

## **Foreign Direct Investment and Economic Growth in Nepal: Evidence from a Multivariate ARDL-VECM Model (1989–2024)**

<sup>1</sup>GURUNG ABIN, <sup>2</sup>TIWARI ANIL

<sup>1</sup>Ph.D Scholar, Singhanian University India (Author), <sup>2</sup>Associate Professor Dr., Singhanian University, India  
(Co-author)

Email: <sup>1</sup>[abin.gurung2014@gmail.com](mailto:abin.gurung2014@gmail.com), <sup>2</sup>[anil.tiwari@singhanianuniversity.ac.in](mailto:anil.tiwari@singhanianuniversity.ac.in)

### **Abstract**

This study examines the relationship between foreign direct investment (FDI), exports, and economic growth in Nepal from 1988/89 to 2023/24. The analysis shows that Real GDP has steadily grown over time, reflecting improvements in productive capacity, structural reforms, and rising domestic demand, whereas exports have expanded slowly and irregularly, and FDI inflows have remained volatile. Econometric results indicate that all variables are stationary, and Johansen cointegration tests confirm significant long-run relationships among Real GDP, FDI, and exports. Stability tests (CUSUM and CUSUMSQ) show that the model coefficients are stable, while Granger causality analysis reveals that economic growth drives both FDI and export performance in the short term, emphasizing GDP as a key driver of investment and trade. Regression analysis further demonstrates that FDI and exports have a significant positive impact on Real GDP, explaining approximately 94% of the variation in output. These findings highlight the importance of policies aimed at attracting stable foreign investment, enhancing export competitiveness, improving infrastructure, and fostering a favorable investment climate to promote sustained economic growth. The study underscores the interconnected role of investment, trade, and economic growth in Nepal and provides evidence to guide future economic planning and policy-making.

**Keywords: Investment, Gross Fixed Capital Formation, Export, Economic Growth (RGDP), FDI**

## INTRODUCTION

### 1. Introduction

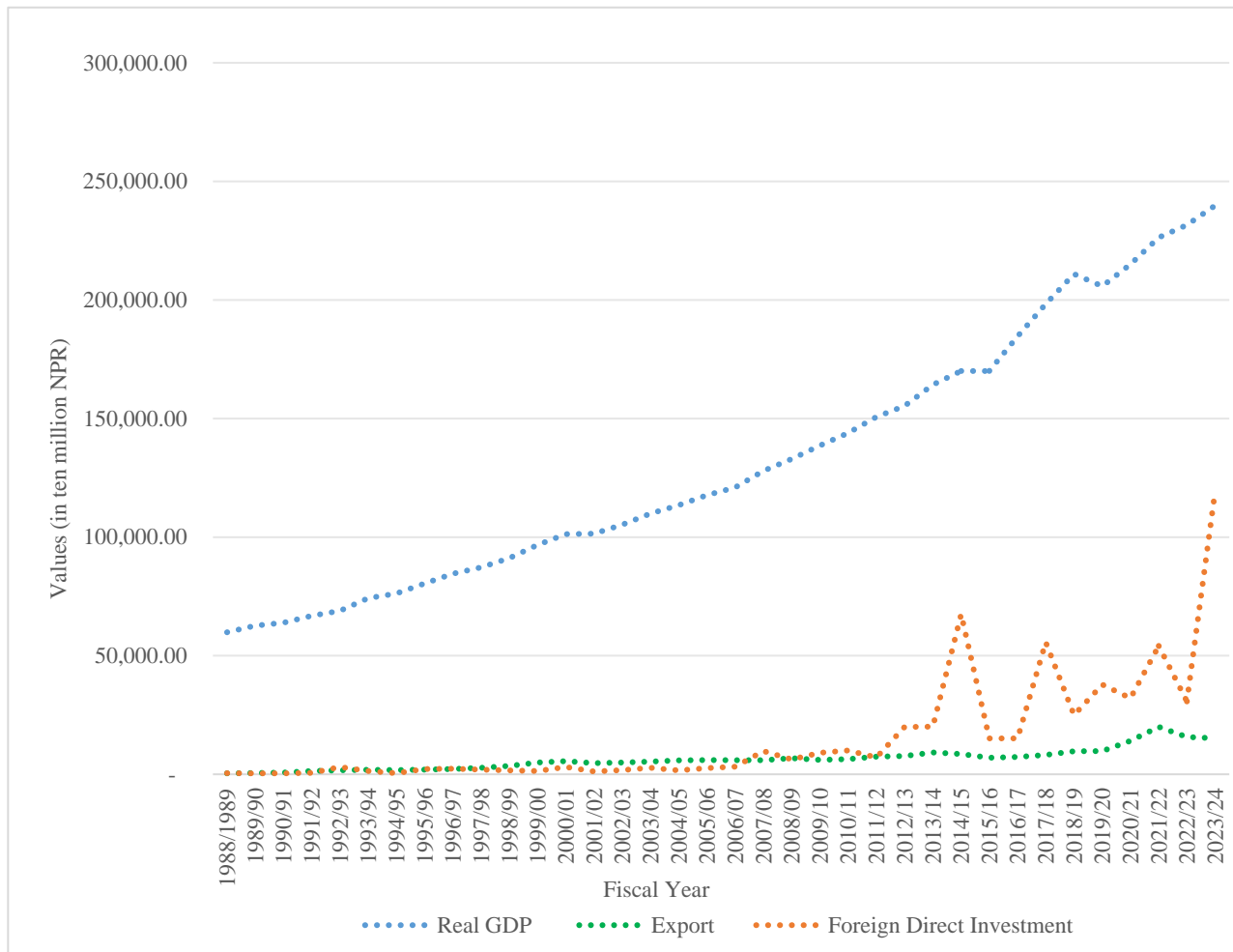
Foreign direct investment is major sources of capital for host country. It is support to growth economic development through capital formation, technology transfer and human capital. The country investment from one country to another country is called foreign direct investment. Foreign direct investment reflects an indivisible part of the world economic system, openness and effectively functioning world economic system boosts investment inflows and outflows across continents or respective countries and presents a crucial mechanism to development. Nepal is one of the emerging countries and in recent years has encouraged an important portion of foreign direct investment. Foreign direct investment plays an important role, particularly in Nepal, given the incredible natural resources, adjacent markets, and suitable climate, among other things. The economic growth rate was significantly increased over 2017 to 2019. A major role is played by government policies towards encouraging foreign investors to the country. The host nations shall introduce an apparent and improve the institutional and human capacities. The study will be pointed out the significance of FDI in boosting the growth of the nation's economy and is aimed at exploring the flow of inward FDI into Nepal in the structure of the economic development of the nation and presented a growing impact of FDI. Impact of FDI consists in the increasing numbers of jobs, as result decreasing level of unemployment; development of infrastructure; technological transfer; increasing of tax revenues; development of related industries; growth of the number of highly qualified and skilled labor; involvement in the production process and an overall increase in national GDP.

### 2. Objectives

The prime objective of the research to examine the relationship between FDI, export and economic growth in Nepal for the period fiscal year of 1988/89 to 2023/24.

### 3. Trends of RGDP, Investment, GFCS, Export and FDI flow in Nepal

Figure 1. Trends of RGDP, Investment, GFCS, Export and FDI flow in Nepal (1988/89-2023/2024)



Source: Government site, MOF of Nepal

Figure 1 presents the long-run movement of Real Gross Domestic Product (RGDP), investment, government final consumption spending (GFCS), exports, and foreign direct investment (FDI) inflows in Nepal from fiscal year 1988/89 to 2023/24. The figure provides a comprehensive overview of how key macroeconomic indicators have evolved over time and reflects both structural progress and persistent challenges within the Nepalese economy. Real GDP demonstrates a steady and sustained upward trajectory across the entire study period. Beginning from a modest level in the late 1980s, RGDP gradually increased, with stronger momentum observed after the early 2000s. This long-term expansion suggests gradual improvements in productive capacity, supported by structural reforms, increased domestic demand, and growth in service-oriented activities. Although temporary slowdowns can be observed during periods of political transition and external shocks, these interruptions do not alter the overall positive growth pattern. Exports exhibit a gradual but uneven growth trend, remaining relatively low in comparison to the expansion of real output. While export values increased over time, the growth pace is modest and marked by noticeable fluctuations. This pattern reflects Nepal's limited export diversification,

dependence on a narrow range of commodities, and sensitivity to regional and global market conditions. Despite recent increases, export performance has not kept pace with broader economic growth. In contrast, foreign direct investment inflows display considerable volatility throughout the period. FDI remained negligible during the initial years but began to increase sporadically following economic liberalization and policy initiatives aimed at attracting foreign investors. Several sharp rises in FDI inflows, particularly in the post-2010 period, suggest the influence of large, project-specific investments, mainly in hydropower, energy, and infrastructure sectors. However, the absence of a consistent upward trend highlights Nepal's ongoing difficulties in sustaining stable and continuous foreign investment inflows. Overall, the figure reveals a clear divergence between stable economic growth and unstable external capital inflows. While Nepal has experienced continuous expansion in real output, the fluctuating nature of FDI and the slow growth of exports indicate structural weaknesses in fully utilizing foreign investment and trade as drivers of long-term growth. These observed trends provide a strong justification for empirically examining the relationship between FDI, investment, and economic growth in Nepal, which is addressed in the subsequent econometric analysis.

#### 4. Literature Review

Acaravci and Ozturk (2012) found that a causal relationship exists between FDI, economic growth, and exports in four of the ten transition European countries. Sultanuzzaman et al. (2018), study shows that foreign direct investment (FDI) inflows have a positive and significant effect on economic growth in both the long run and short run, implying that higher FDI inflows lead to increased GDP growth. In contrast, exports display a negative and significant relationship with economic growth in the long run, suggesting that export expansion may reduce GDP growth. This outcome reflects Sri Lanka's heavy dependence on primary commodity exports, which are subject to resource limitations and price volatility, a common feature of developing economies. However, in the short run, exports exert a positive and significant influence on economic growth, indicating temporary growth benefits. Overall, the findings confirm that both FDI inflows and exports affect economic performance. Moreover, FDI inflows enhance production efficiency, supporting improved export quality and long-term economic growth in Sri Lanka.

Almfraji and Almsafir (2014) revealed that, in a few cases, the relationship between foreign direct investment and economic growth was insignificant and neutral. However, the major findings of the study indicated that FDI and economic growth were highly correlated during from 1994 to

2012. Mahmoodi and Mahmoodi (2016) found that, in the European developing panel, there is bidirectional causality between GDP and FDI, while GDP and FDI exert unidirectional causality on exports in the short run. In the Asian developing panel, exports and economic growth exhibit bidirectional causality in the short run. Furthermore, for both panels, the results show long-run causality running from exports and FDI to economic growth, as well as from economic growth and exports to FDI. Sunde (2017) found evidence of cointegration between FDI, economic growth, and exports.

The relationship between exports and economic growth is strong in developing economies, where export activities generate positive externalities for the non-export sector and exhibit higher marginal productivity compared to non-export activities. These factors significantly contribute to export expansion and GDP growth. Using the FEDER (1982) model and provincial-level data from China, evidence shows that economic structure, trade openness, and the policy environment play a crucial role in shaping the export–growth relationship (Sun & Parikh, 2001). Oyatoye et al. (2011) found a positive relationship between direct foreign investment (DFI) and gross domestic product (GDP). Specifically, a one-naira increase in DFI is associated with an increase of N104.749 in GDP. However, the coefficient of determination ( $R^2$ ) indicates that DFI explains only 18.5% of the variation in GDP, while the remaining 81.5% is attributable to other factors not captured by the model. Overall, the results confirm a positive association between GDP and DFI. Nguyen (2011) shows that exports are a long-term driver of economic growth in both Malaysia and Korea. In Malaysia, most variables exhibit bidirectional causality, except GDP does not cause exports. In Korea, causality is mostly unidirectional, and exports are unaffected by other variables. These differences reflect each country's industrialization policies, with Malaysia promoting FDI and Korea focusing on integrated national development through chaebols.

Pelinescu and Radulescu (2009) examine the FDI has been shown to positively impact economic growth in both developed and developing countries, with higher inflows linked to stronger GDP growth (IMF & World Bank recommendations). In transition economies, FDI not only boosts production and export potential but also supports economic re-specialization and structural development. Overall, foreign investment plays a key role in integrating economies into global markets and enhancing long-term growth. Rashid et al. (2023) indicates a long-term relationship among FDI, exports, imports, and inflation with economic growth in India. Specifically, FDI inflows, exports, and inflation appear to have a positive but statistically insignificant effect on economic growth, whereas imports exhibit a negative and insignificant impact.

Szkorupová (2014) finds a strong bidirectional causal relationship between economic growth and exports, evident in both the short and long run.

## 5. Research Methodology

To investigate relationship between foreign direct investment and economic growth in Nepal. This section demonstrates an economic models that use to examines the relationship between FDI (dependent variable) and export and real gross domestic product as independent variables. The data is collected from the sources of government of Nepal such as ministry of finance and department of industry.

To test the hypothesis of research model whereas FDI variable is dependent and total export and GRDP is as independent variables. GRDP is considered as a proxy of economic growth variable.

The hypothesis are presented as below:

H1: The relationships among FDI, economic growth, and exports follow a unidirectional causal pattern.

H2: The relationships among FDI, economic growth, and exports follow a bidirectional causal pattern.

The unit root test is presented as below:

$$\Delta Y_t = \beta_0 + \sum_{i=1}^p \beta_i \Delta Y_{t-i} + u_t \quad (1)$$

causal relationships.

## 6. Empirical results and discussion

### 4.1. Results of Unit root test

The study used various tests to explore the relationship between foreign direct investment and economic growth in Nepal. This chapter demonstrate about the empirical results and discussion.

There are several approaches for determining the unit root in time series data. This article uses the ADF test for the purpose. Because of its resilience and ability to eliminate autocorrelation from the model, the ADF is a better strategy for determining whether a time series is stationary or not or not.

**Table 1**  
*ADF-Unit Root Test*

Variables	Unit root test (Level)		Unit root test (First Difference)	
	T-test	P	T-test	P
RGDP	-3.633765	0.0412	-5.898255	0.0002
FDI	-5.260099	0.0007	-8.782130	0.0000
EXP	-3.791893	0.0294	-4.287023	0.0092

Source: Authors' computation

Table 1 reports the results of the Augmented Dickey–Fuller (ADF) unit root test conducted to examine the stationarity properties of Real Gross Domestic Product (RGDP), Foreign Direct Investment (FDI), and Exports (EXP). The test is applied at both the level and first difference to determine the order of integration of each variable. The results indicate that RGDP is stationary at level, as the ADF test statistic ( $-3.633765$ ) is statistically significant at the 5 percent level ( $p = 0.0412$ ). This suggests that the real output series does not contain a unit root and exhibits mean-reverting behavior in its level form. However, RGDP also remains stationary after first differencing, confirming the robustness of the result. Similarly, FDI is found to be stationary at level, with a highly significant ADF test statistic of  $-5.260099$  ( $p = 0.0007$ ). This implies that foreign direct investment inflows do not follow a random walk and adjust toward a long-run equilibrium without requiring differencing. The first-difference result further reinforces this finding, showing strong stationarity at the 1 percent significance level. In the case of exports (EXP), the ADF test statistic at level ( $-3.791893$ ) is statistically significant at the 5 percent level ( $p = 0.0294$ ), indicating that the export series is also stationary in its level form. The variable continues to exhibit stationarity after first differencing, as reflected by the significant test statistic ( $-4.287023$ ,  $p = 0.0092$ ). Overall, the findings suggest that all variables are integrated of order zero,  $I(0)$ , as they are stationary at level. This stationarity property supports the suitability of employing econometric techniques that do not require higher-order differencing and ensures that regression results are not affected by spurious relationships. These results provide a reliable foundation for subsequent empirical analysis examining the relationship between FDI, exports, and economic growth in Nepal.

Table 1 indicates the entire variables are stationary at level and first difference.

**Table 2**  
*Lag Length Selection Test*

Lag	LogL	LR	FPE	AIC	SC	HQ
0	-36.64821	NA	0.002219	2.402922	2.533968	2.448686
1	78.8597	203.0139*	0.0000035	-4.052103	-3.507919*	-3.869600*
2	89.1603	16.23125	0.00000329	-4.130927	-3.178604	-3.810573
3	94.56548	7.534487	0.00000425	-3.913059	-2.552598	-3.455336

Source: Authors' computation

Table 2 presents the results of the lag length selection criteria applied to determine the optimal lag for the vector autoregressive (VAR) model. Selecting the appropriate lag length is a crucial step

in time-series analysis, as it ensures the model captures the dynamic relationships between variables while avoiding overfitting. The table reports the log-likelihood (LogL), sequential likelihood ratio (LR) test statistics, final prediction error (FPE), Akaike Information Criterion (AIC), Schwarz Criterion (SC), and Hannan–Quinn (HQ) criterion for lag orders ranging from 0 to 3. From the results, the first lag (lag 1) is identified as the optimal choice, based on several indicators. The LR test at lag 1 is statistically significant (203.0139\*), indicating that adding the first lag significantly improves the model fit compared to a model with zero lags. Additionally, the SC and HQ criteria attain their minimum values at lag 1 (-3.507919\* and -3.869600\*, respectively), supporting the selection of the first lag. The AIC also suggests a minimum around lag 2 (-4.130927), but SC and HQ are generally considered more reliable for small sample sizes, which justifies the preference for lag 1. Choosing lag 1 ensures that the model adequately captures the short-run dynamics among the variables without introducing unnecessary complexity or multicollinearity. This selection forms a reliable foundation for subsequent econometric analyses, including ARDL modeling, cointegration testing, and causality analysis, providing robust estimates of the relationship between FDI, RGDP, and other macroeconomic indicators in Nepal.

#### 4.2 Contegration Test and Granger Causality Test

##### 4.2.1 Contegration Test

**Table 3**  
*Contegration Test*

Unrestricted Contegration Rank Test (Trace)				
Hypothesized No. of CE(s)	Eigenvalue	Trace Statistics	0.05 Critical Value	Prob.**
None*	0.642409	55.12505	35.01090	0.0001
At most 1*	0.321011	21.18895	18.39771	0.0198
At most 2*	0.225037	8.413012	3.841465	0.0037
Unrestricted Contegration Rank Test (Maximum Eigenvalue)				
Hypothesized No. of CE(s)	Eigenvalue	Maxi-Eigen Statistics	0.05 Critical Value	Prob.**
None*	0.642409	33.93609	24.25202	0.0020
At most 1*	0.321011	12.77594	17.14769	0.1937
At most 2*	0.225037	8.413012	3.841465	0.0037

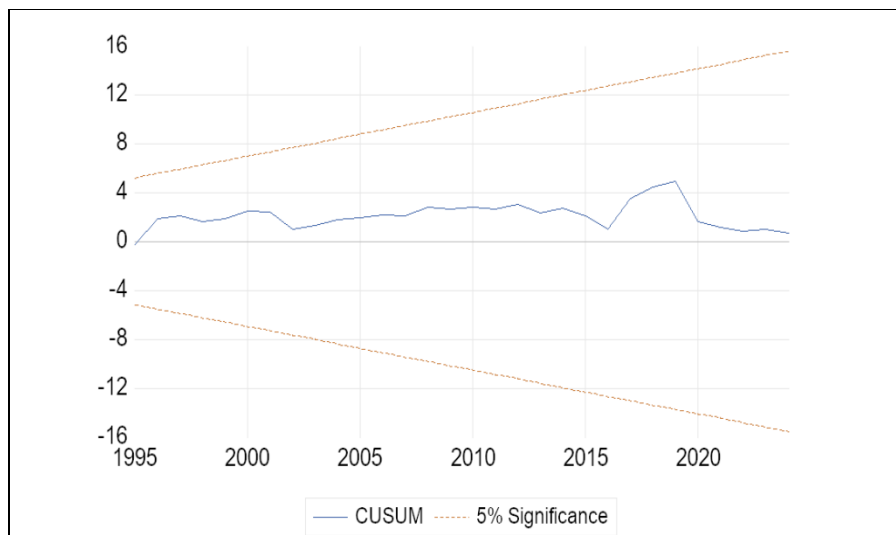
Source: Authors' Computation

Table 3 presents the results of the Johansen cointegration test, which examines the long-run equilibrium relationships among the study variables. The test is conducted using both the Trace Statistic and Maximum Eigenvalue Statistic approaches, allowing for robust identification of cointegrating vectors. Trace Statistic Results The Trace test indicates the presence of three cointegrating relationships among the variables. For the null hypothesis of no cointegration ( $r =$

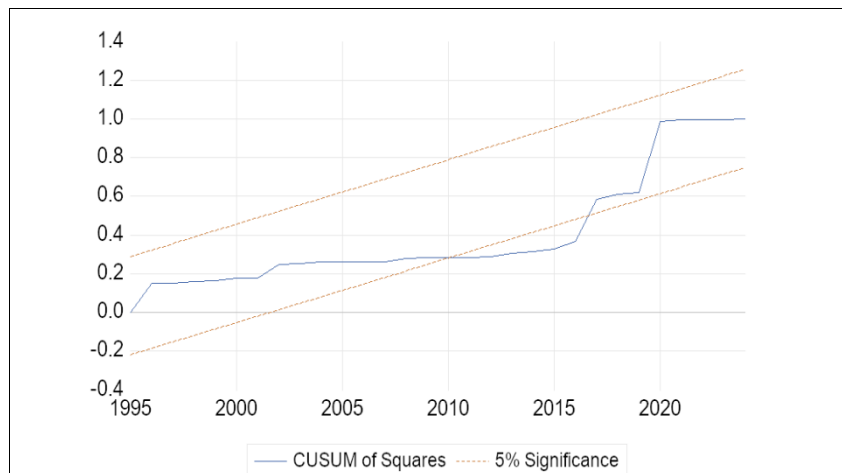
0), the Trace statistic is 55.12505, exceeding the 5% critical value of 35.01090, with a p-value of 0.0001, strongly rejecting the null. Similarly, for the null hypothesis of at most one cointegration relationship ( $r \leq 1$ ), the Trace statistic is 21.18895, above the critical value of 18.39771 ( $p = 0.0198$ ), again rejecting the null. For at most two cointegration relationships ( $r \leq 2$ ), the Trace statistic is 8.413012, exceeding the critical value of 3.841465 ( $p = 0.0037$ ), confirming that multiple long-run relationships exist among the variables. Maximum Eigenvalue Statistic Results The Maximum Eigenvalue test complements the Trace results. For the null hypothesis of no cointegration ( $r = 0$ ), the Max-Eigen statistic is 33.93609, higher than the 5% critical value of 24.25202 ( $p = 0.0020$ ), indicating rejection of the null. For the hypothesis of at most one cointegrating equation ( $r \leq 1$ ), the Max-Eigen statistic is 12.77594, below the critical value of 17.14769 ( $p = 0.1937$ ), suggesting that no additional cointegrating vector exists beyond the first. Finally, for at most two cointegrating relationships ( $r \leq 2$ ), the Max-Eigen statistic is 8.413012, exceeding the critical value of 3.841465 ( $p = 0.0037$ ), further supporting the existence of multiple long-run equilibria. Interpretation The results from both approaches confirm that the variables under study exhibit significant long-run equilibrium relationships. This indicates that despite short-term fluctuations, the variables move together over time, validating the theoretical expectation of interdependence between

### 6. Stability Test in ECM

**Figure 2. CUSUM Test**



**Figure 3. CUSUM of Square Test**



As shown in Figures 2 and 3, both the CUSUM and CUSUMSQ tests remain within the 5% significance level critical bounds, indicating that the coefficients of the error correction model are stable and do not exhibit structural instability over the sample period.

**Table 4**  
*Pairwise Granger Causality Test Results*

Null Hypothesis	Obs	F-Statistic	Prob.
FOREIGN_DIRECT_INVESTMENT does not Granger Cause REAL_GDP	34	0.06775	0.9346
REAL_GDP does not Granger Cause FOREIGN_DIRECT_INVESTMENT	34	5.89053	0.0071
EXPORT does not Granger Cause REAL_GDP	34	0.10176	0.9036
REAL_GDP does not Granger Cause EXPORT	34	7.99540	0.0017
EXPORT does not Granger Cause FOREIGN_DIRECT_INVESTMENT	34	1.31773	0.2833
FOREIGN_DIRECT_INVESTMENT does not Granger Cause EXPORT	34	0.67102	0.5189

Source: Authors' Computation

The table 4 show the Pairwise Granger Causality test was conducted to examine the short-term predictive relationships among Real GDP, Foreign Direct Investment (FDI), and Exports in Nepal

using 36 annual observations with a lag length of two years. The results indicate that Real GDP significantly Granger causes both FDI and Exports, as reflected by the statistically significant F-statistics ( $p < 0.05$ ). This suggests that economic growth serves as a key driver for attracting foreign investment and promoting export activity. In contrast, FDI and Exports do not Granger cause Real GDP, implying that these variables do not significantly influence short-term changes in economic output. Moreover, the analysis reveals no significant causality between FDI and Exports, indicating that they operate independently in the short run. These findings highlight the central role of GDP growth in stimulating both investment and trade activities, emphasizing that policies aimed at increasing FDI inflows or expanding exports should prioritize strategies that foster sustainable economic growth, such as improving infrastructure, stabilizing macroeconomic conditions, and enhancing the business environment. From a research perspective, the results justify incorporating Real GDP as an explanatory variable in models assessing FDI and export performance, as it demonstrates a consistent and significant influence on these key macroeconomic indicators.

The unit root tests showed that all variables except transportation were stationary at the first difference. Cointegration tests, using trace and max-eigen statistics, confirmed a significant long-term relationship among the variables at a 5% significance level, indicating that capital expenditure on education, health, agriculture, transportation, and RGDP are integrated and move together in the long run.

**Table 5**  
*Regression Analysis: Dependent Variable = REAL\_GDP*

Variable	Coefficient	Std. Error	t-Statistic	Prob.
FOREIGN_DIRECT_INVESTMENT	0.143628	0.021203	6.773973	0.0000
EXPORT	0.210360	0.036906	5.699925	0.0000
C (Constant)	8.702631	0.184667	47.12604	0.0000
Statistic	Value			
R-squared	0.9404			
Adjusted R-squared	0.9368			
Standard Error of Regression	0.1059			
F-statistic	260.2980 ( $p < 0.0001$ )			
Durbin-Watson statistic	1.2643			

Source: Authors' Computation

Table 5 presents the results of the regression analysis examining the influence of Foreign Direct Investment (FDI) and Exports on Real GDP. The estimated coefficients indicate a positive

relationship between the explanatory variables and Real GDP. Specifically, FDI has a coefficient of 0.1436, which is statistically significant at the 1% level ( $p = 0.0000$ ), suggesting that increases in foreign investment contribute meaningfully to economic growth. Exports also demonstrate a positive and significant impact, with a coefficient of 0.2104 ( $p = 0.0000$ ), highlighting the importance of trade in driving national output. The constant term is 8.7026 and is statistically significant, representing the baseline level of Real GDP when the independent variables are zero. The model summary indicates a high goodness of fit. The R-squared value of 0.9404 implies that approximately 94% of the variation in Real GDP is explained by FDI and Exports, while the adjusted R-squared of 0.9368 accounts for the degrees of freedom and confirms the robustness of the model. The F-statistic of 260.2980 ( $p < 0.0001$ ) confirms that the overall regression is statistically significant, validating the joint explanatory power of the independent variables. The Durbin-Watson statistic of 1.2643 suggests the presence of moderate autocorrelation in the residuals, which may warrant further diagnostic testing. Implications The results emphasize the critical role of foreign investment and export activity in promoting economic growth. Policymakers aiming to enhance GDP should focus on strategies that attract FDI, such as creating a stable macroeconomic environment, improving infrastructure, and implementing investor-friendly policies. Similarly, policies promoting export competitiveness can significantly contribute to national output. From a research perspective, these findings reinforce the inclusion of FDI and Exports as key determinants of economic growth in empirical models assessing Nepalese macroeconomic performance.

## 7. Conclusion:

This study offers a detailed examination of the relationship between foreign direct investment (FDI), exports, and economic growth in Nepal over the period 1988/89–2023/24. The long-term trends indicate that Real GDP in Nepal has consistently grown, reflecting improvements in productive capacity, structural reforms, and rising domestic demand. In contrast, exports have expanded more slowly and irregularly, highlighting limited diversification and vulnerability to both regional and global market fluctuations. FDI inflows have shown sporadic increases, particularly after 2010, but overall remain volatile, suggesting ongoing challenges in attracting sustained foreign investment. These observations emphasize the need to empirically explore how FDI and exports interact with economic growth to support Nepal's development objectives.

The econometric analysis supports the robustness of the study. All variables were found to be stationary at level, indicating reliable modeling. Johansen cointegration tests confirmed the

existence of long-term relationships among Real GDP, FDI, and exports, suggesting that these variables move together over time despite short-term fluctuations. Stability tests, including CUSUM and CUSUMSQ, further confirmed that the coefficients of the error correction model are stable. Granger causality analysis revealed that Real GDP significantly drives both FDI inflows and export performance, whereas the reverse relationship was not significant in the short run. This finding underscores the pivotal role of economic growth as a driver of investment and trade in Nepal.

Regression results further highlight the importance of FDI and exports for economic growth. Both variables exert a positive and statistically significant effect on Real GDP, with the model explaining approximately 94% of the variation in output. These findings suggest that policies designed to attract stable foreign investment and enhance export performance can have substantial impacts on national economic expansion. From a policy perspective, measures such as improving infrastructure, creating a favorable investment climate, and implementing trade-friendly strategies are crucial for maximizing the growth potential of FDI and exports. Overall, the study illustrates the interconnected nature of investment, trade, and economic growth in Nepal and provides evidence that can inform future economic planning and policy formulation.

## **8. Recommendation:**

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