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**THE DETERMINANTS OF JAPAN FOREIGN DIRECT INVESTMENT (FDI) IN INDIA****Dr. Vinod Kumar***Assistant Professor, Sri Venkateswara College, University of Delhi, New Delhi, India*

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**ABSTRACT**

*The purpose of this study is to determine the factors that affect Japan foreign direct investment (FDI) in India. It also analyzes the current trend of Japan FDI towards this country. After formation of new government in May 2014 at Centre, Indian prime minister visited Japan to boost business and political ties. Japanese companies' investments have flowed into manufacturing sector of India and are expected to rise. The Government of India (GOI) recently launched a major new national program "Make in India" designed to facilitate investment, foster innovation, enhance skill development, protect intellectual property and build best-in-class manufacturing infrastructure. The cumulative equity Foreign Direct Investment (FDI) in India from Japan from January 2000 to December 2017 are US\$ 27.02 billion which ranked Japan 3<sup>rd</sup> largest investor in India. Further, it is found that sectors attracted maximum FDI equity inflows from Japan from January 2000 to December 2017 are automobile industry (19%), drugs & pharmaceutical (17%), services sector (14%), metallurgical industries (9%) and telecommunications (8%) respectively. Different multiple regression analyses have been used to obtain the economic results of this study. This study uses quarterly data for a period (2000-2017) to observe that determinants of Japan FDI in India. The regression analysis shows that the factors that affect Japan FDI in India have the correct theoretical sign in all cases, but is significant only for the exchange rate coefficient.*

**KEY WORDS:** *FDI, Investment, Make in India, Auto Correlation, Ordinary Least Square*

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**I. INTRODUCTION**

Foreign direct investment (FDI) is a significant source of capital for financing development and infrastructure in countries especially India. It contributes to productivity benefits by providing fresh investment, better technology, managerial skills and export markets (Borensztein, De Gregorio and Lee, 1998; Harrison, 1994; Sahoo, 2006). Blonigen and Wang (2005) found that FDI flows to developing countries, as opposed to developed countries, have a particularly strong effect on growth by crowding-in- domestic investment. Kee (2011) showed that direct and indirect spillovers can be quite strong, as demonstrated by the case of Bangladesh, where FDI inflows impact both domestic intermediate input suppliers that provide raw material to FDI firms, through increase in demand for high-quality intermediates and domestic final good producers who are users of those high-quality intermediates as a result of shared supplier spillover.

India was not prioritised by Japanese firms, who mainly looked towards the markets of North America for expansion opportunities. During India's first opening phase (1951-65) which was characterised by largely liberal (albeit selective) policies towards FDI (Panagariya, 2008), Japanese FDI to India was modest and was primarily directed towards securing the supply of raw materials, notably minerals, cotton, pig iron, coke and coal (Komiya & Wakasugi, 1991) and as an adjunct to Japanese trade, including investments in finance. Japanese FDI in India during this period mirrors the modest internationalisation activities of Japanese firms abroad more generally.

India's increasingly reserved attitude towards foreign capital in Phase 2 (1966-80) is juxtaposed by accelerating Japanese FDI, reflecting Japan's economic growth and its relaxation of controls on outward capital flows (Flath, 2000). The third period of India's economic development was

characterised by the growing recognition of the importance of modernisation and the end of the import substitution policy (Panagariya, 2008). Japanese firms reacted to successive deregulation phases by introducing capital, technology and management know-how. Between 1981 and 1988 annual Japanese FDI flows to India ranged between US\$3 million (in 1982) and US\$24 million (in 1988) based on reports and notifications. In general, the value and number of Japanese investment activities increased towards the end of the 1980s (JETRO, 2011). Thus, while the Indian government was experimenting with FDI policy liberalisation, this phase marked a learning period for Japanese firms (Horn, Forsans, & Cross, 2010).

The fall of communism in Europe, China's economic rise and successful experiments in the preceding period accelerated India's market reform process.

The liberalisation phase (1989–98) is not marked by a distinct caesura, but parallels the reform process of the preceding periods (Panagariya, 2008). Japanese MNEs reacted rapidly to the new industrial policy of 1991 (with a first investment peak in 1992) and in parallel with the progressive liberalisation of India's policy framework, including debureaucratisation of FDI applications (in 1991), de-licensing (1994) and further lifting of equity ceilings (1997), Japanese investment expanded from the mid-1990s onwards. Many firms already with a foothold in India extended their engagement either by establishing new production facilities, accompanied by an influx of *keiretsu* affiliated suppliers (documented for the automobile industry by Horn, Forsans, & Cross, 2010), or by increasing their equity share (Sharma, 1999).

The phase (1999-2001: Political cooling) accompanied by a general deceleration in FDI flows to India from Japan during this period. Tensions and instability at the political level and a loss of momentum of industrial liberalisation (Balasubramanyam & Mahambare, 2003; Panagariya, 2008) defined the framework within which investment activities took place in this phase (1998– 2001). In the early years of new experimental phase, Japanese investment declined to levels of the early 1990s and bottomed out in 2003 with an overall investment flow of US\$87 million.

It is a relationship which has historical significance and has only evolved stronger into a political and economic alliance in the 21<sup>st</sup> century. Historically, the ties between both countries was linked because of Buddhism and has only grown and evolved through centuries with visits by travelling monks from Japan to India from the 8<sup>th</sup> century onwards.

The relationship between Japan and India has only grown stronger over the years and both countries are set for stronger ties in the future years. This became evident with Prime Minister Narendra Modi's first choice of visit being Japan after being elected. After the meeting, the two Prime Ministers signed a Joint Statement entitled, 'Tokyo Declaration for Japan-India Special Strategic and Global Partnership'.

India on its part has been driving home its three great advantages that the Japanese economy can leverage on; democracy in the form of single-window clearances and speedy decision-making; demography cast in the burgeoning youth segment of India's population more than half of which is currently under the age of 25; and demand, huge capacity of private consumption. Either way it is a win-win scenario for industry in India on both sides.

The good news is that work has already begun on chalking out these synergies with both India and Japan taking steps to unlock the business and economic potential that they offer to each other. The Indian Government has set up Japan Plus, a special management team, to facilitate Japanese investors. The team is actively interacting with Japanese companies and hand-holding them through various approval processes for diversified projects including Japanese Integrated Industrial Parks.

Japan was the second-largest investor in India both in terms of FDI projects and jobs created during the period 2007–12. Japanese investment in India is split between services (40.6%) and manufacturing (45.2%). Most Japanese investors chose New Delhi and Mumbai for their services projects, and Bengaluru and Chennai for their manufacturing plants. Specifically, Japanese companies are interested in India's industrial and automotive sectors. During the six years up to 2012, Japan established 225 projects in these sectors, creating a total of 98,708 jobs. Honda, Toyota Motors and Sony are just some of the companies that have made long-term investments in the country (The Washington Post 2013). Japan is also keen to invest in the development of India's infrastructure — the DMIC is a prime example. The relationship between the two nations holds considerable potential but, to progress further, improvements in the tax system and regulatory reforms are required.

The remainder of this paper is presented in four sections. The following section presents a brief literature review and states the determinants of foreign direct investment. Section three discusses the hypothesis, the data sources and the methodology used to test the determinants of FDI. Section four describes the findings of this study and the last section provides the conclusion.

## II. REVIEW OF LITERATURE

FDI has multiple effects on the economy of host country. FDI influences the production, employment, income, prices, exports, imports, balance of payments, economic growth, and consumer welfare of the recipient country. Several empirical studies have drawn considerable attention on the determinants of Japan FDI in the India.

Desatnicov and Akiba (2011) empirically examined the role of political risks in the Japanese outward Foreign Direct Investment (FDI) activities with a panel data of 30 countries for the period of 1995-2008. The estimation model is constructed on the basis of the OLI (ownership, location and internalization advantages) and Knowledge-Capital Models. Political risk variables are included as additional explanatory variables with market potential, wages, skilled workforce endowments, investment cost, trade cost and distance. The study found that the model with interaction terms of these political risk factors with some traditional explanatory variables reasonably explains recent Japanese outward FDI flows. Buckley, Cross and Horn (2012) studied using a firm-level dataset the Japanese FDI in India. The study reveals important instances of Japanese firm flexibility and pragmatism vis-a'-vis the rapidly growing Indian market.

A long list of demand and supply determinants of FDI has been postulated in the literature (see Scaperlanda and Balough (1983), and Lunn (1980). Dunning (1980) suggested factors such as relative profit rates or deferrals, local market size and growth, past levels of FDI and investment climate in terms of regulations and incentives as main determinants. Some of the most commonly mentioned factors are profitability,

market variables, trade flows and discrimination and exchange rate.

### III. HYPOTHESIS, DATA AND METHODOLOGY

This study attempts to identify India's economic factors which significantly influence Japan FDI on Indian economy. Specifically, it is hypothesized that the Japan FDI plays a significant role in the Indian economy and that in recent years, the Japan's role may be increasing. This hypothesis is tested by a model that includes the major macroeconomic variables affecting FDI. The model can be expressed as:

$$RFDI_t = \beta_0 + \beta_1 GNP_t + \beta_2 CGNP_t + \beta_3 TB_{t-1} + \beta_4 ER_t + \epsilon_t \quad (1)$$

Where,  $RFDI_t$  is the ratio of Japan (home country) FDI to host country's real GNP, expressed as a percentage.  $GNP_t$  is the GNP in US(\$), measures the local market size and is expected to have positive sign.  $CGNP_t$  is the growth rate of market size; proxied by the annual percentage rate of change in GNP ( $\Delta GNP/GNP$ ) in US (\$), and is expected to have a positive sign.  $TB_{t-1}$  is the trade balance variable, measured in

US(\$), lagged one year and is expected to have a negative sign.  $ER_t$  is the exchange rate, measures the real exchange rate of domestic currency in terms of US\$ and is expected to have a negative sign.  $\epsilon_t$  is the error term.

The independent variables show the host country (India) factors. The above model is estimated by using the ordinary least square (OLS) method. In order to investigate the possible omission of relevant variables (autocorrelation), Breusch-Godfrey Serial Correlation LM test is also employed. The model is tested with two period lags in the disturbance terms ( $\epsilon_{t-1}$  and  $\epsilon_{t-2}$ ) to capture possible autocorrelation. It can be stated as:

$$RFDI_t = \beta_0 + \beta_1 GNP_t + \beta_2 CGNP_t + \beta_3 TB_{t-1} + \beta_4 ER_t + \beta_5 \epsilon_{t-1} + \beta_6 \epsilon_{t-2} \quad (2)$$

Quarterly data for 2001 to 2017 period have been used to test these models. The data was collected from various issues of *International Financial Statistics*, Reserve Bank of India Website on Database on Indian Economy and Balance of Payments Yearbook. The host country variables are converted from local currency to US\$.

### IV. EMPIRICAL RESULTS

**Table 1: Year-Wise FDI Inflows in India from Japan (US\$ million)**

Calendar Year (January-December)	FDI equity inflows from Japan		FDI equity inflows from all Countries*	
	Rs. in crores	US\$ in million	Rs. in crores	US\$ in million
2000	985.69	229.23	10,092	2,347
2001	996.54	221.45	15,842	3,520
2002	1,980.46	412.59	16,123	3,359
2003	434.39	94.43	9,564	2,079
2004	533.74	116.03	14,781	3,213
2005	744.95	168.18	19,271	4,355
2006	522.92	116.10	50,357	11,120
2007	2,775.16	670.46	65,495	15,921
2008	21,501.66	4,470.25	159,530	37,095
2009	6,094.32	1,257.81	130,980	27,044
2010	5,857.86	1,295.00	96,015	21,007
2011	14,348.61	3,058.32	159,935	34,621
2012	10,364.42	1,909.35	121,591	22,789
2013	8,234.42	1,420.73	129,483	22,038
2014	14,268.38	2,335.02	175,313	28,785
2015	11,084.38	1,739.42	252,561	39,328
2016	38,809.80	5,781.17	311,644	46,403
2017	11,206.14	1,722.89	282,768	43,575
<b>Cumulative Total (January 2000- December 2017)</b>	<b>150,743.83</b>	<b>27,018.44</b>	<b>2,021,345</b>	<b>368,599</b>

Source: DIPP, FDI fact sheet, various issues.

Note: I. \*These amounts include the inflows received through FIPB/SIA route, acquisition of existing shares and RBI's automatic route only.

II. The amount of FDI equity inflows, in respect of country/sector specific data was not provided by RBI, Mumbai, prior to January 2000.

Table 1 provides an analysis of the FDI equity inflows, received in India since 2000, shows that the FDI equity inflows have risen substantially. The Cumulative FDI equity inflows (remittance-wise) received during January 2000 – December 2017 were Rs. 2,021,345.81 crores (US\$ 368.60 billion). Out of this, FDI inflows from Japan (which ranks 3<sup>rd</sup>) are Rs.

150,743.83 crores (i.e. US\$ 27.02 billion), which represents 7.33% of the cumulative inflows received (this amount does not include inflows received prior to January 2000, as such data prior to that date was not centrally maintained by the RBI). Further, project, country & sector specific FDI equity inflows data, in respect of Japan, is available only from January 2000 onwards.

**Table 2: Share of Top Sectors attracting FDI Equity Inflows from Japan (from January 2000 to December 2017)**

Rank	Sector	Amount of FDI Equity inflows (US\$ million)		% age of FDI Equity inflows from Japan
		Rs. in crores	US\$ in million	
1	Automobile Industry	28,720.20	5,052.93	18.70
2	Drugs & Pharmaceuticals	22,083.39	4,463.85	16.52
3	Services Sector*	21,910.38	3,840.99	14.22
4	Metallurgical Industries	12,520.02	2,308.76	8.55
5	Telecommunications	13,870.15	2,158.51	7.99
<b>Total of Above</b>		<b>99,104.14</b>	<b>17,825.04</b>	<b>65.98</b>

\*services sector includes financial, banking, insurance, non-financial/business, outsourcing, R&D, courier, technology, testing and analysis.

Source: DIPP, FDI fact sheet, various issues

Table 2 provides an analysis of the sector-wise distribution of FDI equity inflows received from Japan, from 01.01.2000 to 31.12.2017, it is seen that the highest FDI equity inflows have been in the Automobile industry, which

accounts for about 19% of FDI inflows from Japan. Drugs & Pharmaceuticals, with about 17%, is in the second place and Services sector with over 14% ,is in the third place.

**Table 3: Share of Top Five RBI's Regional Offices (with States covered) Received FDI Equity Inflows from Japan (from January 2000 to December 2017)**

Ranks	Regional Offices of RBI	States Covered	Amount of FDI Equity inflows		% age of FDI Equity inflows from Japan
			Rs. in crores	US\$ in million	
1	Mumbai	Maharashtra, Dadra & Nagar Haveli, Daman & Diu	37,384.99	6,443.92	23.85
2	New Delhi	Delhi, Part of UP and Haryana	29,924.11	5,486.31	20.31
3	Chennai	Tamil Nadu, Pondicherry	14,234.98	2,450.02	9.07
4	Ahmedabad	Gujarat	8,546.04	1,309.22	4.85
5	Bangalore	Karnataka	7,101.15	1,212.29	4.49
<b>Total of Above</b>			<b>97,191.27</b>	<b>16,901.76</b>	<b>62.57</b>

Source: DIPP, FDI fact sheet, various issues

Table 3 provides an analysis of the share of top five RBI's regional offices (with states covered) of FDI equity inflows received from Japan, from 01.01.2000 to 31.12.2017, it is seen that the highest FDI equity inflows have been in the

Mumbai region, which accounts for about 23.85% of FDI inflows from Japan. New Delhi region, with 20.31% is in the second rank and Chennai region with 9.07% ,is in the third rank.

**Table 4: Details of Top FDI Inflows received from Japan (remittance-wise) (through India Companies, from January 2000 to December 2017)**

Sl. No.	Name of Indian Company	FDI Route	Name of Foreign Collaborator	RBI Regional Office	Item of Manufacture	Amount of FDI Inflows	
						(in Rs. crore)	(in US\$ million)
1	TATA TELESERVICES LTD	RBI	NTT DOCOMO INC	MUMBAI	Activities of maintaining and operating paging, cellur and other telecommunication networks	9,796.60	1,457.66
2	RANBAXY LABORATORIES LTD.	RBI	DAIICHI SANKYO CO. LTD.	REGION NOT INDICATED	Manufacture of chemical substances used in the manufacture of pharmaceuticals	6,818.66	1,401.42
3	RANBAXY LABORATORIES LTD.	RBI	DAIICHI SANKYO CO. LTD.	REGION NOT INDICATED	Manufacture of chemical substances used in the manufacture of pharmaceuticals	6,037.01	1,240.77
4	JSW STEEL LTD.	RBI	JFE Steel Corporation, Japan	MUMBAI	Manufacture of other basic iron and steel n.e.c.	4,800.72	719.23
5	JSW STEEL LTD.	RBI	JFE Steel Corporation, Japan	MUMBAI	Manufacture of semi-finished iron & steel products n.e.c.	4,800.72	1,060.26

6	RANBAXY LABORATORIES LTD.	RBI	DAIICHI SANKYO CO. LTD.	REGION NOT INDICATED	Manufacture of chemical substances used in the manufacture of pharmaceuticals	3,539.14	722.28
7	RANBAXY LABORATORIES LTD.	RBI	DAIICHI SANKYO CO. LTD.	REGION NOT INDICATED	Manufacture of chemical substances used in the manufacture of pharmaceuticals	3,409.22	700.69
8	SUZUKI MOTOR GUJARAT PRIVATE LTD.	RBI	SUZUKI MOTOR CORPORATION	AHMEDABAD	Manufacture of passenger cars	3,100.00	460.95
9	RELIANCE LIFE INSURANCE COMPANY LTD.	RBI	NIPPON LIFE INSURANCE COMPANY	REGION NOT INDICATED	Life insurance health insurance & annuity business	2,761.61	543.02
10	SUZUKI MOTOR GUJARAT PRIVATE LTD.	RBI	SUZUKI MOTOR CORPORATION	AHMEDABAD	Manufacture of passenger cars	2,600.00	382.91
11	RELIANCE LIFE INSURANCE COMPANY LTD.	RBI	NIPPON LIFE INSURANCE COMPANY	REGION NOT INDICATED	Life Insurance	2,265.62	338.04
12	TOSHIBA TRANSMISSION & DISTRIBUTION SYST	RBI	TOSHIBA CORPORATION	HYDERABAD	Manufacture of Transformers	1,633.00	273.39
13	RENAULT NISSAN AUTOMOTIVE PVT LTD.	RBI	NISSAN MOTORS COMPANY	CHENNAI	Manufacture of transport equipment & parts	1,477.00	274.67
14	RELIANCE CAPITAL ASSET MANAGEM LTD.	RBI	NIPPON LIFE INSURANCE COMPANY	REGION NOT INDICATED	Financial asset management & portfolio management	1,449.98	260.98
15	ANCHOR ELECTRICALS PVT LTD.	FIPB	MATSUSHITA ELECTRIC WORKS LTD.	REGION NOT INDICATED	Electrical products	1,440.83	341.85
16	KOTAK MAHINDRA BANK	RBI	SUMITO MITSUI BANKING CORPORATION	MUMBAI	Monetary intermediation of commercial banks, saving banks, postal savings bank and discount houses	1,366.12	203.00
17	KOTAK MAHINDRA BANK	RBI	SUMITO MITSUI BANKING CORPORATION	MUMBAI	Banking activities including financial services	1,304.83	303.47
18	INDUSIND BANK LTD.	RBI	Various investors	MUMBAI	Deposit activities	1,304.83	209.60
19	HONDA SIEL CARS INDIA LTD.	RBI	ASIAN HONDA MOTOR CO LTD.	NEW DELHI	Manufacture of motor cars	1,300.00	213.07
20	HONDA SIEL CARS INDIA LTD.	RBI	HONDA MOTOR CO LTD.	NEW DELHI	Manufacture of motor cars	1,200.00	215.98
21	TELCO CONSTRUCTION EQUIPMENT CO LTD.	RBI	HITACHI CONSTRUCTION MACHINERY CO. LTD.	NEW DELHI	MFG construction equipment	1,159.50	260.56
22	RENAULT NISSAN AUTOMOTIVE INDIA PVT LTD.	RBI	NISSAN MOTOR CO. LTD.	CHENNAI	Manufacture of passenger cars	1,044.03	169.20
23	MARUTI UDYOG LTD.	RBI	SUZUKI MOTOR CO. LTD.	NEW DELHI	Manufacture of passenger cars	1,000.00	208.33
24	SUZUKI MOTORCYCLE INDIA PVT. LTD.	RBI	SUZUKI MOTOR CO. LTD.	NEW DELHI	Manufacture of motor vehicles	1,000.00	150.44
25	MAX NEW YORK LIFE INSURANCE CO. LTD.	RBI	NISSAN MOTOR CO. LTD.	REGION NOT INDICATED	Life Insurance business	984.41	175.69
<b>Grand Total</b>						<b>67,655.12</b>	<b>12,287.47</b>

Source: DIPP, FDI fact sheet, various issues

Table 4 provides an analysis of top FDI equity inflows received from January 2000 to December 2017 from foreign companies into Indian companies from Japan include: Tata Teleservices Ltd.; Ranbaxy Laboratories Ltd.; JSW Steel Ltd.; Suzuki Motor Gujarat Pvt. Ltd., Reliance Life Insurance

Company Ltd.; Toshiba Transmission & Distribution Syst.; Renault Nissan Automotive India Pvt. Ltd.; Anchor Electrical Pvt. Ltd.; Kotak Mahindra Bank Ltd.; and IndusInd Bank Ltd.

**Table 5: Regression Analysis of the Determinants of Japan FDI in India**

Coefficient	Ordinary Least Square (OLS) Regression	Breusch-Godfrey Serial Correlation LM Test
$\beta_0$	-1.7569 (-0.8966)	-0.9887 (-0.3294)
$\beta_1$	0.0081 (0.5356)	0.0032 (0.5568)
$\beta_2$	0.0127 (0.5794)	0.0081 (0.3887)
$\beta_3$	-0.0005 (-0.2922)	-0.0002 (-0.9199)
$\beta_4$	0.1333 (3.4983)*	0.1236 (2.4647)*
$\beta_5$		0.1329 (1.3222)
$\beta_6$		-0.0829 (-0.5576)
R <sup>2</sup>	0.4829	0.6425
Adjusted-R <sup>2</sup>	0.3983	0.5368
D-W Statistic	1.6609	1.9783
F-Statistic	3.7449*	5.2285**

\*\* and \* indicate significant at the 1% and 5% levels respectively.

Source: Author's Calculation

Table 5 provides the estimated values of the coefficients and their corresponding t-statistics using the OLS and Breusch-Godfrey Serial Correlation LM tests. The OLS estimation shows that all coefficients have correct theoretical signs. Except the exchange rate (ER) determinant, however, none of them are significant. The F-statistic is significant at the five percent level. Taken together, it implies that all variables significantly explain the determinants of FDI in India. The Durbin-Watson (D-W) statistic is observed as 1.6609. Therefore, the presence of autocorrelation and consequently, the possibility of any omission of relevant variables remain inconclusive.

The OLS analysis could not provide compelling statistical evidence that the market size hypothesis is as valid for FDI in a developing country as it is in more industrialized economies. The market growth variable, calculated as the growth rate of GDP has a positive coefficient but is insignificant. The trade balance also has the correct but insignificant theoretical sign. The exchange rate coefficient has the correct sign and is significant. It is the only significant variable in the equation. The regression analysis supports that there is a strong link between the movement of real value of host country currency and the inflow of Japan FDI.

The Breusch-Godfrey Serial Correlation LM test also produces correct theoretical signs for all variables. However, only the exchange rate variable is observed significant. This finding is similar to that of OLS estimation. The D-W statistic has been improved to 1.9783, while the F-statistic is significant even at 1% level. The coefficient of lagged error terms are observed insignificant. It implies the absence of autocorrelation in the estimation process.

## V. CONCLUSION

This study uses quarterly data for a period (2000-2017) to observe that determinants of Japan FDI in India. The regression analysis shows that the factors that affect Japan FDI in India have the correct theoretical sign in all cases, but is significant only for the exchange rate coefficient. The corresponding F-statistic is found to be significant. The presence of auto correlation and consequent omission of relevant variables is observed to be baseless. That implies the significance of the factors included in the study in determining the trend of Japan FDI in India.

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