and Casson (1986, 1987), further stated that, internalization of intermediate products could also lead to monopolistic or oligopolistic advantages for a firm.

The imperfections identified by Buckley and Casson have been criticized on various grounds. In today’s world of competition, it does not help to exploit market by practicing discriminating prices. This is because in modern time buyers are highly informed about the prices of the goods and services available in the market.
Eclectic Paradigm to FDI

John Dunning (1977, 1979, & 1988) in his path breaking works amalgamated three different explanations as to why a firm opens its foreign subsidiary. The theory also discussed the entry choice for MNE. This theory of eclectic paradigm is also referred to as OLI paradigm. In his theory Dunning integrated the oligopolistic theory or the theory of Industrial organization, the internalization theory and location theory to explain the reasons for firms to operate internationally. Dunning argued that the Ownership advantages (O), Locational Advantages (L) and Internalization (I) are the preconditions for a firm to produce its goods internationally. Ownership advantages referred to the MNE’s production process, ensuring a competitive advantage over domestic firms. These advantages may be in the form of both tangible and intangible assets. These include patents, technical knowledge, management skills, natural endowments, superior technology, brand name, managerial and marketing skills and scale economies. This ownership advantage leads to reduction of firm’s production cost and allow it to compete with domestic firms in a foreign economy.

Location advantages of different countries play a significant role in determining host countries for the activities of the multinational corporations. Location advantages may be in the form of access to protected markets, favourable tax treatments, lower production and transport costs, and cheap inputs for production, lower risk, jumping trade barriers, legislation and policies, and the political, legal, and cultural environments etc.

When the above two conditions are fulfilled, internalization occurs to the firm. The cross-border market internalization helps the firm to make higher profits then what it can make by offering this right under license, franchise etc. The exploitation of these advantages relies mainly on the relative cost of equity and non-equity forms of managing interrelated economic activities.

However, Dunning focused only on three advantages of a firm. He completely ignored other determinants of FDI or the advantages enjoyed by a firm which can help them to go international. The important determinants of FDI such as government policy, domestic competitors in the host country, labour costs etc. were not considered in the Dunning theory of eclectic paradigm.
**Oligopolistic Theory explaining FDI**

Similar theory was put forward by Knickerbocker (1973). He argued as that in oligopolistic market conditions, when a firm makes a foreign investment, it will encourage other potential competitors in the same industry to invest in the same foreign market so as to sustain their market share. This theory integrates various theories investment like location, monopolistic competition, exchange rate to give comprehensive view on oligopolistic market structure theory of FDI. Knickerbocker used large number of US MNC data and calculated an entry concentration index to show the extent to which subsidiaries entry dates were clustered in time. The index finds a positive correlation between following the rivals in international investment and market big size.

The essence of the oligopolistic theory is that firms operating abroad and over long distance suffer from an intrinsic disadvantage due to the differences in the language, lack of knowledge of local laws and market conditions. These disadvantages must be overcome by some sort of market power to make the international investment profitable. However, the theory was criticized on the grounds that these disadvantages of the foreign market can be averted well by exporting or licensing instead of making direct investment.

### 2.2.3 Strength of Currency to attract FDI

Aliber (1970) presented his theory of foreign investment on the basis of the relative strength of the various currencies. He identified some of the unique characteristics of international investment which were not available in the domestic investment. He forwarded his theory in terms of the differences in the strength of the currencies in host and source country. He postulated that weaker currencies compared to stronger investing country currencies have a higher capacity to attract FDI. Firms from the stronger currency countries will invest in the weaker currency countries in order to take the advantages of differences in the market capitalization rate. Aliber had tested his hypothesis in the USA, UK and Canada.

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Even though Aliber claims it to be an alternative theory, the fundamental assumption of the theory lies in the some kind of biasness in the capital market. The imperfect market forces helps the investors to higher its profit. Some of the other notable studies in the same genre are Caves (1988), Froot and Stein (1992), De Mello (1997).

Although the Aliber theory is widely accepted, it fails to explain the investment between the developed nations. The relevance of the theory is also not found in the investment made by developing country MNC’s to developed country. Recent investment of the Indian and Chinese firm in US, UK can be cited as an example for the same.

Most of the theories cited are pertaining to FDI from western world. There are few theories formulated to explain the FDI from developed Asian countries like Japan.

One of the first such theories was put articulated by Kojima in (1973, 1975, and 1985). He dealt with the FDI outflow from Japan. He argued that the inability of the firms to compete domestically in Japan had compelled them to look for investment opportunities abroad. The efficient local firms were pushing the less competent firms out of the market. As a result the weaker firms moved to overseas countries especially to other developing countries. However, Kojima hypothesis failed to explain the expansion of business activities of the domestically competent firms in international market.

2.2.4 FDI theories related to International Trade

The expansion of FDI in the last two decades and continuous growth in the output of the Multinational firms has changed the structure of the international trade to a large extent. Foreign direct investment has by some measures become even more important than international trade. Moreover, one third of the total international trade occurs between the intra firms.

Even though Adam Smith was the pioneer of the international trade theories, many other theories was put forwarded by the economist like Ricardo, Haberler, Hechscher

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6 This is exemplified by Suzuki Motor Corporation of Japan which came to India as it was unable to face competition in the domestic market.
7 See Graham (1996)
8 UNCTAD (2004)
Ohlin, Krugman etc. However, all of the theory maintains that a country will produce and export that good which it can produce at relatively lower cost and will import the good which it produces at a relatively higher cost.

Hirsch (1976) developed his theory of international trade and investment to find the answer of two important questions. First, when does the profit-maximizing firm choose to serve foreign market and what are the conditions which lead to its foreign investment and export? However, according to Hirsch in the absence of transport and marketing costs, optimum size plant or plants will be less costly to operate in countries enjoying comparative advantage. Economies of scale are not associated with the size of the domestic market; thus they enhance rather than counteract comparative advantage. International direct investment takes place only in a world which admits revenue-producing factors which are firm specific on the one hand and information, communication, and transaction costs, which increase with economic distance, on the other.

Kojima (1973, 1975, and 1985) was the first economist who tried to integrate trade theories and international investment theories. He suggested guiding trade and investment by a common theory. Kojima strongly recommended that FDI is required in order to make factor markets more competitive and efficient internationally and to improve production processes in the country which is well endowed with the given resource. He believed that Multinational Enterprises (MNEs) would lead to the improvement of production and exports if it is transferred as a package of capital, managerial skills and technology from an industry which has a comparative disadvantage in the investing country compared to the recipient country, thus contributing to the productivity and comparative advantage of host country.

Kojima identified resource orientation, labour orientation and market orientation as the three major motives behind the international investment of a firm. If a firm invests with a view to increase and secure the imports of the goods which home country lacks or produces at a higher cost it is referred to as trade oriented or resource oriented FDI. If investment is made to reap the benefit of cheaper labour cost then it is known as labour oriented FDI. Investments in order to capture a big market or to supersede the trade barriers are called as market oriented FDI. Even though there are some examples of international investment which verifies the Kojima’s assumption of firms inability
to compete domestically, leads them to invest in abroad. But, it would not be satisfactory to generalize this proposition.

Further, Kojima’s theory was mainly focused on Japanese investment. The other major Asian countries like Korean Republic, India, China, Taiwan was missing in his theory. These countries have proved their potential in international investment market in the recent decades.

2.2.5 Theories based on General Equilibrium Model

Helpman (1984) developed a general equilibrium model extending his earlier work which deals with the firms producing single product. His model is based on the differences in the factor endowments in different locations where a vertical MNC choose to start its production centre. The model argues that firms like to choose cost minimizing locations to maximize their profits. The differences in the factor endowments are associated with relative size of the country. The theory identifies and analyzes the circumstances in which corporations find it profitable to become multinational. The theory explains the simultaneous existence of inter-sectoral trade, intra-industry trade, and intra-firm trade. The theory also explains cross-country penetration of multinational corporations as a result of impediments to trade.

2.2.6 FDI Theories and Regional Trade Agreement linkages

Some theories have explained FDI in terms of Regional Trade Agreement (RTA). These theories have found that FDI and RTAs are co-related. Some of the notable works are by Blomstrom and Kokko, (1997); Dunning, (1997). These scholars have put forwarded three categories of FDI and RTA relationship. These are investment rules, second, trade rules and finally other initiatives. Blomstrom and Kokko (1997) described that it can results economic agglomeration as RTA can strengthen the effects of technology spillovers which will in turn attract more multinational companies to invest. Further, Jovanovic (1998) argued that FDI inflow significantly increased after the formation of RTA in some developing courtiers. This is because RTA creates more opportunities for the developing countries to take advantages of

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9 A regional trading arrangement is an agreement among governments to liberalize trade and other trade related activities.
advanced technology, management skills, and marketing network from MNCs of the developed countries. Robson (1998) showed that RTA can motivate more aggressive import-substitution investment, as RTA leads market innovation, expansion, and economic growth. Velde and Bezemer (2006) ascertained that RTAs can decrease horizontal (tariff-jumping) intraregional FDI as it may become cheaper for member countries to serve other member countries in the region through trade rather than establishing a subsidiary and thus incurring plant level costs.

Even though the RTAs removes the tariffs restrictions between member countries and leads to increase in the trade between them, it does not necessarily impact positively the investment climate and the capital movement among them. International movement of capital does not take place only because there is not restriction on trade. There may be common economic interest among the members of a RTA, but the investing member may not find the other member country to attractive to invest. Moreover, investment in host country is more influenced by its FDI policy or investment policy not by the trade policy or any trade agreement.

### 2.2.7 FDI theories explaining investment from Developing Countries

The theories reviewed above have mainly explained the movement of investment from developed countries/regions to other developed countries/regions or developing countries/regions. The above discussion however, fails to capture the phenomenon of investment from developing countries to other developing countries or developed countries. In the recent times, especially in the last two decades a number of developing countries have emerged in the map of international investors.

Multinationals have not only emerged from the newly industrialized countries like Taiwan and Korean Republic but also from countries like India, Brazil, Argentina, Philippines etc. The so called Third World Multinational Corporations (TWMNCs)\(^{10}\) have established themselves in every important sector of the world economy.\(^{11}\) In the light of this it is necessary to explain the growth of the TWMNCs and their investment abroad consistent with this growth. At the outset, it needs to be mentioned that these third world countries have generally brought the technology from the

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\(^{10}\) The term TWMNC was first used by Agarwal and Weekly (1982)

\(^{11}\) See Kumar and McLeod (1981)
developed world. But since these technology is more suitable for an area having large market size, the firms importing the technology exports these products abroad once the local demand is met. As the product becomes more familiar in foreign market and the market become gradually established, the firms show a preference to set up subsidiary abroad rather than export it. Thus the product life cycle theory operates to explain the investment abroad by third world countries.\(^\text{12}\)

In certain cases the product is modified and the technology undergoes changes to suit the taste of consumers abroad. In this way third world firms enjoy oligopolistic advantages. Thus, the firm specific advantage as highlighted by the Hymer is also applicable to the firms from the Third world countries. In fact, firms from developing countries enjoy monopolistic advantages as put forward by Kindleberger (1969). These advantages are in the form of ownership specific and location specific.\(^\text{13}\)

Although multinationals from developing countries generally do not produce new products and do not have the advantage of brand name, they still possess owner specific advantages in the form of (a) \textit{Suitable operating technology}: most of the TWMNCs acquire technology from their industrialized counterparts and modified it as per the requirement or demand of the local markets. Thus, the technology becomes more suitable for the developing economies. (b) \textit{Lower overhead and expatriate payment}: this is because the TWMNCs make minimum investment in their factory, office and work facilities. Moreover, they provide moderate wage to their staff which is lower than the developed country MNCs as well as international standard norms. (c) \textit{Familiarity with local conditions}: third world firms share common socio-economic background, ethnic and cultural environment and infrastructural condition. This help the third world firms to develop bond easily with the local business environment (d) \textit{less threatening position}: unlike their western counterparts these firms are neither politically nor economically threatening for the host country.

Apart from ownership advantage, the locational advantages have also been mentioned by Kumar (1982) and Sharan (1995). The locational advantages in the form of barriers on inputs in host countries, lower production cost, the attraction of raw material, similarity between the cultural and economic system of home and host countries and political-economic stability of the host countries relative to the home environment.

\(^{12}\) See Ting (1982)

\(^{13}\) See Kumar (1982)
Thus, the theory of location can be suitably applied to the firms from developing countries. There are also other motives which have facilitated firms from the third world to make direct investment in abroad. These motives are mostly defensive in nature and promoted by three considerations. Firstly, there is a perception to protect foreign market of these firms which have been developed through exporting operations. Secondly, there is a desire for reducing risk through diversification. Thirdly, government policies have been identified as a common motive for TWMNCs to invest abroad. Government measures are not only in the form of incentives offered by the host government but also by the influences exerted by the home government which are restrictive or punitive in nature that have created pressure on third world firms to invest abroad. Furthermore, if the domestic currency is relatively weak as compare to foreign currency then it will be advantageous for these firms to go abroad. This is specifically true for firms from China. In other words, the currency based theory of FDI, is also an explanation for foreign investment from the third world countries.

Over and above the economic variables in some cases political uncertainty followed by industrial disputes may also have an effect on the movement of capital for developing country. According to Tcha (1998) the labour disputes in South Korea, in the 1990s have to a large extent influenced Korean firms to invest in countries of North America and Asia. The rapid increase in labour cost as a result of the labour disputes and uncertainties in production has not only reduced the comparative advantage of Korean firms in labour intensive industry but also adversely affected the profitability of capital intensive industries. This has resulted in the relocation of Korean firms to countries having lower wages and lack of labour disputes.

To sum up, it can be stated that a large body of theories exist for explaining the cause for movement of international capital. Some of these theories are a corollary to trade theories under perfect market set up while other theories are developed in a condition of imperfect market. However, no single theory in isolation can explain international investment.

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14 See Agarwal and Weekly (1982)
15 Wang and Swain (1995)
In spite of their different approach, these theories are unanimous in their view that a firm moves abroad to reap the benefit of some advantage enjoyed by them in form of locational, firm specific or internationalization of market. These theories have also articulated the fact that, the government policy of the domestic economy also plays a vital role in encouraging the international investment of the firms. These policy measures by removing restriction on foreign capital flows may increase FDI. Further, trade liberalization in the form of removal of trade barriers reduces MNCs product cost. Thus promotes FDI.

It is pertinent to the note that majority of theories are in the context of first world multinationals. In the recent past the growing importance of third world MNCs have necessitated the modification of these theories to incorporate features such as labour disputes in home country, lower expatriate cost, familiarity with local conditions and less threatening postures to explain international movement of capital from developing countries to other countries in general and developing countries in particular.

2.3 Survey of Empirical Studies

After having reviewed different theories explaining the movement of capital among different countries, in the foregoing section, an attempt will be made to review the existing empirical studies on the impact of FDI on host country. As stated earlier, the main objective of conducting the review is that it facilitates the identification of various research issues and the knowledge gap in the existing field. Ever since UN development decades of 1960s the role of FDI in enhancing economic growth has been a contested one. There are arguments in favour of FDI as well as against it.

There is sufficient number of empirical literature available on the impact of the FDI in the host country. These studies are available across different countries, regions and different sectors. The inflow of foreign investment contributes to different sectors of the host country’s economy in different ways. It also helps to raise the income and standard of living of the labourers, and increase the choice of the consumers, thus leads to higher level of consumer satisfaction. At the same time it raises the employment level and provides the technological knowhow. Thus, the FDI plays an important role

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16 See Valde (2006)
in both micro and macro level development of the host economy. Against this background, the empirical literatures are reviewed in two parts. First, those studies which examine the link between FDI and its impact on the host country in general will be reviewed. Second, some of the studies which are conducted with SAARC groups of countries will be examined.

2.3.1 Review of studies pertaining to the effect of FDI on host countries

One of the first studies which have examined the effect of FDI on growth was conducted by Lall and Streeten (1977). They examined 88 foreign owned and locally owned projects in 6 different countries using cost-benefit analysis to estimate the national income effect of FDI. As per their study they came to the conclusion that the effect of FDI on national income was positive for about 58 countries and for the remaining 30 countries it was negative. In a similar study conducted by Encarnation and Ethier (1986) the contribution of 50 FDI projects made to national income minus cost to the national economy both at the world prices was calculated. They found that the majority of the project would not increase the national income, while the remaining sizable minority would actually decrease the country\'s national income.

Blomstrom et al. (1994) analyzed the data for 78 developing and 23 developed countries. They found that the inflow of FDI had a significant positive influence on income growth rate of the host countries. The influence was mainly confined to those developing countries having higher level of income. However, it was not evident among the poor countries. They therefore, concluded that the host countries will be benefitted from investment of foreign firms if they had certain threshold level of development.

Fry (1993) analyzed the effects of FDI in a macroeconomic framework containing investment, saving, growth and current account equations. He applied this framework to a sample of 16 developing countries including India. From his study he found that for 11 developing countries FDI is associated with reduced domestic investment. This implies that for these countries FDI is simply a close substitute for other capital inflows. But for the remaining 5 countries FDI has raised domestic investment. In other words, the impact of FDI on growth shows a mixed result. However, Chen et. al
(1995) using time series data for the period of 1979-1993 found that there exist a positive relationship between FDI and GNP for the Chinese economy. Their result was also significant at 5% level.

In one of the studies by Balasubramanyam et. al. (1996), the hypothesis given by Bhagwati (1978) that export led growth strategy can reap enormous benefit from FDI, was tested. By employing CUSUMSQ test, the Bhagwati hypothesis was tested with the help of cross section data for 46 countries for the period 1970-1975. From their study they concluded that FDI thus provide a fillip to the process of economic growth to those countries pursuing outward policy.

Barrell and Pain (1996) put forwared the argument that FDI could enhance growth in the host economy. They used the panel data method to conclude that FDI in European countries by increasing export has led a higher GDP growth.

Blomstrom and Kokko (1997) examined the host country effect of FDI. They mainly focused on the transfer and diffusion of technology from MNC to the host country and examined the impact of MNC on trade performance of the host country. It was concluded by them that FDI may promote development by enhancing productivity growth and export from the host country. However, the impact varies from industry to industry and country to country. In other words the net benefit of FDI deepens up the host country's industry and policy environment.

A similar study was conducted by Dutt (1997) to investigate the impact of sectoral FDI inflows and economic growth. He tested Singers (1950) hypothesis. On the basis of Singers hypothesis Dutt (1997) argued that FDI in manufacturing sector will have more positive implication for the host developing country because of greater technological development of this sector, whereas primary FDI may not have positive

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17 Cumulative sum squared (CUSUSMQ) tests is used to test the constancy of the coefficients in a model. See Brown Durbin and Evans (1975)
18 However, UNCTAD (2007) identified several channels through which FDI in primary sector can help the host countries to exploit the natural resources in such a way that it provides an opportunity for development and growth. The channels are in the form of provision of financial resources, transfer of technology and provide necessary skills with the help of which technology barriers can be worked out.
19 Singer has stressed that FDI in developing countries mainly go to primary sector rather than manufacturing sector. He argued that due to low income elasticity of demand of primary product the benefit of FDI will go more to the consumer in the form of lower prices rather than to the producer in the form of higher profit.
effect due to less technologically advanced product produced by the sector. However, by using cross country growth equation and data of 47 countries for the period 1985-1994 did not find any empirical support for his argument. In other words FDI in both primary and manufacturing sector appears insignificant in his analysis.

Borensztein et al. (1998) on the basis of endogenous growth model tested the effect of FDI on economic growth for 69 developing countries for two different time periods 1970-1979 and 1980-1989. From their study they came to the conclusion that the effect of FDI on economic growth depends upon the level human capital development in the host country. As per the study, it was found that the impact is greater for those countries having high level of human capital development. Further, the contribution of FDI to growth is relatively more as compare to domestic investment.

Another study which has examined the sector wise impacts of FDI was conducted by Alfaro (2003). The author argued that the impact of FDI to the host countries economic growth varies across primary, manufacturing, and services sectors. The benefits of FDI, such as transfer of production technology, innovation, organizational and managerial skills, and the ability to enter the international markets, are more likely to occur to manufacturing FDI rather than to primary FDI. This is because the linkages between foreign and domestic firms are generously weak in agriculture and mining sectors which curb the impact of primary FDI on economic growth in the host country.

Hansen and Rand (2006) have analyzed the relationships between FDI and GDP with the sample of 31 developing countries covering three continents for 30 years time period of 1970-2000. The study employed Granger-Causality test. It was found by the study that there is a strong causal link between GDP and FDI. In the long run when allowing for country specific heterogeneity of all parameters it was found that FDI has a significant long run impact on countries during the period GDP irrespective of the level of development. Thus as per the study no significant difference in total across regions was found.

Adewumi (2007) studied the impact of FDI inflows to the economic growth of developing countries considering the case of select African countries for the time period of 1970-2003. He found that the contribution was positive from the continent point of view. But in terms of selected countries, it was discovered that effect is
positive for some cases and not positive in other. Further, in most of the countries and for the continent as a whole the relevant co-efficient estimate is not significant. It was pointed out by the author the negative result obtained may be due to relatively a low FDI flows to the African countries.

Johnson (2006) also examined the effect of FDI inflows to a host country’s economic growth both for developing as well as developed economies. The paper argued that FDI should have a positive impact on economic growth due to technological spillover and inflow of physical capital. With the help of both cross section and panel data analysis covering 1980-2002 the study indicated that FDI enhances economic growth in developing countries but not in developed country. This may reflect that in a developed market economy there is no difference between domestic and international investment.

Mengistu and Adams (2007) studied how the inflow of FDI affects the domestic investment scenario and economic growth in the host country. The study employed cross section data of 88 developing countries to empirically investigate the issue. Using Ordinary Least Square (OLS) method and fixed effect estimation techniques. The study observed the existence of significant co-relation between FDI and economic growth. It was found that FDI had greater impact in Asian countries than other developing countries. The study also found the co-relation between institutional infrastructure and economic growth of the host economy.

Beugelsdijk et.al. (2008) have studied US MNC’s impact on host countries economic growth by making a distinction between the broad effects of Horizontal FDI and Vertical FDI. The study used panel data for a time period of 20 years from 1983 to 2003 and sample of 44 host countries. The study found that both Horizontal FDI and Vertical FDI have a positive and significant effect in developed countries. The growth effect of Horizontal FDI is about 50% larger than the vertical FDI in this set of developed countries. The paper finds no significant relationship between Horizontal FDI and Vertical FDI and growth in developing countries.

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20 In Horizontal FDI, multi-plant firms duplicate the same activities in multiple countries, while in vertical FDI; firms locate different stages of production in different countries.
Recent studies come to the conclusion that FDI varies from countries to countries depending upon whether the local factors are conclusive to FDI inflows. For instance Ali (2010) found that the impact of FDI on economic growth depends upon the institutional quality of the host country. On the basis of a sample of 62 countries including 40 developing countries\(^{21}\), he found that those countries which have acquired minimum threshold of institutional quality have benefited even from primary FDI. The implication of this result is that policy makers should direct the effort in improving institutional quality to reap the benefit from FDI.

Another study by Djurovic (2011) analyzed the impact of FDI inflows to the economic growth for all developing countries for the period from 2000 to 2010. He used endogenous model for the study. His research model offered a strong inward validity of the impact of FDI on the economic growth of the developing countries in the past decades. The findings indicate that FDI was more attracted to developing countries with higher availability of educated labour, higher government spending and efficient governance.

Farkas (2012) studied the impact of FDI on economic growth on the basis of the absorptive capacities of the host country covering the period between 1975 and 2000. Cross section data for 69 countries were used for the study. He found the contribution of FDI to economic growth was positive and significant. Further, the results indicated that a minimum level of human capital and well developed financial market are necessary for positive impact from FDI.

The main message to take from the above survey is that there seems to be a strong relationship between FDI and economic growth. But at the same time there are studies which point out a weak relationship between development and FDI. Thus, the results are mixed. Some research works concluded that the contribution of FDI to growth is positive but it depends on some factors in the host country such as the sector to which FDI flows, the human capital base of the country and the degree of openness in the country. It is also noteworthy that some studies have claimed that the contribution of FDI to growth is not positive.

\(^{21}\) India was also included in the sample.
2.3.2 Association between Trade and FDI

Willmore (1976) has investigated the foreign trade behaviour of the Multinational Corporations at the individual level using a recursive model of export and import of Central American manufacturing firms.\(^{22}\) The study used a sample of 572 foreign firms for the time period between 1962 and 1969. The study assumed imports as depended on exports. Using a logistic model, the author concluded that foreign investment had a strong and significant effect on both export performance and import propensities of the host country.\(^{23}\) The study found a positive relation between the degree of foreign control of leading firms and the degree of seller concentration in local industries.

Aitken et. al. (1997) used panel data of 2104 Mexican manufacturing firms. The time period considered for the study was 1986-1990. Using logit model the study found that MNCs lean to generate positive export spillover effects to domestic firms. However, this spillover cannot be created through general export activity. They argued that the export spillover effects can take place in a host country when MNCs connect domestic suppliers and sub-contractors to the international markets through improved and improved infrastructure or advanced access to information about which these goods are preferred among foreign consumers. Thus, MNCs can generate export spillovers to the host economy through FDI and create a multi-market presence for the domestic firms.

World Investment Report by UNCTAD (1999) analyzed cross country data for 52 countries and reports that there exist a strong and positive relationship between FDI and manufacturing firm& exports. The study also found that the relationship is stronger for developing countries compared to their developed counterparts. Moreover, the relationship is also found to stronger in high- and low-tech industries than in medium-tech ones.

Kokko et al. (2001) investigated the relationship between FDI spillovers and the export performance of domestic firms taking the case of Uruguay and used cross-

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\(^{22}\) The causal flow in the model is unidirectional. At a given point in time a variable cannot be both a cause and an effect of another variable.

\(^{23}\) Logistic model is a regression model mostly used for predicting the outcome of a categorical based on one or more predictor variables.
section firm level data. The study argues that in the presence of foreign firms, domestic firms of Uruguay are more likely to export, that too in relatively high volume. The study also argues that the capacity of the MNCs to generate positive export spillovers are influenced by the existing trade regime of the economy.

Werreso (2001) studied the impact of FDI on trade considering the case of Poland’s trade with European Union. The time period covered for the study was 1995 to 1998. FDI affects trade by creating and restructuring export creation of the host country. The inflow of FDI in Poland has not substituted its trade with the EU. The author argued that foreign investment is generally accompanied by transfer of technology and managerial skills. This helps to upgrade the economy and improve the competitiveness of the goods produced in the domestic market.

Aizenman and Noy (2006) have examined the linkages between foreign direct investments and disaggregate measures of international trade. The study employed panel data method to a sample size of 81 developed as well as developing countries including India, for the time period of 1982 to 1998. This study like UNCTAD found that association between trade and FDI are stronger in developing than in industrialized developed countries. This is because a major portion of FDI to developing countries has been vertical rather than horizontal.

Magalhaes and Africano (2007) investigated the relationship between foreign trade and FDI in Portuguese economy during 1995-2000. In the study a panel data analysis was applied for a sample of 28 trading partner of Portugal. The gravity model was used for testing the hypothesis of complementarily and substitutability on a panel analysis. The study came to the conclusion that a complementary relation between inward FDI trade- import and export existed. For the period under analysis, foreign firms operating in Portuguese economy act as trade channel facilitating the expansion of both export and import. Thus, foreign investment had an overall neutral impact on the trade balance of Portugal. The study came to the conclusion that vertical FDI had a greater impact on export than import because of high value added activities. As opposed to this FDI in low value added activities will have a negative impact on Balance of Trade because it generates high volume of intermediate imports.

Njong (2008) in his study estimated the potential effects of FDI inflows on export growth in Cameroon economy during the period of 1980-2003. The study found
strong evidence that FDI inflow has contributed to increase the supply capacity and spillover effects in Cameroon economy. This led further growth of export during the reference period of the study. Therefore, a positive alliance between FDI inflows and export performance in Cameroon has been established by this study.

From the above discussion, it is evident that a strong association between FDI and trade is traceable. However, studies reviewed above have pointed out that impact of FDI on trade varies from country to country and the type of the FDI flows (horizontal/vertical). Nevertheless it is clear that economic and institutional factors play a major role in this regard.

2.3.3 Impact of FDI in SAARC Region

One of the pioneering studies on FDI in SAARC region was conducted by Sengupta and Banik (1997). The authors argued that FDI and regional trade are generally mutually supportive. According to the authors FDI as a fraction of GDP is marginal among all the SAARC countries. Yet it was found that there is a significant positive impact of FDI on Gross National Investment of the member countries with exception of Nepal, India and SAARC region as a whole. The authors were of the view that benefits to the host country will depend on both the size of the package of incentives and disincentives to FDI and the extent of other distortions in the economy. As far as the impact of FDI on export was concerned it was found to be positive in SAARC countries with the exception in Maldives. FDI inflows in the reference period raised exports and reduced imports from non-SAARC and SAARC countries.

Agrawal (2000) is a study provided the empirical evidence for the positive association between FDI, National Investment and economic growth. The author used time-series cross-section panel data from the five major South Asian countries covering time period between 1965-1996 to estimate the impact of FDI inflows on domestic investment and on GDP growth. He argued that there exists a complementary linkage between foreign and national investment. The study found that the impact of FDI on GDP growth was negative before 1980s but the reverse case was noticed in

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24 The impact of FDI on trade is more positive in developing countries as compared to developed industrialized countries. For further discussion see Aizenman and Noy (2006)
25 The study included all the eight member countries of the SAARC region.
26 India, Pakistan, Bangladesh, Sri Lanka, Nepal.
late eighties and early nineties. They supported the argument that FDI is more likely to be beneficial in more open economies.

Sahoo (2006) made an extensive study about the Policy, Trends, Impact and Determinants of FDI in SAARC region. The study employed panel co-integration method for the analysis for the period of 1970-2003. He found all the five south Asian countries were lacking in adequate infrastructure facilities and governance. The FDI in South Asia is mostly concentrated in manufacturing and services sectors. For Indian and Pakistan FDI inflows were found to be dominating domestic market oriented whereas for Sri Lanka and Bangladesh it is found to be in export market oriented sector. The study found a positive impact of FDI on the economic growth of South Asian countries. However, Pakistan was as exception in this regard. The study also pointed out market size, labour force growth, and infrastructure index and trade openness as major determinants of FDI in South Asian region.

Iftikhar (2012) studied the relationship between FDI and economic growth in select SAARC countries for the period 1970 to 2004. The study employed heterogeneous panel co integration technique and Granger- Causality test. He found a strong causal link between FDI to GDP. His findings indicate that as FDI promote growth, GDP growth also helps to attract more FDI inflows. Once growth is enhanced and stimulated, further foreign investment will be attracted. The study suggested that the economic growth of the SAARC region can further be promoted by FDI inflows in the region. The SAARC countries may be benefited from adopting investment friendly policies that attracts FDI flows into their economies.

Awan et al (2012) explored the relationship among FDI, Imports, Exports, Domestic Investment and Economic Growth in four South Asian countries. The study used time series (annual) data for the time period between 1973 and 2010. The study employed Granger Causality test to analysis the relationship between the variables. On the basis of the test results the study argued that imports are caused by GDP at different lag periods in all the selected countries. But no evidence of causality from imports to GDP was found in the study. The authors also argued in support of the

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27 The study includes only five South Asian Countries India, Pakistan, Nepal, Sri Lanka and Bangladesh

28 The study included only four countries of South Asian region, namely Bangladesh, India, Pakistan and Sri Lanka.
two-way causality between FDI and Trade Openness. The authors have also supported adoption of liberal policies to increase investment in the host country.

2.3.4 Studies related to individual SAARC member countries

Pakistan

Atique et al. (2004) argued that the impact of FDI on economic growth of Pakistan tends to be greater under an export promotion trade regime as compared to an import-substitution regime. The study employed time series data for Pakistan for the period 1970-2001. The study pointed out trade policy regime as one of the major factors of growth associated with TNC and FDI inflow. The authors argued that FDI can stimulate the human resource development through investment in education and training. This will further enhance the stock of human capital, and also increase productivity of labour and other factors of production.

Yousaf (2008) argued that FDI has contributed significantly in the development of human resources, capital formation, and improvement of organizational and managerial skills in Pakistan. The study analyzed the impact of FDI on imports and exports of Pakistan using time series data. The study employed co-integration technique for the period between 1973- 2004. The study found FDI has positively impacted the real demand for imports both in the short and long run. The study also found that, with one per cent increase in FDI inflow, the real demand for import has increased by 0.08 per cent in the short-run, while it was 0.52 in the case of long run. However, with one per cent of increase in FDI inflow, the real export has decreased by 0.08 per cent in the short-run and increased by 1.62 per cent in the long run. The study also mentioned political instability, lack of infrastructural facilities as the major hurdles in the FDI inflow.

Falki (2009) studied the impact of FDI on economic growth of Pakistan, during the period of 1980-2006. The study employed theoretical model developed by Cobb-Douglas and Granger’s Causality technique to examine the relationship between FDI and economic growth. He found a negative and statistically insignificant relationship between the GDP and FDI Inflows in Pakistan in his reference period. The study argued that liberal trade regime, a threshold level of endowments of human capital, and an adequate domestic market for the goods produced are some of the pre-
conditions for attracting FDI. The study suggested that government should formulate policy variables in such a way so that it can attract more investment.

Yousaf et al. (2011) found FDI has a negative impact on economic growth of Pakistan during the period of 1980-2009. The study used OLS model for the empirical analysis. The study reported unfavourable government policy, technological gap; under-qualified human skills have been the major hurdle in taking the benefits of FDI. The study suggests that government should create opportunities for the foreign investors to transfer current management skills and technological innovations, and provide sound business environment and opportunities to strengthen local markets.

Tabassum et al (2012) studied the relationship between foreign direct investment with both import demand and export supply of Pakistan. The study covered the time period from 1973 to 2009. The study employed Co-integration method for the analysis. The study argued that FDI generally have a tendency to increase the host country's imports, because Multi-National Corporations often have a high tendency to import intermediate inputs, capital goods and services. The study found that there exist a stable and long run equilibrium relation between real import and FDI. The study also found positive and long run relationship between FDI and real exports in Pakistan.

**Sri Lanka**

Athukorala (2003) used time series data from 1959 to 2002 to study the impact of FDI on economic growth of Sri Lanka. The study applied co-integration model to capture the two way linkage between FDI and trade. He argued that attractive investment opportunities are available for foreign companies in Sri Lanka. He also argued that a number of policy measures have been adopted to attract international investment into the country. Sri Lanka also offers one of the most liberal FDI regimes in South Asia. Lack of transparency in the trade policy, discrimination against non-export oriented sectors and high lending rate were found as the major constraints to FDI flows in Sri Lanka. The current study suggested developing of the port network, road and rail network, communication facilities and more flexible labour markets to increase in the inflow of international investment.

Balamurali and Bogahawatte (2004) have investigated the relationship between foreign direct investment and economic growth of Sri Lanka over the period 1977-
2003. This study also employed Granger-causality test for the analysis. They found that FDI was a key determinant for Sri Lankan economic growth after 1977. The study also found bi-directional causality between foreign direct investment and economic growth in Sri Lanka. The results showed that foreign direct investments exert an independent influence on economic growth of Sri Lanka. The current study also explored a long-run equilibrium relationship between GDP, FDI, Domestic Investment (DIN) and Openness of trade policy.

**Bangladesh**

Ahamad and Tanin (2010) studied the determinants and the relationship between FDI and economic growth in Bangladesh. The study covered the time period 1975-2006 and developed multiple regression model based on time series data. They argued that economic growth of the host country is a significant determinant of FDI. It is the level of economic growth that attracts FDI. The authors made the argument from the fact that foreign investors invariably prefer to invest not only in large markets but also in economies which are experiencing ongoing high rates of economic growth. Therefore, the role of FDI is pivotal in providing Bangladesh the necessary finance and capital to achieve sustainable growth as well as poverty alleviation. The study also argued that FDI inflows in Bangladesh in the recent decades have been able to increase GDP by raising the economy’s output capacity and employment level.

Quader (2009) studied the robustness between FDI inflow and various economic indicators and their impact on Bangladesh economy. A positive relationship was found between FDI and economic growth after studying the time series data for the period of 1990-91 to 2005-06. The study employed OLS method and extreme bound method for the analysis and results were found to be significant at 95% level.\(^{29}\) The study suggested a consistent incentive package should be implemented to encourage foreign investment and to ensure long term economic growth.

Athukorala and Sharma (2006) studied the FDI inflow in Nepal for the period between 1985-2001 using time series data. They revealed that in spite of significant liberalization of the economy, foreign investment regime and providing attractive

\(^{29}\) Extreme bounds analysis is a global sensitivity analysis that applies to the choice of variables in a linear regression.
investment incentives, Nepal’s achievements in attracting FDI is far from satisfactory level and national expectations. The paper argued that FDI in Nepal has failed to make a significant contribution to the productivity growth of manufacturing sector. The authors suggested that Nepal need to develop the pre-conditions of investment and trade to enjoy the benefits from FDI.

Bista (2010) argued that instable and volatility in business environment, political instability is the major hurdles in attracting FDI in Nepal. Econometric model based on Cobb-Douglas production function was used for the study during the period between 1990 and 2004. The study argued that the situation in Nepal is such that FDI firms could not behave normally as required for production decision and for smooth trade flow inside and outside the country. Because of growing risk aversion cost and transaction cost international firms are not encouraged to invest in Nepal.

India

Kumar (2005) examined the effect of FDI on domestic investment in India. He did not find a statistically significant effect of FDI on domestic investment. He argued that the changing policy framework has affected the trends and patterns of FDI inflows in India. The study revealed that India is spending relatively smaller amount in the development of technology and R & D. Export oriented industrialization by India with the FDI has also been much poorer in compare to other East Asian economies.30

Chakraborty and Nunnenkamp (2008) found FDI inflow has surged in Indian economy especially after the post reform period. The study used Granger-Causality test in the panel co-integration framework for the time series data for the period between 1987 and 2000. The study argued that FDI stocks and output are co integrated in the long run. FDI can promote growth through productivity gains resulting from spillovers to local firms. The study also argued that the impact of output growth in attracting FDI is relatively stronger than that of FDI in inducing economic growth. At the sector level, it was found that favorable growth rate of Indian economy has affected FDI inflows in India. But, it is largely restricted to the manufacturing sector. However, results of Granger-Causality test revealed that output

30 Although large bodies of literatures on impact of FDI on India’s trade and growth are available, in this chapter recent studies have been reviewed. Other studies will be reviewed in the relevant chapter.
growth in the service sector has also been stimulated by FDI inflow. Moreover, no causal relation was found in primary sector.

Pradhan (2008) found unidirectional causality between FDI and GDP for Indian economy. The study was conducted for the period 1970-2004. Time series data was used for the analysis. The study employed Granger-Causality test to investigate the relationship between FDI inflows and economic growth. He argued economic growth promotes FDI but FDI do not promote growth. However, the author pointed out that FDI can affect economy indirectly by productivity spillover and export growth.

Sarode (2012) studied the effect of FDI on capital account and GDP of India. The study covered the time period between 1997 and 2011. The study employed the Granger-Causality test for the analysis. The author found a negative effect on current account and positive effect on capital account for the period of analysis in India.

From the above studies reviewed, it is evident that results provide a mixed response as far as the impact of FDI on trade and growth is concerned. Some studies have reported the positive impact while some have given evidence the impact is negative. Further, it is also evident that very few studies have been conducted for all the SAARC member countries. In fact there is dearth of studies for countries such as Afghanistan, Bhutan and Maldives. It is this lacuna that the present study makes an attempt to bridge.

2.4 Conclusion

In this chapter two part analysis was undertaken to examine the theories explaining international movement of capital and to review that literature which explores the relationship between FDI, economic growth and trade. In the first section we have discussed the major investment theories explaining the foreign investment from different countries. These theories have explored the causes of the international movement of capital. Different theories have explained different approaches and motives followed by the MNCs to undertake international investment. These approaches and motives vary with the investing firm and host country. According to one approach FDI takes place because of the monopolistic advantages enjoyed by the firm over the domestic firms. Another approach argued that when a firm fails to
compete in its domestic market it chooses to go abroad. There are also a theory which mentioned that firms undertake international investment to take the benefit of the exchange rate differences between the domestic and host country. Nevertheless all of the theories were of the view that firms go abroad to reap benefit of some advantage it enjoys.

In the second section of the current study empirical studies were reviewed describing the impact of FDI on economic growth and trade in general. The section was followed by another sub-section explaining the studies which tried to explore the relationship between FDI and trade in SAARC group of countries. The results provided a mixed response. Some studies came to the conclusion that FDI has a positive impact on trade and economic growth while some studies show a negative impact. Further studies pertaining to countries of SAARC region are limited and these studies are mainly focused on India, Pakistan, Sri Lanka and Nepal. It is this lacuna that the current study will make an attempt to fill. The evidence from other studies in that government policy also plays a major role in making a country an attractive destination for FDI. It is in this context that our next chapter will focus on the existing foreign investment policy in the SAARC group of countries.
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