

EVALUATION OF FOREIGN DIRECT INVESTMENT IMPORTANCE IN PROMOTING ECONOMIC DEVELOPMENT IN DEVELOPING COUNTRIES

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Abstract

This insight paper examines the relationship between foreign direct investment (FDI) and economic development in developing countries. The paper begins with an introduction that provides a brief overview of the research topic. The research methodology is then discussed, followed by an exploration of the theoretical approaches to FDI and economic development. Case studies of FDI in developing countries are presented and analyzed, providing into the impact of FDI on economic development. The analysis section of the paper examines the data collected from the case studies and discusses the findings. Singapore is taken as a case study to measure for better understanding of the impact of FDI on economic development in developing countries. Foreign direct investment and gross domestic product variables were used to measure this relationship. Gross domestic product is dependent and foreign direct investment is independent variable in the study. In conclusion, the paper provides a summary of the key points. The references section provides a list of sources used in the paper.

Keywords: *foreign direct investment, economic development, developing countries, regression analysis.*

JEL Classification: O16

Introduction

In the current era of globalization, we see a rise in foreign capital investments. A foreign direct investment, also known as FDI, refers to an investment made by an organization in one nation into businesses situated in another nation. Foreign direct investment, which can bring a range of benefits to the host country such as financing current account deficits, transferring technology, and fostering economic growth, is particularly attractive to developing nations lacking in capital.(Gurgu, E., & Cociuban, A., 2016). Not only developing countries, but also developed countries are eager to receive foreign direct investment. Because foreign direct investments have significant positive effects on the country's economy. However, in addition to these positive effects, foreign direct investment can have several negative effects on the countries it enters. These types of investments are typically made by multinational corporations, which dominate the field of foreign direct investment.

The aim of this study is to investigate how foreign direct investments that can contribute to economic development attracted to developing countries. The study consists of several parts. Abstract, introduction, main body, research methodology, analysis part, conclusion and references are included in the article. Here, first, various ideas about foreign direct investment and economic development will be put forward, examples of foreign direct investment in several developing countries will be shown. Later, an analysis will be conducted to understand the topic more clearly. Given this information, the study's objective is to thoroughly examine how foreign direct investment impacts economic growth in developing nations. To achieve this, regression analysis was conducted using data from Singapore, a developing country, spanning from 2012 to 2021. The estimation results indicate that foreign direct investment has a positive effect on economic growth, which aligns with theoretical expectations. Furthermore, a positive correlation between foreign direct investment and economic growth was discovered.

Research Methodology

The purpose of this study is to evaluate the importance of Foreign Direct Investment (FDI) in promoting economic development in developing countries, with Singapore as the specific case study. Here, both quantitative and qualitative research methods are reflected in order to achieve the goals of the research. For qualitative research, the articles of various authors, international journals, internet

resources were examined and necessary parts were added to the article. The study will use regression analysis to determine the relationship between FDI inflows and GDP in Singapore. This study is a quantitative research design that will use secondary data to analyze the relationship between FDI and economic development in Singapore. The study will collect data on FDI inflows to Singapore and GDP for the period from 2012 to 2021. The data will be collected from the World Bank's World Development Indicators and Macrotrends.com website which is statistical portal for market data. The variables used in the study will be GDP as the dependent variable and FDI inflows as the independent variable.

The regression equation will be $Y = \beta_0 + \beta_1 X + \varepsilon$, where Y is the dependent variable (GDP growth), X is the independent variable (FDI inflows), β_0 is the intercept, β_1 is the regression coefficient, and ε is the error term.

Theoretical approaches to “foreign direct investment” and “economic development”

Economic growth refers to the expansion of a country's ability to produce goods and services, as well as the amount of economic resources available within its borders, during a specific time frame. Economic growth can be understood as the rise of national income per person. In a broader sense, economic growth involves an increase in GDP, NI and GNP. Economic growth can take three forms: positive, negative or zero. Positive growth is observed when the yearly rates of macroeconomic indicators surpass the population's average growth rate. Negative economic growth is the opposite of this form. Zero economic growth occurs when the average growth rates of macroeconomic indicators, such as GDP, are equivalent to the population's growth rate. [Haller,2012]

Economic growth is influenced by several factors that one of them is foreign direct investment. Foreign direct investments, which gained significance after the discovery of the "New World" America in 1492, have historically been unidirectional, moving from developed nations to less developed ones. These investments were primarily aimed at exploiting the natural resources beneath and above ground, as well as the low-cost labor available in less developed countries. [Sabioghlu,2006]. Olokoyo (2012) noted that foreign investment has opened up numerous possibilities, including but not limited to job opportunities, infrastructure development, transfer of technology, and heightened productive efficiency. Foreign direct investment assists in filling the void of insufficient capital and supplements domestic investment, particularly when directed towards high-risk regions with limited domestic resources for new businesses. FDI offers valuable resources to

developing countries, such as capital, management expertise, technology, entrepreneurial skills, brand recognition, and market entry opportunities, which can give them an edge over others. This can be beneficial for developing countries. [Alshehry, 2015]. These factors have a significant impact on crucial elements for developing countries, including employment, production, trade and etc. that are important for their industrialization, development, and poverty reduction efforts. Finally, foreign companies can bring better management and marketing strategies, which can be beneficial for developing countries. [Pacheco-Lopez,2005]

These are the positive effects of foreign direct investment to host nation when coming into country:

- **Accumulation of Capital-** Typically, nations encounter difficulties in generating enough domestic savings and capital to support their developmental efforts. To address this issue, foreign investments can play a critical role in contributing to the economic growth of the host country. Therefore, foreign direct investments (FDIs) are highly valuable resources that can help overcome this challenge. [Aytekin, 2019]
- **Technology effect:** FDI can lead to the development of the local industry through technology, which can enhance the host country's export competitiveness by producing goods with superior technology that are easier to sell abroad. [Pacheco-Lopez ,2005]
- **Employment-** The entry of foreign direct investments (FDIs) into the host country leads to the creation of new employment opportunities for the workforce and enables employees to enhance their skills and experience in various technological environment and working places. [Ozdemir,2020]
- **Market competition-** When foreign direct investments (FDIs) are allowed to participate in the trade of goods and there are no restrictions on the quantity traded, it leads to liberalization, which in turn increases the number of firms operating in the national market, resulting in a more competitive market structure. This increased competition brought about by FDIs injects vitality into the economy of the host country, prevents domestic firms from monopolizing the market, and causes domestic production to rise while prices fall. [Aktan, 2006]

In addition to these positive effects, foreign direct investment can also have negative effects:

- **Balance of payments:** Although Foreign Direct Investments (FDIs) can have a favorable impact on the balance of payments, by boosting the export sector and reducing reliance on imports, this may not benefit all local companies equally. Some firms that lack the necessary capabilities to compete in the international

market may not be able to take advantage of these opportunities. Moreover, FDI in the service sector may not result in foreign currency inflows or may even have a negative impact on the balance of payments due to the use of imported inputs. [Vural, 2006]

- **Competition-** The likelihood of a monopoly is higher when foreign firms possess greater capital and technological advantages than domestic firms. If the host country fails to take required actions, local businesses may not be able to compete effectively with foreign businesses, leading to negative consequences for the local market and economy. Businesses that are unable to compete with foreign businesses may have no choice but to leave the market. [Gedikli,2011]

The challenges and risks associated with FDI in developing countries, including political and regulatory risks, cultural differences, and environmental concerns

Foreign direct investments can be influenced by several factors. If an investor wants to invest in another country, he tries to decide before investing by researching a few factors that may affect his business in the future. A foreign investor considers several factors when making a decision to invest abroad in another country. These include economic and socio-political factors. According to Emir and Kurtaran (2003), the size of the market, labor costs can be shown as an example for these economic factors, and political risks may be socio-political factors. The presence of political risk results in modifications to projected cash flows of multinational investment initiatives and has an adverse impact on the profitability of such investments. Political risk encompasses both large-scale macro factors and smaller-scale micro factors.

According to Turkey (2013), the escalation of political risk can lead to various negative outcomes, including:

- Foreign investors may withdraw their investments and leave the country;
- The uncertainty caused by political risk may result in a reduction in the overall level of investments in the country;
- Local investors may decide to transfer their capital abroad due to the elevated level of risk;
- In times of heightened political risk, speculators can exploit the situation to create greater instability in foreign and domestic currencies.

Numerous studies have examined the correlation between political risk and foreign direct investment, but the findings have been varied. Some studies suggest that FDI declines in response to an increase in political risk. [Masca,2008]

Acar (2012) identifies several factors that can impact political risk, including:

- The political regime of the country;
- social and demographic characteristics;
- rules pertaining to foreign investment;
- wars;
- trade barriers;
- government recession and etc.

The next challenge for foreign investors during decision making process is cultural differences. The dissimilarities in culture between the country of origin and the country of investment can impact foreign investment activities in numerous manners. The "cultural proximity" theory suggests that countries with higher cultural diversity may receive lower investments from foreign investors. [Lee,2008] Hennard (2002) noted in his article that when the cultural difference between the home country and the host country grows, foreign investors tend to opt for greenfield investment over acquisition. This is because significant cultural gaps can result in more pronounced disparities in management and organizational practices. If there is cultural similarity and a long-standing history between the home country and the host country, it can create a favorable political environment in the host country for foreign investors. This can make it easier for foreign investors to gain acceptance and support. Moreover, the strength of cultural and historical ties may increase the inclination of foreign investors to acquire greater ownership of their investments in the host country. [Vachani,1995] According to Berry (2010), the cultural differences between countries can be a major deterrent for firms looking to invest in foreign markets. Therefore, it is believed that when two countries have more similar cultures, their level of international trade will be higher. This is because a greater level of cultural similarity can reduce uncertainty and make it easier for firms to understand and negotiate with the foreign country.

Religion is a significant factor that influences the cultural fabric of a nation. It has a profound impact on the behavioral patterns of individuals and groups, and consequently affects the economic performance at different levels - be it individual, group or national. [Landes,2000] The impact of religious faith on foreign direct investment can be assessed in the context of the cultural proximity theory. Typically, foreign investors are inclined to invest lesser in countries with a more diverse religious landscape. This is because the divergence in religious beliefs leads to an increase in the cultural disparities between the home country and the host country. [Ak,2009]

According to Akay (2008), investors generally prefer to invest in countries where they are familiar with the local population, their culture, and their social norms. While commercial considerations and profitability are the primary drivers of investment decisions, differences in social and moral values can also play a role. Even though the legal framework may not differ significantly, the capital from the West and America tends to invest more among themselves, possibly due to shared cultural and social ties.

According to Mabey (2009), over the past ten years, there has been a noticeable increase in environmental degradation across various areas such as deforestation, greenhouse gas emissions and etc. This degradation is mainly attributed to the rise in economic activity, with foreign direct investment (FDI) being a notable factor.

Official statements on the environmental impacts of foreign direct investment (FDI) typically revolve around three key arguments:

- The first argument is that FDI is generally cleaner than domestic investment: FDI often introduces new technologies that are more environmentally friendly than those used by domestic producers, so promoting FDI can lead to an improvement in a country's environmental performance.
- Foreign direct investment (FDI) can raise the need for better environmental standards in host countries. As the host country's income levels increase, this can ultimately lead to a decrease in environmental damage over time according to the environmental Kuznets curve theory.
- Each country has unique environmental strengths that may give it a competitive edge. As a result, countries will create their own environmental regulations based on their specific domestic preferences and available resources.

Hypotheses

Here's a possible hypothesis that will be tested for this study:

Null hypothesis (H_0): There is no significant relationship between foreign direct investment (FDI) and the GDP of Singapore.

Alternative hypothesis (H_1): There is a significant positive relationship between foreign direct investment (FDI) and the GDP of Singapore.

This hypothesis suggests that as the level of foreign direct investment increases, the GDP of Singapore will also increase. As a result, if there is a positive relationship between FDI and GDP, it would suggest that Singapore is benefiting from foreign investment and that the economy is growing as a result.

Case studies of FDI in developing countries

In 2021, FDI inflows showed an upward trend in most subregions, except for South Asia. However, only six countries received more than 80% of the FDI inflows. China was the largest recipient, followed by Singapore, Indonesia, the United Arab Emirates, and India. [UNCTAD,2022] Some examples of foreign direct investment attracted to the country by several developing countries are shown below:

Singapore-Singapore is among the countries that attract the most foreign direct investment. FDI has played a crucial role in the economic and developmental history of Singapore, dating back to the period after the country gained independence in 1959. At that time, Singapore faced significant challenges related to poverty and unemployment, and due to limited financial resources, it was essential for the country to attract foreign investment in order to support its economic growth and development. [Siddiqui,2010] Lee and Tan (2006) indicate that Singapore considers FDI as a means to promote economic growth by leveraging successful technology transfers, implementing effective government strategies and policies to capitalize on FDI inflows, enhancing human resources, and creating a more open trade environment. The amount of foreign direct investment in Singapore will reach \$105.49 billion in 2021. This number means 26.57% of the gross domestic product of the country. This is quite a large number and makes a great contribution to the development of the country. There was a rise of 36.7 billion USD in the amount of Foreign Direct Investment (FDI) in Singapore for previous year. [World Bank,2022]

China- Hong (2014) and Peng (2016) analyzed data from panels at the provincial and municipal levels in China. Using the GMM approach, they recalculated the favorable relationship between China's economic growth and its production input, which is supported by the foreign direct investment (FDI). The result of their research showed that indeed foreign direct investment has a great impact on China's development. According to UNCTAD (2022) China has been ranked among the top countries globally in terms of foreign direct investment (FDI), with a total FDI of 189.1 billion U.S. dollars in recent years. The primary driver of growth was the service sector, which contributed to over 70% of the inflows. The inflow of Foreign Direct Investment (FDI) saw significant growth in industries related to technology. To encourage further investment, the government broadened the range of industries that welcome FDI, eased limitations on foreign investment in crucial sectors.

Azerbaijan- Following its independence, the Republic of Azerbaijan needed to adopt new economic principles to establish and develop its economy. This required

the country to engage in open market relationships with other nations. However, the Azerbaijani government encountered military, political, and other difficulties, which hindered the achievement of the desired level of economic liberalization. To compensate for the lack of resources needed for international trade and liberalization of prices, the government sought external resources. Foreign investment began flowing into the Azerbaijani economy in 1994, and legal and administrative changes were made between 1994 and 1997 to facilitate foreign capital inflow to the country. These changes ultimately resulted in the successful inflow of foreign capital. During the initial years, investment from Western countries began to flow into the country with the aim of exploiting its abundant oil and natural gas resources. [Ogan,2003] Mirzeyev (2019) noted that from 1994 to 2016, the Azerbaijani economy received approximately \$180 billion in foreign investment, with the oil sector receiving 74% of the total foreign direct investment. Between 2000 and 2020, the country attracted \$90.8 billion in foreign direct investment, with 85% of this amount directed towards the oil sector, and the rest invested in non-oil sectors. [ANB,2020]

Data regarding foreign investment in sectors other than oil is accessible until 2014. Throughout history, the industrial sector has been the most attractive sector for foreign direct investment in Azerbaijan, followed by the construction sector in second place. Despite the agricultural sector's significant potential, it has not received any foreign direct investment during this period. However, foreign investment in the agricultural sector could bring modern technologies, ultimately increasing productivity. [Mikayilov,2012]

Brazil-Starting from the 1990s, Brazil experienced a significant increase in foreign direct investment (FDI) from other countries, primarily due to privatization efforts. These investments played a crucial role in reducing recurring current account deficits (caused by the country's greater integration with the global market) and boosting productivity within the domestic economy. In 2021, Brazil received a total of US\$ 46.4 billion in foreign direct investment. Among different sectors, the service industry had the highest performance, with an increase of 83% in FDI inflows in 2021. The commerce, electricity and gas sectors also received a significant amount of FDI. However, the natural resources and manufacturing sectors saw a decline in investment. The information technology services sector also received significant amounts of foreign direct investment. [ECLAC, 2022]

Analysis part

Amount of foreign direct investment inflows and Gross Domestic Product (GDP) of Singapore are used to make regression analysis for the study. Followings are the amount of foreign direct investment and GDP for each year between 2012-2021.

Table 1. Values of Singapore's foreign direct investment and gross domestic product

Year	FDI (in billions)	GDP (in billions)
2012	55,31	295,09
2013	64,39	307,58
2014	68,7	314,85
2015	69,77	308
2016	65,36	318,83
2017	99,21	343,19
2018	81,18	377
2019	111,48	375,47
2020	74,75	345,3
2021	105,49	396,99

Source: World Bank, www.worldbank.org

By using following data, regression analysis was conducted to show the relationship between these two dependent and independent variables.

Table 2. Results of regression analysis for Singapore

Regression Statistics	
Multiple R	0,85208376
R Square	0,726046734
Adjusted R Square	0,691802576
Standard Error	19,45647915
Observations	10

Regression Statistics:

Multiple R: This is the correlation coefficient between the dependent variable (Y) and the independent variable (X). In this case, it is 0.85208376, which indicates a strong positive correlation between the two variables.

R Square: This is the coefficient of determination, which represents the proportion of the variance in the dependent variable that is explained by the independent variable. In this case, it is 0.726046734, which means that 72.6% of the variance in the dependent variable is explained by the independent variable.

Adjusted R Square: This is a modified version of R Square that takes into account the number of independent variables and the sample size. In this case, it is 0.691802576, which is slightly lower than R Square.

Standard Error: This is the standard deviation of the residuals (the differences between the actual and predicted values of the dependent variable). In this case, it is 19.45647915, which indicates the degree of variability in the data around the regression line.

Observations: This is the number of data points used in the analysis. In this case, there are 10 observations.

Table 3. Analysis of Variance

ANOVA	<i>Df</i>	<i>SS</i>	<i>MS</i>	<i>F</i>	<i>Significance F</i>
Regression	1	8026,137352	8026,137352	21,20206109	0,001745
Residual	8	3028,436648	378,554581		
Total	9	11054,574			

df: This stands for degrees of freedom, which is the number of independent pieces of information in the data.

SS: This stands for sum of squares, which is a measure of the total variability in the dependent variable.

MS: This stands for mean square, which is a measure of the variability of the dependent variable that is explained by the independent variable.

F: This is the F-test statistic, which is the ratio of the mean square of the regression to the mean square of the residual. In this case, it is 21.20206109, which indicates that the regression model is statistically significant.

Significance F: This is the p-value associated with the F-test statistic. In this case, it is 0.001745, which is less than 0.05 (the commonly used threshold for statistical significance), indicating that the regression model is statistically significant.

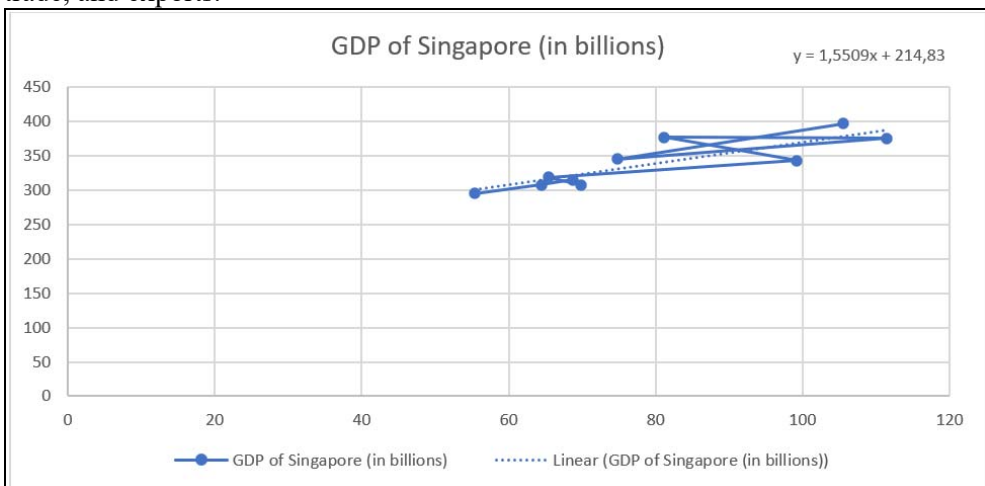
Table 4. Intercept and coefficient results of analysis

	<i>Coefficients</i>	<i>Standard Error</i>	<i>t Stat</i>	<i>P-value</i>
Intercept	214,832001	27,49624471	7,813139695	5,17461E-05
X Variable 1	1,550927543	0,336823565	4,604569587	0,001745

Intercept: This is the y-intercept of the regression line, which represents the predicted value of the dependent variable when the independent variable is zero. In this case, it is 214.832001.

X Variable 1: This is the coefficient of the independent variable (X), which represents the change in the predicted value of the dependent variable for a unit change in X. In this case, it is 1.550927543.

Overall, these results indicate that there is a strong positive relationship between the independent and dependent variables, and the regression model is statistically significant. The intercept and coefficient values can be used to make predictions about the dependent variable based on the independent variable. The other factors that may also influence dependent variable (GDP), such as demographic, economic, or geographic factors. Therefore, it cannot be mentioned that only foreign direct investments contribute to the development of the country. According to Yue (2016), The success of Singapore’s economic growth are mainly reliant on trade. There is a strong and positive statistical relationship between GDP and FDI, trade, and exports.



Graph 1. Scatter chart of relationship between GDP and FDI of Singapore

y represents the dependent variable, in this case, GDP.

x represents the independent variable, in this case, FDI.

1,5509 is the slope coefficient, which indicates how much the dependent variable changes for each unit increase in the independent variable. This indicator means that for each unit increase in FDI, GDP is expected to increase by 1,5509 units.

214,83 is the intercept, which is the value of the dependent variable when the independent variable is equal to 0. If there were no FDI, the expected value of GDP would be 214,83 units for this equation.

Therefore, this equation represents a linear regression model that estimates the expected value of GDP based on the value of FDI, assuming that the relationship between the two variables is linear and that there are no other variables that affect the relationship between FDI and GDP.

Conclusion

The research used regression analysis to examine the correlation between economic growth and foreign direct investment in Singapore, which is considered a developing nation, during the period from 2012 to 2021. For analysis part two different variables which are foreign direct investment and GDP are used. GDP is chosen as indicator of economic growth. Foreign direct investment is independent and GDP is dependent variable here. Based on the regression analysis conducted with the provided data, the study has found a strong positive correlation between the X(Variable1) (presumably foreign direct investment) and the economic growth of the selected country (Singapore). The regression model shows that the coefficient of determination (R Square) is 0.726, which implies that approximately 72.6% of the variation in economic growth can be attributed to foreign direct investment. Additionally, the p-value of the F-test is less than 0.05, indicating that the regression results are statistically significant. The regression model's intercept coefficient has a value of 214.83, indicating that if there were zero foreign direct investment, the estimated economic growth would be approximately 214.83. The coefficient of X(Variable1) is 1.55, which implies that for every one-unit increase in foreign direct investment, the estimated economic growth increases by 1.55 units.

The model's ANOVA (analysis of variance) table shows that the regression model's F-statistic is 21.20, and the corresponding p-value is less than 0.05, indicating that the regression results are statistically significant. Moreover, the residual standard error is 19.46, which implies that the regression model's

predictions have an average deviation of approximately 19.46 units from the actual data.

It's worth noting that this study has some limitations that may impact the generalizability of the findings. Firstly, the study only analyzes data from one developing country (Singapore), and the results may not be applicable to other developing nations with different economic characteristics. Additionally, the study only examines the impact of foreign direct investment on economic growth and does not consider other factors that may also contribute to economic growth, such as political stability, technological advancements, and infrastructure development.

Furthermore, the study assumes a linear relationship between foreign direct investment and economic growth, and this may not always hold in reality. Additionally, the study's data covers a relatively short period, and the results may not reflect the long-term effects of foreign direct investment on economic growth. Despite these limitations, the study's findings provide valuable insights into the impact of foreign direct investment on economic growth in developing countries. Apart from implementing strategies targeted at drawing foreign direct investments, it is crucial for nations to consider measures that enhance the degree of financial advancement, guarantee stability in macroeconomic conditions, and boost domestic investments.

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