

A study on foreign direct investment: Post-liberalization impact of FDI on Indian economy

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Abstract

FDI has become a key component of national development strategies for all most all the countries over the Globe. FDI is considered to be an essential tool for jump-starting economic growth through its bolstering of domestic capital, productivity and employment. FDI are investments made by residents of one economy with the objective of establishing a lasting interest in a company located in another economy (host economy). With 'lasting interest' we mean both the existence of a long-term relationship and a degree of ownership of the foreign firm. In statistics, ownership of at least 10 percent of the ordinary shares in US, India etc. and 25 per cent in Britain has been the criterion for the existence of a direct investment relationship. Ownership of less than 10 percent is considered as a portfolio investment. The presence of foreign investors means that firms controlled by foreigners produce part of the domestic output. Foreign direct investment has grown at rates far beyond those of international trade since the late 1980s. Especially in the second half of the 1990s, firms were exceptionally active in cross-border Mergers and Acquisitions (M&A). The outstanding global stock of FDI more than doubled in ten years' time from 8.3 percent of world output in 1990 to 17.5 percent in 2000. It is conceivable that the larger presence of FDI is partly responsible for the observed increase in cross-country business. FDI refers to the purchase by the citizens of one country of non-financial assets in another country. Foreign direct investment involves the acquisition or establishment of a firm, company or enterprise in a country outside of the registered corporate home country. FDI in real estate involves acquisition of land or building across all commercial, residential and retail segments. Any construction activity is also included in FDI.

Keywords: foreign direct investment, GDP, economic growth, world Bank, five year plan

1. Introduction

Foreign direct investment (FDI) is an investment made by a company or individual in one country in business interests in another country, in the form of either establishing business operations or acquiring business assets in the other country, such as ownership or controlling interest in a foreign company. Foreign direct investments are distinguished from portfolio investments in which an investor merely purchases equities of foreign-based companies. The key feature of foreign direct investment is that it is an investment made that establishes either effective control of or at least substantial influence over, the decision making of a foreign business. Broadly, foreign direct investment includes "mergers and acquisitions, building new facilities, reinvesting profits earned from overseas operations and intra-company loans". In a narrow sense, foreign direct investment refers just to building a new facility, a lasting management interest in an enterprise operating in an economy other than that of the investor. FDI is the sum of equity capital, other long-term capital, and short-term capital as shown the balance of payments. FDI usually involves participation in management, joint-venture, transfer of technology and expertise.

FDI is one example of international factor movements. An FDI is a controlling ownership in a business enterprise in one country by an entity based in another

country. Foreign direct investment is distinguished from foreign portfolio investment, a passive investment in the securities of another country such as public stocks and bonds, by the element of "control". According to the Financial Times, "Standard definitions of control use the internationally agreed 10 percent threshold of voting shares, but this is a grey area as often a smaller block of shares will give control in widely held companies. Moreover, control of technology, management, even crucial inputs can confer de facto control."

According to the IMF's Balance of Payments Manual 5th Edition, along with OECD's Benchmark Definition of Foreign Direct Investment 3rd Edition (OECD 1999) [35], FDI is defined as: "the objective of obtaining a lasting interest by a resident entity in one economy in an entity resident in an economy other than that of the investor. FDI can be categorised into three components: equity capital reinvested earnings and intracompany loans. Equity capital comprises of the shares of companies in countries foreign to that of the investor. Reinvested earnings include the earnings not distributed to shareholders but reinvested into the company. Intercompany loans relate to financial transactions between a parent company and its affiliates. FDI is an investment made to acquire a lasting management interest in a business enterprise operating in a country other than that of the investor defined according to residency.

2. Literature Review

Arindam Banerjee (2005) examined the grey areas of Indian economic policies, which prevent the free flow of FDI into India. To sustain the growth rate, Indian economy needs impetus through capital inflow. And found that the factors which determine the FDI inflows are economic and political stability, national policy towards foreign investment, country's regulatory, availability of quality and quantity of physical and financial infrastructure, good governance, size of local market and labour cost.

Basu P. *et al.* (2005) examined empirically inter-industry analysis, the time effects of the variables influencing the FDI inflows to India during the post reforms periods with special reference to temporal variations in the effect of these determinants using time dummies for both intercept and elasticity. They found that at the initial factor-driven stage of the development, resource-seeking FDI was strongly influenced by such determinants as marketing-intensity, gross fixed assets and to some extent by export-import ratio. However, the elasticity or the response of FDI to these stimuli started declining in early 1997. The situation started improving by 2000.

Bodla, B. S. *et al.* (2004) studied that there is a misconception that FDI comes to India because of cheap labour and found that MNC's look more at productivity than low wage in any country, and suggest that accelerated investment is the need of hour.

Hejazi *et al.* (2003) examined the changing pattern of FDI stock have raised important questions about their impact on domestic economies. It is often thought that increased inward FDI contributes to domestic capital formation, whereas increased outward FDI reduces it. And found that rapid growth in outward FDI, relative to inward growth, should not be considered as a negative development, and may reflect success.

Wilbur Chung. *et al.* (2003) examined the US auto component industry between 1979 and 1991. During this period, Japanese automobile assemblers began to produce vehicles in North America, and began to purchase inputs from US auto component manufacturers. Those US manufacturers that sold components to Japanese transplants would be direct recipients of any technologies transferred from the Japanese. And found that the direct investment made by Japanese assemblers was associated with overall productivity improvement in the US auto-component industry and little evidence of direct technology transfer. The productivity growth of US suppliers affiliated with Japanese assemblers was no greater than that of other, non-affiliated US suppliers. Further they found that the Japanese assemblers tended to purchase components from less productive US suppliers and moreover, that low productivity supplier that sold goods to Japanese assemblers had a higher survival rate than low-productivity suppliers that did not sell to Japanese firms. They suggest that increased competitive pressure in the auto-sector was the main cause of overall productivity improvement, at least during the initial stages of FDI of the 1980s.

Padhi S. P. (2002) examined that FDI inflows are industry-specific and, therefore, are regional-specific and

noted that the regional FDI inflows related positively related to cross regional differences in initial level of manufacturing output. That is especially when cross regional differences in initial level of manufacturing output do not confirm to a regional manufacturing convergence process and point to cross-regional differences in production structures. And found that regional FDI inflows were attracted less by regional incentive pattern (both provisions of financial incentive and infrastructure facilities) that was independent of cross-regional differences in manufacturing levels. At the same time, though FDI inflows were attracted to regions with initial higher level of manufacturing output, they do not directly support a divergence process.

Sahoo R. K. (1999) studied an attempt to empirically understand separately the role of foreign and domestic firms in augmenting development process in post reform India. It takes in account export orientation, import dependency, capital intensity, profit intensity, vertical integration, product differentiation and effective tax rate as the indicators for assessing their comparative development effort. And found that foreign firms are relatively better export performer, less import dependent, less capital intensive and contributes more to the national exchequer.

Sethi D. *et al.* (2003) examined that provide a rationale for changing trends in the flow and determinants of FDI as a result of macro-economic and firm strategy considerations. They identify several factors that impact on such trends. Factors were lucrative market, liberal host government policies, technological infrastructure, skilled labour and cultural proximity. And found that the Asian region is not ideal according to the determinants of US FDI. The liberalization of these countries' economies and the improvements in their infrastructure have facilitated a shift in efficiency-seeking US FDI, and have contributed to a change in the FDI trend over time.

Moore, M. O. (1993) attempted to look into the determinants of German Manufacturing Direct Investment to 17 countries during the period of 1980-88. The main object of the research is to shed light on the economic determinants that can best explain the privately financed manufacturing sector investment in German throughout the period. The study is based on the FDI outflow into five specific industries that are chemicals, steels, machinery, electronic and automotive sectors, the statistical model allows for estimation of country specific effects Md. Shah Alam (1998) examined an overview of FDI in Bangladesh. Analysis of the study is done based on economy, government policy and foreign direct investment. The study demonstrates that the economy of Bangladesh faces resource constraint, adverse balance of payments, negative balance of current account, debt burden and unemployment problem. In order to overcome the above situations, the Government of Bangladesh has liberalised investment policy to attract FDI. And found that mere FDI policy cannot attract sizable inflows of foreign investment. Along with FDI policy, congenial investment environment should be created for foreign investors.

3. Objectives of the Study

1. To study the trend and pattern of FDI.
2. To study the impact of FDI on the Indian economy.
3. To put forward certain challenges faced by FDI and its relative solutions.

4. FDI and Growth of Economy in India

The historical background of FDI in India can be traced back with the establishment of East India Company of Britain. British capital came to India during the colonial era of Britain in India. After Second World War, Japanese companies entered the Indian market and enhanced their trade with India, yet U.K. remained the most dominant investor in India. Further, after Independence issues relating to foreign capital, operations of MNCs, gained the attention of the policy makers. Keeping in mind the national interests the policy makers designed the FDI policy which aims FDI as a medium for acquiring advanced technology and to mobilise foreign exchange resources. With time and as per economic and political regimes there have been changes in the FDI policy too. The industrial policy of 1965, allowed MNCs to venture through technical collaboration in India. Therefore, the government adopted a liberal attitude by allowing more frequent equity.

In the critical face of the Indian economy, the government of India with the help of World Bank and IMF introduced the macro-economic stabilisation and structural adjustment program. As a result of these reforms, India opens its door to FDI inflows and adopted a more liberal foreign policy in order to restore the confidence of foreign investors. Further, under the new foreign investment policy Government of India constituted FIPB (Foreign Investment Promotion Board) whose main function was to invite and facilitate foreign investment.

Starting from a baseline of less than USD 1 billion in 1990, a recent UNCTAD survey projected India as the second most important FDI destination (after China) for transnational corporations during 2010-2012. As per the data, the sectors which attracted higher inflows were services, telecommunication, construction activities and computer software and hardware. Mauritius, Singapore,

the US and the UK were among the leading sources of FDI to the country. According to GYANPRATHA – ACCMAN (Journal of Management, Volume 5 Issue 1, 2013) FDI for 2009-10 at US\$ 25.88 billion was lower by five per cent from US\$ 27.33 billion in the previous fiscal. Foreign direct investment in August dipped by about 60 percent to approx. US\$ 34 billion, the lowest in 2010 fiscal, industry department data released showed. In the first two months of 2010-11 fiscal. FDI inflow into India was at an all-time high of \$7.78 billion up 77% from \$4.4 billion during the corresponding period in the previous year. In 2013, the government relaxed FDI norms in several sectors, including telecom, defence, PSU oil refineries, power exchanges and stock exchanges, among others. In retail, UK-based Tesco submitted its application to initially invest US\$ 110 million in starting a supermarket chain in collaboration with Tata Group's Trent. In civil aviation, Malaysia-based Air Asia and Singapore Airlines teamed up with Tata Group to launch two new airline services. Also, Abu Dhabi-based Etihad picked up a 24 per cent stake in Jet Airways that was worth over Rs. 2,000 Crore (US\$ 319.39 million).

India has received a total foreign investment of US\$ 306.88 billion since 2000 with 94 per cent of the amount coming during the last nine years. In the period 1999–2004, India received US\$ 19.52 billion of foreign investment. In the period 2004–09, foreign investment in the country touched US\$ 114.55 billion, further increasing to US\$ 172.82 billion between 2009–September, 2013. During FY 2012–13, India attracted FDI worth US\$ 22.42 billion. Tourism, pharmaceuticals, services, chemicals and construction were among the biggest beneficiaries. The January-November period in 2013 witnessed mergers and acquisitions deals worth the US \$ 26.76 billion in India, according to a survey by tax advisory firm Grant Thornton.

5. Assessment of GDP and FDI in India during (1991-92 to 2011-2012)

The following table depicts the picture of FDI inflow and its impact on GDP:

Table 1

Year	FDI Inflow (Rs. In Crore)	Growth Rate of FDI Inflow (%)	GDP	Growth Rate of GDP (%)	FDI as % of GDP
1991-92	409	-	1099072	-	0.038
1992-93	1094	167.49	118025	5.36	0.950
1993-94	2019	84.450	1223815	5.69	0.165
1994-95	4313	133.68	1302075	6.40	0.33
1995-96	6918	60.39	1396975	7.29	0.50
1996-97	9655	40.86	1508375	8.74	0.65
1997-98	13547	40.33	1573264	4.31	0.87
1998-99	12356	-8.90	1678411	6.69	0.74
1999-00	10321	-16.52	1786532	6.45	0.58
2000-01	12654	22.64	1864300	4.34	0.68
2001-02	19360	53.12	1972608	5.82	0.99
2002-03	14930	-22.89	2048285	3.86	0.73
2003-04	12120	-18.88	2222756	8.56	0.55
2004-05	17140	41.45	2388760	7.45	0.72
2005-06	24615	43.60	3254215	36.25	0.74
2006-07	70632	186.95	3566010	9.59	1.99

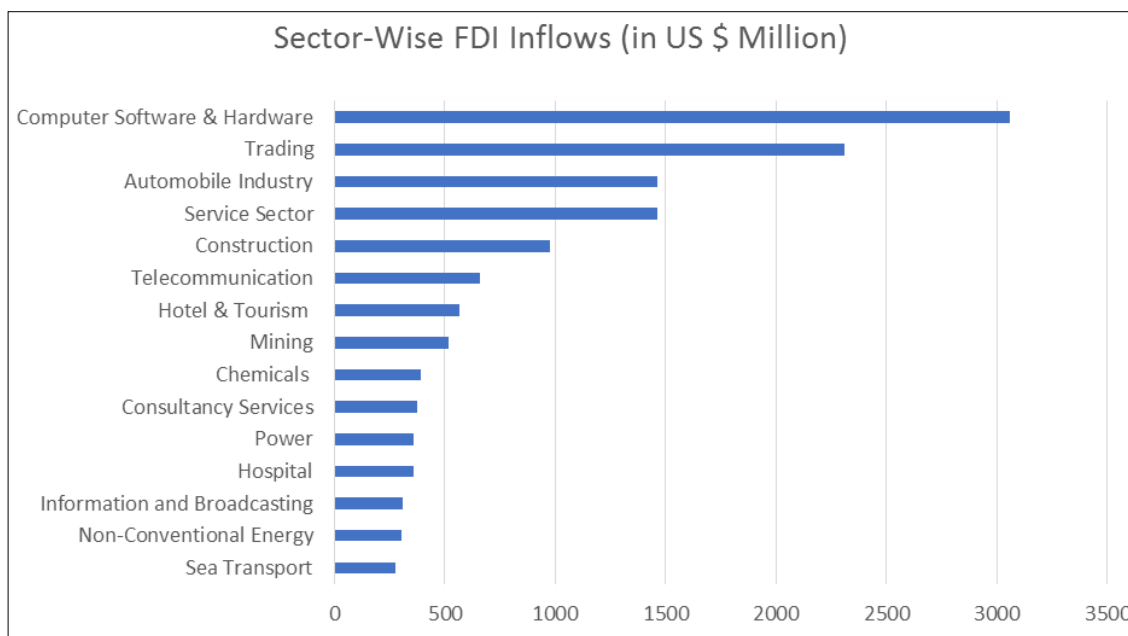
2007-08	92665	39.65	3898956	9.35	2.50
2008-09	122920	24.59	4162510	6.75	3.00
2009-10	123375	0.36	4493745	7.95	2.75
2010-11	97325	-21.15	4877845	7.85	2.00
2011-12	165146	69.70	5202515	5.76	3.15
2012-13	121905	-26.19	5503475	4.32	2.23
2013-14	147516	21.09	5741790	5.00	2.55
2014-15	189110	28.20	6023140	6.00	3.14

Source: IMF, World Economic Outlook (April, 2014) (www.unctad.org/fdistatistics)

The data set out in Table 1 reveals that the FDI inflows in India has increased at a higher rate from Rs.409 crores in the year 1991-92 to Rs. 189110 crores in the year 2014-15. While, the growth rate of FDI inflows indicates some-times fluctuating situation and some-times negative situation. The highest growth rate was recorded in the year 2006-07 i.e. 186.95% and lowest in the year 2009-10 i.e. 0.36%. The above table also shows that during the

period under review i.e. 24 years, in these years, 6 years have shown negative growth of FDI inflows. The growth rate of GDP has been recorded between 3.86% (lowest) in the year 2002 – 03 and 9.59% (Highest) in the year 2006-07. The FDI as percentage of GDP was recorded 0.038% in the year 1991-92, which has increased to 3.14% in the year 2014-15. It shows a continuous rise in FDI as percentage of GDP.

5.1 FDI Inflows: Sector Wise Analysis (During April – September 2015)



Source: Ministry of Finance (Government of India)

Fig 1: Sector-Wise Inflow

From the above graph, we can conclude that, Telecommunication Sector in India is growing at an astonishing pace. India has more than 125 million telephone networks, which is one of the largest communication networks around the globe. Construction Sector is among the top 5 sectors in attracting FDI. This includes housing, commercial premises, hotels, resorts, hospitals, educational institutions and infrastructure. FDI to this sector is permissible under automatic route. Automobile Industry: FDI inflows to automobile industry in India have been increasing at a fast pace. 100 percent FDI is allowed in this sector and India is becoming a prime destination for many international players in the automobile industry who wish to set up their base in Asia. FDI inflows in the sector of Petroleum and Natural Gas have started pouring since the year 2004. Since then the inflows in this sector have picked up in absolute sense

and it has just managed to rank itself among the toppers although important initiatives have been taken by the Indian government to drive FDI inflows.

5.2 Imminent Viewpoint

India is estimated to require around US\$ 1 trillion during the 12th Five-Year Plan period (2012-17), to fund infrastructure in sectors such as roads, airports and ports. The government is in the process of liberalising FDI norms in construction activities and railways, which could bring in investments to meet the target. The government is also relaxing FDI norms in other sectors for foreign investors to invest. FDI in multi-brand retail has been allowed up to 51 percent. The minimum requirement for the FDI is US\$ 100 million, of which at least 50 percent must be invested in 'backend infrastructure' within three years following the initiation

of the FDI. FDI limit in single-brand retail has been increased to 100 per cent; 49 per cent will be under the

automatic route and the rest through the FIPB route.

5.3 Portfolio Investment and FDI in India

Table 2

Year	FDI (%)	Portfolio (%)	Total (\$ Million)
1992-93	55.35	43.64	560
1993-94	14.12	85.91	4154
1994-95	25.60	74.45	5139
1995-96	43.84	56.19	4895
1996-97	46.15	54.23	6136
1997-98	66.08	33.97	5384
1998-99	102.28	-2.56	2403
1999-00	41.63	58.46	5186
2000-01	59.38	40.67	6784
2001-02	75.36	24.82	8153
2002-03	83.75	16.31	6016
2003-04	27.56	72.45	15697
2004-05	39.35	60.63	15367
2005-06	41.74	58.26	21454
2006-07	76.55	23.47	29830
2007-08	56.12	43.94	62110
2008-09	157.80	-57.76	23985
2009-10	53.85	46.14	70140
2010-11	49.16	50.89	61855

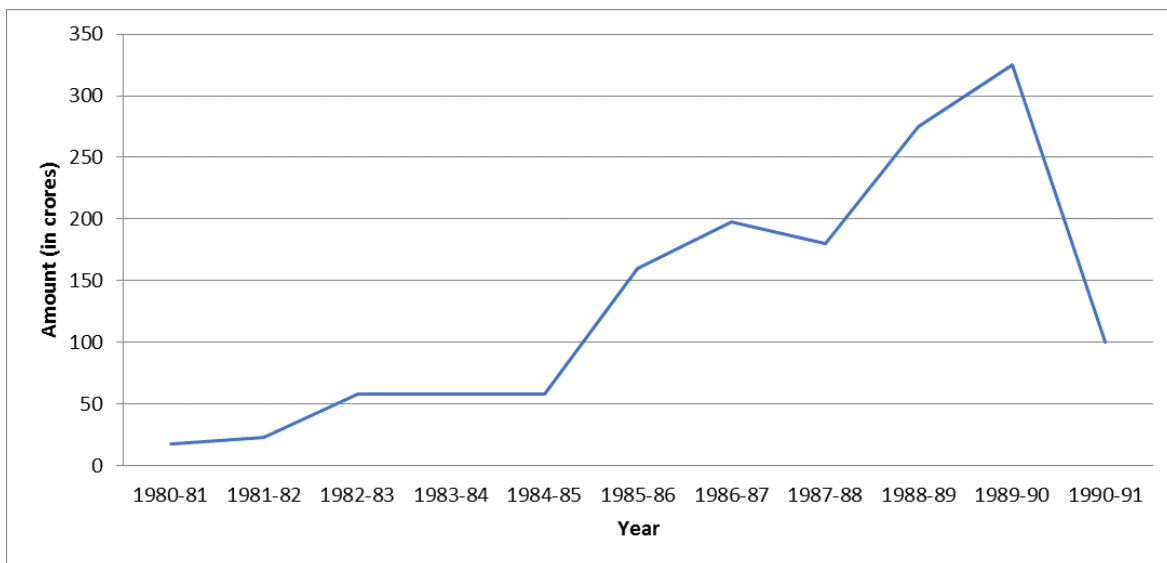
Source: RBI Reports

With the announcement of New Economic Policy in 1991 the FDI flows in India took a new turn. The above table depicts that the FDI flow in India has increased from 560 million dollar in 1992-93 to 61855 million dollar in 2010-11. We can also infer that out of total inflows portfolio

investment has contributed 43.64% and Direct Investment has contributed 55.35% in 1992-93. Over the period of 19 years we can see a drastic change in the share of Portfolio and Direct Investment.

5.4 FDI Inflows Pre-Liberalization and Post-Liberalization Period

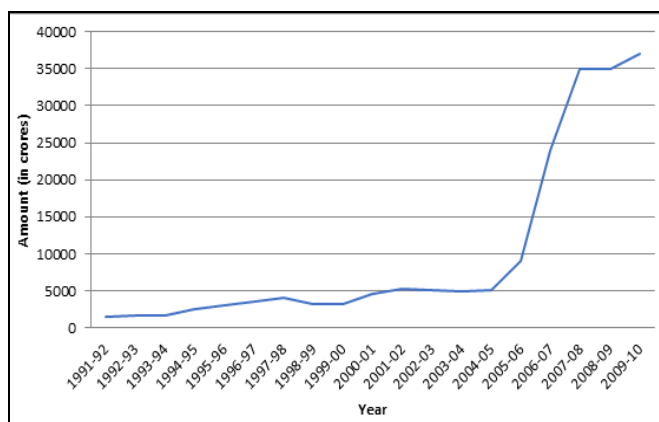
5.4.1 Pre-Liberalization Period



Source: Department of Industry Policy and Promotion Factsheet

Fig 2

5.4.2 Post-Liberalization Period

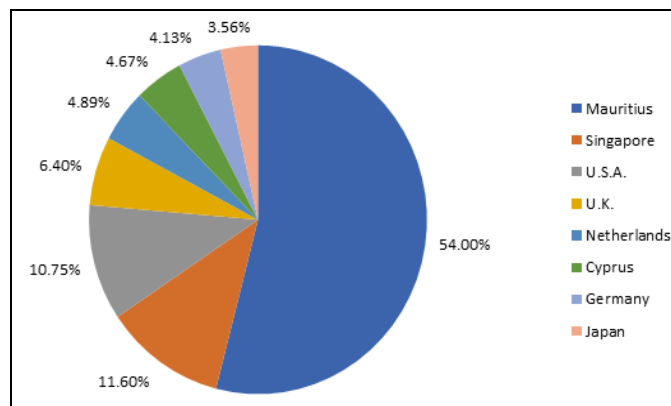


Source: Department of Industry Policy and Promotion Factsheet

Fig 3

From the above 2 graphs we can infer that FDI inflows before the 1991 policy was minimal. As during this period foreign investments in India were restricted. This was mainly because the kind of policies adopted by Government of India. In 1991, when the Government adopted the economic policy FDI suddenly became an important part of economic reform. There was substantial increase in FDI inflows into India during Post-Liberalization Period.

5.5 Equity Flow of FDI by Countries



Source: Various issues of SIA Bulletins and Various issues of RBI bulletin

Fig 4

We can see in the above graph that 54% of the total inflows were from Mauritius. Then 11.60% of the inflows were from Singapore followed by U.S.A. (10.75%), U.K. (6.40%), Netherlands (4.89%), Cyprus (4.67%), Germany (4.13%) and lastly Japan (3.56%).

6. Present Issues and Suggestions

India is definitely a lucrative place for FDI, but there are certainly some challenges and areas for improvement still present. Until these areas are honed to perfection, India will not become the number one place for FDI. India is focusing on maximising political and social stability along with a regulatory environment. In spite of the

obvious advantages of FDIs, there are quite a few challenges facing larger FDIs in India, such as:

- **Equity challenge:** India is definitely developing in a much faster pace now than before but in spite of that it can be identified that developments have taken place unevenly. This means that while the more urban areas have been tapped, the poorer sections are inadequately exploited. To get the complete picture of growth, it is essential to make sure that the rural section has more or less the same amount of development as the urbanized ones. Thus, fostering social equality and at the same time, a balanced economic growth.
- **Resource challenge:** India is known to have huge amounts of resources. There are manpower and significant availability of fixed and working capital. At the same time, there are some underexploited or unexploited resources. The resources are well available in the rural as well as the urban areas. The focus is to increase infrastructure 10 years down the line, for which the requirement will be an amount of about US\$ 150 billion. This is the first step to overcoming challenges facing larger FDI.
- **Federal Challenge:** Very important among the major challenges facing larger FDIs, is the need to speed up the implementation of policies, rules, and regulations. The vital part is to keep the implementation of policies in all the states of India at par. Thus, asking for equal speed in policy implementation among the states in India is important.
- **Political Challenge:** The support of the political structure has to be there towards the investing countries abroad. This can be worked out when foreign investors put forward their persuasion for increasing FDI capital in various sectors like banking, and insurance. So, there has to be a common ground between the Parliament and the foreign countries investing in India. This would increase the reforms in the FDI area of the country.
- India must also focus on areas of poverty reduction, trade liberalisation, and banking and insurance liberalisation. Challenges facing larger FDI are not just restricted to the ones mentioned above because trade relations with foreign investors will always bring in new challenges in investments.

7. Conclusion

The Foreign Direct Investment plays a very significant role in the long-term development of a developing economy like India. It plays a vital role not only as a source of capital but also for increasing competitiveness of the domestic economy through strengthening infrastructure, transfer of technology, enhancing productivity and creating new employment opportunities. In order to make the market investors' friendly the foreign direct investment policy has been gradually liberalised by the Government of India. The tables and statistical tools used by the researchers also indicate that the results of foreign direct investment have been encouraging. As a result, India is consistently ranked among the top three global investment destinations by all international bodies including the World Bank, as per the

reports of United Nations.

However, at present, India has emerged as the 5th largest recipient of foreign direct investment across the world and second largest among all developing nations (World Investment Report 2010). The major factors that enabled India to attract more foreign direct investment are sound economic policy, highly skilled human resources, abundant natural resources and huge market size etc. On the contrary, it has also been noted that there has been increased flow of foreign direct investment into the country after liberalisation of the economy. However, the global share of foreign direct investment in India is very low as compared to other developing nations. It may be due to lack of political environment, instability of government, high rate of corporate taxes and limited exports processing zones etc. in order to overcome these limitations the Government of India should revise the sectoral cap and brings more sectors under the automatic routes. Moreover, in order to increase bilateral trade India should sign the agreements of Double Taxation Treaties with other nations. The present study has found out that the Indian economy has a tremendous potential and foreign direct investment had a positive impact on the gross domestic product. The foreign direct investment inflow not only supplements domestic capital but also technology, skills of existing companies.

During the liberalised era, India has attracted huge quantum of funds in the form of foreign direct investment, while, on some fronts, the performance of foreign direct investment has been impressive, on some front, it has been satisfactory whereas on several other fronts it has been inadequate. However, there is still need to launch deeper reform programmes in various areas to get the better results. One of the most important weaknesses of the Indian economic reforms is that the economy of the country is growing, but, with jobless growth, which means the policy of liberalisation has generated employment opportunities but not as required by the country. It is therefore suggested that during the coming era of reforms attention should be given towards agriculture sector reforms, labour sector reforms, financial sector reforms, industrial restructuring etc. However, it is the need of the hour to adopt imperative and innovative policies and good corporate governance practices at par with international standards, to attract more and more foreign direct investment in various sectors by the Government of India.

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