

IMPACT OF FOREIGN DIRECT INVESTMENT ON ECONOMIC GROWTH OF INDIA- AN EMPIRICAL ANALYSIS

VIKAS MADHUKAR*

ANIL K MITTAL**

Foreign direct investment (FDI) is an essential aspect of 'globalisation', and has been playing a key role in shaping the world economy during the last two decades. Recognising that FDI can contribute to economic development, all governments would like to attract FDI flows into their economies. The FDI inflows into India was US\$ 5.34 billion in 2004, which is 0.82% of the sum of world FDI inflows, 2.29% of the amount of FDI inflows into developing countries, and 3.62% of the total of FDI inflows into Asia. The present paper is aimed at analysing the role of FDI in the economic growth of India. The index of economic growth is the growth rate of real per capita gross domestic product (GDP). Our regression results indicate that the relationship of FDI with economic growth is robust. The relationship is positively correlated and has a significant impact on economic growth. The results for openness are positively correlated and significant, emphasising the impact of external sector, liberalisation, on economic growth. The ratio of private sector credit to GDP is significant and positively correlated with economic growth. Our study suggests that FDI exerts a significant impact on economic growth of India, and a greater allocation of credit to the private sector will increase financial depth, development, and economic growth.

I- Introduction

Foreign direct investment (FDI) has grown at a phenomenal rate since the early 1980s, and the world market for it has become more competitive. FDI is the dominant form of private capital flow to developing countries, accounting for about 70 percent of private flows to developing countries as a whole and a higher percentage of private flows to low-income countries. FDI comprises a bundle of assets, some of which are proprietary, and others are not. Key assets include capital, technology, management techniques, skills, market access, etc. Non-proprietary assets such as finance, capital goods, and intermediate inputs can be obtained, at least in part, from international markets; but, proprietary

* Assistant Professor, International Finance and Strategy, Amity Business School, Manesar (Gurgaon).

** Reader in Finance at Department of Management, Kurukshetra University, Kurukshetra.

assets can be obtained only from the firms that create and possess them. Of the proprietary assets that transnational corporations make available to their affiliates in host countries, the most important is probably technology. But, there are other things like brand names, skills, the ability to organise, and integrate production across countries, and privileged access to markets, which, if taken together, would mean that FDI can contribute to the economic performance of host countries and, in particular, to their development and growth. Keeping in view the developmental aspect of FDI in a host country, the present research analyses the role of FDI in the growth of India.

II- Trend of Foreign Direct Investment

The liberalisation of FDI through legislative and regulatory changes in a growing number of countries since the 1990s, and the integration of international capital markets have raised global FDI flows strongly in the recent past at a rate well above that of global economic growth or global trade. Average inflows of FDI during 1991-2000 and 2001-2005 rose nearly by 380% and 600% as compared to the average inflows during 1981-90 respectively(see Table-1).

Table- 1: FDI Inflows by Host Region

Host Region	Amount in US \$ Billion			
	1971-1980 Average	1981-90 Average	1991-2000 Average	2001-2005 Average
Developed Countries	21.7 (76%)	84.7 (78%)	375.1 (72%)	467.5 (64.3%)
Developing Countries	6.8 (24%)	24.2 (22%)	147.8 (28%)	259.7 (35.7%)
World	28.5 (100%)	108.9 (100%)	522.9 (100%)	727.2 (100%)
Asia	1.8 (6%)	13.8 (13%)	81.5 (16%)	134.9 (18.55%)

Source: Own computation based on WIR, various issues.

Table-1 indicates that, though most of the FDI inflows went into developed countries, the share of developing countries is rising. The FDI inflows are concentrated in few countries and ten largest host countries accounted for 65 per cent of the world FDI inflows in 2005(see Table-2).

Table-2: Top 10 World FDI Destinations

Rank	Country	Y 2005 (millions of dollars)	% of World Inflows
1	United Kingdom	164530	17.96
2	United States	99443	10.85
3	China	72406	7.90
4	France	63576	6.94
5	Netherlands	43630	4.76
6	Hong Kong, China	35897	3.92
7	Canada	33822	3.69
8	Germany	32663	3.56
9	Belgium	23691	2.59
10	Spain	22987	2.51
	Total of world inflows		64.68

Source: UNCTAD, WIR 2006.

Table-2 shows that FDI inflows into developed countries in 2005 amounted to \$542 billion, an increase of 37% over 2004; while, into developing countries, FDI flows rose to the highest level ever recorded – \$334 billion. The United Kingdom saw its inward FDI surge by \$108 billion to reach a total of \$165 billion, making it the largest recipient in 2005. Among developing economies, the list of the largest recipients compared with that of previous years remained stable, with China and Hong Kong (China) being followed by Singapore, Mexico, and Brazil. Out of the total amount of FDI flows that went into developing countries, Asia dominates the position with a share of 60 per cent. The region's share of FDI inflows worldwide also increased from 23 per cent in 2004 to 27.5 per cent in 2005. However, they remain concentrated: the top 10 host economies accounted for 89 per cent of FDI inflows to the region (Table- 3).

Table- 3: Asia and Oceania- FDI Flows, Top 10 Economies during 2004 and 2005

Rank	Host Economy	Y2004	% of Inflows in Asia	% of Total World inflows	Host Economy	Y2005	% of Inflows in Asia	% of Total World inflows
1	China	60 630	41.07	9.35	China	72406	36.28	7.90
	Hong Kong,				Hong Kong,			
2	China	34 035	23.06	5.25	China	35897	17.99	3.92
3	Singapore	16 060	10.88	2.48	Singapore	20083	10.06	2.19
	Korea,				United Arab			
4	Republic of	7 687	5.21	1.19	Emirates	12000	6.01	1.31
5	India	5 335	3.61	0.82	Turkey	9681	4.85	1.06
					Korea, Republic			
6	Malaysia	4 624	3.13	0.71	of	7198	3.61	0.79
7	Turkey	2 733	1.85	0.42	India	6598	3.31	0.72
	Taiwan							
	Province of							
8	China	1 898	1.29	0.29	Indonesia	5260	2.64	0.57
	Saudi							
9	Arabia	1 867	1.27	0.29	Saudi Arabia	4628	2.32	0.51
10	Vietnam	1 610	1.09	0.25	Malaysia	3967	1.99	0.43
			92.46	21.05			89.06	19.40

Source: UNCTAD, WIR 2005 & 2006.

Table-3 reveals that the FDI inflows into South, East and South-East Asia reached \$165 billion in 2005, corresponding to 18 per cent of world inflows. About two thirds went to two economies: China (\$72 billion) and Hong Kong, China (\$36 billion). The South-East Asian sub-region received \$37 billion, led by Singapore (\$20 billion) and followed by Indonesia (\$5 billion), Malaysia, and Thailand (\$4 billion each). FDI Inflows into South Asia were much lower (\$10 billion), though they grew significantly in several countries, with the highest level of \$6.6 billion for India.

FDI is an important avenue through which investment takes place in India. The importance of FDI extends beyond the financial capital that flows into the country. In addition, FDI can be a tool for bringing knowledge, and integration into a global production chain, which is the foundation of a successful export strategy. Policies in post-reform period emphasised encouragement and mobilisation of non-debt items, creating private capital inflows for reducing reliance on debt flows as the chief source of external resources. FDI inflows indicate the long term stake of foreign investors in a host economy. A constant and steady relaxation of

FDI regulations, and inclusion of more sectors under the automatic route coupled with a change in the global scenario and a strong inflow of FDI into developing countries led to an increase in FDI inflows into India. India's share in global FDI increased from 0.48 per cent in 2002 to 0.72 per cent in 2005, but it remained below 1 percent of world FDI inflows. This is shown in the following table:

Table- 4: Inflows of FDI in India

Year	In Rs Crore	In US\$ million	% increase/ decrease
1991-92	316	129	32.99
1992-93	965	315	144.19
1993-94	1838	586	86.03
1994-95	4126	1314	124.23
1995-96	7172	2144	63.17
1996-97	10015	2821	31.58
1997-98	13220	3557	26.09
1998-99	10358	2462	-30.78
1999-00	9338	2155	-12.47
2000-01	18406	4029	86.96
2001-02	29235	6130	52.15
2002-03	24367	5035	-17.86
2003-04	19860	4322	-14.16
2004-05	25395	5652	30.77
2005-06 p	34316	7751	37.14

P : Provisional.

Source: Reserve Bank of India.

Table-4 shows that the FDI inflows have picked up in the earnest only from the last quarter of 1993, though India has adopted the policy of liberalising capital controls in 1991. The increase was 124 per cent in 1994-95 compared to the previous financial year. It was further increased by 63 per cent in 95-96 and reached at US\$ 2.1 billion. Government expanded the list of industries and items eligible for automatic approval by RBI, because of which, the FDI inflows rose substantially and achieved a level of US \$ 3557 million, highest since 1991. The investment was substantial in Engineering, Chemicals, and Food & Dairy products. FDI inflows declined by 30 per cent in 1997-98, and reached a level of US\$ 2462 million. The FDI flows into developing countries were

also sluggish in the said period. The declining trend continued in 1999-2000. In line with aligning the Indian FDI definition with the global standards, the FDI definition was widened and two more components were included in calculating the FDI (DIPP, May 2002). As a result, FDI inflows increased from 2155 US\$ million in 99-00 to 4029 US\$ million in 2000-01. FDI inflows rise sharply in 2001-02. The FDI inflows declined in 2002-03 by more than US \$ 1 billion. The decline was principally on account of a sharp drop in net equity inflows. The declining trend continued in the next year also, and the FDI inflows turn down to US \$ 4673 million in 2003-04. The reversal in World FDI inflows took place, and; as a result of increased inflows of FDI into developing countries, the FDI inflows were raised nearly by 31 per cent in 2004-05 and 37 per cent in 2005-06.

III- Need for FDI

Bosworth and Collins (1999) and Mody and Murshid (2002) have found evidence of a strong link between long-term FDI and investment. An additional Dollar of FDI is associated with a 73% increase in domestic investment. This "crowding in" may be due to positive FDI spillovers on domestic firms in terms of a new technology or the need of new local suppliers for FDI investors. FDI may also facilitate the expansion of domestic firms through complementarities in production. There is also a considerable scope for the initial FDI to attract foreign capital further as "additional investors producing similar goods may invest nearby if the pioneer firm performs well" (Altenburg and Meyer-Stamer, 1999). Rising standards of living can accrue to domestic labour in form of higher real wages and to consumers by way of lower prices. An increase in real wages may be one of the major direct benefits from an inflow of foreign capital. As the capital stock of an economy augments, the marginal product of capital falls. Since the profit rate, which is assumed to be equal to the marginal product, decreases simultaneously, the redistribution of income from domestic capitalists to domestic labour takes place with an increase in real wages. Domestic consumers may also benefit from FDI. By enlarging consumer choice, foreign direct investment can help to increase the level of competition in national markets, thereby driving down prices and increasing the economic welfare of consumers. For economies of transition, the inflow of direct investment not only raises the productivity of a given amount of labour, but also allows a larger labour force to be employed. A shortage of capital in poor countries limits the employment of labour from the rural sector into the advanced sector, where wages are higher; an inflow of

foreign capital may then make it possible to employ more labour in the advanced sector. So, the international flows of capital can be interpreted as an alternative to labour migration.

The benefits of FDI to the recipient country include improvement of the balance of payments because of the inward flows of capital. Within the general classification of financial flows into autonomous (non-debt creating) and compensatory (debt-creating), FDI is considered as autonomous and production-oriented, thus permitting a country to finance a current account deficit in a solid manner or to maintain interest payments on international debt. Furthermore, positive balance of payments effects arise from import substitution effects and from subsequent exports by the new enterprise (*Tomann, 1999*). Large capital inflows may also lead to a real appreciation of a recipient-country's currency (as observed in most of the CEE countries in the past decade), thus indirectly lowering balance of payments' liabilities in foreign exchanges. Apart from being a source of finance, one of the most significant contributions of FDI is likely to come from external economies. FDI not only provides capital and foreign exchange, but also new technologies, managerial know-how, and innovations in products and production techniques (*Meier, 1995; Zukowska-Gagelmann, 2001*). The access to foreign knowledge promotes domestic economic development, human capital formation, and, through spillovers, enhances the productivity, and the profitability of local firms. Therefore, FDI inflows are important forces behind the rising competitive pressure that is expected to encourage local producers to adopt efficiency enhancing strategies.

IV- A Brief Review of Literature

In developing countries, policy makers are now very much concerned with FDI inflows. Such inflows bring additional resources, which these countries need to improve their economic performance. A well-documented study by UNCTAD (1992) lends a clear support to the role of FDI as an engine of growth in developing countries, a conclusion reached independently by Blomstrom et al (1992). The higher efficiency of FDI has also been examined empirically. The efficiency is assumed to arise from the combination of foreign advanced management skills with domestic labour and inputs. Findlay (1978) suggests that foreign direct investment increases the rate of technological progress in the host country through a "contagion" effect from the more advanced technology and management practices used by the foreign firms. Wang (1990)

incorporates this idea into a model where the increase in "knowledge" is applied to production as a function of FDI.

Fry (1993) examines the role of FDI in promoting growth in the framework of a macro model for a data set of pooled time series and cross-section of 16 developing countries for the period 1966-88. He finds that FDI exerts a significantly different effect from domestically financed investment on the rate of economic growth. He also finds that FDI has a significant negative effect on domestic investment, suggesting that it crowds out domestic investment. Hence, FDI appears to have been immiserising economic growth. However, this effect varies across countries. In the Pacific basin countries, FDI seems to have crowded in domestic investment.

De Gregorio (1992) shows, in a panel of 12 Latin American countries, that FDI is about three times as efficient as domestic investment. FDI is also expected to act as a catalyst for local investment by complementing local resources and providing a signal of confidence in investment opportunities.

Blomstrom *et al* (1992) find that FDI inflows have a significant positive effect on the average growth rate of per capita income for a sample of 78 developing and 23 developed countries. However, when the sample of developing countries is split between two groups based on the level of per capita income, the effect of FDI on the growth of lower-income developing countries is not statistically significant. They argue that least developed countries learn very little from MNEs because domestic enterprises are too far behind in their technological levels to be either imitators or suppliers to MNEs.

Balasubramanyam *et al* (1996) analyse the effect of FDI on average growth rate for the period 1970-85 for the cross section of 46 countries as well as the sub-sample of countries that are deemed to pursue an export-oriented strategy to be positive and significant, but not significant, and sometimes negative for the sub-set of countries pursuing an inward-oriented strategy. This is immediately understandable in a theoretical context of export-led growth. He also observe that, when developing economies implement policies in order to protect national industries from foreign competition, a wedge between social and private returns to capital arises, and the resulting international specialisation of the economy does not reflect its comparative advantage. As a consequence, in a protectionist environment, the spillovers associated with FDI are

likely to be limited because the allocation of capital takes place in an economy in which prices are distorted.

E. Borensztein, J. De Gregorio and J.W. Lee (1998) examine the role of FDI in the process of technology diffusion and economic growth in developing countries. The study uses data on FDI flows from industrial countries to 69 developing countries over the last two decades. The results from the regression show strong complimentary effects between FDI and human capital on the growth rate of income. These results are consistent with the idea that the flow of advanced technology brought along by FDI can increase the growth rate of the host economy only by interacting with the host country's absorptive capability. FDI makes a negative contribution to growth in countries with a low level of human capital. The study also finds some evidence of a crowding-in effect in that FDI is complementary to domestic investment.

Andrea Marino (2000) analyses whether the degree of "openness" influences the inward FDI, and whether the differences in trade policy are better than the differences in development level so as to discriminate how the FDI-growth nexus changes over countries. He considers a sample of 42 developing countries. The results show that (1) inward FDI is positively correlated with the degree of "openness", and (2) the impact of foreign investment is significantly positive in "open" countries and significantly negative in "closed" countries. The author has found no evidence that a minimum human capital threshold level has to be reached for the impact of FDI to be positive.

Nikolai Flexner (2000) in his study employs ordinary least squares (OLS) estimation to examine the effect of FDI on per capita GDP growth in Bolivia over the period 1990:1-1998:4. The study finds that the key factors influencing economic growth in Bolivia are the ratio of FDI to GDP, the terms-of-trade, the ratio of private sector credit to GDP, and the ratio of government consumption to GDP.

Jeannine N. Bailliu (2000) examines the role of net private capital inflows in the determination of economic growth. The relationship between private capital inflows and economic growth is estimated by using panel data for 40 developing countries for the period 1975-95. The results suggest that the domestic financial sector plays a pivotal role in ensuring that international capital inflows do indeed promote economic growth in developing countries. This means that net capital flows will have a positive effect on growth only for those countries that have

developed banking sectors; otherwise, the effect of net capital inflows on growth is negative.

Robert Lensink and Oliver Morrissey (2001) examine the impact of FDI on growth, specifically accounting for volatility. It presents a simple endogenous growth model in which FDI has a positive effect on growth; whereas, the volatility in FDI flows has a negative effect. The total sample of 88 countries includes about 20 developed countries. A number of 'standard' explanatory variables are included apart from the FDI variables. The most important of these are the initial values of GDP per capita and the secondary school enrolment rate. Both the variables are measured in logs. Other variables are the black market premium and government consumption expenditure as a share of GDP. A number of political and institutional indicators are also used in estimating equations with instrumental variables. The findings show that the volatility of FDI has a consistent negative impact on growth. There is a suggestion that it is not the volatility of FDI per se that retards growth but that such a volatility captures the growth-retarding effects of unobserved variables.

Laura Alfaro (2003) investigates, using cross-country data for the period 1981-1999, whether FDI in the primary, manufacturing, and services sectors exerts different effects on a country's growth. The study explores the roles the different types of FDI have played in different sectors. The growth is considered as the dependent variable and FDI the independent variable. Other variables used in the study are Government spending, inflation, institutional quality, schooling, private credit, and openness. The study concludes that FDI inflows into the different sectors of the economy; namely, primary, manufacturing, and services sectors, exert different effects on economic growth. FDI inflows into the primary sector tend to have a negative effect on growth; whereas, it has a positive effect in the manufacturing sector, and the effect of FDI in the service sector is ambiguous. The study further suggests that not all forms of foreign investment seem to be beneficial to host economies.

Abdur Chowdhury and George Mavrotas (2005) have employed an innovative methodology to test the direction of causality between FDI and growth for three major FDI recipients in the developing world; namely, Chile, Malaysia and Thailand, each with different macroeconomic episodes, policy regimes, and growth patterns over the period 1969-2000. The empirical findings, which are based on the Toda-Yamamoto causality test, seem to suggest that it is the GDP that causes FDI in Chile, and not vice versa. The findings of the study suggest that

the direction of causality running from FDI to economic growth is not confirmed to the case of Chile; while, in the cases of both Malaysia and Thailand, the causality is bi-directional. Consequently, this casts some doubt on the validity of policy guidelines which emphasise the importance of FDI for growth and stability in developing countries under the assumption that FDI causes growth. Increased attention needs also to be given to the overall role of growth as a crucial determinant of FDI, along with the quality of human capital, infrastructure, institutions, governance, legal framework, and tax systems in host countries.

V- Research Methodology

Our study is an empirical exercise which uses the annual time series data from 1987 to 2004. The data was taken from the data banks of International Monetary Fund (IMF), and Reserve Bank of India (RBI). OLS regressions have been computed to analyse the impact of FDI on economic growth of India.

To estimate the role of FDI in the economic growth of India, researchers have taken the variables from the models adopted by Nikolai Flexner (2000), Robert Lensink and Oliver Morrissey (2001), and Laura Alfaro (2003). Literature suggests that one of the standard measures of economic growth is per capita real GDP, which is taken as the dependent variable. The empirical literature on economic growth has identified a number of variables that are typically correlated with economic growth. Out of these variables, our model considers the ratio of FDI to GDP as the index of the impact of FDI on economic growth of India. Other variables chosen in the model include openness, which provides a good measure of the external liberalisation of economy; and inflation, which has proven to be a good indicator of macroeconomic stability. In recent years, a number of empirical studies have suggested that inflation may have adverse effects on economic growth. While a study by Bruno and Easterly (1998) finds that inflation had little relation to economic growth at annual rates below 40 percent. Barro (1996), in a cross-country regression of over 100 countries from 1960 to 1990, finds that an average annual inflation rate of 10 percent reduces real per capita GDP growth by 0.3-0.4 percentage points per year. The ratio of government consumption to GDP, which has been used in previous growth studies to measure the extent of fiscal adjustment, is also considered. The basic argument is that a reduction in government consumption reduces the level of distortion in taxation, and may help to reduce a crowding-out of private sector investment. He also points out that the variable of government

consumption is intended to capture public expenditures that do not directly affect productivity, but will entail distortions of private decisions. The coefficient on that variable is thus expected to be negative. Our model also includes the ratio of private sector credit relative to GDP. The ratio measures the value of credits by financial intermediaries to the private sector. Levine et al (2002) find a strong positive relationship between this ratio and per capita GDP growth.

Considering the above principal determinants of economic growth, we specify our model in terms of the following two regression equations:

$$RGDP_t = \alpha_0 + \alpha_1 FDI_{t-1} + \alpha_2 OPEN_t + \alpha_3 INFL_{t-1} + \alpha_4 GOV_t + \alpha_5 DOCRED_{t-1} + U_t \dots \quad (1)$$

where U_t is a random term. The other variables are defined in the following table:

Table- 5: Definition of Variables and Expected Signs

Variable		Explanation	
Dependent			
RGDP	Real per capita GDP measures the economic growth		
Independent		Explanation	Expected Signs
FDI _{t-1}	FDI/Real GDP (one year lag)	Foreign Direct Investment	+ VE
OPEN	Openness (sum of exports and imports to real GDP)	Measures the extent of external sector liberalization	+ VE
INFL _{t-1}	Inflation (one year lag)	measures the percentage of change in the GDP deflator and used as a proxy for macroeconomic stability	- VE
GOV	Ratio of government consumption to GDP	Measure the extent of fiscal adjustment	- VE
DOCRED	Ratio of private sector credit relative to GDP	Measures the value of credits by financial intermediaries to the private sector divided by GDP	+ VE

V- Empirical Results

The computed form of regression (1) is presented in the following table:

**Table- 6: OLS Regression Analysis Explaining the Variations in Economic Growth
(Dependent Variable – per capita real GDP)**

Model	Variable	Coefficients	S.E.	t	Sign.	R ²
1	(Constant)	6994.254	475.716	14.703	***	0.99
	FDI (lag)	67981.250	21433.497	3.172	***	
	OPEN	8781.846	2734.587	3.211	*	
	INFL (lag)	-30.910	28.359	-1.090	.	
	GOV	247.391	109.768	2.254	**	
	DOCRED	1360.611	1155.242	1.178	.	
2	(Constant)	6561.892	264.818	24.779	***	0.99
	FDI (lag)	75795.447	20370.767	3.721	***	
	OPEN	7619.589	2539.537	3.000	***	
	GOV	262.001	109.873	2.385	**	
	DOCRED	1973.068	1017.963	1.938	*	

*Significance at *** 0.01 level, **0.05 level, and *0.10 level.*

Table 6 indicates that the independent variables explain 99% of the variation in per capita real GDP. All the independent variables have expected signs, except the ratio of government spending to GDP (GOV). The results show that the relationship of FDI is robust, and positively and significantly correlated with economic growth. The results for OPENNESS are positively correlated and statistically significant, emphasising the impact of liberalisation on per capita GDP growth. This may imply that India would gain most from further opening of its economy to international trade and expanding its markets. Inflation is negatively but not statistically correlated with economic growth. The ratio of government spending to GDP (GOV) is positive and has a significant impact on growth. This may be due to the fact that, in a country like India, a major part of government expenditure is on public welfare activities such as education, health, infrastructure, etc.. These factors ultimately facilitate economic growth in the economy. The ratio of private sector credit to GDP (DOMCRED) is significant and positively correlated with economic growth. The assumption underlying this measure is that a greater allocation of credit to the private sector will increase financial depth and development, and then economic growth.

VI- Conclusion

Our empirical analysis clearly outlines the important determinants of FDI in India. The results show that Market Size (GDP), and financial soundness (external debt to exports) come out to be strong determinants

of FDI. It is found that a larger market or an increasing market size will create opportunities for increased profits, and this will attract a rising amount of foreign investment. A high level of debt burden makes the country less attractive for foreign investors to bring more capital into India. Power consumption is positively correlated with FDI, which highlights the importance of infrastructure in the attraction of FDI. The inflation is negatively correlated with FDI, which signifies the requirement of a moderate level of inflation to attract more FDI. Moreover, our results show that the FDI is crucial for the economic growth of India. The extent of external sector liberalisation and the grant of domestic credit by financial intermediaries are important factors in the determination of the level of economic growth in India.

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