
Determinants of Foreign Direct Investment Inflows in Sri Lanka

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Abstract

Foreign direct investment (FDI) has grown strongly as a major form of international capital transfer over the past decades. It is considered a key element for a country's economic integration and represents a key source to finance capital investment. This paper investigates the determinants of FDI inflows in Sri Lanka for the period from 1977 to 2016 by expanding the literature focusing on the behavior of investors in pre and post-civil ethnic war. Gross domestic production (GDP) growth rate, exchange rate, trade openness, military expenses and inflation are considered as major determinants to the foreign direct investments and regression is used to find out the relationship between selected variables. According to the results of correlation analysis, two regression models are developed and first model suggests that the growth rate of GDP, inflation, exchange rate and military expenses have significant impact on FDI inflows. The second model shows that trade openness also has a significance impact on FDI inflows. Though a considerable increase in FDI inflows is expected after the victory of war from 2009, it has not taken place. Sri Lankan government has to take necessary actions to attract more investment from foreigners by maintaining favorable economic conditions inside the country.

Keywords: Civil War, Foreign Direct Investments, Gross Domestic Production

1. Background of the Study

Foreign direct investment (FDI) is an investment made by a company or individual in one country in business interest of 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 investment is a major source of investment inflow for a developing country like Sri Lanka. Foreign direct investment provides path for human capital, technology and managerial skill to come into the host country. There are three types of FDI, Horizontal FDI: Investment in the same industry out of the country as a firm operates in at home, Platform FDI: a source country into a target country for the reason of

exporting to a third country and Vertical FDI: it takes place when a firm during FDI moves upstream or downstream in diverse value chains i.e., when firms perform value-adding actions stage by stage in a vertical fashion in a host country (Gupta and Singh, 2016). The foreign direct investor may gain voting power of an enterprise in an economy through any of the following methods: by incorporating a wholly owned subsidiary or company anywhere, through a merger or an acquisition of an unrelated enterprise, participating in an equity joint venture with a different investor or enterprise (Ran, 2015).

Foreign investment can take place for many reasons, including benefit of FDI. It can be a useful way to enter into a foreign market. Some countries may particularly limit foreign company entrance to their domestic markets. Acquiring or initializing a business in the market is the means to increase access to their markets (Chen, 2019). FDI is also an effective way for acquiring important natural resources, such as precious metals, fossil fuels and oil. (Kumari, 2016). FDI is a means for to reduce cost of production if the labor market is cheaper and the regulations are less restrictive in the target destination country, for example, it's a well-known fact that the shoe and clothing industries have been able to drastically reduce their costs of production by moving operations from developed countries to developing countries(Varghese, 2014).

Sri Lanka has a great potential to become an international business hub. It possesses significant natural resources, location advantages and human capital indicators. When considering the Sri Lanka's geographical location in the Indian Ocean, there is a major shipping route connecting South Asia, Far East and the Pacific with Europe and the America. Rapid growth of neighboring countries such as India and China could create ample opportunities for Sri Lanka. Sri Lanka is moving towards achieving a per capita income of US dollars 4000 by 2016 and it has to maintain a growth rate around 8 per cent per year to realize the expected target (Kelegama, 2011). There is a limited internal investment capability due to low domestic savings (Jayasekara, 2014). Therefore, Sri Lanka has to rely on external finance. Foreign Direct Investment is also called as an external finance. It can be used to achieve expected prosperity (Desbordes and Wei, 2016).The ending of prevailed civil war in the north and east for 30 years in 2009 has given a great opportunity for Sri Lanka to move forward as a fast growing country.

Identifying the factors that determine foreign direct investment inflow into a country is a complex problem. Empirical results (Wijeweera & Mounter, 2008; Froot & Stein, 1991; Czinlota, Knight, Liesch & Steen, 2010; etc.)revealed that GDP growth rate, exchange rate, inflation, infrastructure quality, wage rate, trade openness, and military expenses were some of the significant determinants of FDI in Sri Lanka. This paper also considered the same

factors except wage rate and infrastructure quality to identify the significant variables to FDI inflows.

1.1. Research problem

Sri Lanka possesses significant resources, location advantages and human capital indicators. Only a few countries are having these facilities, but Sri Lanka has poorly performed when attracting FDI. After the civil war, Sri Lankan government expected to achieve its economic development and higher level of incensement in FDI inflows. After the introduction of open economic system in 1978, Sri Lanka has widely liberalized its foreign policies and launched several strategies to increase FDI inflows. However, Sri Lanka was unable to achieve its FDI targets due to the uncertain environment created after civil ethnic war. However, according to the previous FDI data, recent governments cannot achieve considerable amount of FDI inflows to the country. Civil ethnic war is not a major factor which affects the FDI. It is a significant factor. Empirical evidences provide hints for many factors affected to get in attracting FDI. This study was conducted to identify determinants of foreign direct investment inflows in Sri Lanka.

Research in FDI in the context of Sri Lanka is limited. Only a handful of studies (Athukorala & Jayasuriya, 2004; Wijeweera & Mounter, 2008; Athukorala, 2003; Athukorala, 1995) have looked at FDI in the context of Sri Lanka. To fill the research gap, this research attempts to formulate systematic and in-depth studies of FDI inflows in Sri Lanka, investigating the determinants.

1.2. Research Questions

- What are the determinants of FDI inflows in Sri Lanka?
- What are the new trends in FDI inflows after civil war period?
- What is the main factor which affected the FDI inflows to Sri Lanka?

1.3. Research Objectives

1.3.1 General Objective

Main objective of this study is to identify determinants of Foreign Direct Investment inflows in Sri Lanka.

1.3.2. Specific Objectives

- To examine the new trends in FDI inflows to Sri Lanka with reference to post war period.
- To examine the main factor which affected the FDI inflows to Sri Lanka.

1.4. Significance of the Study

Determinants of foreign direct investment are a popular topic among the researchers. There are many previous studies on the determinants of foreign Direct Investment inflows in Sri Lanka, but there are few researchers who have added the effect of civil war as a determinant of FDI inflows. It has been included some other important economic factors like GDP growth, exchange rate, infrastructure, wage rate and trade openness. The objective of this paper is to identify the determinants of FDI inflows in Sri Lanka. During the late 1970's, major changes in economic policy took place in Sri Lanka due to the adaptation of the economic liberalization policy. These types of policies led the government to use the private sector as the main engine of economic growth and development. The importance of FDI to Sri Lanka arises in light of the dismal performance of previous policies that emphasized more attraction of FDI in Sri Lanka. Although many relevant investment policy reforms have been introduced in Sri Lanka, the institutions and investment authorities supporting FDI were weak, fragmented and uncoordinated. Their services are quite basic, mainly focusing on short term benefits. There were hardly any initiatives for targeted, comprehensive and sustained support specifically to facilitate upward mobility of FDI in Sri Lanka. As a result, in Sri Lanka, FDI inflows are below the expectations. This situation is likely to worsen as competition intensifies with ongoing globalization. It is in line with the above argument that this paper intends to identify the determinants of FDI in Sri Lanka. This study makes contribution to the knowledge on the determinants of FDI inflows in Sri Lanka as this study uses more recent data. When the government implements some economic policies related to the selected variables, they should be very keen on the changes happening in FDI inflows. This paper will help for that and that is the major contribution of this paper.

2. Literature Review

There are many theories which attempt to explain the importance of FDI inflows. After World War II, FDI acquires an important role in international economies. Major theories which are used to explain the importance of FDI are product life cycle theory, the theory of exchange rate and the eclectic paradigm theory.

Raymond Vernon's product life cycle theory (1979) explains the pattern of FDI over time. According to Vernon, the firms originally developed the product to establish manufacturing

facilities to produce the product in foreign countries. There are four stages in the production cycle; innovation, growth, maturity and decline. In the first phase, there is a technological advantage that a firm has, an advantage which reduces with time as other players come into the host market and imitate the advantage; as such, to save their market share, multinational enterprises (MNEs) shift their production facilities to host countries. This theory was able to explain investments in Western Europe made by U.S. firms between the years 1950 to 1970.

The relationship between FDI flows and exchange rate movements is based on the currency area of FDI theory with two different directions. A financial view of FDI is conditional on some form of imperfections or information asymmetry in international financial markets where the exchange rate is one of the most important financial variables that affect the relative advantage of a MNE in comparison with a local firm.

Dunning's Eclectic Paradigm theory (1980) developed by John Dunning as an approach to explain FDI emphasized that, firms engage in international operations are to realize three types of advantages: ownership advantages, location advantages and internalization advantages (Dunning & Lundan, 2008). In brief, ownership advantage explains who will undertake FDI; location advantage explains where FDI flows to; and the internalization advantage explains how the FDI flows or the mode in which international production will take place.

GDP is one of the most important factors of FDI inflows. Wijeweera & Mounter (2008) emphasise that GDP shows a positive impact on FDI inflows in the long run. Khachoo & Khan (2012), in their panel data analysis of developing countries, find strong empirical evidence of a positive relation between FDI and the level of GDP. They mentioned that the countries with larger market sizes (higher GDP) are getting more of overseas investments. Ravinthirakumaran, Selvanathan, Selvanathan & Singh (2015) emphasize that GDP growth contributes positively to FDI inflows and is statistically significant at the 1 percent level confirming the argument of motivation of the market seeking FDI. A high level of GDP growth is a strong indication of market opportunities.

The relationship between FDI and trade has attracted significant research interest. Wijeweera & Clark (2006) indicate that the level of trade between a host country and the rest of the world is positively related to the amount of FDI inflows to that country. Others have demonstrated the existence of complex relationships between export opportunities and FDI. For example, Blonigen (2001) shows that in some countries, an increase in FDI flows can lead to a decrease in exports. Wijeweera & Mounter (2008) State that investors are more concerned with the openness of the economy's trade policies in recent time periods rather than the policy adopted historically.

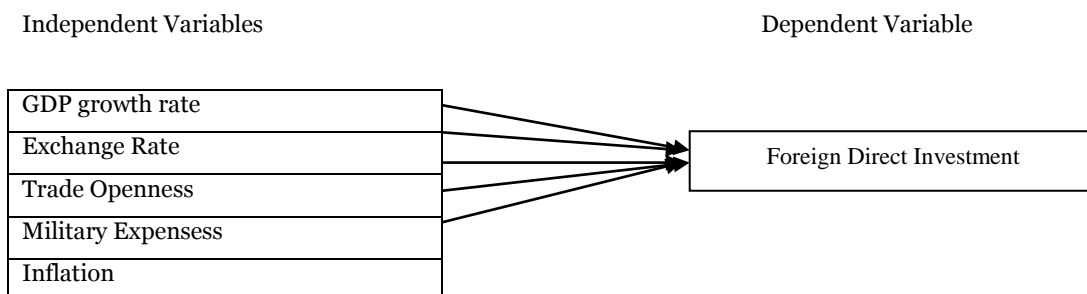
Exchange rate uncertainty and the impacts of exchange rate fluctuations on FDI have also received considerable attention in the literature. Froot & Stein (1991) observed a positive link between currency depreciation in the host country and increased FDI. Though the focus of their studies was on US investors, Blonigen (1997) reached the same conclusion in a study of Japanese firms investing in the US. In contrast, other studies have failed to find evidence of a significant relationship between FDI and the exchange rate.

Military expenditure is known as a defense budget of a country. It is the amount of financial resources dedicated by an entity or a country. Military expenditure is the amount spent by a nation on the military activities in a given year. Relatively few studies have empirically investigated the relationship between war conflict and FDI (Czinlota, Knight, Liesch & Steen, 2010).

3. Research Methodology

To achieve the objectives of the research, several methods and approaches were used. The reunion of these methods and approaches depend on the nature of the work and the research that is going to be conducted. Following conceptual framework was identified according to the set objectives of the research. First, descriptive statistics were identified to build up images of the selected variables to get an overall idea. Then, correlation analysis was used to find out correlation between independent variables and the dependent variable. At the same time, multi-collinearity was identified by looking at the correlation among independent variables. Finally, a regression model was used to identify the impact of independent variables on the dependent variable.

3.1. Conceptual Framework



3.2. Data Analysis Tools

3.2.1 Correlation Analysis

Pearson Correlation analysis was done to measure the degree of association between variables. This coefficient (usually represented by the letter r) can take on any value between -1 and +1. A value of +1 represents a perfect positive correlation. By contrast, a value of -1 represents a perfect negative correlation. Correlation coefficients between -1 and +1 represent weaker positive and negative correlations, a value of 0 represent no correlation situation.

3.2.2. Regression model development

Following regression model was developed to identify the impact of the selected economic variables on FDI inflows in Sri Lanka. The model consists of the determinants of Foreign Direct Investment inflows as follows.

$$FDI = \beta_0 + \beta_1 GDP + \beta_2 ER + \beta_3 TO + \beta_4 ME + \beta_5 INF + \epsilon_t$$

When,

FDI = Foreign Direct Investment, GDP = Growth of GDP, ER = Exchange Rate, TO = Trade Openness, ME = Military Expenses, INF = Inflation and ϵ_t = Error Term

3.3. Foreign Direct Investment

Figure 01 shows annual net inflows of foreign direct investment as a percentage of gross domestic production for the period from 1977-2016. Fluctuations in FDI can be identified in both pre-war periods from 1977 to 1982 and post-war period from 2010 to 2016. When considering the pre-war period, FDI inflows slightly increased. In 1979 it is mounted to 1.394 (% of GDP). From the beginning of the war in 1983, FDI inflows gradually decreased. As the Figure 01 shows from 1885 to 1996 there is a slight increase in FDI inflow, but then it has rapidly increased in 1999. But from 2000 to 2004 a gradual drop was found and then a sudden increase from 2004 until 2007 and a sudden drop in 2008, which was at the edge of the war period were found. After the end of the civil war government expected increment of FDI inflows, but that did not take place. After observing, the post war period, FDI inflow gradually increased, but it was unable to reach that target. Absolute values of FDI inflows in US\$ were used for the analysis purpose of this study.

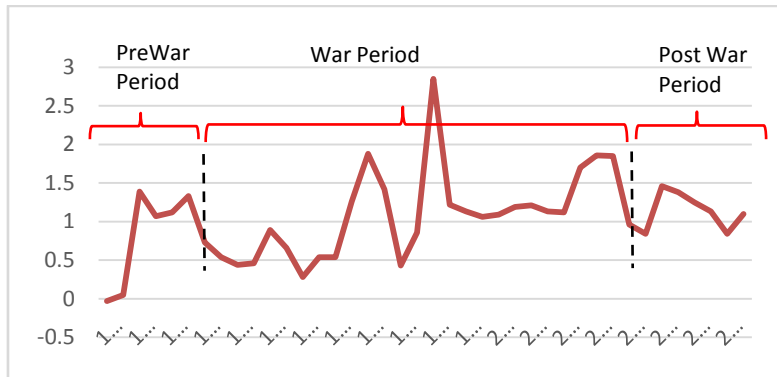


Figure 1: Annual FDI Net Inflows as a percentage of GDP

3.4. Other selected variables

Annual GDP growth rate was taken and it was calculated as $(GDP_t - GDP_{t-1}) / GDP_{t-1}$ for this study. As exchange rate it used the value of Sri Lankan rupee over the American Dollar. Inflation rate which is calculated by Central Bank of Sri Lanka on the basis of Colombo Consumer Price Index has been selected for the study. Trade openness was used as another variable and it was calculated as $[(Exports + Imports) / GDP]$ for this study. Military expenditure as a percentage of GDP was calculated as a separate variable.

3.5. Sample Period

In order to study the effects of the variables on the FDI inflows in Sri Lanka, researchers had obtained data on the indicators of GDP growth rate, Exchange Rate, Trade Openness, Military Expenses and inflation. Annual data from the year 1977 to 2016 is used which was published by Central Bank of Sri Lanka was used.

3.6. Data Collection methods

Secondary data sources and other valuable information sources from World Development Indicators, annual Reports and Economic and Social Statistics Reports of Central Bank of Sri Lanka, Board of Investment of Sri Lanka and World Bank Database and some International organizations were used for the purpose of collecting data for this research.

4. Results

4.1. Descriptive Statistics

The results of descriptive analysis help to explain the relevant aspects of the phenomenon of foreign direct investment and provide detailed information about each relevant variable.

Table 1: Descriptive Statistics

Variable	Minimum	Maximum	Mean	Std. Deviation
FDI	-0.0297	2.8496	0.9003	0.6258
GDP	-1.5000	9.1000	4.4553	2.1167
INF	1.2249	26.1454	9.6452	5.5745
ER	5.9349	152.4474	61.8066	45.4915
TRADE	2.7597	80.4288	38.1775	26.6152
ME	0.5400	5.8600	2.5206	1.4258

Source: Software output taken from collected data set

Table 01 shows descriptive statistics for FDI inflow in Sri Lanka during the period from 1970 to 2016. According to the results, mean FDI value is 0.9 with Standard error of 0.0913. Average 5% GDP growth rate can be seen in selected period and somewhat higher (10%) inflation can also be seen. Monetary value of US dollar has depreciated speedily throughout the period. The range of more than Rs. 90 can be observed. Total import and export as a percentage of GDP is nearly 38%. While can vary from time to time. A military expense as a percentage of GDP is always below 5% which has an average of 2.5%.

4.2. Test of Multico-linearity

Table 2: Results of Collinearity Test

Variable	Tolerance	VIF
GDP	0.889	1.124
INF	0.848	1.180
ER	0.086	11.600
TRADE	0.071	14.088
ME	0.507	1.970

Multicollinearity indicates the interrelationship existing among independent variables in multiple regression analysis. High inter correlation among independent variables in a regression model make the regression coefficient unreliable. Variance Inflation Factor (VIF) and Tolerance are used to measure the multicollinearity. Independent variables which have VIF value greater than 10 needs to be eliminated. Tolerance value should be greater than 0.2 (Garson, 2012). According to the Table 02, two of the variance inflation factors are fairly large for some of the variables indicating multicollinearity issues.

4.3. Correlation Analysis

Table 3:Results of Correlation Analysis

	FDI	GDP	INF	ER	TRADE
GDP	0.433				
INF	0.241	0.154			
ER	0.574	0.223	-0.165		
TRADE	0.652	0.223	-0.059	0.941	
ME	0.483	-0.001	-0.036	0.487	0.621

In addition to the results of collinearity test, correlation matrix also shows a higher correlation value between trade openness and exchange rate which is 0.941. Trade openness is highly correlated with the exchange rate. Based on that, two separate models are developed by having selected five variables.

GDP growth shows 0.433 significant correlation value with FDI which denotes a moderate degree of positive correlation while correlation of FDI with inflation rate is 0.241. Besides, the correlation is somewhat lower between FDI and inflation rate. Moreover, Correlation between exchange rate and FDI shows a high degree of positive significant correlation than the other variables while the Correlation between trade openness and FDI inflows shows the highest positive significant correlation. There is a significant correlation between military expenses and FDI since the correlation value is 0.483.

4.3.1. Model 01 - Multiple Regression Analysis

R square of this model is 0.532. This means the fact that explains the linear regression explain 53.2% of the variance in the data. In other words, 47% of fluctuations or variations of FDI is explained by other factors which are not included in the model. The

DurbinWatson value is 1.894 which is close to 2. This model has not suffered from autocorrelation problem.

Table 4: Model 01 - ANOVA Table

Model 01	Sum of Squares	Df	Mean Square	F	Sig.
Regression	10.319	4	2.580	14.081	0.000 ^b
Residual	7.695	36	0.183		
Total	18.015	40			

a. Dependent Variable: FDI

b. Predictors: (Constant), ER, INF, GDP, ME

F value in the ANOVA table is significant since p value is 0.000. This indicates that the fitted regression model is good for the data set. It can be assumed that the model explains a significant amount of the variance in FDI inflows.

Table 5: Model 01 - Coefficient Table

Model 01	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta		
(Constant)	-0.464	0.208		-2.228	0.031
GDP	0.089	0.032	0.300	2.816	0.007
INF	0.031	0.012	0.273	2.607	0.013
ER	0.006	0.002	0.409	3.344	0.002
ME	0.129	0.051	0.294	2.517	0.016

a. Dependent Variable: FDI

Coefficient table of the regression analysis represents the degree to which the dependent variable can be affected by a certain independent variable while other independent variables remain constant. If the p value is lower than 0.05 there is a significant impact between the dependent variable and the independent variable.

According to the result of regression, it clearly shows that all the selected variables are statistically significant since all p values are less than 0.05. Based on the results, regression equation can be written as follows.

$$FDI = -0.464 + 0.089GDP + 0.031INF + 0.006ER + 0.129ME$$

4.3.2. Model 2 - Multiple Regression Analysis

R square of the second model is 0.549. This means that the fitted linear regression explains 54.9% of the variance in the data. In other words, 45.1% of fluctuations or variations of FDI is explained by other factors which are not included in the model. Durbin Watson value is 1.863 which is close to 2. This model has not suffered from autocorrelation problem.

Table 6: Model 02 - ANOVA Table

Model 02	Sum of Squares	Df	Mean Square	F	Sig.
Regression	10.604	4	2.651	15.023	.000 ^b
Residual	7.411	36	.176		
Total	18.015	40			

a. Dependent Variable: FDI

b. Predictors: (Constant), ME, GDP, INF, TRADE

F value in the ANOVA table is significant because p value is less than 0.05 indicating that the fitted regression model is significant. It can be assumed that the model explains a significant amount of the variance in FDI inflows.

Table 7: Model 02 – Coefficient table

Model 02	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta		
(Constant)	-0.378	0.203		-1.863	0.069
GDP	0.086	0.031	0.291	2.770	0.008
INF	0.026	0.011	0.232	2.300	0.026
TRADE	0.011	0.003	0.481	3.636	0.001
ME	0.085	0.056	0.193	1.500	0.141

a. Dependent Variable: FDI

GDP growth rate, inflation and trade openness have a significant impact on FDI inflows since P value of these variables are less than 0.05. Military expenses is not a significant variable for the second model. The fitted regression equation is,

$$FDI = -0.378 + 0.086GDP + 0.026INF + 0.011TRADE$$

5. Discussion

Based on the regression results, GDP growth has a significant impact on FDI as hypothesized. This finding is complied with the studies done by Hossain and Hossain (2012) and GuechHeang & Moolio (2013). Correlation analysis also helped the researcher to discover that there is a positive relationship between the above mentioned two dimensions ($r = 0.433$). According to the coefficient table, inflation has a significant impact on FDI inflows. Inflation shows a positive relationship with FDI ($r = 0.241$). Investors make their investment decisions based on the inflation rate. When considering the general situation of investors, they prefer a low and stable inflation rate. According to the previous studies they have shown mix results. The findings of the study tally with the findings of the study done by the Alshamsi, Hussin, & Azam, (2015). A study by Shah (2011) found a negative relationship between FDI and inflation rate. Ravinthirakumaran, et al., (2015) revealed that the Low rate of inflation in Sri Lanka negatively impacts FDI. Their findings do not comply with the findings of this study.

Exchange rate shows a significant positive impact on FDI inflows. This finding is in line with the results reported by Aqeel, Nishat and Bilquees (2004). In addition to that, there was a positive relationship between Exchange rate and Foreign Direct Investment ($r = 0.574$). Military expenditure has a positive significant relationship with FDI inflows. Pearson value for military expenditure is 0.483 which means that there is a significant positive relationship with FDI. Furthermore, regression analysis found that there is an impact of military expenditure on FDI ($\beta=0.129$). The researcher used military expenditure variable to measure the civil war effect. In general, military expenditure shows higher amounts during the civil war period and foreign investors are discouraged to invest in those countries. According to the output, it shows a positive relationship with FDI. However, the finding of the researcher does not comply with the findings of the study done by Azam and Lukman (2010). Based on the above article, there is a negative relationship between military expenditure and Pakistan FDI inflows.

Model 2 shows a significant impact of trade openness on FDI inflows. Correlation analysis also confirmed that finding which discovered a positive relationship between above-mentioned two dimensions ($r = 0.652$). Most of the researchers have found a positive relationship between trade openness and FDI (Suliman & Mollick, 2009, Asiedu, 2002). Figure 01 is used to identify civil war effect on FDI inflows in Sri Lanka. According to that there is not a significant effect of the civil war. During that period FDI inflows have gradually increased and shown the highest amount. At the end of the civil ethnic war, they were not performed in that way. Their performances were going down.

6. Conclusion

This study investigated the determinants of Foreign Direct Investment inflows in Sri Lanka. 40 years were considered when collecting data for this study. Five independent variables namely GDP, growth rate, inflation, exchange rate, trade openness and military expenditure were identified to determine FDI inflow to Sri Lanka. Multiple regression analysis was performed to achieve research objectives with five variables as independent variables and the Foreign Direct Investment as the dependent variable. The correlation analysis was used to identify the association between those five independent variables and the Foreign Direct Investment inflows. The researcher has identified two models as Model-1 and Model-2 for the ease of analyzing of data by considering multicollinearity of the data. Referring to Model-1; the researcher aimed at identifying the impact of GDP growth, Exchange Rate, Inflation and Military Expenditure on FDI inflows. All of the four variables were significant in determining FDI inflows. Referring to model-2; the researcher aimed to identify the impact of GDP growth, Inflation Rate, Trade Openness and Military Expenditure. GDP growth, Inflation Rate and Trade Openness were significant in determining FDI inflows, while Military Expenditure was insignificant in determining FDI inflow in Sri Lanka. The study has also focused on identifying the behavior of foreign direct investment during the Pre-war period and post-war period. According to the Foreign Direct Investment behavior, there is no significant impact of Foreign Direct Investment inflows after the civil ethnic war. During the civil war period, (2007-2008) Sri Lanka's FDI net inflows reported the highest amounts.

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