Macrothink Institute™

Asian Journal of Finance & Accounting
ISSN 1946-052X
2015, Vol. 7, No. 2

Foreign Direct Investments and Economic Growth: The Primary Drivers

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Received: August 21, 2015 Accepted: Sep. 23, 2015 Published: December 1, 2015

doi:10.5296/ajfa.v7i2.8185 URL: http://dx.doi.org/10.5296/ajfa.v7i2.8185

Abstract

In order to achieve the Global Millennium Development Goals (MDGs) there is need for enhanced global partnerships in areas such as trade, health, security, environmental sustainability, food security and education. Owing to these initiatives Foreign Direct Investments (FDIs), Official Foreign Development Assistance (ODAs) and other external capital flows are increasingly considered as drivers of economic growth for developing countries. By year 2000 FDIs flow to developing countries accounted for 19% of the total global FDI flow compared to 52% in 2010. Collectively FDI equates to 11% of global GDP and generates close to 80 million jobs globally. Global FDI totaled to US$ 1.2 trillion in 2010, US$ 1.4 trillion in 2011 and US$ 1.8 trillion in 2012. Similarly, the developing countries received half of the FDI and only invested a quarter of the FDI out flow. Studies show that FDIs contributes to economic growth by stimulating several macro-economic and demographic variables which are major agents of economic growth. This paper sought to explain the effect of FDI on the determinants of economic growth human capital

development, financial sector development and trade openness. A sample of 30 African countries was used for the study. The data used was retrieved from UNCTAD and World Bank online databases for the period between 1980 and 2012 and analyzed through a fixed effect regression model. The results of the study show that FDI had a positive impact on measures of financial sector development and trade openness. However the effect of FDI on human capital development was negative. The study recommends the need for favorable monetary policies that elicit more FDI for enhanced economic growth. The study also suggests increased global trade liberalization and integration to boost trade. Finally the study recommends that additional FDI flows should be directed towards human capital development.

Keywords: FDI, Economic Growth, Human Capital Development, Financial Sector Development, Trade Openness

JEL Classification: F23, F36, F43, O40

1. Introduction

The global urge to achieve the Millennium Development Goals (MDGs) by 2015 has led to enhanced and integrated transnational partnerships in trade, health, education and security. These partnerships are demonstrated by the increased flow of FDIs, Official Development Assistance (ODAs) and other foreign capital flows to developing countries. This is true for Africa which in the last five decades received a smaller portion of FDI inflows compared to developed countries (Asiedu, 2003). Today there is unprecedented increase in the volume of FDIs flowing to Africa. For instance in year 2000 FDIs received by developing countries was estimated at 19% of total global FDIs compared to 52% in 2010. FDIs accounts for 11% of global GDP and creates close to 80 million jobs globally (UNCTAD 2010). Global FDI totaled to US$ 1.2 trillion in 2010, US$ 1.4 2011 and US$ 1.8 in 2012 notably the developing countries received half of the FDI and invested only a quarter of the FDI out flow (UNCTAD 2012).It should also be noted that foreign direct investment have potentially desirable elements that affect the quality of growth which in the long run effect on poverty reduction, diffusion of technology, capital and managerial transfer and human capital accumulation. FDIs also absorb adverse shocks emanating from inefficiencies in the financial systems that adversely affect the poor population. Besides FDIs support corporate governance through the creation of sound institutional frameworks. Studies show that revenue generated from FDI support the development of safety nets for the underprivileged (Klein, Aaron and Hadji Michael, 2001). Owing to the importance of FDI on economic growth, studies are focusing on the determinants of FDI in developing countries identify supportive infrastructures, technical and managerial skills, macroeconomic stability and sound institutions as the key pull factors of FDI. With globalization interconnectivity ICT has been documented in empirical work (Addison and Heshmati, 2003). Other determinants include lower borrowing costs, economic reforms, and commitments to macro-economic discipline Dabla-Norris *et al* (2010). FDI and other foreign capital flows such as remittances remain significant external sources of finance for developing countries are face serious credit constraints. Another branch of studies concentrate on the impact of FDIs on the recipient countries economic growth (Alfaro and Chanda 2006,) and technological advancement through a spillover effect associated with transnational interaction. Important to note today is a growing relationship between China and African countries in areas such as trade and infrastructural development as noted by Judith (2006).

2. Theory and Hypothesis Development

The impact of FDIs and other foreign capital flows on human capital development, technology transfer and economic growth (through the spillover effect) is extensively debated in literature. Theories in economics claim that an efficient financial sector, political stability and human capital development are the key drivers of a sound and sustainable economic growth. The effect of FDIs on economic growth can be analyzed as either direct or indirect. The direct effect is exhibited by infrastructural development, new businesses, job creation and portfolio investments. Indirectly, FDI leads to improved technical knowhow, transfer of managerial practices and concepts and technology spillovers. FDIs also contributes to capital accumulation through initiating domestic demand and consumption of goods and services

(Feenstra and Markusen, 1994). Studies by De Mello (1997 and 1999) show that FDIs contributes to new job opportunities, enhancement of technology transfer, and boosts overall economic growth in recipient countries. FDI are classified FDIs as either horizontal or vertical Beugelsdijk et al. (2008). The two types of FDIs have different impacts and these differences arise from the type of FDI and the characteristics of the receiving countries. These country characteristics include economic, political institutions and other factors which determine a country's affinity for FDIs. For instance, developed countries enjoy solid institutional framework which make horizontal FDIs have a higher impact on economic growth than vertical FDIs. Vertical FDIs stimulate demand for labour. There is vast literature on the FDI – human capital – economic growth triangle. The impact of FDI solely depends on a country's capacity to absorb the embodied technologies. This absorptive capacity depends on the level of human capital development. They estimate that 0.45 years of secondary school education is necessary to benefit from an infusion of foreign technology.

The impact of FDIs on human capital development is explained by Lucas and Romer endogenous growth model. Endogenous Growth Model argue that endogenously accumulated human capital has a direct impact on productivity of labour since human capital development is specific to individuals thereby leaving innovation as a stock of knowledge as an exogenous factor. Human capital development is vital for long term growth owing to its direct input into scientific knowledge (Romer, 1990; Aghion and Howitt, 1992) or due to its positive externalities. Lucas (1988) notes that growth differentials among countries originate from transnational variations in human capital development. The key constituents of human capital development are education and health care. Foreign Direct Investment is classified based on the motive behind such foreign capital flows; natural resources FDIs (access to natural resources), market seeking FDIs (increase market share), efficiencies seeking FDIs (reduction of production cost) and Strategic Asset Seeking FDIs (technological transfers) USAID (2005).

Notably FDIs and other foreign capital flows remain important sources of capital for developing and emerging economies thereby prompting academicians, development agencies and governments' agencies to carry out numerous studies focusing on the key drivers of FDIs. Most of these studies are aimed at policy issues that create an enabling economic climate for FDIs to flourish and have a greater macro-economic impact. Some studies argue that real GDP, inflation and political stability as the primary determinants of FDI. Other determinants of FDI include; macro-economic conditions of the recipient country Blonigen (2005); push factor in the source country and pull factor in the recipient country (Fernandez–Arias, Eduordo, 1996); GDP and bi-directional causality, Chowdhury and Mavrotas(2006) whose findings are premised on economic soundness as a precondition for external capital inflows and vice versa; Trade protection, exchange rates, taxes and institutions (Blonigen 2005); financial markets development (Alfaro *et al*, 2003); skilled labour (Waldkrich 2010); Superior plant and management expertise (Miyamoto 2003); financial sophistication (Adeniyi *et al* 2012). Several theories have attempted to explain the magnitude and direction of FDIs and other foreign capital transfers.

Production Cycle Theory (Vernon 1966) maintains that a production cycle has four stages: innovation, growth, maturity and decline. According to the theory, a product was created for developed and high income markets and as the market matures competition and imitation begins the product is standardized and this pushes the product to lower income markets in developing countries. Subsequently, FDI will flow alongside the product life cycle. Another theory is "The Theory of Exchange Rates on Imperfect Capital Markets" by Itagaki (1981) and Cushman (1985). This theory identifies exchange rate uncertainty as the determinant of FDI. Cushman found that an appreciation in real exchange rate spurred FDI made by US$ while an appreciation in foreign currency reduced American FDI (Denisia 2010). Based on the theory of exchange rates speculative behaviour on exchange rates therefore determines the magnitude and the direction of FDIs. The Internalization Theory by Buckley and Casson, (1976) modified by Hennart (1982) later revised by Casson, (1983) postulate that multinational corporations capitalize on their own internal capabilities accordingly will organize their internal processes in a manner that maximize specific foreign advantages in production and distribution. Multinational Corporation enjoys certain economies through direct foreign investment compared to other entry strategies to foreign markets. Hyme (1976) found that FDI is a firm-level strategy decision rather than a capital-market financial decision. "The Eclectic Paradigm" theory by Dunning (1988) merges both industrial economics and international trade to explain the existence, activities and strategies of MNEs. The Electric Paradigm theory identifies three sources of competitive advantage which prompts the establishment of MNCs; Ownership advantage, geographical advantage and internalization advantage. Lastly is the "Transaction Cost" theory developed by Coase (1937) that suggest that cost discovering relevant to prices and cost of certainty, if high enough in market place, justifies firms' decisions to coordinate economic activities locally and globally. Since many studies have focused on the effect of FDI on economic growth; this study will shift its focus by looking at the effect of FDIs on the key determinants of economic growth. The concept of economic growth is multifaceted and it's the output of the interaction of a number of variables. Some of the determinants of economic growth are; inflation, trade openness, and current account balance Tolo (2011); demography, education, economic openness, institutions and trade policy Bhalla (2012); rule of law and international, openness, human capital (Barro 2003); human capital and foreign direct investment and stock market liquidity (Salahuddin 2010); terms of trade, improvements on the quality of capital, and the presence of distortions; human and physical capital accumulation Chumacero and Fuentes (2003). The impact of FDI on economic growth is dependent on the casual relationship between remittances and the drivers of economic growth. This paper therefore sought to explain the effects of FDIs on the primary drivers of economic growth namely; Human Capital Development (HCD), Trade Openness (TO), and Financial Sector Development (FSD). These drivers are also considered as pull factors of FDIs and other foreign capital flows. For example on human capital development, a report by UNCTAD (1994:218) note MNCs' "demand for highly trained graduates manifests itself in the form of financial support, particularly to business schools and science facilities, the provision of assistance and advice through membership of advisory boards, curriculum review committees, councils and senates"

The study had three hypotheses as shown below:

H_{01} Foreign Direct Investment has a positive and statistically significant effect on Financial Sector Development

H_{02} Foreign Direct Investment has a positive and statistically significant effect on Human Capital Development

H_{03} Foreign Direct Investment has a positive and statistically significant effect on Trade Openness

2.2 Conceptual framework

The diagram below illustrates the conceptual framework of the research. In the diagram Foreign Direct Investment is the independent variable while the three primary drivers of economic growth are considered as the dependent variables.

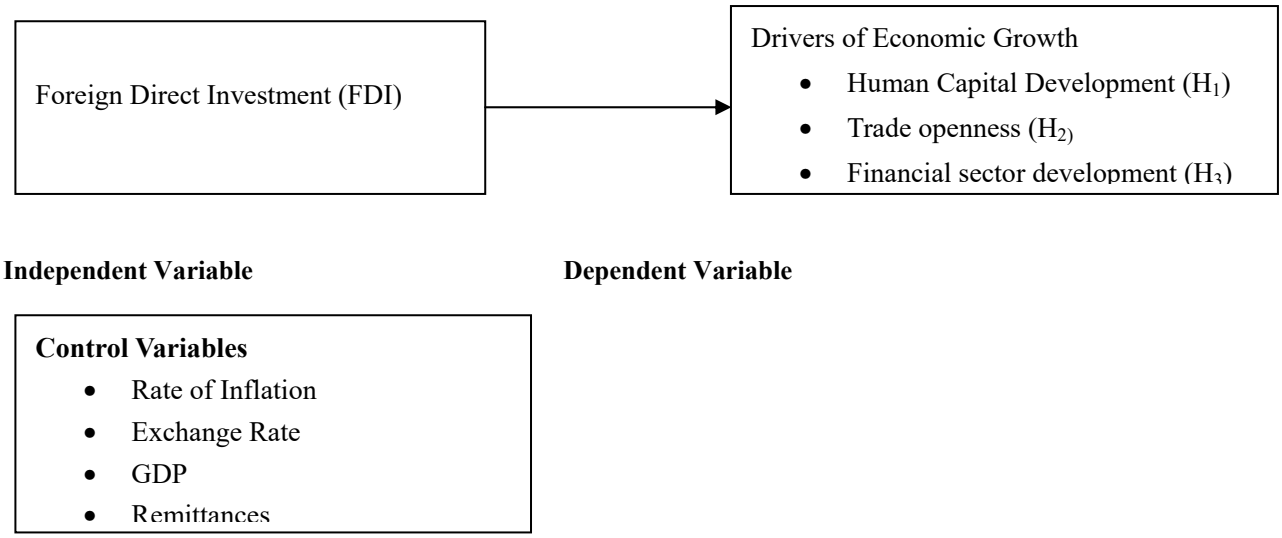

Figure 1. Conceptual framework

3. Research Methodology

The study used a sample of 30 countries and their data for the period between 1980 and 2012(see the list of countries in Table 7). The data used was collected and stored by World Bank's (World Development Indicator Database) (2014) and UNCTAD (2014). FDI was measured as a percentage of the recipient country GDP. This will help control for country size and population. Economic and monetary policies were indexed by the rate of inflation and exchange rates. Trade openness with be measured by the volume of exports as a percentage of GDP while the financial sector development was indexed by domestic credit to Private Sector as a percentage of GDP and bank deposit as a percentage of GDP. Human Capital Development (HCD) is measured by health component indexed by infant mortality rate. The study controlled for monetary policies, GDP per capita income (initial state) and other foreign capital flows and local investment. A country's monetary policy attracts or discourages local and foreign investor. The attractiveness of monetary policies is measured

by exchange rates (EXCH) and the level of inflation (INF). The determinants of economic growth were influenced by government and private citizens' investments. Gross capital formation (local investment denoted by LI) controls for the aggregate improvement in a country's capital stock. Apart from FDI a country benefits from other external capital flows such as remittances and foreign aid which also have an impact on economic growth. The effect of these foreign capital inflows on the determinants of economic growth was controlled for by personal remittance received as a percentage of GDP (REM). The research model is shown below;

$$DEG_{it}=\beta 0_i+\beta_1 FDI_{it}+\beta_2 MP_{it}+\beta 3GDP_{it}+\beta 4LI_{it}+\beta_5 REM_{it}+\mu_{it}.$$ Where;

DEG represents drivers of economic growth (Financial Sector Development, Trade Openness and Human Capital Development). FDI represent Foreign Direct Investments (explanatory variable). MP represents monetary policy, GDP denote Gross Domestic Product, REM represents other foreign capital flows and LI local investment both (government and private investment). μt denotes an error term

4. Empirical analysis

4.1 Descriptive Statistics

Table 1 shows the period averages and summary statistics for the research variables for the period 1980-2012. The mean FDI net inflows were estimated at 3.520% of the GDP of the receiving countries with a minimum value of -6.897 and maximum value of 35.24. Table 1 confirms a significant increment in FDI in the last decade up from 1.4% in 1980 to 3.2% in 2012. The average domestic credit to private sector was estimated at 36.5% of GDP. Credit to private sector double between 1980 and 2012 as shown by the average values of 2.6% in 1980 and 4.8% in 2012. The mean remittances received in the period were 5.38% of GDP. There was a slight improvement in these transfers of 0.6. What is worth noting is the fact that remittances are a larger component of the receiving countries GDP compared to GDP. The analysis further show that the combined effect of remittances and foreign direct investment is approximate 7.6% of GDP compared to an average local investment of 23.26% of GDP (approximately one-third of local investments)These figures suggest that foreign capital flows are important external sources of finance if well harnessed. The high exchange rate of 90.71% and inflation of 28.49% indicate ineffective monetary policies that discourage investment both local and foreign. The table further shows high infant mortality rate averaged at 45 deaths per 1000 of the population which is deterrence to human capital development.

Table 1. Summary Statistic of the Research Variable

Variable	Obs	Mean	Std. Dev.	Min	Max
FDI	990	2.351571	3.520934	-6.897609	35.23495
DEPOSIT	990	27.18864	353.0369	-128.9158	11046.93
CREDIT	990	36.57213	30.61217	1.542268	319.4609
HCD	990	45.17061	30.49665	1.7	133.5
EXPORT	990	31.02137	16.61088	3.279997	100.949
GDP	990	5328.565	9819.106	168.7364	67435.95
EXCH	990	90.71891	215.3887	.0000245	1401.437
INF	990	28.4905	395.1565	-11.16159	12338.66
LI	990	23.26887	7.992249	3.377636	74.82202
REM	990	5.385063	11.88878	.0014116	106.4789

4.2 Correlation Analysis

The correlation matrix represented in table show that FDIs are positively correlated with other foreign capital flows, GDP, trade openness (export), investments and domestic credit to private sector investment. The positive link between FDIs and other foreign transfers could be due to similarities of push and pull factors. FDIs and local investments have a dual causality. The existing state of infrastructure attract foreign investors or still foreign investors and donors would be willing to invest on infrastructural development where locals are not willing to invest due to the huge capital outlays, lack of expertise or risks involved. The relationship between FDIs and bank credit is likely to be duo. Availability of credit locally attracts foreign investors; likewise foreign investor interested in lending or interesting in securities can help alleviate credit constraints affecting households. The relationship between FDI and exchange rates, inflation and human capital development is negative. Unfavorable monetary regime inhibits foreign investors. Foreign capital flows are on the other hand associated with the Dutch Disease.

Table 2. Pairwise Correlation of the Research Variables

	FDI	DEPOSIT	CREDIT	HCD	EXPORT	GDP	EXCH	INF	LI	REM
FDI	1.0000									
DEPOSIT	-0.0229	1.0000								
CREDIT	0.2362	-0.0088	1.0000							
HCD	-0.1335	0.0553	-0.5388	1.0000						
EXPORT	0.2837	-0.0245	0.2017	-0.3182	1.0000					
GDP	0.1138	-0.0120	0.6043	-0.5503	-0.0676	1.0000				
EXCH	-0.0862	-0.0159	0.1277	-0.1281	0.0382	0.0375	1.0000			
INF	-0.0281	0.9972	-0.0313	0.0687	-0.0308	-0.0235	-0.0226	1.0000		
LI	0.3083	-0.0153	0.2074	-0.1691	0.1661	0.0225	0.0291	-0.0248	1.0000	
REM	0.2304	-0.0226	-0.1113	0.1599	0.0732	-0.1726	-0.1145	-0.0201	0.4520	1.0000

4.2 Results of Panel Regression

The study predicts that 1% increase in FDI stimulates 1.4% growth in domestic credit to private sector and 0.4% expansion in bank deposits. However it's only the link between FDI and domestic credit to private sector that was found as statistically significant as confirmed by t=8.39 and p=0.000 as shown in table 3. The regression results for FDI and bank deposits shown in table 5 with t=1.47 and p=0.141 illustrate that the effect of FDI on bank deposits is statistically insignificant. The study further established a significant and negative relationship between FDIs and human capital development (infant mortality rate) as reported by t= - 5.71 and p= 0.000 as shown in table 4. The beta coefficient suggests that 1% increase in FDI contributes to 0.87% deterioration in health care in the receiving country. The relationship between trade openness FDI was statistically significant and positive (t=3.8, p=0.000) illustrated in table 6.. One point improvement in FDI is accompanied by 0.35 point improvement in trade openness. It's therefore logical to conclude that foreign capital flows be it official development assistance, portfolio investments or altruistic transfers such as personal remittances will open up a country's economy.

Table 3. Regression of FDI on Domestic Credit to private sector

CREDIT	Coef.	Robust Std. Err.	t	P>|t|	[95% Conf.	Interval]
FDI	1.37113	.7512414	1.83	0.078	-.1653311	2.907591
GDP	.0021414	.0006562	3.26	0.003	.0007993	.0034835
EXCH	.0191303	.0353532	0.54	0.593	-.0531751	.0914357
INF	-.0011974	.0003237	-3.70	0.001	-.0018594	-.0005355
LI	.2572714	.1251571	2.06	0.049	.0012964	.5132464
REM	.1376739	.1419627	0.97	0.340	-.1526723	.4280202
_cons	13.50807	6.13415	2.20	0.036	.9623242	26.05382

Table 4. Regression of FDI on Human Capital Development

HCD	Coef.	Robust Std. Err.	t	P>|t|	[95% Conf.	Interval]
FDI	-.8730139	.3293321	-2.65	0.013	-1.546574	-.1994542
GDP	-.000244	.0001721	-1.42	0.167	-.000596	.0001079
EXCH	-.0289548	.0150678	-1.92	0.065	-.0597718	.0018622
INF	.0028719	.0003142	9.14	0.000	.0022292	.0035145
LI	-.1469277	.2457637	-0.60	0.555	-.6495709	.3557154
REM	-.4430031	.2837535	-1.56	0.129	-1.023344	.137338
_cons	56.8733	6.44161	8.83	0.000	43.69873	70.04787

Table 5. Regression of FDI on Bank Deposits (Claims to Private Sector% GDP)

DEPOSIT	Coef.	Robust Std. Err.	t	P>|t|	[95% Conf.	Interval]
FDI	.4115461	.3733992	1.10	0.279	-.3521409	1.175233
GDP	-.0002186	.0002034	-1.07	0.292	-.0006346	.0001975
EXCH	.0084561	.0171578	0.49	0.626	-.0266355	.0435477
INF	.8914029	.000979	910.52	0.000	.8894006	.8934052
LI	.6107197	.2393492	2.55	0.016	.1211955	1.100244
REM	.0055936	.0626753	0.09	0.929	-.1225917	.133779
_cons	-13.01903	5.887971	-2.21	0.035	-25.06128	-.976776

Table 6: Regression of FDI on Trade openness

EXPORT	Coef.	Robust Std. Err.	t	P>|t|	[95% Conf.	Interval]
FDI	.3475294	.2111934	1.65	0.111	-.0844096	.7794684
GDP	.0001116	.0000684	1.63	0.113	-.0000282	.0002514
EXCH	.0240264	.0054303	4.42	0.000	.0129203	.0351325
INF	-.0005887	.0001303	-4.52	0.000	-.0008552	-.0003223
LI	-.0291776	.2098073	-0.14	0.890	-.4582816	.3999264
REM	-.1613849	.1707604	-0.95	0.352	-.510629	.1878593
_cons	28.99464	5.422434	5.35	0.000	17.90452	40.08476

5. Conclusion and Recommendations

The study concludes that FDIs stimulates financial sector development. FDIs enhance the availability of capital for investment purposes either through direct investments by the foreign investors or indirectly through investment vehicles such us investment banks, money markets or capital markets. The study also established that foreign direct investments boost trade openness. Trade openness could be as a result of market drive FDIs or spillover effect arising from cross border transactions. In the study FDI was found as having undesirable effect on health care replicating Peter and Nunnenkamp (2012) and Wilkinson (2000) who maintain that FDIs contributes to unequal societies that are described by relative deficiency and prolonged stress considered the main channels through which inequality ruins health. This observation is informed by the argument that FDIs are market driven unlike official development assistance and remittances. Many studies show that FDI have a positive effect on economic growth. This study sought to establish the direct impact of FDIs on the primary drivers of economic growth. The study therefore recommends the need for favourable monetary regimes that attracts foreign investments. Favorable monetary regime encompasses stable exchange rates, controlled inflation and interest rate regimes. Favorable monetary policies attract more foreign direct investments for development purposes. The study further recommends preferential trade agreements and market liberation as a way of encouraging international trade. Enhanced international trade facilitates the flow of factors of production including foreign capital. The study further recommends that foreign investors should consider investing directly into human capital development.

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Table 7. List of Countries whose data was used in the study (1980-2012)

1) Algeria
2) Botswana
3) Cameroon
4) Costa Rica
5) Dominican Rep
6) Egypt
7) Guatemala
8) India
9) Israel
10) Jamaica
11) Kenya
12) Jordan
13) Korea
14) Lesotho
15) Mexico
16) Pakistan
17) Senegal
18) Sudan
19) Swaziland
20) Thailand
21) Tunisia

22) Turkey
23) USA
24) Honduras
25) Australia
26) Bolivia
27) Bangladesh
28) Iceland
29) Fiji
30) Ghana