International Journal of Business and Applied Social Science Vol.2, No.1, January, 2016

Determinants of Foreign Direct Investment in Indochina: A holistic approach

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DOI: http://doi.org/10.33642/ijbass.v2n1p1

Abstract:

This paper investigates the role of economic, instructional and political factors in attracting Foreign Direct Investment (FDI) inflows in Indochina (Cambodia, Laos, and Vietnam CLV) economies. Using panel unit-root test and Random effects on panel data for 16 years from 1996 to 2012 to examine significant determinants of FDI in Indochina, the paper takes into account economic factors (inflation rate, trade openness, market size), institutional factors (corruption and rule of law), and political factors (political stability, government effectiveness, regulatory quality, voice and accountability) to explores the role of these determinants. The results show that market size, government effectiveness, rule of law and political stability are statistically significant and have positive influence on inward FDI.

Keywords: Indochina, Foreign Direct Investment, Determinants

1. Introduction:

According to World Bank ,(1999); Crespo and Fontura,(2007); Romer, (1993), foreign investment generates economic benefits to the host countries by providing capital, foreign exchange, technology and enhancing competition and access to foreign markets. FDI plays an important role in bring variety of benefits related to new innovation, new technologies, new management techniques, skills development, capital increases, job opportunities, working conditions improvement and industries development of host countries. Hence, it is important for the countries to find what encourages outside investors to invest in the host countries. (Haddad and Harrison, 1993; and Markusen and Venables, 1999).

There are four types of FDI derived from Elective Paradigm of Dunning including market seeking FDI, resource seeking FDI, efficiency seeking FDI and strategic asset seeking FDI. Investors who are market seeking oriented, aim to exploit the possibilities of new markets while those investors who are resource seeking oriented want to acquire particular types of resources, for example, raw materials, or lower unit labor cost in host countries. The efficiency seeking FDI is motivated by creating new sources of competitiveness for firms and lower production cost. Finally, strategic asset seeking FDI targets in improving the company or regional strategy into foreign networks of created assets like technology, organizational abilities (Faeth, 2009).

Cambodia, Laos and Vietnam are developing countries and all actively welcome FDI inflows. They are

endowed with rich natural resources, and have cheap labor cost; yet do not have enough national savings to finance their investments. Likewise the other developing economies, they are in need of foreign capital to develop the countries without taking any risks related to the debt. Therefore, FDI inflows are expected to address the issue. Indochina economies are increasingly being considered as ripe for potential investment. They keep continuing to open up the market, allowing foreign investment to enter the countries for a number of years. Three countries broadly opened up to foreign investment at very roughly the same time. Vietnam first began attracting FDI in 1987, and Laos followed one year later. Cambodia's current foreign investment law dates from 1994. Export oriented and economic openness has been the driving forces of economic reform of CLV.

Figure 1 shows the trend in FDI inflows into Indochina during 1996-2012. Cambodia and Laos were left far behind Vietnam in terms of attracting inward FDI. In the 90's, Cambodia and Laos received a small amount of FDI inflows due to their late market openness to FDI compared to Vietnam. Whereas, inward FDI in Vietnam increased dramatically from just a mere $ 2.1 billion in 2006 to reach its peak to almost $10 billion in 2012. Even though Cambodia and Laos had the same starting point, Cambodia achieved a bigger step in attracting FDI wile while Laos stayed stagnant for 16 years.

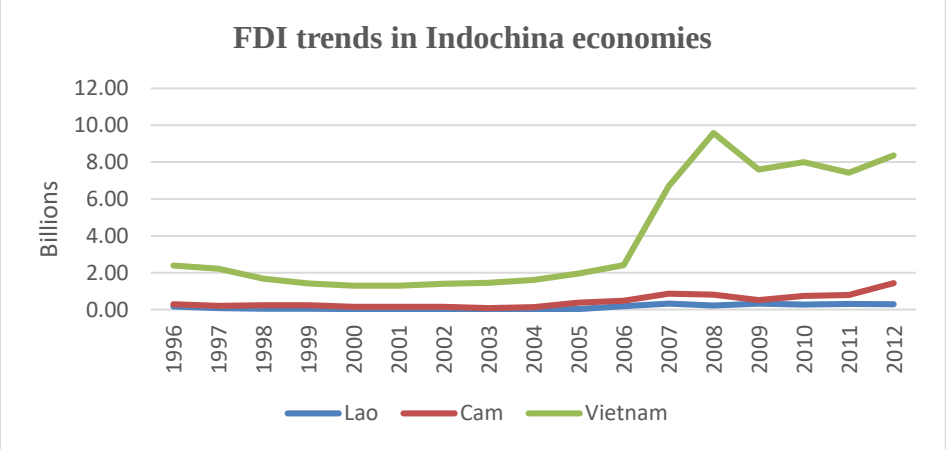


Figure 1: FDI inflows in Laos, Cambodia and Vietnam from 1996-2012

Attracting foreign direct investment (FDI) has been a key focus of market oriented policy reforms in these transitional economies. While FDI in CLV is continuously increasing, there is little empirical research about inward FDI in Indochina [John, Ronald Bruce St (2006); Ishi, Kotaro (2010)]. What is determining the FDI flows into Indochina economies? Will CLV be able to attract more FDI and what can be done by to improve the investment climate?

To the best of our knowledge, there is no holistic approach with respect to economical, institutional and political determinants of FDI inflows in Indochina countries. Therefore, this paper attempts to explore in a holistic way about the determinants of inward FDI by employing data ranging from 1996 to 2012.It is expected to contribute its empirical results for Indochina countries along with existing economic literature a better understanding about factors encouraging FDI inflow in CLV. The remainder of this article is organized as follows. Section 2 reviews related literature on determinants of FDI flows. Section 3 introduces data and model specification. Section 4 summarizes empirical results and discussion. And section 5 concludes the paper.

2. Literature Review:

In fact, the topic about identifying FDI determinants has been researched by numerous scholars (Nunnenkamp and Spatz, 2002; Bandera and White, 1968; Schmitz and Bieri, 1972; Wheeler and Mody,

1992; Jun and Singh, 1996). Thus, the reviews help us in choosing the factors encouraging FDI inflows into CLV.

Vannarith and Yushan (2011) reviews the evolution and economic reform in CLV from the early 1990s and the cooperation among three countries in promoting economic development and poverty reduction. The paper concludes that CLV economies are raising new stars adding to the economic gravity of ASEAN region, however, the remaining challenges are good governance and labor productivity.

Ludo, et.al (2009) examines the determinants of factors influence FDI inflow in Cambodia by integrating economic, geographic and political factors. The paper employs panel data from 1995-2005 for both approved and realized FDI. The results reveal that international trade has a major impact on FDI inflows into the country.

Suiwah,Vo and Kim (2005) reviews the integration and transition of Vietnam, Cambodia and Laos which embarked on market oriented reforms in the late 1980s and early 1990s. The paper finds that although the three economies are open to international trade and investment flows, their domestic market structures are still very much under developed, with heavy protection of the state sector in terms of tariff structures and bank credits. As a result, foreign investment flows went principally into state owned enterprises. The choice of independent variables also varies among studies, although some variables are commonly used such as market size (Cheng & Kwan, 2000; Moosa & Cardak, 2006; etc), trade openness, inflation, natural resources, political risks Asiedu, 2002; Moosa, 2002; Moosa & Cardak, 2006). Based on the discussed literature review, our study examines a set of determinant variables that influence FDI flows including economic factors (inflation rate, trade openness, market size), institutional factors (corruption and rule of law), and political determinants (political stability, government effectiveness, regulatory quality, voice and accountability). The determinants and their relations to FDI will be explained in the light of earlier studies.

2.1 Economic factors:

In this category, we use three variables, which are inflation, trade openness, and market size. The general implication is that the countries with low inflation rate, high degree of trade openness and larger market size attract more FDI.

Inflation

A volatile and unpredictable inflation rate in the host market creates uncertainty and discourages FDI activities of multinational enterprises (Buckley et al, 2007). The high inflation rate devalues domestic currency, and reduces the real return on investment as a result. Hence, the government launches policies reducing inflation rate to create an investment environment with less risk (Birhanu, 1998). Therefore, a low and predictable inflation rate is expected to stimulate the inflow of FDI, and vice versa.

Trade openness

Trade openness is a significant factor affecting FDI inflows. Inward FDI in a host country could be positively or negatively influenced by trade openness, which is commonly measured by the ratio of experts plus imports to GDP (Charkrabarti, 2001). According to Jordaan (2004), the impact of trade openness on FDI is subjected to the type of investment. If the investment is export oriented and requires the import of various goods, the the volume of trade is increased and therefore trade openness is expected to have significantly positive relationship with *FDI* (Holland and Pain, 1998; Lankes and Venables, 1996).

Market size

Market size is the most robust factor in attracting FDI inflows in previous studies (Shatz and Venable, 2000; Fung, Iizawa, Lee, and Parker, 2000, Billington 1999; Dees, 1998). Firms invest FDI to countries with larger

markets and greater purchasing power, where they can get higher returns (Jordaan, 2004). Therefore, it is expected that there is a positive relationship between the market size of host country and FDI inflows.

2.2 Institutional variables:

Several studies have analyzed the importance of institutional quality in FDI performance in developing countries, based on the understanding that good institutions should have a positive influence in the promotion of FDI. Dumludag et.all. (2007) investigates the relationship between FDI flows and institutions in several emerging markets, employing a panel data approach from 1992 to 2004. The socio-political variables cover corruption, investment profile, political stability and economic, social and political risks. They conclude that institutional variables are significant, particularly corruption, investment profile and government stability

2.3 Political variables:

The quantitative impact of governance quality on inward FDI has got the attention of researchers for last ten years. The relationship between political instability and FDI flows is skeptical. While there is no relationship between FDI inflows and political risk found by Jaspersen et al. (2000) and an inverse relationship between them are recorded in the research of Schneider and Frey (1985). Edwards (1990) uses political instability and political violence to measure political risk and its impact on FDI performance.

Amal, et.al (2010) findings indicate that government effectiveness has a negative significant impact on FDI inflows, which is similar to the conclusion of Koen, et.al (2012) in a research about 28 OCED countries from 1997-2004. After examining 45 developing countries in the African, Latin American and Asian regions from 1996-1005, Ourvashi (2012) shows that the level of FDI inflows is significantly positively influenced by all governance indicators. By using two-stage least square regressions for 96 countries, Meon and Sekkat (2007) concludes that “Voice and Accountability” has a positive and statistically significant impact on the FDI to GDP ratio.

3. Data and Model specification:

3.1 Data Description:

Due to the difficulty of obtaining sufficient FDI data prior to 1990, past studies on FDI in the 3 Southeast Asian transition economies were often limited to qualitative analyses. This study is based on yearly observations ranging from 1996 to 2012. The required data set have been obtained from World Bank and World Bank Indicators.

The dependent variable used for the study is the log of FDI inflows in current USD. The explanatory variables are divided into three categories which based on motives of FDI inflows as follows. All values of Political and institutional variables are estimated value of governance (ranges from approximately -2.5 (weak) to 2.5 (strong) governance performance).

***Economic factors*:** Inflation rate is measured by annual percentage change of consumer prices; trade openness is trade to GDP ratio and market size is proxied by the log of GDP in current $USD.

***Institutional factors*:** Rule of law is the agent’s confidence in and abide by the rules of society; corruption is the public power is exercised for private gain

***Political factors*:** *Political Stability and Absence of Violence* is the likelihood that the government will be destabilized or overthrown by unconstitutional or violent means, including politically-motivated violence and terrorism; *Government Effectiveness* is the quality of public services, the quality of the civil service and the degree of its independence from political pressures, *Regulatory Quality* is government’s ability to

formulate and implement sound policies and regulations that permit and promote private sector development, *Voice and Accountability* is a country's citizens with ability to participate in selecting their government, as well as freedom of expression, freedom of association, and a free media.

We present descriptive statistics for Indochina economies in Table 1. As mentioned earlier, panel regression is used in the study. Data for three countries is collected for 17 years, thus making the number of observation equal to 51. We observe that net FDI inflow to CLV between 1996 and 2012 rage from US$15.308 billion to US$22.982 billion with an average of US$19.855 billion and standard deviation of US$ 1.801 billion.

3.2 Model Description:

Panel regression model is used in the study as the data is a combination of times series and cross section. The following is the panel model which is estimated:

$$LFDI_{it}=\alpha+\beta_1 INF_{it} + \beta_2 TO_{it} + \beta_3 LMRK_{it} + \beta_4 COR_{it} + \beta_5 RL_{it} + \beta_6 PS_{it} + \beta_7 GE_{it} + \beta_9 RQ_{it} + \beta_{10} VA_{it} \quad (1)$$

Where $LFDI_{it}$ denotes log of FDI net inflows; Economic variables=Inflation rate INF_{it}, Trade openness TO_{it}, Market size $LMRK_{it}$; Institutional variables=Corruption COR_{it}, Rule of law RL_{it}; Political risk variables=Political stability PS_{it}, Government effectiveness GE_{it}, Regulatory quality RQ_{it}, and Voice and Accountability VA_{it}.

Table 2: Descriptive statistics

Variables	Indicators	Obs.	Mean	Std.	Min	Max
Dependent variable	FDI	51	19.855	1.801	15.308	22.982
Independent variables						
Economic variables	Inflation rate	51	1.724	1.472	-3.344	4.855
	Trade openness	51	4.598	0.287	4.102	5.093
	Market size	51	25478	37443	1280	155820
Institutional variables	Corruption	51	-0.870	0.312	-1.322	-0.110
	Rule of law	51	-0.834	0.308	-1.249	-0.237
Political Risk variables	Political stability	51	-0.246	0.482	-1.52	0.462
	Government effectiveness	51	-0.667	0.329	-1.222	0.297
	Regulatory quality	51	-0.686	0.415	-1.503	0.108
	Voice and Accountability	51	-1.234	0.317	-1.822	-0.515

4. Empirical results and discussion:

As the data also contains the time series, so stationarity is checked. In order to investigate the possibility of non-stationary in the data set, the paper uses Augmented Dicky Fuller (ADF) and Phillips Perron (PP) tests, stationary test for all variables is reported in Table 1.

From Table 1, the ADF and Phillips Perron test indicate that null hypothesis of unit root test can be rejected for FDI, trade openness, rule of law, political stability, government effectiveness and voice and accountability after taking first difference. So these variables are stationary at their first differences I (1).

Inflation rate, corruption and regulatory quality are stationary at their levels I (0) at 1%, 5% and 10% significance level, respectively and only market size is stationary at I (2).

Table 1: Unit root tests

Variables	Augmented Dickey-Fuller		Phillips-Perron	
	Levels	*Differences*	*Levels*	*Differences*
Foreign Direct Investment	-0.500	-6.578***	-0.672	-6.574***
Inflation rate	-4.188***	-9.133***	-4.174***	-13.852***
Trade openness	-1.784	-8.898***	-1.643*	-8.898***
Market size	11.903	-6.489***	24.682	-1.644
Corruption	-2.764*	-9.608***	-2.657*	-9.597***
Rule of law	-1.286	-7.611***	-1.286	-7.607***
Political stability	-2.420	-7.697***	-2.425	-9.519***
Government effectiveness	-0.734	-7.761***	-3.466**	-18.272***
Regulatory quality	-2.796*	-9.470***	-2.647*	-10.019***
Voice and Accountability	-2.183	-8.312***	-2.183	-8.410***

****,*,* denotes values significant at 1%, 5% and 10%, respectively*

The correlation results for the selected variables for Indochina countries are given in Table 2. The independent variable INF is highly correlated with TO, the variable COR is highly correlated with TO and MRK; and GE is highly correlated with MRK. The existence of high correlation among the independent variables will lead to the problem of multicollinearity in the estimation. Still we consider these variables because of advantageousness of the panel data estimation which takes care of the collinearity problems.

This study analyses three developing economies in the context of Indochina. However, the study does not analyze how selected determinants influence the FDI inflow on each country, but in general Indochina as a whole. The panel data analysis is a pooled cross section and time series data which allows us to exploit the time series nature of the relationship between FDI and its determinant variables for selected countries. We estimate Panel data analysis including OLS pooled regression, Fixed effects method and Random effects method for the selected study period. Since, the results of OLS pooled regression and Random effects parameter coefficients sign and their significance levels are almost similar, we choose Random effects model to check the robustness with Fixed effects model. The Fixed effects model is rejected in the analysis due to p-value of Hausman test is 0.185, meaning that Random effects is preferred. The estimation results of Random effects are presented in Table 3.

Table 3: Correlation of variables

	LFDI	INF	TO	MRK	COR	RL	PS	GE	RQ
LFDI	1								
INF	-0.062	1							
TO	0.136	0.652	1						
MRK	0.121	0.192	0.427	1					
COR	0.076	0.374	0.685	0.637	1				
RL	0.062	0.325	0.547	0.41	0.698	1			
PS	-0.251	0.438	0.126	0.209	0.067	-0.217	1		

GE	-0.114	0.454	0.635	0.617	0.53	0.475	0.327	1	
RQ	-0.183	0.124	-0.29	0.135	-0.315	-0.395	0.644	0.042	1

Table 3 shows the results of Random effects model for the explaining variables included in the model is fairly good explanation for the dependent variable (R^2=0.875 means that the variable FDI is explained of about 87% by the independent variables in the model). The result confirms the significance of Market size (represented by GDP), Government effectiveness. Among them, Rule of law expressed the strongest impact on attracting FDI which reflecting in the regression with relatively high coefficient. Or the institutional indicator that performs the best for attracting FDI seems to be rule of law. The coefficient of Rule of law (i.e perceptions of the extent to which agents have confidence in and abide by the rules of society) will lead increase of FDI with an average of 2.310 percentage points. The coefficient Market size is almost 0 even it is statistically significant. That is because market size is proxied by GDP. Political stability and government effectiveness also show positive and significant impact on FDI.

The reason why FDI performance in CLV seems to be positively correlated with institutional and political variables may be greatly related to attitude toward FDI in these three countries. Vietnam is serious about attracting

Table 3: Results of Random Effects

Explanatory variables	**Random effects**	
	Coefficients	*t-value*
Inflation rate	-0.068	-0.845
Trade openness	0.345	0.509
Market size	0.000***	3.448
Corruption	-0.623	-1.181
Rule of law	2.319**	2.48
Political stability	1.038**	2.259
Government effectiveness	1.623***	3.55
Regulatory quality	-0.947	-1.64
Voice and Accountability	0.705	1.187
R^2	0.875	
Hausman test	0.185	

*Notes: ***,**,* denote significance at 1%, 5% and 10%*

FDI, especially in sectors that bring advanced technology and improve Vietnam's labor productivity. Vietnam's attractiveness as an FDI destination has grown as the country has made key legal reforms related to the business climate. Other draws are Vietnam's stable political system, strategic location and an abundant labor force that is significantly less expensive than that of China.

And Cambodia has an open and liberal foreign investment regime with relatively pro-investor legal and policy framework. It began its transformation from a command economy to a free market in the late 1980s. All sectors of the economy now are open to foreign investment. The risk of political violence directed at foreign companies operating in Cambodia is low. While the government of Laos officially welcomes both

domestic and foreign investment as it seeks to graduate from Least Developed Country status. The pace of foreign investment has increased over the last several years. Laos offers a range of investment incentives through its Special and Specific Economic Zones.

The CLV countries are rich in terms of their endowments of natural resources, and possess a competitive edge when it comes to the cost of labor or market size. If there is a constraint on attracting FDI, then it would have more to do with the domestic investment climate in these countries. However, as can be seen from the findings, the estimated coefficients of the governance variables (rule of law, political stability and government effectiveness) have a positive and significant on FDI.

The three countries with relatively poor institutions for good governance, with low government effectiveness, poor regulatory quality and rule of law as shown min and max value in Table 1. This relatively poor institutional quality may exacerbate the effects of external threats. As higher economic growth and better economic integration in other regions may divert FDI flows into Indochina countries, their appropriate response is to improve institutional quality so that the share of FDI will increase in the total FDI inflows. Meaning that an important economic relationship exists between the quality of governance and the FDI inflows.

Therefore, our results are in accordance with previous studies, which have concluded that governance quality is an important factor to explain FDI performance in Indochina. In particular, our results show that, not only market size political stability and government effectiveness have significant influence but rule of law also does matter.

5. Conclusion:

The paper examined economical, institutional and political determinants in attracting FDI in Indochina economies in the 1996-2012 periods. The results show that the level of FDI inflows is significantly related to the governance quality in Indochina economies. An important policy implication of this result is that governments in these regions can play an important role in promoting FDI. Thus, countries which were previously disadvantaged have a possibility to catch up with the others if they implement the appropriate institutional reforms. As for the regulatory quality, incentives can be given to promote FDI.

Building sound financial and legal institutions that would facilitate procedures for investors and protecting the property rights is also important as well as other aspects such as the repatriation of profits. The specific promotional tools depend, among other things, on a country's stage of development, its physical geography and the sectors targeted. Tools to be considered include special economic zones, export processing zones, industrial zones and favorable incentive schemes. Political institutions that can make credible commitments to some level of policy stability and retain the necessary policy flexibility will foster an environment multinational corporation’s desire. Hence, political institutions must provide commitments to market-friendly policies both today and in the future. Indochina can will attract higher levels of FDI if realize these commitments.

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