

CHAPTER ONE

IMPACT OF MACROECONOMIC VARIABLES ON FOREIGN DIRECT INVESTMENTS IN SRI LANKA

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Abstract

This study investigated the impact of selected macroeconomic variables; Gross Domestic Production (GDP), Inflation, Exchange Rate, and Population on Foreign Direct Investments (FDI). The study employed secondary annual data over 35 years from 1985 to 2016. A dummy variable was introduced to incorporate the impact of war period. The multiple regression models confirmed that only the exchange rate was significant, the inflation and population of the country were found insignificant in determining FDI inflow. A long-run association within all four variables was found through the Johansen Cointegration test. Further, a causal relationship was found between exchange rate and FDI through the Granger Causality test. Only exchange rate was identified to have a significant relationship with FDI, and it showed a high degree of positive correlation. Primary data analysis showed the preference of investors from the most preferred to the least; exchange rate, inflation, GDP, and population, respectively. In conclusion, both Model-A and Model-B concluded that the exchange rate has a significant relationship with FDI.

Keywords: Foreign Direct Investment, Gross Domestic Production, Inflation, Population, Macro-economic Variables.

1. Introduction

It is widely regarded that Foreign Direct Investment (FDI) is a major source of external financing, especially for developing economies. Generally, FDI is recognized as an investment involving acquiring or creation of assets that is undertaken by foreign investors or a joint venture with local governments with the main aim of creating a long-term relationship.

In other words, FDI is the international capital flows from one country to another country in order to get an advantage from investment opportunities and to deliver positive production effect for the host country. Moreover, FDI has become instrumental in economic growth of a country anywhere in the world. One of the main economic problems faced by the developing economies is the lack of national savings to finance their potential investments. Therefore, governments are constantly looking for foreign capital investments at their top priority. In addition to that most governments seek loans from international financial institutions which will further aggravate the debt burden to the economy. As a result, governments prefer a comparatively easier source of financing; which is FDI. The realization of the benefit package that tags along with the capital inflow has made FDI more attractive for economies. Infrastructural developments, employment opportunities, new technology, and human capital, are few of the positive inflows to the host country from FDI inflows. It is visible that significant changes are being proposed on government policies and regulations to encourage FDI flows across nations.. However, the effectiveness of these amendments is still open to discussion and it requires further objective verification for policy implications. Flow of literature in this premise shows that many researchers have focused the studies to explore the determinants of FDI inflow to a country and there is no common consciences over the factors determining FDI. However, there are several theories which attempt to explain the determinants of FDI. According to Lipsey (2001), macroeconomic theories explain factors motivating investors to invest in foreign countries, explain the phenomena associated with the macro-economy. Macroeconomic factors such as gross domestic production, exchange rate, inflation, population, labor force, economic growth and interest rate affects the host country's FDI flows.

Sri Lanka being a country, full of natural resources with a high growth potentials, should have attracted more foreign investors. However, when making their investment decisions foreign investors practically consider a wide range of other factors, such as demographic variables, macroeconomic policy, credibility, and good governance. Therefore, what attract FDI to a country is yet to be scientifically explored. This is an important question that should be answered by every government in the effort of attracting more FDI. Therefore, identification of the determinants and managing them properly may assist in attracting more FDI to the host countries. There is a paucity of research conducted investigating the

relationship between these variables and the FDIs in the Sri Lankan context. Accordingly, it has been identified as a research gap of this paper.

Thus, the objectives of the study are to examine the impact of selected macro-economic variables on foreign direct investments and to explore the perception of foreign investors who have already invested in Sri Lanka in making investment decisions.

2. Literature Review

FDI has now become one of the most demanded sources of finance for countries. Parvin (2013) stated that the main purpose of FDI inflow to a country is to have access to natural resources, market size, geographic locations, and low labor cost. Moreover, Dunning (2009) and Kosekahaoglu (2006) pointed out that FDIs induce total demand for domestic goods and foster technology transformation. Also, Aremu (2005) examined the growing interest in FDIs and the perceived opportunities derived from the utilization of foreign capital injection into the economy. Moreover, Arbatili (2011) stated that it provides many development options for the host country and stable FDIs inflow creates a barrier against reversals in portfolio inflows during crisis periods.

Further, empirical evidence suggests that FDI as an important source of capital, complements domestic private investments, creates new employment opportunities, enriches technology transfer and boosts economic growth in host countries (Chowdhury and Mavrotas, 2003). Host countries are using policy incentives such as granting tax allowances and other facilities to attract and retain FDIs into their economies. Bilawal, *et.al.* (2014) proposed that FDI flows help to build strong economic ties between developing and industrialized nations. It is generally believed that gross domestic savings in least developed countries are very low. Therefore, FDI is an alternative mechanism to fill the saving and investment gaps in those countries.

However, there are also counter arguments forwarded by many scholars discussing the negative influence from FDI to the host country. That is FDI might lower or replace domestic assets and investment, transfer low level or unsuitable technologies for the host countries and can even slow the development of local firms, limiting their growth opportunities. Certainly, initial investment of foreign firms improves the current and the capital account of the host country. However, in the long run, substantial import of intermediate and capital goods, repatriation of profit, interest, royalties and management

fees may harmfully affect the foreign exchange position of the host country (Organization for Economic Operation Development, 2002).

Nevertheless, the negative consequences of FDI can be controlled with proper trade and labor regulations (Rose and Mwege, 2006; Kinuthia, 2010). FDI can also be classified into market-seeking, export- oriented and government initiated FDI. A market-seeking FDI is highly determined by the growth potential and the size of national market, access to regional & global markets and country-specific consumer preferences. When a foreign firm produces raw materials, intermediate and final goods and sells these products for non-local market, this FDI is referred as export-oriented FDI. An investment is called government initiated FDI, when governments of developing countries invite and give incentives to direct foreign investors to invest in specific sectors and industries with a view to addressing socio-economic problems like unemployment, regional disparities and deficits in the balance of payment (Accolley et al, 1997).

However, Pradhan (2001) stated that Sri Lanka has great potential to become an international business hub with the wealth of human capital and geographical location. Trade liberalization policy adapted in 1977 has created an enabling environment for the foreign investors to invest in Sri Lanka. The intention of this move has been to bring the country as one of the most open economies in South Asia, which has created the significance of FDIs to the country. Athukorala and Rajapathirana, (2000) discussed liberalization and industrial transformation in Sri Lanka, considering the first decade of Sri Lankan market after independence in 1948. However, Athukorala, (2003) forwarded a study to explore the role of FDI in economic growth, in Sri Lanka and stated a robust link between FDI and growth in Sri Lanka. Added to this Balamurali and Bogahawatte, (2004) carried out a study on FDI and economic growth in Sri Lanka. Athukorala & Jayasuriya (2004) discussed complementarity of trade and FDI liberalization in Sri Lanka referring to the trade liberalization in 1975 and then the introduction of market oriented policy reforms in 1977.

Rauf (2016) compared influence of exchange rate on FDI and concluded that there is no any relationship between FDI and exchange rate. It also explored that the government should attract more FDIs, to maintain a stable exchange rate. It further evidences that currencies appreciate and depreciate according to prevailing Market conditions (Kabura 2013). One of the many influences on foreign direct investment activity is the behavior of

exchange rates. This is because the exchange rates can influence equally the total amount of foreign direct investment that takes place as well as the allocation of this investment spending across a range of countries. Oude (2013) highlights that the exchange rate fluctuations are mainly caused by the changes in the demand and supply of the money in the FOREX market.

Inflation Rate acts as a signaling mechanism to both foreign investors and local investors, to make their investment decisions. The relationship however has not yet been clearly stated. According to Sajid et. al (2012) where they have analyzed the role of FDI and trade on the growth in Pakistan, results indicated a positive and not statistically significant relationship between inflation and the FDI. Moreover, Djokoto (2012) investigated the effects of investment promotion on foreign direct investment inflow in Ghana for the period 1970 to 2009 and discovered a negative relationship between inflation and the FDI.

The FDI inflow is significantly related with the economic condition of a country. If the economic condition of a country is healthy, then FDI inflow will be more and with that the retention time period of the investments would be longer. On the other hand, Todaro and Smith (2007) defined it as a steady process by which the productive capacity of an economy is increased overtime to ensure raising levels of national output and income while Jhingan (2003) defines it as a quantitative sustained increase in the country's per-capita income accompanied by the capital, expansion, and volume of trade.

Many researches on the factors that influence FDI have ignored the role of population of a country. According to Abdul and Bilal (2012), such neglect seems to be motivated by the theoretical support for the assumption that large population is likely to be negatively related to the economic growth. Based on a review of the latest research on the role of population in economic growth and the determinants of FDI, it was hypothesized that a country's population would be related to the FDI. Along with the density of the population, other related factors like labor force, market size and labor cost differ. China and India produce five million and three million graduates respectively each year (Gupta and Wang, 2009). Yet the demand for highly trained professionals is still far greater than the supply. The cost of these professionals for a multinational corporation is much lower than employing home country nationals, but scarcity has contributed to a rapid increase in the cost of technical and managerial personnel.

3. Methodology

Since the study comprises a large representative sample, secondary data collection, and analysis methods such as correlation analysis, and regression analysis were used to test specific hypotheses of the study. The authors have identified this requirement of analyzing quantitative data under Model-A. In addition, a qualitative approach has been used in this study to gain a further understanding of underlying reasons, opinions, and motivations of the foreign investors. For this purpose, we introduced Model-B to the study.

3.1 Sources of Data

The study employed both primary and secondary data. Secondary data was obtained from the Central bank of Sri Lanka, the Sri Lanka National Bureau of Statistics, and the World Bank Indicators (WDI). Primary data was collected through face-to-face semi-structured interviews with selected foreign investors to provide insights into the research problem and assist in developing hypotheses for potential quantitative research done.

3.2 Sample and Data Collection

The study employed a mixed approach. Therefore, the research utilizes both secondary and primary data. Secondary data was analyzed under Model-A, and Primary data was analyzed under Model-B. Due to the limitation of access to data, annual data from all the companies who have invested in Sri Lanka from 1985 to 2016 were considered, and this time range consists of both the post-war and pre-war periods. In Model-B, primary data have been collected through several face-to-face semi-structured interviews conducted with selected foreign investors. The study applied the convenient sampling technique.

The preliminary study for the research was conducted using secondary data sources such as previous literature to identify the type of data, sources of data, and the frequency of data required. We identified two models based on the type of data as Model-A and Model-B. Based on that, secondary data were collected from respective data sources, which are annual data (Model-A). Further, primary data were gathered through face-to-face semi-structured interviews carried out across a selected sample of investors (Model-B).

Model-B consists of primary data, which were collected through face-to-face semi-structured interviews with selected foreign investors from 10 different organizations in Sri

Lanka with the aim to enriching the findings of Model-A. The following 10 Companies were selected for this purpose;

Table 1: Selected Companies for the Interview

Company Name	Sector / Industry	Origin Country
AVIC International Corperation Ltd	Service - IT Consulting Services	China
Hotel Riu Sri Lanka	Service - Hotel Industry	Spain
Skyway Seafoods Specialist (Pvt) Ltd	Service - Hotel Industry	China
Dialog Axiata PLC	Service - Telecommunication	Malaysia
Moody's Corporation	Service - Financial Services	USA
ZyLAN Luxury Villa	Service - Hotel Industry	Thailand
Shangri-La Hotels & Resorts	service - Hotel Industry	Hong-Kong
John Keels Holdings	Service/Manufacturing	Multi national
Taj Samudra Hotel	Service - Hotel Industry Manufacturing - Food &	India
Nestle Lanka	Beverage.	Switzerland

3.3 Analysis Tools

Using the original data series descriptive analysis was derived to get an overview of the entire model. Through this, detailed information about each variable was derived including mean, standard deviation, minimum value, and the maximum value of the data series.

To address the main objective of the study, the impact of selected macroeconomic variables on the FDI to Sri Lanka needs to be analyzed. Therefore Multiple regression analysis was carried out to identify the impact of the independent variables on the dependent variable as suggested by Kwoba & Kibati (2016). To find the long-term association between all the four variables, Johansen cointegration test was used as suggested by Khan and Mitra (2014). Trace test and Maximum Eigen Value statistic have been used for this purpose. Since, four endogenous variables were taken into consideration, there were three cointegration relations. Eviews software was used for this analysis. Subsequently, to identify the causality between macroeconomic determinants and the FDI in Sri Lanka from 1986 to 2016, the Pair-wise two way Granger Causality test was used as suggested by Maku (2015), which is a short run approach.

To establish the degree of relationship within two variables, Karl Pearson's correlation test was used as suggested by Kirthika & Nirmala (2014). Here, the study tested whether there

is a correlation between the two variables. Model-B; feedback from ten foreign investors have been summarized and converted in to the percentage values by converting them into a fraction from the total and multiplying by hundred.

4. Results and Discussion

The Multiple Regression Analysis results are shown in Table 3, the exchange rate was the only significant variable which determine the FDI, have a positive relationship. The exchange rate has a P-value of 0.0011, which is lesser than 0.05, and a t-statistic of 7.7028, which is higher than 2. A lesser P-value than 0.05 and a higher t-statistic than 2 denote that the independent variable significantly influences the dependent variable. Outcomes from the regression model showed a +0.04 coefficient amount for exchange rate, which means a 4% increase in the FDI per every unit of increase in the exchange rate. An increase in the exchange rate refers to a depreciation of the local currency. In other words, the number of rupees paid in exchange for a dollar will be increased. Therefore, Sri Lanka becomes costly for local investors and cheaper for foreign investors. This attracts the FDI since foreign investors may find Sri Lanka as a cheaper location to invest in. This finding is consistent with the findings of Ibrahim *et al*, (2014). GDP, Inflation, and Population, were found insignificant to determine the FDIs; however, this complies with the findings of Kwoba & Kibati (2016). GDP was omitted from the model due to the multicollinearity issue. Inflation and population were found insignificant in determining the FDI inflow. The dummy variable, which represents the war period, was found significant, which means that war showed an impact on the FDI inflow, and it showed a negative impact on the FDI.

The model is significant, and it could explain 68% of the variation in the FDI. Therefore, the exchange rate and the dummy variable explain 68% of the FDI's behavior while the remaining 38% is explained by the other factors, which are not included in the model. The DW statistic was found 1.87, which is closer to two, which means that the model is free from autocorrelation, and the f-statistic of 17.00798, which is higher than one conveyed homoscedasticity. According to the regression output Population and Inflation are not significant and they have been removed from the model and the estimated revised regression equation is as follows.

$$FDI_t = 1.208492 + 0.041962EXCH_t - 1.543216D1_t + e_t$$

Table 3: Multiple Regression

Variable	Coefficient	t-statistics	P-value
Constant	1.2084	2.2324	0.0344*
Population	26.1149	1.5735	0.1277
Inflation	0.0156	0.5296	0.6009
Exchange Rate	0.0419	7.7022	0.0000*
Dummy 1	-1.5432	-3.4459	0.0019*
R-squared	0.7235	F-statistics	17.0079
Adjusted R-Sqr	0.6809	Durbin-Watson stat	1.8747

*Significant at level 0.05

Source: Analysis Results.

Table 4 presents the long-run association among the variables which was identified by utilizing Johansen Cointegration test, and both the trace test and maximum eigenvalue were tested. The trace test resulted in two cointegrating equations, which denoted the rejection of null hypothesis at 0.05 level. This means that there is a long-run association among the variables. In other words, all four variables move together in the long-run. The maximum eigenvalue test indicated one cointegration equation at the 0.05 level, which denoted rejection of the null hypothesis at the 0.05 level. This means that there is a long run association among the variables or in other words all four variables move together in the long run.

Table 4: Trace Test

Hypothesized No. of CE(s)	Eigenvalue	Max-Eigen Statistic	0.05 Critical Value	Prob.**
None *	0.6872	33.7069	33.8769	0.0024
At most 1	0.582	25.2984	27.5843	0.0954
At most 2	0.4427	16.955	21.1316	0.1742
At most 3	0.3495	12.471	14.2646	0.0942
At most 4	0.0036	0.1037	3.8415	0.7475

Significant at level 0.05

Source: Analysis Results.

Table 5: Maximum Eigenvalue Test

Hypothesized No. of CE(s)	Eigenvalue	Trace Statistic	Critical Value	Prob.**
None *	0.6872	88.535	69.8189	0.0008
At most 1 *	0.582	54.8281	47.8561	0.0096
At most 2	0.4427	29.5296	29.7971	0.0537
At most 3	0.3495	12.5746	15.4947	0.1314
At most 4	0.0036	0.1037	3.8415	0.7475

Significant at level 0.05.

Source: Analysis Results.

Granger Causality test was run to identify whether one data series impacts the other, or in other words, it is a statistical hypothesis test for determining one time series which is useful in forecasting another. This also shows from which data series to which the impact occurs or simply the direction of impact. Therefore, according to Table 6, the first null hypothesis is exchange rate does not granger cause the FDI. It has an f-statistic of 4.3762 and a P-value of 0.0240. The P-value of 0.0240 is less than 0.05, which means that we must reject the null hypothesis, meaning, we reject the statement; the Exchange rate does not granger cause the FDI. Therefore, we accept the alternative hypothesis, which means exchange rate granger causes the FDI. The rest of the variables were found P-Value higher than 0.05. Therefore, the null hypothesis was accepted. Thus, as per the Granger Causality test results, only the exchange rate data series affects or contributes in forecasting the FDI. Further, since the rest of the null hypotheses were accepted, it denotes that the GDP, Inflation, and Population do not contribute in resulting the dependent variable, FDI.

Table 6: Granger Causality Test

Null Hypothesis:	F-Statistic	Prob.
EXC does not Granger Cause FDI	4.3762	0.0240*
FDI does not Granger Cause EXC	0.6591	0.5264
GDP does not Granger Cause FDI	1.4872	0.2461
FDI does not Granger Cause GDP	1.1613	0.0419
INF does not Granger Cause FDI	2.3704	0.1150
FDI does not Granger Cause INF	0.0479	0.9533
POP does not Granger Cause FDI	0.1169	0.8901
FDI does not Granger Cause POP	2.7360	0.0850

*Significant at level 0.05

Source: Analysis Results.

Pearson Correlation analysis was considered to measure the degree of association among variables. According to Table 7, the Pearson value for the exchange rate is 0.765, which shows a high degree of positive correlation between the exchange rate and the FDI. The P-value for this variable is 0.011, which is less than 0.05. This explains that there is a significant relationship between the exchange rate and the FDI. However, the rest of the variables resulted in a p-value higher than 0.05, proving an insignificant relationship. Therefore, to conclude the results of the Pearson correlation test, GDP, Population, and Inflation do not have a significant relationship with the FDI and only exchange rate has a significant relationship with the FDI.

Table 7: Pearson Correlation

Variables		FDI	GDP	Population	Inflation
GDP	Pearson Correlation	0.095			
	Sig.	0.610			
Population	Pearson Correlation	-0.273	-0.166		
	Sig.	0.137	0.535		
Inflation	Pearson Correlation	0.050	0.887	-0.166	
	Sig.	0.786	0.000*	0.371	
Exchange Rate	Pearson Correlation	0.765	-0.771	0.370	-0.103
	Sig.	0.011*	0.045*	0.141	0.574

Significant at level 0.05

Source: Analysis Results.

Model B resulted in the responses from the interviewed foreign investors (See Table 8). Each investor was interviewed focusing the four selected macroeconomic variables. Importantly, 2 out of 10 interviewees, that is, 20% has considered the GDP of Sri Lanka, and only one out of 10, that is, 10%, has considered population as an influencing factor when making their investment decisions in Sri Lanka. Inflation and exchange rate had a higher percentage, which denotes that most of the investors have found these factors as significant in making their investment decisions. The inflation rate was considered by six investors out of 10, and the exchange rate was considered by seven investors out of 10. One of the main findings from the interviews was that the perception of foreign investors differs from industry to industry as well as it depends on the focused market that they cater. A group of 10 interviewees from diverse industries that operate in Sri Lanka were selected for the study.

Other than these four variables, there were other macro-economic factors which the foreign investors consider when making investment decisions in Sri Lanka. Tax regimes and policies, government stability and predictability, skilled labor force, geographical location, output supply and demand, infrastructure, competitive advantage, and the availability of natural resources. The majority of responses denoted competitive advantage, geographical location, and government stability as factors considered by investors when making the decision to invest in Sri Lanka. Investors also responded to the war situation that prevailed in Sri Lanka, the majority of the respondents did not find a huge impact on their operations or investments. However, there was poor denying of the impact of the war situation, and rather the investors mentioned that the impact was not significant; therefore, it did not affect their investment decisions. 20% of the responses depict that there was an impact from the war situation and the rest of 80% said that there was no major impact.

To conclude the analysis of Model B with regards to the macro-economic variables selected. Most investors perceived exchange rate as the most important factor for the investment (70%) followed by inflation rate (60%), the GDP (20%), and Population (10%). The geographical location, competitive advantage, and infrastructure were the major influential factors that the investors considered highly in making their investment decisions. The impact of war did not have much influence on investment decisions as most of the investors pointed out.

Table 8: Preference of Foreign Investors

Independent Variables	Preference of independent variables by foreign investors (as a % of sample)
GDP	20%
Population	10%
Inflation	60%
Exchange Rate	70%

Therefore, the study suggested that the exchange rate was significant to determine the FDIs in Sri Lanka, and a positive relationship was established. On the other hand, the other macroeconomic variables, GDP, Inflation, and Population, were insignificant in determining the FDIs. Interestingly, the results contend that there is a long-run association between the macroeconomic variables and the FDIs.

It is also found that exchange rate granger cause with the FDIs while the other macroeconomic factors, GDP, Inflation. and Population, does not granger cause with the

FDIs. Very importantly, the results with the secondary data (Model – A) supported the findings of primary data (Model – B.) analysis. The most influential factors for foreign investors were the exchange rate and inflation. This suggests that the inflation and exchange rate determine the FDIs movements in Sri Lanka. Furthermore, additional factors, which investors had considered in their investment decisions were revealed through the interviews such as infrastructure, competitive advantage, skilled labor, geographical location, and so on.

5. Conclusion

In this paper, the researcher had initially identified four macroeconomic variables to determine the FDI inflow to Sri Lanka: GDP, Inflation, Population, and Exchange Rate. Two models used as Model-A and Model-B for the ease of analysis of data. Augmented Dicky-fuller test was run to identify the stationarity of the data set, Multiple regression was run to identify the significance of the model, Johansen cointegration was run to identify the long-run association, causality relationship was tested through Granger Causality test, and finally Pearson correlation was considered to identify the correlation among the variables. The Model-A; aimed at identifying the impact of the above mentioned variables on the FDI. Out of the four variables, only Exchange Rate was significant in determining FDI while GDP, Population, and Inflation were insignificant in determining the FDI inflow in Sri Lanka, which concluded that only the Exchange Rate impacts the FDI. GDP was identified with multicollinearity effect, therefore omitted from the final regression model. The study has also focused on identifying the causal relationship between dependent variables and independent variables. Only Exchange Rate was identified to granger cause the FDI while for the rest of the variables; FDI granger cause GDP, Inflation and Population, which means the direction of impact is from the FDI to above-mentioned variables. Results stated that there was an impact from the war situation to the FDI inflow in Sri Lanka. Moreover, the paper also targeted at identifying the long-run association between macro-economic variables and the FDI. Findings stated that variables are cointegrated, and therefore, there is a long-run association within all four variables and all four variables showed that move together in the long-run. The researcher also aimed to explore the perception of foreign investors as if why they have selected Sri Lanka as an investment destination. Model-B concluded that the majority of foreign investors found the

Exchange Rate and Inflation as important determinants of the FDI, which also had strengthened the findings in Model-A.

The findings will give practical implications for various parties. Foreign investors identified the infrastructure, interest rate, trade openness, foreign exchange reserves, and unemployment as the major influential factors in determining the FDI inflows in Sri Lanka. Therefore, it would be worthwhile to take steps for infrastructural developments and establish better political stability in the country, which lead to attracting more investors. As the investment decision making seems to be in the long run, the study also proposes the inclusion of the exchange rate movements via systematic exchange rate (monetary) policy to promote an attractive long-term FDI for a country in order to achieve sustainable economic development.

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