

The effects of foreign direct investment on economic growth: evidence for Togo

Efectele investițiilor străine directe asupra creșterii economice: studiu pentru Togo

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Abstract

The objective of this paper is to examine the effect of foreign direct investment (FDI) on economic growth. I use data running over 33 years from 1975 to 2008. Generally, the results, obtained by using the ordinary least squares (OLS) methods show foreign direct investment (FDI), Trade volume, and Human capital to have a positive impact on economic growth. There is some evidence that inflation and Government consumption to found to have a negative impact on economic growth. The empirical analysis shows that FDI alone plays an ambiguous role in contributing to economic growth.

Keywords: *foreign direct investment; Togo; economic growth*

Rezumat

Obiectivul acestei lucrări este de a examina efectul investițiilor străine directe (ISD) asupra creșterii economice. Se folosesc datele referitoare la peste 33 de ani din 1975 până în 2008. În general, rezultatele, obținute prin utilizarea metodei celor mai mici pătrate, arată că investițiile străine directe (ISD), volumul comerțului și capitalul uman au un impact pozitiv asupra creșterii economice. Există unele dovezi că inflația și cheltuielile guvernamentale ar avea un impact negativ asupra creșterii economice. Analiza empirică arată că numai ISD singure au un rol ambiguu în ceea ce privește contribuția la creșterea economică.

Cuvinte-cheie: *investiții străine directe; Togo; creștere economică*

JEL Classification: F21; F23; O40

Introduction

Research on foreign direct investment (FDI) is one of the most intensive areas of international economics in the last decade (Pan, 2003). Although there are a number of researches on the determinants of FDI, the empirical study on FDI in developing countries, such as Togo is relatively scarce.

Foreign direct investment is usually viewed as a channel through which for technology is able to spread from developed countries to developing countries. This frequently leads to the following question: Does foreign direct investment contribute to economic growth? The answer to this is uncertain. In the theoretical literature, the role of FDI is that of a carrier of foreign technology that can boost economic growth (Findlay, 1978; Romer, 1993). In the empirical studies on FDI, however, the evidence is still divided. Aitken & Harrison (1999), for instance, find that the net effect of FDI on productivity is quite small. Borensztein et al. (1998) and Carkovic and Levine (2005) also arrive at similar results by finding FDI does not have an unmitigated and positive effect on economic growth. On the other hand, Haddad & Harrsion (1993), Kokko et al. (1996), and Alfaro et al. (2004) point out that FDI can increase the rate of growth in the host economy through technology transfer.

Although the evidence on the relationship between FDI and economic growth is ambiguous, several studies argue that the host country's absorptive capacity plays an important role in explaining FDI. For instance, Blomstrom et al. (1994) state that FDI is positive and significant only for higher income countries and that it has no impact in lower income countries. Borensztein et al. (1998) point out that the contribution of FDI to economic growth is enhanced by its interaction with the level of human capital in the host country.

Balasubramanyam et al. (1996) argue that FDI plays different role in the growth process due to the differing trade policy regimes. For these reasons, in this paper we choose three variables which are the initial GDP, human capital and the volume of trade.

The main contribution of this paper is that it revisits the relationship between FDI and economic growth using the least squares (LS) approach. Using a survey of 33 years over the 1974–2008 period, we find that FDI to have a positive effect on growth. In addition, FDI is found to have a positive and significant effect on economic growth when the host countries have higher level of initial GDP and human capital.

The remainder of this paper is organized as follows. Section 2 review of investment policy in Togo and we present the location-related determinants of foreign direct investment in section 3. The methodology and data measurement is described in section 4. Section 5 depicts the empirical results; section 6 presents conclusions, lessons, and policy challenges.

Review of Investment Policy in Togo

Togo remained on the fringe of global foreign direct investment (FDI) flows until the middle of the 1990s. Structural reforms and the opening of the economy, however, have recently generated increasing FDI flows. These investments have generated mostly positive impacts, creating employment, value-added, tax revenue and exports. In spite of the achievements over the past decade,

Togo remains among the poorest countries in the world and the country faces major challenges in terms of development and poverty reduction. The Government is determined to tackle these challenges and to continue the reforms initiated in the 1990s. It is also determined to better exploit the country's FDI potential and to maximize the impact of FDI flows on development.

The Investment Policy Review proposes a number of reform axes in view of improving the investment framework:

- Putting in place an efficient and attractive fiscal and customs regime;
- Accelerating the integration process within the WAMEU;
- Elaborating a competition policy to serve development objectives;
- Improving governance and simplifying administrative procedures.

The Investment Policy Review also proposes an institutional setup to promote FDI. It is articulated around the future Investment Promotion Agency and President Council for Investment, whose creation has been decided by the Government. Detailed and concrete proposals are offered for the functioning of these institutions.

The Location-Related Determinants of Foreign Direct Investment

Dunning (1993) argued that location is one of the important factors for attracting FDI. The literature of the location-related determinants of FDI proposes a few important factors that affect FDI, such as the wage costs, interest rate, infrastructure, human capital, exchange rate and market size. Some of the factors are likely to affect all types of FDI. Nevertheless, the different strategic objectives implicit in vertical FDI and horizontal FDI suggest that some factors might affect one type of FDI more than the other (Ewe-Ghee, 2001).

The lower the factor costs of production, the more attractive they are to FDI. Therefore, the higher the wage costs is likely to defer FDI and the relationship between FDI and the wage costs is expected to be negative. Cheng and Kwan (2000) found the real wage costs have a significant negative impact on FDI in China.

Interest rate is a measure of the cost of capital. A higher interest rate implies a more costly investment and therefore, a higher interest rate is likely to defer FDI and the relationship between FDI and the interest rate is expected to be negative (Erdal & Tatoglu, 2002; Love & Lage-Hidalgo, 2000).

The better the infrastructure of the host country, the more attractive it is to FDI. A good infrastructure will facilitate activities of production and also the distribution of output. Therefore, the relationship between FDI and better infrastructure is expected to be positive. Most of the empirical studies concluded that their infrastructure proxy (or proxies) has a significant positive impact on FDI (Billington, 1999; Cheng & Kwan, 2000).

The better the human capital, the more attractive it is to FDI. The hypothesis that the human capital in the host country is a determinant of FDI in

developing countries has been embodied in theoretical literature (Dunning, 1993; Lucas, 1990; Zhang & Markusen, 1999). Therefore, the relationship between FDI and better the human capital is expected to be positive.

Exchange rate movements can influence FDI by affecting the currency cost of acquiring an asset abroad (Froot & Stein, 1991). For example, a decrease in domestic currency value against foreign currency value or depreciation of domestic exchange rate will make it less expensive for a foreign investor to invest in the domestic country as the cost of acquiring asset becomes cheaper. Thus, depreciation of exchange rate of a country will make inflows of FDI in that country rise (Erdal & Tatoglu, 2002; Kerr & Peter, 2001; Love & Lage-Hidalgo, 2000).

Generally, the larger the market size of the host country, the more attractive it is to FDI. A large market size is conducive to increase in demand for the products and services. Moreover, a large market size allows the achievement of economies of scale (Caves, 1971; Erdal & Tatoglu, 2002). Most studies in the literature suggest that the market size, expressed by real GDP or GDP per capita is found mostly to have a significant positive impact on FDI (Billington, 1999; Cheng & Kwan, 2000)

Most studies in the literature of the determinants of FDI are investigated using cross-sectional or panel data. Nevertheless, there are some studies that are investigated using time-series data, such as Yang, Groenewold and Tcha (2000), Love and Lage-Hidalgo (2000), Kerr and Peter (2001) and Erdal and Tatoglu (2002), amongst others.

Methodology and data

Model formulation. The linkage FDI and economic growth has occupied a central position in the development literature (see Findlay, 1978; Romer, 1993; Aitken & Harrison, 1999; Borensztein et al., 1998; Haddad & Harrison, 1993; Kokko et al., 1996; Alfaro et al., 2004; Carkovic and Levine, 2005). In examining this on Togo's data, the study use the neoclassical growth model, otherwise referred to as the growth accounting framework, to explain the source of growth in an economy. The national accounts form the basis of the economies to be analyzed and it is used in conjunction with the aggregate production function.

Using a production function approach, it states that the growth rate of output (GDP) is principally determined by the following factors: the rate of growth of gross labour and/or the rate of growth of its quality, multiplied by the labour income share; the rate of growth of gross capital input and/or the rate of growth of its quality, multiplied by the capital income share; and change in technology or total factor productivity (TFP). This is given as:

$$g = f(L, K, T), \quad (1)$$

where:

g = growth of GDP;
L = labour;

K = capital formation / investment;
 T = technology.

The application of this method, however, has been extended to incorporate other determinants of economic activities such as financial sector development (proxy: by FDI), Trade volume, and Human capital. In line with the above specification, our model is specified thus:

$$Y_i = \beta_0 + \beta_1 F_i + \beta_2 X_i + v_i \quad (2)$$

where: Y_i is the rate of growth, equals foreign direct investment (F_i),
 X_i = a vector of other determinants of FDI (Human capital; trade volume; Government consumption and inflation),
 v_i = error terms.

As is widely known that the effect of FDI on growth give rise to the possibility of both endogeneity and reverse causality of FDI, as a result of which both FDI and growth are simultaneously determined and FDI is correlated with the error term.

The results and discussions

Empirical results

Data and variables. This paper uses of Togolese economy data over the period 1974–2008 to analyze the relationship between foreign direct investments (FDI) and economic growth. FDI (F_i) equals net FDI inflows as a share of GDP. The economic growth rate (y_i) equals the rate of real per capita GDP growth. We also control other determinants (X_i), namely, initial GDP, human capital, government consumption, inflation, and the volume of trade. A detailed description of all the variables is included in Table 1.

Variables and sources

Table 1

Variable	Definition
Growth	The growth of real per capita GDP
FDI	The net FDI inflows as a share of GDP
Initial GDP	The logarithm of real per capita GDP in the initial
Schooling	Human capital measured as the average years of secondary schooling for the overall population
Government consumption	Total expenditure of central government as a share of GDP
Inflation	Percentage changes in the consumption price index
Trade volume	Sum of exports and imports as a share of real GDP
Log of population	The logarithm of the total population growth

Data of the study was obtained from the World Development Indicators (WDI) and from Central Statistical Office, of West African monetary union (UMOA).

Summary Statistics

Table 2

Variable	Mean	Maximum	Minimum	Std. Dev.
GDPGR	2.497	14.982	-15.096	6.148
GDP	16.445	17.145	15.409	0.485
FDI	15.437	18.356	0.000	4.903
TV	20.931	21.793	19.962	0.442
GGFC	15.348	25.469	8.408	4.297
INF	6.328	39.163	-3.527	8.787
POP	15.192	15.681	14.686	0.309

Table 2 provides summary statistics for our sample data. The mean of the per capita growth rate for the sample is 2.49. The mean of the FDI is 15.43.

Findings

Explaining the process of economic growth is an intricate issue. This is because many variables can be used to explain economic growth. However, the link between FDI and economic growth is derived from the services the FDI provides to the economy as a whole. For instance, the most obvious effect of FDI on the growth potential of host countries may be the provision of additional capital. Table 3 presents the Correlation Matrix of the data of study; we can see that all two variables are positively correlated with the FDI.

Correlation matrix

Table 3

Variables	FDI	GDP	POP	TV
FDI	1	0.55	0.64	0.73
GDP		1	0.85	0.89
POP			1	0.78
TV				1

This result is a preliminaries evidence of the link between the foreign direct investment and economic growth. The coefficient of correlation is 0.55 between GDP and FDI; 0.64 between FDI and Population growth and; 0.73 between FDI and Total trade value. Table 4 presents the estimation result for the data. The coefficient of FDI is positive; this result confirms the previous findings, such as Balasubramanyam (1996), Borensztein et al. (1998), Durham (2004), Le and Suruga (2005).

Regression results A

Table 4

Variable	Coefficient	t-Statistic	Prob.
C	38.824020	3.872113	0.064600
FDI	0.073117	1.614448	0.002600
GDP	-0.142735	-1.643092	0.007800
GGFC	-1.582735	-2.152277	0.000300
INF	-0.330398	-1.260826	0.003800
POP	0.012964	4.927939	0.007400
TV	0.019470	5.786278	0.019100

We can find that the coefficient of the GDP is negative in Table 4. This finding point to conditional convergence, for it predicts a higher growth in response to a lower starting per capita GDP, and has an important influence on the growth rate (Barro and Sala-i-Martin (2003)). Human capital also has a significant impact with the expected sign, as explained in Borensztein et al. (1998).

The negative coefficient of the variable *GGFC* suggests that the positive effect of FDI on economic growth is reduced by public current expenditure exceeds. This finding follows the study of Le and Suruga (2005) who suggested that the effect of FDI on economic growth becomes weaker as the public capital expenditure exceeds 8-9%.

According to Galor and Moav (2004), the main engine of its economic growth varies at different stages of a country's development. While physical capital accumulation is the main engine of economic growth at the early stages of development, human capital accumulation plays the similar role in more advanced societies. As such, one should expect that FDI, public capital, and private capital – factors increase directly the physical capital accumulation rather than human capital accumulation - may be less important the higher development level of the country becomes. To sum up, we find that FDI alone plays an ambiguous role in contributing to economic growth when we use the LS regressions. The main result of this paper is that the effect of FDI on growth is dependent upon the extent of the host country's absorptive capacity. In particular, initial GDP and human capital are the most important factors for FDI.

Regression results B

Table 5

R-squared	0.766352	Mean dependent var	2.497471
Adjusted R-squared	0.651999	S.D. dependent var	6.148022
S.E. of regression	4.949065	Akaike info criterion	6.213131
Sum squared resid	685.8109	Schwarz criterion	6.524201
Log likelihood	-101.7298	F-statistic	4.078178
Durbin-Watson stat	2.058474	Prob(F-statistic)	0.004612

With 77 percent R-squared and 65 percent Adjusted R-squared, the result (Table 5) indicated that economic growth in Togo is adequately explained by the model for the period between 1974 and 2008. By implications 65 percent of the variation in the growth of economic activities is explained by the independent variables.

Further analysis of the empirical results

The most obvious effect of FDI on the growth potential of host countries may be the provision of additional capital. The inflow of foreign funds can help overcome the pervasive investment-saving gap, thus enabling countries to grow faster without sacrificing current consumption. Indeed, in many theories of economic development the main driving force behind a higher growth potential is seen in an expanding capital base. By attracting foreign venture capital, the growth potential could be raised without incurring the vulnerabilities typically associated with external debt burdens. In addition, the investment by one multinational enterprise (MNE) in a foreign firm can induce other MNEs to invest in the same host country as well in order to retain a role as a supplier of intermediate products. Moreover, MNEs usually enjoy better access to international financial markets than firms based only in the host economy. Also, a positive effect on the saving gap can be expected if the MNE is seen as an attractive investment opportunity by local residents or firms. Estimates have put this latter effect at one extra US dollar of domestic investment for every US dollar invested by an MNE, which substantially exceeds estimates for the effects of portfolio flows or bank lending. Furthermore, FDI may have a positive influence on the development of the local stock market if foreign firms were to recover part of the investment by selling equities in the host country. Additionally, the liquidity of stock markets is increased if foreign investors choose to purchase existing equities of the local firm as part of the investment.

Another avenue in which FDI can bear positively on growth in emerging market economies (EMEs) is through endowing host firms with more efficient technology as well as management techniques. Otherwise domestic resources would have to be spent by firms on either undertaking their own R&D or on importing the required technology. The new growth theory has highlighted the role of technological innovation or – more relevant for EMEs – the role of technology diffusion. By supplying new state-of-the-art technology and by training the local employees the foreign investor can also initiate a spillover process where local firms will eventually adapt and implement the superior technology, thus raising productivity and boosting growth additionally. In the longer run, FDI in the financial sector of EMEs can be particularly helpful in this regard, thereby also enhancing the stability of the domestic financial system. M&As typically provide advantages of the latter kind, while greenfield investments are usually even more beneficial because they generally imply the desired transfer of additional venture capital.

Since FDI will usually be a long-term commitment, its contribution to growth is generally taken for granted. Keeping only to the effect of providing additional capital, the picture is not quite that clear-cut, however, because the actual inflows must not be very large. This is due to the fact that, if a developed capital market exists in the host country, the foreign investor could in principle borrow the needed funds locally. As a negative side-effect, local investors might be crowded out, especially if the MNE possesses market power and can gain preferential access. Furthermore, for the economy as a whole the positive effect on the supply of capital might be significantly reduced by the preferential treatment often extended to MNEs as incentives to invest. Depending on the size of the subsidies, the expected contributions of FDI on growth may be partly or even completely lost.

Yet, investments by MNEs can also be accompanied by sizeable capital leakage effects back to the home country, depending on the size of repatriations taking place. Moreover, the competitive structure of the economy might actually be worsened rather than improved, as MNEs often wield considerable market power that enables them to collect monopolistic or oligopolistic rents. The empirical evidence on the relation between FDI and growth is mixed, with several studies not finding any significant correlation and others noting that FDI can act as a significant impetus to growth but only if the level of human capital has crossed a certain threshold. The intuition behind this result is that the more advanced technologies can be fruitfully put to use only after the required human capital has been acquired.

Should the technology, however, exceed the absorptive capability of the host country, no trickle-down effects will ensue. Similarly, it can be argued that the products of MNEs may often be too capital intensive for the needs of the host country. The effect may then be to create “dual economies”, with one modern sector and distinct from it a backward domestic sector with only limited overlap. FDI of this kind might consequently result in an excessively capital-intensive production process, leading to a less favourable development of the overall employment situation.

In order to attract FDI in high value-added activities, it is no longer sufficient for the host country to have a single location-related determinant. FDI in high value-added activities seek not only cost reduction and bigger market shares, but also seek to technology and innovative capacity. These resources, as distinct from natural resources are human made. Thus, human capital is an important factor to attract FDI in a globalizing world economy. Countries to have a pool of human capital become more attractive to FDI. Moreover, other factors which are important to attract FDI are such as clustering of economic activity, infrastructure facilities, access to regional market and competitive pricing of relevant resources and facilities. Transparency and anti corruption, which are not discussed in this study, are potentially important in attracting inflows of FDI in a country.

Conclusions, lessons, and policy challenges

Conclusions and lessons learned

FDI can play an important role in the development efforts of the region. To date, Togo have not been successful in attracting significant FDI flows, reflecting largely the combined effects of political and macroeconomic instability, weak infrastructure, poor governance, intensification of competition for FDI flows due to globalization, and poor marketing strategies. There is the need to reverse the declining FDI trend in the country. This requires concerted efforts at the national, regional, and international level. It also requires a new and more effective approach to investment promotion. In the past, investment promotion activities in the region were carried out in an environment in which domestic policies were by and large not conducive to foreign investment and so were not successful.

An enabling environment has to be created first before marketing investment opportunities to foreign entrepreneurs could be done effectively. The maintenance of a sustained political and macroeconomic policy environment would get the region closer to attaining this objective. Furthermore, the realization of Togo's FDI potentials will also depend on the ability of its leaders to improve the FDI climate and take advantage of the new global interest in the affairs of the region by implementing sound macroeconomic policies, enforcing the rule of law, reducing risks of policy reversals, and improving the provision of infrastructure.

Foreign direct investment is now perceived in many developing countries as a key source of much needed capital, foreign advanced technology, and managerial skills. Realizing its central importance to economic development, these developing countries have taken wide-ranging steps to liberalize their inward FDI regime and have succeeded in attracting substantial amount of FDI.

Policy recommendations

General recommendations

First of all, Togo should make stronger efforts to attract as much FDI as possible to the foreign exchange sectors in the short term. Taking into account unfavorable balance of payments prospects, it should refrain from attracting any further massive FDI in the nonforeign-exchange-earning sectors for some years in the future. Political stability and satisfactory law and order are likewise critical to attract FDI.

The international press and media coverage Togo has received in recent years is not at all conducive to attracting foreign investors. News items on Togo being one of the most corrupt countries in the West Africa, its bomb detonations, and its use of child labor will hardly encourage foreign investors to undertake initiatives in Togo. The country's political leadership must take practical steps to improve the law and order situation particularly in the major "growth poles" of the

country including north region Kara and Savane. Macroeconomic stability plays a key role in boosting economic growth (see Kim (1993)) and restoring foreign investors' confidence on the economy. In an environment of large fiscal deficit and precarious foreign exchange reserves position, foreign investors are unlikely to increase their participation. Togo's fiscal situation and foreign exchange reserves position will remain under considerable strain for some time making the macroeconomic environment less conducive for foreign investors. Some drastic and far-reaching measures are needed to reduce the fiscal deficit on the one hand and raise foreign exchange reserves on the other. Inconsistent economic policies discourage foreign investors in undertaking projects of medium to long-run duration.

Specific recommendations

- Taxes

Payment of taxes and contributions in Togo is complex and cumbersome. Essentially, separate collection of taxes and contributions have forced enterprises to face unnecessary, cumbersome, and costly administrative procedures, and to deal with a large number of collecting agencies at all three levels of government. There is an urgent need to reduce the number of taxes and contributions; streamline tax regulations and administrative procedures; and most importantly reduce the contact of foreign firms with a large number of tax and contributions-collecting agencies. The existence of such a large number of taxes and collecting agencies may breed corruption, which adds to the cost of production. Import tariffs on plant and machinery have discouraged investment, more so in Pakistan where capital is scarce and cost of borrowing is high. Because of this high cost, manufacturers are discouraged to modernize and the quality of local industry products is restricted against international competition. There is a need to examine tariffs of plant and machinery with a view to substantially reducing them.

- Credit facilities

Foreign firms operating in Togo are currently facing cash flow problems as a result of many taxes and the Asian crisis. That these firms cannot borrow more than their equity capitals have further aggravated the cash flow problem. There is a need to review this policy.

- Labor laws

Overprotective labor laws do not encourage productivity and frighten away much needed productive investment. There is a need to rationalize the labor laws and multiple levies on employment that inhibit business expansion and job creation.

- Infrastructure

The availability of better quality and more reliable services in all areas of infrastructure are key ingredients of a business environment conducive to foreign investment. In most infrastructure services, Pakistan is highly deficient as compared with many developing countries that have attracted higher levels of

foreign investment. If Togo wants to catch up gradually with the development of the economies of East and Southeast Asia, it will have to invest more in the areas of education and physical infrastructure. On the education front, the government should identify the nature of skills critical to sustained industrial growth, and formulate strategies, policies, and programs that could facilitate the enhancement of these skills.

In telecoms, the government should expedite the privatization of Togo telecom. In the railway and road sector, government must engage the private sector in leases, concessions, and build operate- transfer (BOT) type contracts.

- Confidence-building measure

The close partnership between the private and public sector is essential to build confidence. In this respect, it is recommended that a forum be established where the private and public sectors could sit together to discuss business promotion-related issues. The forum must be composed of the prime minister, all the presidents of the national chambers, top businessmen/industrialists, top bankers, as well as heads of overseas chambers of commerce and relevant ministries' secretaries and ministers. The forum may meet regularly to review the economic situation of the country. The problem faced by the business community can be discussed and decisions could be taken immediately. This kind of partnership between the government and private sector will help restore market confidence.

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