© April 2023| IJIRT | Volume 9 Issue 11 | ISSN: 2349-6002

Determining Factors of FDI inflow in a Country: A Theoretical Perspective

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Abstract: Foreign direct investment (FDI) is an investment from a party in one country into a business or corporation in another country with the intention of establishing a lasting interest. A foreign direct investment can be made by obtaining a lasting interest or by expanding one's business into a foreign country.
This paper is discussing the theoretical exposition of FDI and it is divided into three sections, Section first discussing the motives and determinants of FDI. On the basis of orientation, most of the FDI motivations can be classified into four categories: Resource-Seeking, Market-Seeking, Efficiency-Seeking, and Strategic-Seeking. Section two identifies various determinants of FDI like Economic factors, Policy framework of FDI, Business facilitations and some others factors that play an important role as determinants of FDI like Macroeconomic Stability, Wages, Human Capital and Natural Resources, infrastructure (Roads, Water, Electricity, Telecommunications), labour cost, Geographical distance and Cultural differences. Section three discussing the impact of FDI, its depending on the nature of entry of FDI that is Greenfield FDI and Brownfield FDI.

Keyword: Foreign Direct Investment, Development, Motivations FDI, Determinants of FDI, impact of FDI etc.

1.INTRODUCTION

FDI is one of the most important sources of transfer of technology. It can impact the development of the host country. Development is an open-ended process and has no specific definition. According to United Nations, development means economic and social progress and improving the standard of living. FDI plays a significant role in training of labour and upgradation of R&D activities in host country. And it plays an important role in the development of a Nation. For the development of any nation to become need of sufficient domestic savings for capital formation, but in case of developing country has lack of domestic saving and capital formation. In this case FDI play a vital role to remove gap of savings and capital formation. Domestic savings gap is arise then our domestic investment is more than of domestic savings. FDI is a best external source of to remove gap of domestic saving a domestic investment.

1. Motivations of Investors

In this section, we provide a brief literature review relating to motivations of FDI inflows. The literature on FDI identifies four most common investment motivations: Resource-seeking, Market-seeking, Efficiency-seeking and Strategic-resource seeking, which are important motives to attract FDI (Dunning, 1993).

1.1. Resource-Seeking

Kudina & Jakubiak (2008) in their paper examined that motive behind FDI in a group of CIS countries (Ukraine, Moldova, Georgia and Kyrgyzstan); the sample size of survey was 120 investors. The main finding was that non-oil multinational enterprises play an important role in the local market. The main motive of the firms is to acquire particular resources that are not available in the home country. Availability of natural resources (minerals, raw materials and agriculture products), semi-skilled labour, and physical infrastructure does influence resource seeking activities. The availability of natural resource is not sufficient to promote FDI activity, but that comparative advantages are also important to promote the motive of resource seeking activity.
Resource seeking FDI is relatively more important as compared to others motives, and is supported by the survey of South African (17% of respondents) and Chinese TNCs (WIR, 2006).24 FDI in primary sector could be divided into resource-scarce countries TNCs (China, India and other and TNCs) and resource-abundant developing countries. Assessment of natural resources is very important for developing countries

TNCs (China and India) because the supply of raw material is a must for rapidly growing economies.

1.2. Market-Seeking

The motive of market seekers is to gain profit from foreign market. Market-seeking investment is attracted by factors like host country market size, market growth and per capita income. Market seeking provides new market competitiveness and technological advances (Kudina & Jakubiak, 2008). Market seeking FDI is the most common strategy for developing countries in the process of internationalization. According to UNCTAD global survey, 51% of respondents refer to market-seeking as a significant motive for FDI including TNCs in these 70 per cent of all responses from the South Africa, Indian and Chinese TNCs and other developing host countries (UNCTAD, 2006).

1.3. The Efficiency Seeking

Efficiency seeking FDI is established by resource and market-seeking investment that the investing company could gain from the common governance of geographically dispersed activities. The basic objective of efficiency seeking of multinational enterprises is to harness the benefits of different cultures, economic policies, institute arrangements, demand pattern, market structure, and factor endowments. FDI may be possible to attract when: (1) firms take advantage of differences in the cost of traditional factor endowments in the different countries, and (2) take advantage of the different country scale and scope of differences in the consumer preferences and supply capabilities (Dunning, 1993). According to UNCTAD global survey, 22 per cent respondents agreed to this as a strategic motive. Efficiency seeking FDI is important for most companies, especially three two industries: electrical and electronic products, garments and it services. Efficiency means essentially the collaboration to be gained through the international integration of production and service activities compared to 'low-cost' inputs (WIR, 2006).

1.4. Strategic Resource Seeking

Strategic resources are intangible resources dealing with the technology and competence of the company (Dunning, 1993). The examples of strategic resources are: patents, knowledge, the skill of the employees and strategic supply for developing comparative advantages. Focusing on strategic resources could support long-term strategic objectives.

2. DETERMINANTS OF FDI IN HOST COUNTRY

In this section, we provide a brief literature review relating to determinants of FDI inflows. The first classical model on determinants of FDI was developed by Dunning (1973 1993a). Determinants of FDI are based on ownership, location and the internationalization (OLI) paradigm. There are three sets of determining factors that should exist simultaneously which would allow FDI to take place easily (Dunning, 1993a).

A. There are certain advantages relating to the ownership of a firm that would give the company market power and would offset additional costs associated with establishing a production unit in the host country.
B. There needs to be locational advantage in terms of access to a large market, cheaper resources such as land or labour.
C. The investor then should be able to combine the first two advantages and maximize the potential by internationalization.

Amongst the above-mentioned conditions for FDI, the locational advantage determinants can influence directly (UNCTAD. 1998).

UNCTAD (1998) states that the determinants of FDI in host country depend on three broad categories:

2.1. Policy framework of FDI

Core FDI policies are more important to attract FDI in the host country; they consist of rules and regulations of foreign investors and it can function of the markets with operations (UNCATD, 1996a and 1997a). FDI policies are more important to other policies and they can also influence investors decisions. Asian countries used both FDI and trade policies to attract TNCs to contribute their export-oriented economic strategies. Policies used internationally to influence FDI form the "inner-ring" of the FDI policy framework. Since the mid-1980s, LPG framework became the most dominant type of FDI to attract policy changes: when 151 policies were changed during the period 1991-1997, and its 94 per cent contribution for attracting more FDI (UNCTAD, 1998).

- Monetary and fiscal policy are macroeconomic tools (that include that taxes and exchange rates) are used to influence economic activity.
- Monetary and fiscal policies are parameters to measure economic stability, such as rate of inflation and budgetary balances or influence of all types of investment. They directly affect the determinants of investment decision.
- In any economy the fiscal policy determinants of general tax level including personal and corporate tax rates influence inward FDI. A country with lower tax rates should stand a greater chance of attracting FDI projects than a country with higher tax rates.
- Exchange-rate policy is also a major determinant of FDI; the exchange rate can measure the stability of prices in host country assets, and the competitiveness of foreign affiliate export.
- Some other macro-organizational policies play an important role in determining FDI: structural policies influence the industry components of manufacturing (e.g. sunset and sunrise industries), and labour market policies determine the functioning of factor markets (UNCTAD, 1998).

2.2. Economic Determinants of FDI

The economic determinants of FDI can be divided into three subdivisions:

- Natural Resources: The most important determinant of FDI in host country is the availability of natural resources. In the nineteenth century, natural resources (minerals, primary products for the industrializing) were the major determinants of FDI in Europe, the United States, and Japan (Dunning, 1993a. p 57). Till the Second World War, about 60 per cent of the FDI came through natural resources (Ibid.). During the 1960’s and 1970’s, the importance of natural resources as a determined declined in host country. The availability of natural resources in host country is not sufficient for determining FDI; comparative advantages also should be must. (UNCTAD, 1998).
- National Market Size: In the context of host country, economic determinants of FDI include market size in absolute terms as well as the size and income of population and market growth. Large markets can formulate of both domestic and host markets with high growth rate in host country could more influence to investment in host country. High market growth rates also influence investment in host country. Access to national market became the most predominant determinant between the developed and developing countries in the 1960’s and 1970’s (WIR, 1998).

2.3. Business Facilitation: They include investment promotion, after-investment services, and improvements in convenience and reduce the “hassle cost” when doing business. Business facilitation measures have become more sophisticated, increasingly targeting individual investors, even though this involves high human capital and other costs. Financial and fiscal incentives are also used to attract more investors even though they only enter location-decision processes when other principal determinants are available in place (UNCTAD, 1998). They include investment promotion, after-investment services, and incentives and measure the cost of doing business (UNCTAD, 1999).

Duran (1999) used the panel data and time series techniques to find out the major determinants of FDI in the host economy during the period 1970-1995. The size of market, growth, domestic savings, trade openness and stability in economy are major determinates of FDI in host country. Luis *et al*. (2006) studies are based on a sample of fifteen Latin American countries for the time duration of 1991-1998. He used the panel data regressions to measure of the determinants of FDI flows. The major variables are market size and growth, infrastructure (roads, water, electricity, and telecommunications), macroeconomic stability, wages, human capital and natural resources, which are determinants of FDI inflow. The limitation is of this study is that some other factors that play important role in determining DI inflow such as trade openness, and policy stability have not been studied.

Ali & Guo (2005) identify major determinants of FDI in China, taking only location advantages in the process of investment. This study is based on secondary and primary data. Primary data was collected from direct foreign investors, and was preferred over secondary data because of its accuracy and easy access. They found that market size and growth, labour cost, host government policies, cost of

capital, geographical distance and cultural differences are most important factors to attract FDI in China. The limitation of this study is that it is based on large population sample size, which does not apply to this study as it is based on a small sample size. There is no found any new techniques and findings are same.

Ang (2008) studied the main determinants of FDI in Malaysia using annual time series data for the period 1960-2005. There is evidence that the growth rate of GDP, level of financial development, infrastructure development, and trade openness can promote FDI inflow. They play significant positive impact on FDI inflow. It found that the increase in corporate tax rate could react negatively in FDI inflow. Lower corporate tax rate can be an effective voice to boost inward FDI. Interestingly, he found that macroeconomic uncertainty can encourage the FDI inflow. It shows positive relationship between the level of uncertainty and FDI inflows. This study is based only on some determinants of FDI inflow and did neglect some important determinants factors in developing country. The problem is that in this framework it is totally based on endogeneity bias and is relatively unimportant in many situations.

According to Chinese economic theories, FDI is of two basic types: market-oriented FDI is related to the size and growth of host country, and export-oriented FDI mainly looks for cost competitiveness (OECD, 2000, p.11).

2.4. Infrastructure Facilities

Good quality infrastructure encourages the flow of FDI into the country. The relationship between quality of infrastructure and FDI inflows is found to be positive and some studies also support this hypothesis (Mody, 1992; Kumar, 1994; and, Asiedu 2002). In the Infrastructure can include water, electricity, transportation and telecommunications also (Sahoo, 2006).

2.5. Currency Valuation

Exchange rate is used for representing the level of inflation and the purchasing power of an investing firm. By the Depreciation of currency can increase purchasing power of investor in terms of foreign currency.

2.6. Proper Regulatory Framework and Economic Polices:

China has a more transparent legal framework and business environment. The Chinese government launched a programme to renew its state-owned sector. China has a series of laws, rules and regulations and provision of equity joint-venture law and contract law for encourage the more foreign capital (OECD, 2000, p.14).

3. IMPACT OF FDI IN HOST COUNTRY

The Impact of FDI is affected by the chosen mode of FDI, Greenfield and Brownfield (M&As). Greenfield FDI establishes new facilities of production, distribution or research in the host country and is likely to result in enhanced economic activity, creation of additional job opportunities and export revenues, and introduction of advanced technologies. Domestic enterprises may benefit from Greenfield FDI through various forms of spillovers, for example, collaborations, movement of personal, demonstration effects, etc., but in Brownfield investment, M&As are likely to result in mere change in the ownership and need not bring in advantages associated with typical FDI as we have seen in the case of Daiichi's takeover of Ranbaxy in 2008. The impact of FDI on host country depends on nature of entry of FDI. Greenfield and Brownfield FDI may be affected by the policy of host country; by the Greenfield FDI can more inflow physical capital while in Brownfield FDI is small inflow of physical capital. Developing countries are engaged in cross-border M&As. According to UNCTAD's global survey of developing countries, TNCs are used less cross-border M&As as rather than to developed-country (WIR, 2000). In developing countries, direct investment and production capacity is immediately increasing in the case of Greenfield FDI and in the case of cross-border M&As it is frequently falling (WIR,2006). The activities of a developing country are: domestic investment, enterprise development and supply capacity in host country depends on significant linkages of establish relation of foreign affiliates with domestic firms in terms of sourcing supplies. Sourcing behavior depends on motivations of TNCs from developed and developing countries. Efficiency –seeking FDI could be expected to establish heavy linkages with host countries in favor of at least manufacturing (WIR, 2001).34 Efficiency-seeking FDI can become more than a source of capital, creating new jobs that are more diversified and with

greater productivity and value. It can also lead to expertise and technology transfers, boosting R&D and economic upgrading in the process.

FDI can affect by the development of complementing domestic investment, trade openness and transfer of knowledge, skills and technology (UNCTAD, 1999). According to United Nations Charter of 1944, development means economic and social progress and improving the standard of living (cultural, educational, and health issues). There are some important components of development.

Development is a process that creates growth, progress, positive changes physical, economic, environmental, social and demographic components. The purpose of development is a rise in the level and quality of life of the population, and the creation or expansion of local regional income and employment opportunities, without damaging the resources of the environment (UNRISD, 1995). Development is an open-ended process; there are many different paths to measure development and no single fixed definition to measure development. The goal of development varies and there are many ways to achieve to the set goals (Sachs, 1992).

Literature on FDI identifies FDI by MNCs as the most important channel of technology transfer. MNCs are an important source of research and development (R&D) activity. The transfer of technology varies according to context and sectors of economy. There are many mechanisms/channels of FDI which can affect the economy of host country. The mechanism of FDI can be divided into five major groups: transformation of new technologies, formation of human resources, global integration, enhanced competition in host country, and developments (OECD, 2002). Studies show that technology transfers, which result in both higher factor of productivity for local firms and in higher factor rewards, should not be taken for granted. The source of new technology to developing countries is basically concentrated in the more advanced developed countries focusing on large TNC based countries. FDI from developed countries may be able to better upgrade contribution in host developing country (UNCTAD, 2006). TNCs of developing countries might be able to make successful investments because it uses an alternative technology is more suites to absorptive technology is more suited to absorptive capacity of host country. Foreign affiliates may be able to contribute in technical upgradation through R&D activities in host economies. In India, data shows that the R&D expenditure by foreign affiliates contributed about 15 per cent of total R&D expenditure of all foreign affiliates in the country, that is, low of 0.1 per cent of total gross domestic expenditure on R&D. In the case of Taiwan province of China, R&D expenditure by foreign affiliates is more than 60 per cent of the country's business enterprise R&D expenditures in 1994 (WIR, 2006, p. 189).

FDI plays a significant role in the training of labour in developing countries; developing country TNCs spend more on training as compared to developed county TNCs (Susanne and Pearce, 2006). Survey of ASEAN-5 shows a higher turnover ratio of labour (5.0%) in foreign affiliates in developing country TNCs than in developed country TNCs (3.6%). This difference may explained by the differences in skill requirements of foreign affiliates. Developing countries lack R&D resources and skills for developing own products and process technology. Transfer of technology through MNCs is beneficial for the developing countries encourage productivity growth. There are many studies that deal with the positive relationship of FDI with productivity or economic growth through technology transfer in the host countries (OECD, 1991).37 The FDI has become an important source of financial resource, technology and skills in the last three decades in both developed and developing countries. A number of studies show mixed findings regarding the impact of FDI on host countries and they cannot be generalized from country to country or region to region.

Mahmood & Rehman, (2013) analyzed how FDI affects economic growth and human capital in host countries. They used the annual data of primary, secondary and tertiary sectors from 1972 to 2010. The impact of FDI on host country is a function of many factors such as macroeconomic environment, political stability and the FDI policy perspective of the host country. FDI may improve economic growth of the host country by employing the people; filling the gap between the savings and the investments; and by generating the revenue through taxes. FDI in the form of Greenfield can raise competition in the producers of host country. The essential problems of this study are: (1) methodology is not clear and (2) what is the reason behind choosing the time period. Besides, the choice of techniques and data source are also not clear.

Findlay (1978) found that the increase in FDI flow in host country increases the rate of technical progress through "contagion" effect, from the use of advanced technology and management practices by foreign firms. The contagion effect can improve productivity and efficiency in local firms in different ways by providing training to local firms, by competition, and new techniques. The limitation of this study is that it uses only selected variables, It should be explained in detail variables wise.

The impact of FDI on host country's international trade will be different, depending on its motive and strategy: efficiency-seeking, market-seeking, resource-seeking and strategic-seeking. The motives of developing countries and developed countries could differ. It can be expected to differ in terms of impact on host country trade. Efficiency-seeking FDI may be less important motive for developing countries rather than for developed counties. It plays an important role in creating exports from developing countries including LDCs in some particular industries are Pharmaceutical industry, textiles and garments. In particular, TNCs from Asia have competitive advantages in terms of export-oriented programmes (WIR, 2006). The impact of efficiency-seeking investments depends on the nature of product, and specially type of global production network (UNIDO, 2004). Market seeking FDI could decrease host county imports, and explore new market outside the host country.

The impact of FDI through the transfer of technology can be positive or negative?

Multinational firms are responsible for almost all of world expenditure on R&D. Large developing country TNCs have established system for generating new knowledge through R&D. Some important TNCs in the Republic of Korea are Samsung Electronics, Hyundai Motor and LG Electronics, which are in list of the 700 largest R&D spending companies in the world (UNCTAD, 2005, pp. 150-151).

In India there are some leading software firms like Infosys, Wipro, Birlasoft (Aditya Birla Group) and HCL Technologies which focus on our R&D (WIR, 2006) and are the major sources of transfer of technology in the world (Borensztein, 1998).

FDI is an important contributor to transfer of technology from developed to developing countries (Lim, 2001).42 FDI is one of the ways to enhance economic performance through the transfer of more advance technologies by multinationals (Frindlay, 1978). The impact of technology transfer is to improve the host country's performance, and improve GDP (Varamini, 2007). Introduction of new technologies by multinationals could help reduce the cost of R&D of a firm (Berthelemy & Demurger, 2000).45 The transfer of new technologies may be in the form of training, technological assistance and the some other important information to improve production quality and quantity of products through multinational purchases (OECD, 2002). The same study states that MNCs provide support to local suppliers by purchasing raw materials and improving facilities. Because of technological improvements, MNCs are able to bring advantages that stem from new production process (Blomstrom & Kokko, 1998). By the MNCs to improve and established of local research entities, like as public institutes and universities this is strong source of technology improvement of technological by the transfer of technologies by MNCs (Kottaridi, 2005).

Some studies state the negative effects of FDI such as the host countries may become dependent on MNCs for introduction of new technologies. Thereafter the local firms lose interest in the production of new technologies (Vissak and Roolaht, 2005). Technology introduced by MNCs in targeted economy could lead to adverse reaction to technological advantages in the local firm's research. In this review study found that MNCs transfer only inappropriate technologies in the host country. By the follow of this route the host country become dependence from multinationals technology (Sen, 1998). Which countries have intellectual property rights for protection in which process of technology transfer become more relevance and if doesn't than MNCs don't use a high technological level, and loss the opportunities for innovative technology transfers (Hermes & Lensink, 2003).

FDI is concerned with directly impacting growth through capital accumulation, and the incorporation of new inputs and foreign technologies in the production function of the host country (Almfraji & Almsafir, 2013, pp.208).51 For the period 1970-90, OECD and non-OECD countries conclude that the long-term growth in host countries is determined by the transfer of technology and knowledge from the investing countries to host countries, and its extent is determined

by the complementarily and substitution between FDI and domestic investment (De Mello, 1999). FDI has become a significant source of financial resource, technology and skills in developed and developing countries. A number of studies show mixed findings regarding the impact of FDI on host countries and they cannot be generalized from country to country or region to region. The impact of FDI on host country is a function of many factors such as macroeconomic environment, political stability and the FDI policy perspective of the host country. The FDI may improve economic growth of the host country by employing the people; filling the gap between the savings and the investments; and by generating the revenue through taxes (Mahmood &Rehman, 2013, pp 1117).

Foreign investment has an initial positive effect on growth but in the long run the dependence on foreign investment exerts negative effects on growth, because the infrastructure and institutions that develop with foreign investment support further foreign investment; and negative externalities such as unemployment, over-urbanization, and income inequality perpetuate the problem (Dixon & Boswell, 1996). New technologies may be in the form of training, technical assistance and other information to improve production of quality and quantity of products by the multinational purchases (OECD, 2002). The positive effects of FDI on host country economic growth is based on certain factors of the host country such as the trading system, availability of human capital, and degree of openness (Chowdhury and Mavroats, 2003), The effects of FDI on economic growth depend on domestic conditions of the host country which include economic and technological conditions (Hansen and Rand, 2006) as well as political stability (Asheghian, 2004). In this study include four Asian countries, the positive effect of FDI on two countries Philippines and Thailand: and the negative impact in Taiwan and Japan with the more developed and higher level of education (Bende.et al. 2001). The impact of FDI is of different types because the nature of investment would define how to affect the local economy (Beugelsdijk *et al*. 2008).

The study of manufacturing FDI in different European countries found a strong correlation between the level of FDI and the level of national income in the host country (Bandera & white's, 1968). It captured a positive effect of FDI on growth and has a strong interaction with the level of schooling in the host country (Lipsey, 2000).

4.CONCLUSION

On the basis of this study, most of the FDI motivations can be classified into four categories: Resource-Seeking (Natural Resources, Physical infrastructure and Semi-skilled labour), Market-Seeking (Market size, Market Growth and Per Capita income), Efficiency-Seeking, and Strategic-Seeking. This paper discusses the motives along with the cost advantages.

Section two identifies various determinants of FDI like economic factors (market size and characteristics, availability of cheap and skilled labour force and Raw Material, Economic Policy of the Host Country), policy framework of FDI (Monetary and Fiscal Policies, Exchange Rate Policy and labour Market Policies), and Business Facilitations and some others factors that play an important role as determinants of FDI like macroeconomic stability, wages, human capital and natural resources, infrastructure (roads, water, electricity, telecommunications), labour cost, geographical distance and cultural differences and the impact of FDI, depending on the nature of entry of FDI. Greenfield FDI established new facilities of production, enhanced economic activity, and created additional job opportunities and export revenue by introducing new technology. But Brownfield FDI only introduced mere changes in the ownership in most of developing countries engaged in cross-border M&As.

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