

Locational Determinants of Chinese Outward Foreign Direct Investment in OECD Countries

Lan Gao

Business School, Loughborough University, Loughborough, UK, LE11 3TU
L.Gao@lboro.ac.uk

Abstract

This study intends to shed more light on the determinants of outward foreign direct investment (OFDI) from emerging economies to developed economies, and deepen our understanding of OFDI behaviours of emerging economies. The rise of China's OFDI has raised important theoretical and empirical questions about the factors affecting the locational choices of Chinese firms. By using the most recent panel data and applying more advanced econometric analytic methods, the results reveal some dynamic changes of locational determinants for Chinese OFDI.

Introduction

It is widely recognised that patterns of FDI across different geographical regions need to be examined over time, because factors motivating MNEs' initial investments into a country could change, which leads to investment interests in other locations (Sethi et al., 2003). Buckley et al. (2007)'s comprehensive empirical research on determinants of Chinese OFDI finds that, prior to 2001, Chinese OFDI had been driven by market-seeking, natural resource-seeking, cultural proximity and institutional support. However, in 2001, the promotion of FDI by the Chinese central government was formalised in the 10th five-year plan which explicitly outlined the 'Go Global' or 'Zou Chu Qu'. Sequentially, both Ministry of Commerce and the National Development and Reform Commission have explicitly encouraged Chinese firms to invest abroad in obtaining advanced technologies, management skills and highly skilled personnel. Considering one of the idiosyncratic characteristics of Chinese OFDI, state-directed (Buckley et al., 2007), this new institutional factor may well lead to new patterns of Chinese OFDI.

Dunning's ownership-location-internalization (OLI) paradigm is the most influential and widely used approach to examining the reason for the existence of MNEs and the location choices of MNEs (Dunning, 1993). The OLI paradigm argues that MNEs must possess certain types of ownership advantages at home, which can be transferred to specific countries to exploit location advantages (L-advantages) through internalisation via foreign direct investment (I-advantages). Dunning (1988) has updated his OLI paradigm and proposed strategic asset-seeking motives and market-seeking motives. It implies that MNEs not only exploit their ownership advantages in host countries, but also use FDI as the way to obtain strategic assets. In other words, FDI is also used as a means of strategic asset exploration. These motives may either

co-exist or MNEs may prioritise their motives by engaging in strategic asset-seeking activities in host countries.

However, the traditional theoretical perspective alone may not be adequate to explain the special feature of Chinese OFDI in OECD countries (Luo and Tung, 2007). Network theory has been recognised as a promising theoretical lens which can be adopted to investigate the motives behind Chinese OFDI. In particular, this approach helps to explore the role of human mobility between China and OECD countries in Chinese OFDI.

Hypotheses

Human Mobility

There is a growing literature emphasizing that networks built by international human mobility facilitate bilateral economic transactions through their removing of informational and cultural barriers between home and host countries (Kugler and Rapoport, 2005). This complementary relationship between human mobility networks and bilateral economic transactions has been supported by previous researches in the field of international trade (e.g., Rauch and Casella, 2003). In a similar spirit, human mobility can also create the types of business networks which lead to FDI investment in a particular location, by helping firms to reduce the uncertainty and information asymmetry while entering a foreign market. Sociologists have found that human mobility encourages the FDI flow from the host country to the home country of the migrants, thanks to migrants taking part in business networks after they settled in the local society (Saxenian, 2002).

Besides the benefit of the extended network, from the perspective of the domestic market of the home country, human mobility has been considered as a ‘brain drain’, especially for developing countries who are in need of the intellectual capital to facilitate the economic development. Like employees have to relocate to where jobs are, FDI will flow to where the type of labour used intensively in production is abundant (Kugler and Rapoport, 2005). For example, it is understandable that strategic asset-seeking FDI will flow to locations where highly-skilled and well-educated personnel are abundant.

Hypothesis 1: The higher the portion of human capital flow from China to the host country, the more this will encourage Chinese OFDI flow to the host country.

Strategic Asset

OFDI has been considered and utilised as a way for MNEs to acquire or develop strategic assets in a foreign market, and explore such assets as technological know-how, reputation, management skills and market intelligence (Chung and Alcacer, 2002; Dunning, 1998). FDI is attracted towards centres of innovation located in recipient countries in order to access complementary resources with the purpose of upgrading firms’ capabilities (Deng, 2007).

This strategic asset-seeking perspective is particularly important concerning Chinese firms. In order to compete with MNEs from developed countries and overcome the disadvantage of possessing few firm-specific resources as latecomers, Chinese firms may consider OFDI as a quick-fix to leapfrog the hurdles in front of

them, such as lack of technology, international reputation, brand recognition and international management skills. Therefore, a host country, with higher levels of intellectual capital and innovative capacity to help Chinese firms build their ownership advantages which can be exploited elsewhere, certainly will attract Chinese firms with strategic asset-seeking intentions (Twomey, 2000).

Hypothesis 2: The higher the relative investment in R&D of the host country to that of China, the more the Chinese OFDI flows to the host country.

Cultural Distance

Cultural proximity to the home country has been identified as a significant determinant of FDI (Hofstede, 2001; Buckley *et al.*, 2007). The Uppsala Model (Johanson and Vahlne, 2009) states that MNEs engage in FDI incrementally by making small investments in geographically and culturally proximate countries, and proceeding to larger investments into countries distant on both counts as accumulating more experience.

However, previous empirical research has not reached a consensus on the conclusion of whether cultural distance is one of the FDI determinants. On one hand, cultural distance has been recognised by its negative effect on internationalisation. On the other hand, researchers find that cultural diversity encourages the learning of new routines and may result in improved performance (Tihanyi *et al.*, 2005). Based on more recent samples, cultural distance has a strong positive effect on firms' international diversification (Tihanyi *et al.*, 2005). In a study based on the FDI flow to Mexico from 11 countries, cultural distance is found to be positively related to the FDI flow, however, it may not be as important in explaining FDI into emerging markets as other factors (Thomas and Grosse, 2001).

Hypothesis 3: Chinese OFDI is negatively associated with the cultural distance between China and the host country.

Market Size

Recent studies point out that the growing importance of market-seeking FDI by Chinese MNEs in developed host countries in response to policy liberalisation in China (Buckley *et al.*, 2007), and this type of investment are increasingly directed towards large markets (Buckley *et al.*, 2007). Chinese market-seeking OFDI involves both defensive (import-substituting and quota-hopping) and offensive (developing new markets) initiatives (Buckley *et al.*, 2007). Market size is a major determinant of market-seeking FDI, especially for offensive market-seeking OFDI, because as markets increase in size, so do opportunities to exploit the economies of scale and scope (WIR, 1998). In 2007, eight of the top ten countries by GDP are OECD countries (World Bank, 2009). Therefore, OECD countries cannot be neglected by any firm with a market-seeking motive, given their high GDPs. A country's market size can be measured by its annual GDP.

Hypothesis 4: The larger the relative market size of the host country to that of China, the more the Chinese OFDI flows to the host country.

Inward FDI

OFDI may be positively affected by inward FDI if inward FDI, attracted by L-advantages, ultimately leads to the accumulation of O-advantages, which can contribute to overseas exploitation (Dunning et al., 2001). Inward FDI plays an important role in the process of China's economic development. In 2007, China remained as the top recipient of FDI among developing countries with 83.5 billion USD (WIR, 2008). Inward FDI contribute to a host country's economic development through both capital accumulation (Chang, 2005) and productivity spillovers (Chang, 2005).

Hypothesis 5: The higher the portion of FDI from the host country to China in the total FDI flow to China, the more this will encourage Chinese OFDI flow to the host country.

Bilateral Trade

High foreign trade prospects can make one country more attractive to foreign investors (Liu et al., 2002). During 1980s and 1990s, much Chinese OFDI was motivated by providing a local support function for domestic Chinese exporters (Wu and Sia, 2002). Like strategic asset-seeking OFDI, OFDI with the aim of supporting domestic Chinese exporters is also among the four types of OFDI that are highly promoted by the Chinese government. Buckley et al. (2007) find strong evidence to support the complementary relationship between Chinese trade and OFDI. The intensity of trade relations between a home country and a host country can be captured by bilateral trade (Buckley et al., 2007). Thus:

Hypothesis 6: The higher the level of bilateral trade between China and the host country, the more this will encourage Chinese OFDI flow to the host country.

Therefore, the relationship of Chinese OFDI and its determinants can be summarised as Equation 1 (Equ 1).

$$OFDI_{it} = \varphi_i HC_i + \phi_i R \& D_i + \gamma_i CD_i + \beta_i FDI_i + \chi_i GDP_i + \delta_i TRADE_i + u_{it} \quad \text{Equ 1}$$

Data and Result

Data

The datasets include 13 OECD countries across nine years time period, 1999 – 2007, which gives 117 observations in total. During a five year time period from 2003 to 2007, the OFDI flows form China to these 13 countries, in average, contributed 92.12% of the total OFDI flow from China to OECD, which can generally represent the whole population. The data for the proposed test are obtained from various sources. GDP (in constant US \$ year 2000), R&D (percent of GDP) and GDP deflator are obtained form the World Bank development indicator (2009). The OFDI flows from China to OECD countries, inward FDI flows from OECD countries to China, export flows from China to OECD countries and import flows from OECD countries to China are drawn from various issues of China Statistic Yearbook (2000 – 2008). All OFDI, inward FDI, export and import flow data have been deflated by using GDP deflator drawn from the World Bank development indicator (2009) into constant US \$ year 2000. The international flows Chinese students and scholars are drawn from UNESCO education statistic report (2009). Cultural distance is calculated following Luo (2000), which is based on Hofstede's culture dimension index (2001) and presented here:

$$CD_{j/China} = \frac{1}{4} \sum \frac{(I_{ij} - I_{iChina})^2}{V_i}$$

where I_{ij} is the index value for the cultural dimension i of country j ; I_{iChina} is the index value for the cultural dimension of China; V_i is the variance of the index dimension i .

Poolability

Before running any regression with the dataset, whether the regression parameters take values common to all cross-sectional units for all time periods needs to be tested, in order to satisfy the overall homogeneity hypothesis of pooling the dataset (Hsiao, 2003). Using the Chow test, the question of whether “to pool or not to pool” is reduced to a test of the validity of the null hypothesis $H_0: \theta_i = \theta$ for all i (Baltagi, *et al.*, 2008). Under H_0 , the following test statistic:

$$F_{obs} = \frac{(ess - \sum_{i=1}^N ess_i)/(N-1)k}{\sum_{i=1}^N ess_i / N(T-k)}$$

is distributed as $F((N-1)k, N(T-k))$. The $ess = \sum_{i=1}^N ess_i$

0.0473 is obtained from pooled OLS, and the $\sum_{i=1}^N ess_i = 0.0103$ is obtained from summing the RSS from 13 individual country OLS regressions. In the test for overall homogeneity, a calculated F-statistic of 1.30 is obtained from Equation 5.1. Since this value is less than the 5 per cent of the critical value of $F(71, 39) = 1.62$, this indicates that, at this level, we can assume that the slopes and intercepts are simultaneously homogeneous among different countries in the dataset. Therefore, the data can be pooled to test the hypothesis.

Endogeneity and Heteroscedasticity Test

System exogeneity tests are performed in order to determine whether the endogeneity problem needs to be addressed in regression methods. Endogeneity between OFDI and human mobility, and OFDI and inward FDI, has been revealed by system exogeneity tests (Table 1). Thus, the reverse causation running from OFDI to human mobility and inward FDI needs to be addressed in the analysis. In this case, Equation 1 should be estimated by applying instrumental variable regression methods, rather than pooled OLS.

Table 1 System Exogeneity Tests

Variable	p-value	Exogeneity tests
Human Mobility	0.0424**	4.118
Strategic Asset	0.3326	0.939
Cultural Distance	0.7122	0.136
Market Size	0.3636	0.825
Inward FDI	0.0790*	3.085
Bilateral Trade	0.3803	0.770

** and * denote significance at the 5 and 10% levels, respectively.

In order to test whether the no heteroscedasticity assumption of 2SLS is valid in this dataset, a LR test is performed to detect the existence of heteroscedasticity. The LR test returns a Chi-square value of 324.87, which is greater than the 1% critical value. Therefore, heteroscedasticity has been proved to be existent, which indicates that 2SLS is less efficient than the GMM estimator when applied to this dataset. As a result, Equation 1 will be estimated by using GMM, and the result is presented in the next section.

GMM Estimator

The result of the GMM estimator is largely consistent with the hypothesis, with some interesting twist, which will be discussed in this section. The GMM estimation result is reported in Table 2.

Table 2 GMM Estimation Result

Independent Variable	p-value	Coefficient
Human Mobility	0.085*	0.1016
Strategic Asset	0.000***	0.0208
Cultural Distance	0.005***	0.0100
Market Size	0.638	-0.0014
Inward FDI	0.018**	0.3792
Bilateral Trade	0.164	0.0084
Adjusted R ²	0.33	

***, ** and * denote significance at the 1, 5 and 10% levels, respectively.

Discussion

This study empirically examines the determinants of location choices of China's OFDI in developed countries. The findings show that inward FDI has a positive influence on Chinese OFDI, with a 1% rise in the variable increasing Chinese OFDI by 0.38%. This indicates that the more direct investments from an OECD country to China, the more Chinese OFDI will flow to this country. This implies that Chinese firms quickly learn from and build networks with their competitors from foreign countries, which prepare themselves for later internationalisation. The knowledge, which Chinese firms learn from the MNEs from OECD countries, includes not only technology and innovation, but also host country culture and management skills.

International knowledge spillovers, including international market information access are promoted by not only inward FDI, but also human mobility which has been largely overlooked in previous researches. Compared to inward FDI, Chinese firms can benefit from the networks formed by human mobility with less communication difficulties because of the same cultural background. This result suggests that China's OFDI does follow human capital flow into OECD countries. There are three ways by which human mobility can facilitate Chinese OFDI in OECD countries.

First, Chinese students and scholars who went abroad can enrol in world class universities, research organisations and MNEs, in order to learn cutting edge technologies, innovations and management skills. Compared to the productivity spillovers and international market information spillovers of inward FDI, knowledge learning and information access by human mobility is more direct and comprehensive. Second, the study and/or work experience accumulated during their stay in OECD countries enabled these people to not only enrich their knowledge and skills, but also

deepen their understanding of local culture and society. Previous researches (Adler, 1997; Black and Mendenhall, 1992) have found that cultural distance can play an negative role in firms' internationalisation. The experience of mingling with local society after moving from China to host countries helps to deepen these migrants' understanding of the difference between Chinese and western culture, which can help Chinese firms better understand host countries' markets and avoid conflicts in communication and negotiations. Third, human mobility can play an important 'bridge' role and providing the necessary networks of host countries in Chinese firms' internationalisation process. This group of talented people who possess advanced knowledge and understand both Chinese and western cultures, form extended international networks in host countries which will attract Chinese firms' investment and provide an effective bridge which connects Chinese firms to host countries and helps them learn about and settle in local markets.

The strategic asset variable, measured by percentage of investment in R&D in GDP, is found to have a highly significant and positive effect on Chinese OFDI to OECD countries. This result suggests that Chinese OFDI to OECD countries is highly driven by strategic asset-seeking motivation over the time period studied, and provides strong evident to support the assertion of strategic asset exploration motivation of firms from emerging markets at the aggregate level. Previous research (Buckley et al., 2007) found evidence suggesting that Chinese OFDI to OECD countries was mainly driven by market-seeking over the time period between 1984 and 2001, since the proxy used to measure the market size, GDP, was positively significant. However, the result of this study indicates that there is a shift in the motive of Chinese OFDI to OECD countries from market-seeking to strategic asset-seeking, since the market-seeking measurement, GDP, is statistically insignificant, but the strategic asset-seeking indicator, investment in R&D, is highly significant. The difference in empirical results between this study and earlier research implicitly suggests that Chinese firms have put strategic asset-seeking motives of OFDI as priority in OECD countries.

Another major finding is that the positive coefficient of cultural distance indicates an increasing relationship between cultural distance between the host country and China, and Chinese OFDI. This stands at the opposite to the normal finding for this variable, which is that the further the cultural distance, the less OFDI. There are two reasons why Chinese firms are increasingly investing in cultural dissimilar countries when investing in OECD countries. First, culture is considered as the informal institution system of a society (Peng et al., 2008). Chinese OFDI has long been considered as an approach utilised by Chinese firms to escape from home country institution restraints (Luo and Tung, 2007). Second, in line with the finding of strategic asset-seeking motivation of Chinese OFDI to OECD countries, Chinese firms are investing after not only existing strategic assets, but also the innovative and creative environment which hatches new strategic assets. This result is consistent with a stream of literature that associates cultural distance with innovation and creativity (e.g., Shane et al., 1995; Shane, 1993).

Of the variables examined, no support was found for Hypotheses 4 and 6. The market seeking variable, GDP, is insignificant, which suggests that Chinese firms have not been motivated to acquire a market share in OECD countries over the period under study, or, at least, market-seeking is not as important as other factors in

explaining Chinese OFDI to developed countries. This is also supported by the insignificant result of trade intensity between host countries and China.

Besides evidence discussed above, the endogeneity test result also proved the existence of the reverse influence of Chinese OFDI on the inward FDI from OECD countries to China and the human capital flow from China to OECD countries. Therefore, the relationships between the FDI flows between China and its OECD counterparts, and the human capital flow and OFDI flow from China and OECD countries are two-way traffic. The dependent variable, OFDI from China to OECD countries, will appear as an independent variable in the determinant function of the FDI from OECD to China and the human capital flow from China to OECD countries. These two-way relationships have been largely overlooked in existing studies.

Conclusion

Although researchers have long identified the factors affecting OFDI by firms from emerging economies , and strategic asset exploration as one of the major motivations behind these investments, there is still relatively little empirical research on the internationalisation of emerging economy firms into developed economies (Wright et al., 2005). Evidence to support the assertion of the exploration motive, especially at country level, is also very limited. This study, based on the most recent dataset of one of the most important emerging economies, China, provides explicit support to this theoretical assertion. Expanding previous research on location choice of Chinese OFDI (e.g. Buckley et al., 2007), the author has discovered the changing pattern of the locational determinants of Chinese OFDI, from market-seeking to strategic asset-seeking in developed economies. Meanwhile, Chinese OFDI to OECD countries is also driven by the human capital flow to the host countries, which implicitly means that international networks established in developed countries play an important role in Chinese OFDI to these destinations.

This study makes a number of contributions to the existing literature. First, this study has examined the impact of a new and under-explored factor, human mobility, on location choices of Chinese OFDI. The finding of this study shows that capital flow from China to OECD countries follows human mobility. The networks built in host countries and the ‘bridge’ role played by this human flow are precious intangible resources for Chinese firms to expand internationally. Especially when the human capital flow is composed of highly skilled and well educated personnel, Chinese firms can boost their internationalisation by utilising the advanced knowledge and networks embedded in these talented personnel.

Second, this study has used the most recent data on China’s OFDI, and the results reveal some dynamic changes of motives for OFDI. The findings provide new insights into the motives of China’s OFDI and contribute a better understanding of location choices of Chinese firms. After two decades of economic reformation and development, Chinese OFDI has started to transform from market-seeking to strategic asset-seeking in OECD countries in the new millennium. In order to achieve the purpose of strategic asset-seeking, Chinese firms prefer investing in countries with heavy investment in strategic asset creation. Meanwhile, Chinese firms are also investing in countries with further cultural distance in order to learn new routines and enhance innovation performance.

Third, this study is the application of more advanced econometric techniques to investigate the endogenous nature of location choices of OFDI. Previous research on location determinants of OFDI rarely considers the endogenous nature and a possible two-way causality between OFDI and its location determinants. In other words, most existing empirical studies fail to investigate the dynamic movements of OFDI and its location determinants. Ignoring the endogeneity and heteroscedasticity of the data can also lead to inconsistent and inefficient coefficient estimation (Boumahdi and Thomas, 2008). In this study, an instrumental variable method, the GMM estimator, is applied to consider the endogeneity and heteroscedasticity of the data in order to generate consistent and efficient coefficient estimation.

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