



## FOREIGN DIRECT INVESTMENT, SUSTAINABLE GROWTH AND BILATERAL INVESTMENT TREATIES

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**Abstract:** Foreign direct investment is often considered to be an important driver of host-country economic growth. Additionally, the investment is associated with technological upgrading, which can often lead to positive effects on host-country environmental performances. Bilateral investment treaties, which seek to protect and promote foreign direct investment, increasingly include provisions related to environmental protection. This can encourage sustainable investment practices of foreign affiliates. For this reason, the well-defined and implemented bilateral investment treaties can serve as a tool for attracting foreign direct investment that leads to sustainable growth of host countries, by defining instruments for screening out the potentially harmful investment projects and support more sustainable ones. In this paper, we review the state of the literature on the relationship between foreign direct investment and the sustainable growth of host countries. In addition, we explore how bilateral investment treaties can contribute to achieving the goal of sustainable growth through environmental provisions. Finally, we present the results of the empirical study investigating the effectiveness of bilateral investment treaties in the case of Serbia.

**Keywords:** foreign direct investment (FDI), bilateral investment treaty (BIT), sustainable development, economic growth, environment

**JEL classification:** F21, F53, Q56

### 1 Introduction

There has been a rapid increase in the foreign direct investment flows since the 1980s. Foreign direct investment inflows often led to numerous positive effects on the host countries, including technology transfer, higher employment, and economic growth and development. However, the sustainability of foreign direct investment-led growth remains a controversial issue. While it could be argued that the technology transfer and diffusion promoted by foreign direct investment results in the application of the best environmental practices in the host economies, there is also evidence of foreign direct investment inflows being positively affected by lax environmental regulation, which could result in a sort of the race to the bottom.

In this paper, we provide a literature review of these two main stances dealing with the relationship between foreign direct investment and the environment. In addition, we consider the most recent statistical evidence of how foreign direct investment directly affects the development of the renewable energy sectors globally. Thereby, we determined the relative significance of various investment modes as well as the sectorial structure of the investment.

We also conceptually considered how the bilateral investment treaties could modulate the relationship between foreign direct investment and sustainable economic growth. We show how these treaties could serve as a type of mechanism to screen and steer the investment toward more sustainable practices. Thereby, we identified the particularly important sustainable development provisions in the bilateral investment treaties, which are increasingly gaining importance today.

Finally, we consider the case of Serbia in describing how the bilateral investment treaties could be employed to promote foreign direct investment inflows. Additionally, we consider how the standards defined in the bilateral investment treaties could support the implementation of more sustainable practices by foreign affiliates.

The remainder of this paper is structured as follows. In the following section we consider the nexus between foreign direct investment and the environmental performances of host countries. In Section 3, we discuss the implementation of environmental standards in bilateral investment treaties. Section 4 deals with the inquiry into the effectiveness of bilateral investment treaties in promoting sustainable foreign direct investment in Serbia. The final section concludes.



## 2 Foreign Direct Investments and the Environment

Foreign direct investments will affect the realization of the goals of sustainable development of the host country. If they achieve possible sustainable benefits, then they will be both ecologically sustainable in their effects and sustainable in growth. In order to make the most of the potential for sustainable development of the host country, a proper understanding of the relationship between foreign direct investments and the environment is necessary.

Due to strict domestic regulations and environmental protection, foreign investors move their production to selected countries. On the other hand, the host countries put growth first through their national policies, while sustainable development is neglected. In this way, the host country has more harm than good, because economic growth is based on the degradation of the environment.

During the realization of foreign direct investments, foreign investors are obliged to apply regulations in the field of environmental protection, rational use of natural resources, accounting for environmental protection costs within investment and production costs. If there are deviations, the state should work to prevent, control, reduce and rehabilitate all forms of environmental pollution.

Host countries are most often developing countries that accept FDIs that do not take environmental protection into account. In this way, the degradation of the environment is approved by supporting weak environmental standards. In these countries, "the scale effect is expected to contribute to increased pollution, waste and environmental degradation" (Doytch, 2020).

The results suggest a potentially positive relationship between foreign direct investment and agricultural greenhouse gas production, weakly supporting the pollution haven hypothesis. Such results could also be a consequence of the change in agricultural production technique which intensifies the emissions (Kastratović, 2019).

Many developing countries are trying to secure the inflow of FDI and bridge the development gap. State institutions have double standards, or by loosely applying regulations, they enable endangering the environment. A mild criminal policy is used in favour of foreign investors and signed agreements are violated.

According to Gallagher and Zarsky (2003), foreign direct investment determines three types of greening effects: transfer of clean technologies - more efficient and less polluting in comparison with domestic production; technology leapfrogging – by transferring technologies to control pollution; spillovers to domestic firms – by transferring best practices in environmental management towards affiliates and domestic competitors and suppliers. FDI could be a useful tool in creating an enabling environment for ecologically sound economic and social development. In other words, FDI role is to support productive, social, regulatory and institutional local conditions and capacities (Zarksy and Gallagher, 2003).

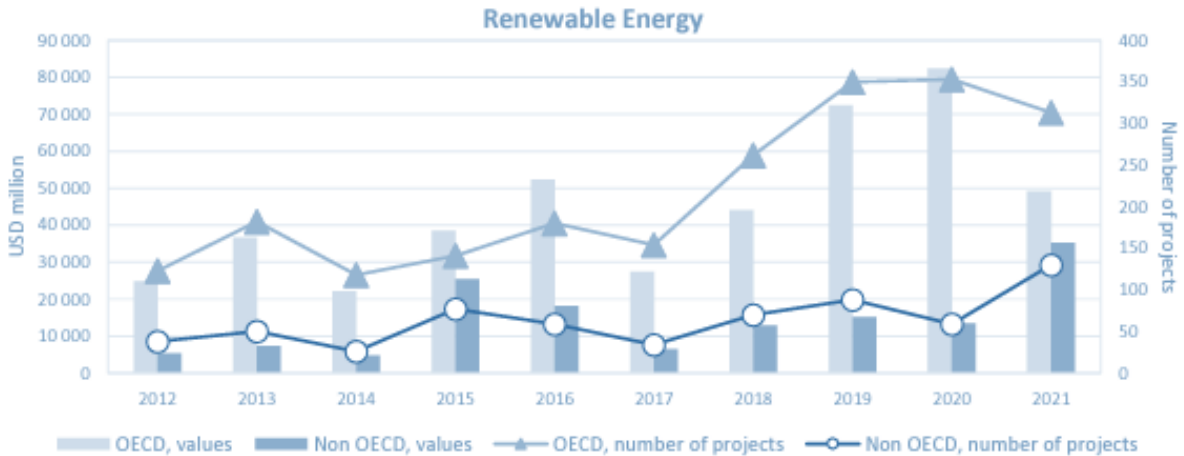
Foreign direct investments can have an impact on the environment and, as in most previous cases, both positive and negative effects are possible. If they are accompanied by the transfer of "cleaner" technologies or if production is organized under pressure from consumers or due to adaptation to higher ecological standards of developed countries in a way that is less harmful to the environment compared to the methods applied by local companies, it can be expected that foreign direct investments contribute to the improvement of environmental performance of the host country. If, on the other hand, foreign direct investments are motivated by avoiding stricter environmental regulations in their home country, this may be accompanied by negative environmental effects.

Foreign direct investments can lead to the transfer of tangible technology or intangible technology what means production processes and techniques, knowledge, modern methods that would ensure higher yields. FDI spillovers are pro-growth because they amplify the transmission of technology to host countries, invest more in infrastructure and expand more trade flows in order to FDI make full effects. FDI is an effective way for technology transfer, which stimulates economic growth of host countries in the economic region.



Relevant spillovers arising from trade and FDI play important roles in achieving economic growth, capital accumulation and economic well-being, providing a path for sustainable development (Zamani and Tayebi, 2022).

Figure 1. Greenfield Investment in Renewable Energy



Source: (Knutsson and Flores, 2022)

The last decade is a period of growing trend of FDI in renewable energy sources, as evidenced by the data presented in Figure 1. The largest volume of investments is realized in America, Asia and Europe.

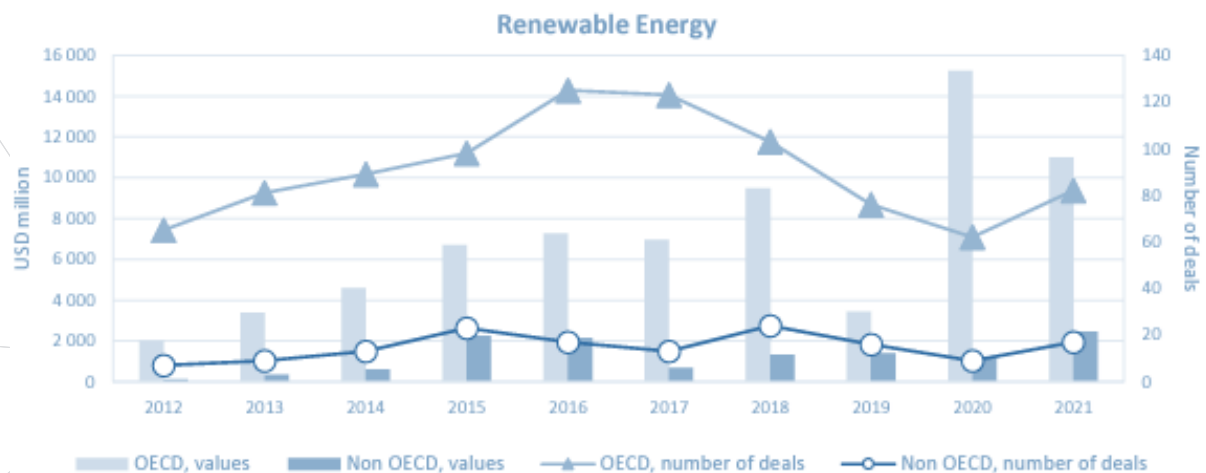
On balance, the more recent papers find that there are significant positive environmental spillovers from foreign to local firms and that on average FDI may have the effect of increasing energy efficiency (hence lower pollution levels) (Cole et al., 2017).

In the period 2012-21, the top investors of greenfield investment into renewable power came from France, Germany, Italy and Spain (41% of total greenfield investment in renewables).<sup>5</sup> The top recipients of renewable energy FDI were Australia, Chile, the United States and the United Kingdom (accounting for 46% of all announced greenfield investment projects in renewable energies in 2012-21). For fossil fuels, in the same period, over half (53%) of announced capital expenditure originated in China, Japan, the Netherlands and the United States, whereas most new FDI in fossil fuels went to Canada, Kazakhstan, the United Kingdom and the United States (42%), possibly reflecting the availability of natural resources in these countries (Knutsson and Flores, 2022).

Cross-border M&A activity in the renewable power sector is substantially more contained than in fossil fuels (Figure 2). In 2021, fossil energy accounted for 3% of total cross-border completed M&A deal values, whereas clean energy represented less than 1%. However, the number of deals in fossil fuels has been falling and total deal values have been shrinking since 2016, at least in OECD economies, where the total value of foreign M&A in fossil fuels peaked at USD 132 billion.<sup>6,7</sup> In contrast, deal making in renewables remained quite stable over time, both in terms of values and the number of transactions. As with greenfield investment, 2020 was the record year for cross-border M&A in renewables for a total deal value of USD 16 billion between OECD and non-OECD economies (Knutsson and Flores, 2022).



Figure 2. Cross-border M&A in Renewable Energy Sector



Source: (Knutsson and Flores, 2022)

The environmental Kuznets curve is a graphical representation of the relationship between economic growth and environmental degradation. It indicates that environmental degradation increases as countries industrialize. However, at the tipping point, the deterioration begins to decrease.

Foreign direct investments contribute to the stabilization of inflation, the growth of the gross domestic product and the improvement of the balance of payments. In order to realize FDI, the transfer of technology, as well as knowledge and skills, is needed. The business and competitiveness of the entire economy is improved. The influence of institutions that monitor the entire process is of great importance to establish sustainable economic growth. Whether the country will be attractive and achieve the maximum effects of FDI depends on the application of regulations and the attitude towards foreign investors, as well as domestic resources.

### 3 Bilateral Investment Treaties and the Environment

Important part of economic cooperation between states, apart from trade, is the investment cooperation. In modern times this interstate investments are sourced from private capital and not like centuries ago that they are state investments. In contemporary world in investment relations between states the main task for states is to create the framework for safe and mutually beneficial exchange of private investments between countries. This regime created by states is known as investment regime, and usually is bilaterally created. The Multilateral Agreement on Investment, negotiated under the auspices of Organisation for Economic Cooperation and Development (OECD), did not have much success (OECD, 2023). The investment law has developed rapidly after 1950, but in the last decades it is specially gaining ground in developing countries.

Main instrument for creation of this investment regimes are bilateral investment treaties (BITs) concluded between states. The main aim of these agreements is to reduce the risks for investors and to safeguard the host country economic interests. First bilateral investment treaty has been signed in 1959 between Pakistan and Germany, and until 1990 it was 500 BITs globally. Today UN Conference on Trade and Development (UNCTAD) keeps a detailed database on BITs and it lists 2827 BITs globally, with 2217 them in force (Shoaf, 2013). Most important form of global private investments is foreign direct investment (FDI) since they represent a long-term commitment of the investor.

Due to the lack of capital globally many countries today compete for FDI and form its investment policies to attract the FDI. UNCTAD follows the annual changes in national investment policies and in 2012 we see that countries still introduce more measures in favour of investors (58) compared to the measures less favourable (42) (UNCTAD, 2022). In modern BITs one of the most important provisions are national treatment clause which gives same right to the foreign investor compared to domestic ones. Developing economies are now taking the prime role of attracting foreign investment into the country, and since the competition is fierce they even offer financial subventions for the foreign investors. One of the major incentives when the investor is in heavy-polluting industries is the more liberal environmental regulation in developing countries than strict anti-pollution



regimes of the developed countries. This is the reason why many heavy-polluting industries move their operations to developing countries.

But the pollution is a global problem that leads to many consequences that are manifested both in develop and developing countries. Economic growth and alleviations out of poverty have been main goals of economic development of the world. Now the emphasis is on the "sustainability" of this global development. The concept of sustainable development refers to the state's efforts to achieve development that will be long term, but with the inclusion of environmental concerns into economic development (Levashova, 2011). The new term was born – sustainable development.

A study from 2011 analysing the sample of 1,623 BITs shows that only 8% of them at that time included references to environmental concerns. It is considered that the first BIT to include environmental provisions is China-Singapore BIT from 1985 (Gordon and Pohl, 2011). Most BITs signed after 2005 all include environmental protection provisions. It was first the developed countries which included this provisions in their model BITs. In the US model BIT from 2004, in article 12, paragraph 2, it is stipulated that Parties to Treaty can adopt measures "to ensure that investment activity in its territory is undertaken in a manner sensitive to environmental concerns" (US Trade Representative, 2004). On the other side, the European Union (EU) has adopted a model of mixed-agreements that incorporate investment protection and promotion provisions in preferential trade agreements encompassing sustainable development commitments. Since 2009, the EU has been handling foreign direct investment policies on a centralized basis on behalf of all EU Members, and has initiated negotiations with major trading partners with an aim to conclude Comprehensive Economic Agreements that include both trade and investment provisions (Gehring and Tokas, 2022).

So the host countries in their BITs more and more address other issues and public interests, including environmental protection, but foreign investors that invested in host country might object to or consider unfavourable these provisions, and this can lead to investment disputes. Most of these disputes are resolved in investment arbitration, and majority of cases are ruled in favour of investors (McLaughlin, 2022).

According to UNCTAD multi-country analysis new generation investment policies place inclusive growth and sustainable development at the heart of efforts to attract and benefit from investment. These policies address specific investment policy challenges. At the national level, these include integrating investment policy into development strategy, incorporating sustainable development objectives in investment policy and ensuring investment policy relevance and effectiveness. At the international level, there is a need to strengthen the development dimension of BITs and balance the rights and obligations of States and investors. These policies are characterized by (UNCTAD, 2015):

1. a recognition of the role of investment as a primary driver of economic growth and development and the consequent realization that investment policies are a central part of development strategies;
2. a desire to pursue sustainable development through responsible investment, placing social and environmental goals on the same footing as economic growth and development objectives;
3. a shared recognition of the need to improve the effectiveness of policies to promote and facilitate investment."

Sustainable development is becoming a major principle in guiding the development strategies of more and more countries in the world. Also the promotion of investments is using the environment protection as a major criterion in FDI selection for more and more countries and this is reflected in BITs countries sign.

#### **4 Bilateral Investment Treaties and Foreign Direct Investment**

With the increased activities of multinational companies in the world economy, there was an increase in interest of foreign investors to protect their assets in host countries. This interest was backed by developed countries of origin, which initiated conclusions of bilateral investment treaties with the main goal of reducing the risk exposure of their investors. Developing countries also increased interest in bilateral investment treaties. Their main expectation from the conclusion of the treaties, was to increase attractiveness for foreign investors, thereby addressing the problem of the capital scarcity and, oftentimes, sluggish economic growth.



For host countries, bilateral investment treaties are an important instrument for attracting foreign direct investment. Through the provisions of the bilateral investment treaties, host countries provide the investors with concessions. Furthermore, the conclusions of bilateral investment treaties serve as an important signal of the institutional stability of the host country and the readiness of the host country to protect the interest of foreign investors. However, increased inflows of foreign direct investment in host countries of, otherwise, insufficient institutional development, poses threats various aspects of its economy, including the negative changes in the market structure and environmental degradation (Kastratović, 2018, Kastratović et al., 2019, Kastratović, 2019).

Economic theory suggests that bilateral investment treaties decrease fixed costs of conducting foreign direct investment. This reduces the minimal level of productivity required to successfully enter the foreign market for the aspiring internationalising firms. The marginally productive firms are, thus, enabled to establish foreign affiliates, which are reflected in the increased foreign direct investment flows (Egger and Merlo, 2007). The recent empirical studies support this theoretical conclusion (Li and Zhao, 2021, Bhagwat et al., 2021). More broadly, the systematic overview of the existing literature that empirically analyses the relationship between bilateral investment treaties and foreign direct investment indicates that the effects of bilateral investment treaties on the investment inflows are generally positive, albeit of low intensity (Brada et al., 2021). The contents of the bilateral investment treaties is, for the most part, neglected in the related literature, providing little insight on how the bilateral investment treaties could modify the relationship between foreign direct investment and sustainable growth.

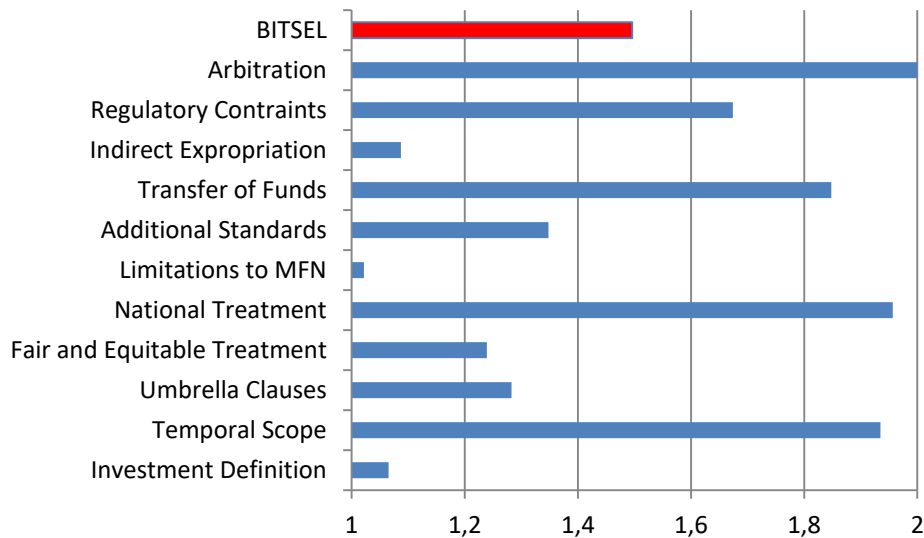
Serbia provides an interesting case study of the relationship between bilateral investment treaties and foreign direct investment. Since the mid-1990s Serbia ratified 37 bilateral investment treaties, significantly increasing its bilateral investment treaties network. The result of these activities are reflected by the fact that nearly 80% of foreign direct investment inflows in the country are covered by bilateral investment treaties (Kastratović and Bjelić, 2022). Compared to the other economies of the West Balkans region, Serbia has the most developed network of bilateral investment treaties. Namely, at the moment, Serbia has 47 ratified and active bilateral investment treaties, whereas the region average stands at 37.

The introduction of environmental clauses in bilateral investment treaties by Serbia is supported by recent developments. The countries in the region, including Serbia, adopted standards of negotiating bilateral investment treaties under the support of Regional Cooperation Council and the European Union. The adoption of the aforementioned standard is the result of efforts aimed at harmonising the relevant regulatory framework of the economies in the region with the European Union. The adopted standards particularly relevant for the topic of this study are the ones dealing with the sustainable development and environmental protection. Serbia committed to introduce the sustainable development standards and the environmental protection standards in the preambles and clauses of all the future bilateral investment treaties. It is likely that the existing bilateral investment treaties are going to be updated in order to include these clauses.

The increasing use of the environmental standards could negatively affect the attractiveness of the host country for foreign investment, due to additional obligations imposed of foreign affiliates and possible conflicting provisions with the internationally adopted standards of protection. The method to analyse this is the application of the BITSEL indicator, which enables us to quantify various aspects of attractiveness in the currently active bilateral investment treaties (Chaisse and Bellak, 2015). The indicator value range goes from 1 to 2, and the higher value indicates greater level of liberalisation and, thus, attractiveness of the host country. The average values for Serbia for the period from 2010 to 2019, is presented in Figure 3.



Figure 3. BITSEL Values for Bilateral Investment Treaties Ratified by Serbia (2010-2019)



Source: Authors, based on the data from the study of Kastratović and Bjelić (Forthcoming).

The existing bilateral investment treaties in Serbia could be characterised as moderately-to-high quality. Certain aspects, such as their temporal scope, national treatment and arbitration clauses are routinely defined in bilateral investment treaties in a way which maximizes the investment liberalization. The additional standards concerning the environment affects the decrease of the average value of the BITSEL index component, indicating increasing constraints placed upon foreign investors. However, no drastic changes in this regard were evidenced in the observed period.

The empirical evidence examining the effects of bilateral investment treaties and their quality on foreign direct investment based on the sample of Serbia and its 198 partner economies observed in the period between 2010 and 2019 indicate that bilateral investment treaties effectively promote the investment inflows (Kastratović and Bjelić, Forthcoming). Furthermore, the bilateral investment quality is shown to positively affect the inflows. However, this also indicates that the increasingly demanding environmental standards could limit foreign direct investment inflows in Serbia. Still, it should be noted that the mere quantity of the investment is the only goal in promoting efforts. What matters more is their quality and their effect on a wide range of parameters of the host economy. Higher quality investment, screened by the increased demands in the provisions of bilateral investment treaties, could, therefore, lead to the sustainable growth and improvement of the ecological performances of the country.

## 5 Conclusions

In this study, we examined the effects of foreign direct investment on sustainable development. Additionally, we consider how bilateral investment treaties could affect this relationship. The results of our study indicate that foreign direct investment has significant potential in contributing to the sustainable development of host countries.

The direct positive environmental effects of foreign direct investment inflows stem from intra-firm technology transfers, diffusion of environmental standards and related spillovers, and the development of green industries, such as renewable energy production. However, the final environmental effects of foreign direct investment are contingent upon the circumstances in which the investment is conducted and, in particular, the conditions in the host country. For instance, the discussed positive effects are the most likely in developed countries and least developed countries. In middle-income countries, it is more likely that the investment would lead to environmental degradation.



We identified a potential for bilateral investment treaties to promote the positive effects of foreign direct investment on sustainable development. This, however, requires careful design of standards and provisions included in the treaties, as well as a sufficiently developed and robust institutional framework in order to practically implement the provisions. New standards in this regard are increasingly being used in the negotiations concerning bilateral investment treaties in the West Balkans region.

Finally, we considered the case of Serbia. We found evidence of the effectiveness of bilateral investment treaties in attracting foreign direct investment in this context. Thereby, we showed that not only the existence but also the quality of bilateral investment treaties matter. Higher levels of liberalisation and protection of foreign investors' interests have a significant positive effect on foreign direct investment inflows. However, increasingly stringent environmental standards are placing additional burdens on foreign investors, which, in the concrete context of Serbia, could potentially lead to limiting the foreign direct investment inflows.

The results imply that the policymakers seeking to improve foreign direct investment inflows could rely on bilateral investment treaties. However, increased inflows do not necessarily lead to sustainable growth. In these circumstances, bilateral investment treaties provide interesting opportunities for promoting a higher quality of investment, which, despite potential negative effects of the inflows quantity, could result in the sustainable development of the host country.

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